

PREM 19/173

PART 6

M.

Confidential Filing

Economic Strategy.

Pay and Prices Monthly Economic Report.

The Economic Prospect.

ECONOMIC POLICY

Part 1: MAY 1979

Part 6 JULY 1980

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
3-7-80							
13-7-80							
1-8-80							
12-8-80							
7-9-80							
11-9-80							
—Ends—							

PREM 19/173

PART 6 ends:-

Tomy Burns to ChEs ³~~9~~.9.80

PART 7 begins:-

Hoskyns to PM 19.9.80

cc Mr. Hushy
Mr. Verker

Printed Minutes

A useful note summarizing
what we are by Tom Burns.

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CHANCELLOR OF THE EXCHEQUER

- c.c. Financial Secretary
- Chief Secretary
- Sir Douglas Wass
- Sir A. Rawlinson
- Sir K. Couzens
- Mr. Rylie
- Mr. Middleton
- Mr. Britton
- Miss M. P. Brown
- Mr. Cassell
- Mr. Evans
- Mr. Monck

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12/5

Mr.

ECONOMIC STRATEGY - LATEST DEVELOPMENTS

This note reviews some of the latest economic developments as background to today's meeting with the Prime Minister.

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2. Output appears to be falling rapidly and unemployment is rising steeply but this is not markedly out of line with the forecast published in the FSBR. In the first half of the year total output appears to have fallen by 1-2%; this is in line with the forecast in the FSBR. The fall in manufacturing output has possibly been faster than expected. The forward indicators all point to weak demand and output in the second half of the year. Unemployment has risen by 160,000 (wholly unemployed, excluding school-leavers) in the past two months. The August figure on this definition is 1.7 million and compares with an FSBR forecast for the third quarter of 1.62 million; the average for the first quarter of this year when the forecast was made was 1.38 million.

not published
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3. The composition of the fall in output during this year has been a little different to the forecast. Net exports have done rather better than forecast while stock-building has shown a larger decline. The balance of payments has been better than forecast.

4. The real income of the personal sector has held up reasonably well with earnings increases keeping ahead of the TPI. The company sector has taken the impact of the fall in real income and is now

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under major pressures which are showing up in attempts to reduce stocks and cut employment. These pressures were not unexpected and reflect: the balance of the effects of high oil prices, a high exchange rate, and rapid wage increases.

5. Money supply has been rising faster than the target of 7-11% growth. Mr. Middleton's note points to a possible underlying increase of 16% per annum in M3 since February if due allowance is made for the removal of the corset. The whole picture has been confused by re-intermediation and estimates of the underlying monetary growth could still change significantly. In addition there is wide variation in the indications of alternative measures of monetary growth with the M1 measure undershooting the target range. There has also been a very large PSBR in the first half of the financial year.

6. Sterling has remained strong and the trade-weighted exchange rate has continued to drift upwards. The extent of the rise continues to confound the expectation of most people including those of us who pay close attention to relative inflation and monetary developments; but the effect on all measures of competitiveness has been substantial and unprecedented. There is a tendency for many observers to confuse the scale of the problem by making comparisons with the fourth quarter of 1976; but comparison with the pre-devaluation periods of 1967 and 1972 shows the difficulty of the present position. Labour costs are not the whole story but nevertheless this indicates very difficult circumstances for those involved in international trade including companies producing for the domestic market.

7. The slowdown in price increases has been marked in recent months. This shows up in the behaviour of retail prices and wholesale prices; the CBI enquiry into the 'balance' of firms

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expecting to raise prices over the next four months points to a continued downwards pressure on price increases. The latest retail price figures for July show that this pressure is affecting the broad categories of prices in very different ways:

Total	16.9
Food	11.5
Housing	29.1
Nationalised Industries	27.4
Other	13.8

7% increase on year earlier



It is also instructive to look at the behaviour of 'prices in the shops'; this can be approximated by the implicit price index for retail sales. In the 12 months to July this rose by 11-12%. The CBI have drawn attention to this in their latest Economic Situation Report. The major pressure upon prices over the next few months will come from Nationalised Industry prices; these are expected to continue to rise at a rate close to 25% per annum over the next six months. Price rises are being held back to an important extent as firms try to dispose of unwanted stocks and to boost sales. But so far there are only few signs of wage settlements responding though claims are now lower.

8. Thus inflation is coming down - possibly rapidly - but money supply growth is not; one interpretation of the recent figures is that the underlying monetary growth since end 1977 may have been around 16%. Two questions follow:

(i) If monetary control is not reducing inflation what is?

(ii) What does it imply for the role of monetary policy; if inflation is being reduced does it matter that money supply is above target?

9. Undoubtedly, the sudden appearance of spare capacity in the economy - however achieved - is closely associated with the fall in inflationary pressure. External factors have also had an important

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influence upon the inflation rate; world oil prices and commodity prices played a crucial part in the increase in inflation and are now contributing to the slowdown. In addition it is now clear the extent to which the pressure of anti-inflationary policy is coming from the exchange rate. The very high real exchange rate combined with a very high PSER since April and a major over-shooting of the monetary target means that the downward pressure upon prices is coming substantially from exchange rate pressure. The extent of the squeeze on those companies trading in international markets is even greater than anticipated whilst non-traded services are protected (eg insurance companies) and nationalised industries and local authorities may be borrowing more than planned.

10. But does an overshooting of the monetary targets matter if the inflation rate is being reduced? I would want to argue that it does matter, particularly from a medium term point of view:

- (i) The present combination of the exchange rate, monetary policy and fiscal policy means that the effect of the squeeze upon the economy is very uneven. Real wages have not begun to fall yet and a disproportionate impact is felt by the internationally traded goods sector. To some extent this is inevitable but an excessive imbalance is not in the longer term interests of the economy. A lower exchange rate combined with tighter fiscal policy and lower monetary growth might produce the same overall pressure on the economy but distribute the pressure more evenly across the economy.
- (ii) The anti-inflationary policy is exposed in the face of a sharp drop in the exchange rate. At some stage downward pressure on the exchange rate is probably inevitable; and despite lower inflation some fall in the nominal exchange rate seems inevitable if the real exchange rate is to return to a more normal level. It would be unfortunate if policy drifted towards support for the exchange rate in order to maintain the anti-inflationary stance.

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(iii) A considerable part of the benefit of the expectations mechanism is lost. It would be useful to be able to argue that "the growth of money supply has been reduced and inflation has been reduced - we intend to continue to reduce monetary growth and agents should take note"; the impact of the message is lost if the first part of the statement does not stand. Nevertheless the reduction in inflation, whatever the cause, will have helpful implications for inflationary expectations. It is also more difficult to sustain the debate in the face of the argument that this is just like any other deflationary policy. Part of the defence of the monetary policy has been that the loss of output will be minimised providing wages and prices move in line with money supply; the extent to which that generalisation holds probably depends in part on the extent to which the exchange rate moves in line with relative monetary growth. On the other hand the limited fall in real money supply over the past year and the enormous CGER in the past five months make it equally difficult to argue that the recession is due to deflationary government policy.

(iv) The crucial period during the cycle for monetary policy is probably when world output recovers and demand begins to expand. Typically at this stage monetary and fiscal policy is relaxed and expansionary forces have been excessive. Excessive monetary growth in recession may not damage the anti-inflationary process immediately but it could provide the basis for an excessive growth of demand later; this might either prevent inflation being reduced as low as it otherwise might or accommodate an upturn in inflation when demand and world prices accelerate.

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11. This would point towards reaffirming the monetary commitment and the intention to continue to work within the framework of the NEPS.

TB

(TERRY BURNS)

3rd September, 1980.

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PRIME MINISTER

Here is an anonymous (ie Peter Middleton) agenda for tomorrow's meeting on monetary policy.

Peter Middleton would be most grateful if you could avoid waving this piece of paper around. He has not admitted to the Chancellor or Treasury colleagues that he has produced it.

The Chancellor will bring Mr. Lawson, Terry Burns, Peter Middleton, and either Sir Kenneth Couzens or Mr. Geoffrey Littler - possibly the latter in view of your warning that the Treasury will need to defend its stance on public expenditure. The Governor will bring one official with him.

M. A. PATTISON

2 September 1980

MONETARY CONTROL

1. Facts: money supply increasing at underlying 16% since February - excluding reintermediation. Has been over 15% since July 1978 on same basis:

- a. bank lending averaging about £1 bn a month - about 30% a year.
- b. PSBR £5 bn in 1st quarter. CGBR £2 bn in August.
- c. Reintermediation post corset much more than thought - now expected to be 6-10%.

Problems with Present System

1. Can we do anything more to control the profile of the PSBR.
2. Can we do anything to restrain bank lending.
 - the banks simply respond to drawing down overdrafts
 - the 12 $\frac{1}{2}$ % reserve asset ratio does not bite because the Bank always relieve banks. If we sell gilts to neutralise high bank lending, we have to lend back to the banks - to prevent reserve asset pressure. Is there any alternative to this as long as interest rates are set at the discretion of the authorities.
 - is the increase in lending after the corset simply reintermediation - or is the banking system out of control and trying to expand in all directions. What is happening?
 - can we do anything by funding policy to take the pressure off bank lending by getting long rates of interest down. Sell fewer gilts and more National Savings: problems for building societies.

More Fundamentally

- How can we get back to a system in which interest rates fluctuate and the market has more of a say?

- 2 possibilities
- a. monetary base
 - b. use present reserve asset system

Both of these at present would mean higher short term interest rates - including base rates + mortgage rates. Yet the economy is now in a sharp recession.

- An essential transitional stage is the Bank's discussions with the banking system on bank liquidity for prudential purposes (in a bit of a tangle) and cash ratios (not even issued yet).

- How are the present monetary base discussions to be brought to a conclusion in such a way as to ensure that at a very minimum we do not impede a move in this direction.

2.9.80



10 DOWNING STREET

From the Private Secretary

21 August 1980

I am writing to acknowledge your letter of 20 August with which you enclosed Mr. Macmillan's Memorandum on the Economic Situation.

I shall of course pass this to the Prime Minister as soon as she returns from her holiday.

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AIMETTI

Mrs. Rosemary Aisnetti.

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From the Rt. Hon. Harold Macmillan, O.M.

Telephone 01 836-6633

4 Little Essex Street,
London, WC2R 3LF

By hand

20th August 1980.

Dear Private Secretary,

When Mr. Macmillan was staying at Chequers at the beginning of August, he promised to send the Prime Minister his views on the present economic situation.

I now enclose a Memorandum which Mr. Macmillan would be grateful if you could hand to Mrs Thatcher.

Yours sincerely,
Rosemary Aisneith
Personal Secretary

The Private Secretary
to The Prime Minister

MEMORANDUM

From: The Rt. Hon. Harold Macmillan, O.M.

1. The world economic situation is dominated by the gap between the sums paid by the oil purchasing countries (chiefly the West) and the oil producing countries (chiefly Arab). This is a classic example of the imbalance between the rate of saving and the rate of investment analysed by Keynes fifty years ago. The scale, however, is far beyond anything that could have been conceived by former economists. After making allowance for genuine investment by the oil producers there is estimated to be some 200 billion dollars, which is known in technical language as 'inrequitable'. In other words, this sum is not turned into goods and services by the oil countries but remains held mainly on short term in the international banking system.

So long as this gap remains there is inevitably world recession, and it is by far the greatest problem which besets the civilised world to-day in the economic field.

2. This gap has been to some extent, dealt with from 1974 by what is called the process of 'recycling'. This really means a desperate effort by the international banking system to find credit-worthy borrowers all over the world. This process cannot be pursued much longer. Already the banking system especially American is at risk

and any further attempt to force money upon unsound borrowers may lead to disaster. There is, therefore, this dilemma. Yet if the money is not re-lent in terms of goods and services (chiefly capital goods) the world recession will continue. If it is re-lent beyond what sound banking practice would allow, there is danger of a liquidity crisis overcoming the international banking system similar to, but on a much greater scale than, that of 1931. It only needs another Credit Anstaldt to start it off.

3. Short of occupying the oil producing countries by force, which seems both immoral and impractical, there is no method except by persuasion or compelling the Arab countries to allow this huge surplus to be invested fruitfully. What is really required is a massive investment in non oil producing countries, especially the so-called Third World, similar to the Marshall Aid for Europe in 1947. It is clear that this is a difficult task needing long and skilful negotiation. It cannot be solved by the sudden appearance of international officials for a few days in this or that Arab country. It needs a long and patient negotiation headed by trusted American and European figures. Meanwhile every effort should be made to increase the production of oil all over the world and the production of energy by atomic power as rapidly as possible. But since all this will take a long time the fact of the tendency towards constant recession must be taken into account.

4. All the circumstances, therefore, would demand at the present time not restriction and deflation, but powerful reflationary measures largely on capital account throughout all the countries of the West.

* * *

5. What is it that prevents the adoption of the natural remedy of reflation? It is the phenomenon which has developed in all the market economies certainly of the West and more particularly in Britain, of inflation caused by excessive wage increases without corresponding increases in production in industry and commerce, accompanied by equal or even greater increases in the administrative classes.

6. The situation in Great Britain has been worse than other Western countries because of the almost negligible rise in productivity. To the extent that the British disease has become more serious than the Continental, our competitive position had fallen in world markets even before 1974.

7. Faced with this situation most countries have taken restrictive action of various degrees of intensity. Only in Britain has this taken the severe form of the last year.

8. Here in Britain a combination of high Bank Rate (to a point which would have been regarded as sheer usury in any other age) and the consequent attraction of foreign money (mostly in the form of hot money) into Britain, by rates

higher than those prevailing in other countries and a corresponding increase in the value of the pound against the dollar, has seriously increased the competitive difficulties of British exporting industry without so far producing any marked effect upon the inflation of prices.

9. The so-called 'money supply' policy may be useful as a guide to what is happening just as a speedometer is in a car; but like the speedometer it cannot make the machine go faster or slower. In the first year of this Government the whole concentration of effort to squeeze wages down or to prevent excessive rises has fallen naturally upon that part of industry and commerce which, whether publicly or privately controlled, has to compete in the market. It has affected equally British Leyland, the Steel and the Coal Industries which are Government owned; but it has fallen more particularly upon private enterprise in its true sense, that is to say that part of the economy which is still operating independently of Government ownership or support. It must not, however, be forgotten that so-called private enterprise depends in many cases largely on the purchases by central or local government (for instance local authorities are the largest buyers of furniture in the country). Hence the squeeze upon public expenditure whether central or local both in capital and consumer goods coupled with the high rate of interest and the over-valuation of the pound (which is based partly upon British oil production and partly upon the attraction of high interest rates) have combined to put British production

industry, whether public or private, in an increasingly precarious position with little corresponding relief. It is, of course, true that in the private sector these processes are likely to result in smaller wage concessions this autumn (10% or less). This is partly due to the actual inability to pay any increase without bankruptcy and partly through the fear of trades unionists seeing the rapid growth of unemployment and their corresponding willingness to accept more reasonable terms.

10. Nevertheless, the picture is a serious one. For even if firms may be able to remain in business, either by drawing on existing liquid assets or by the sale of other assets, or by borrowing from the banks, many of them will be forced to reduce their output and to abandon their investment projects with a corresponding reduction in their competitive power in the future.

11. What then can be said to have been gained? Certainly a shock has been given by the Government's policies to the nation as a whole, and even a sense of exhilaration amongst those who believe that steady continuance of these deflationary policies will achieve the desired result. (Incidentally, Mr. Biffin one of the protagonists of 'monetarism' has admitted that the effect of this policy on inflation may be negligible). The main visible pressure has fallen on private competitive enterprise. The high value of the pound, the excessive interest rates, and the postponement of capital investment by the central government, local governments and

industry, are together threatening not merely an alarming increase of unemployment (which so far as it is a result of reducing over-manning may be healthy economically, although dangerous socially). But in due course it threatens a serious blow to the balance of payments through the collapse of parts of certain important industries (e.g. textiles, paper making, etc.)

12. Meanwhile it is quite true that the Government have tried to bring similar pressures in the public sector whether in that of the producing side or the purely administrative side. Unhappily, they entered the campaign with apparently little knowledge of what powers they really have. They have little if any control of the wages paid either by central government or by local government. The powerful bureaucratic system which has taken away the central powers of the Treasury over state employment and much reduced the power of Ministers over their own departments, makes it almost impossible for the Government to fix the wages of its own employees, since they are now controlled by a whole series of committees and mechanisms which have become rooted in the system. (Even with the teachers, which is a solitary case where the Government has statutory control, subject to Parliament, it was found impossible to set aside an arbitration). On local authorities the only instrument which the Government can bring to bear is to reduce the grant. But the local authorities can retaliate in three ways. In spite of a reduced grant they can increase rates. Secondly, they can postpone capital projects, even the most essential and worth-

while. Thirdly they can cut their purchases of various commodities greatly to the injury of private enterprise and to that of the public as a whole. There is no way by which the Government can stop this nor is there any way in which the Government can force the local bureaucracy to reduce its own numbers or remuneration. Thus both locally and centrally the tendency is the other way, (just as it used to be said, perhaps jokingly, that the fewer ships the Navy had, the greater the number of Admirals).

13. It must be admitted that the troubles of the last fifteen years are largely due to the refusal of the trades unions to accept any curb upon their monopoly position, and their determination to force up the wages in terms of money rates without regard to productivity.

Conservative and Labour Governments in turn have made an attempt at a so-called 'wages policy', sometimes by voluntary method, sometimes by statutory control, and sometimes by a mixture of both. It was, of course, part of Conservative policy at the last General Election, that a Conservative Government would not attempt a wage policy but would only exercise control by 'monetary' means. That is to say, by squeezing productive enterprise, especially private enterprise, by putting cash limits upon public industries or services, and by restricting the cash available to local authorities. In fact, this amounts just as much to a wage policy as formerly, but by other means. Can it be said to have succeeded so far? Will it succeed if continued,

or will the cost be too high?

14. These are the questions which must now be faced. It is clear that a very considerable amount of success has been reached in the sense of giving a severe shock to the nation. Nor would it be wise to make a sudden change of policy, thus losing the confidence of the Party and of the people and creating a sense of confusion. There are, however, many adjustments that can be made, the most vital of which are

- (a) to reduce the rate of interest to a reasonable figure.
- (b) to try to repel rather than attract foreign hot money, again by reducing interest rates and thus reach a more realistic value of sterling.

15. It will be argued that the reduction of interest rates would force the Government from its policy of funding the public requirements rather than living on Treasury bills. I believe it will be found on examination that little of the foreign hot money goes into buying long term Government securities. These are the result of internal saving. My experience over a great number of years is that the mass of the public save out of habit or prudence. The only budget which I introduced as Chancellor of the Exchequer in 1955 was called 'the savings budget' and we raised enormous sums when money was 5% or less. The story of the Building Societies has

been the same. It may be argued that reduction in the rate of interest would not automatically reduce the excessive value of the pound. Nevertheless it can be tried and if it fails normal open market measures can be taken. If these remedies were applied they could be claimed as a success of the policy rather than a failure or change of direction. If they are not, the Government will be gradually forced either to further nationalisation of industries fallen into bankruptcy and/or to protective measures with all that this implies to world trade.

16. Wage policies as such have failed both Labour and Conservative Governments. Is there any way out other than a reversion to voluntary or statutory wage control? It would appear that the only course now is to try to divert attention from the excessive emphasis of wages to the problem which we all know to be basic - that of productivity.

17. British wages are not high compared to Continental or American, but British productivity is lamentably low. We all know the problem. We all know its roots. We all know its history and we all know what should be its solution. But in spite of some progress in various industries, we are lagging behind. The new industrial revolution is upon us, and we are not taking advantage of its opportunities.

18. It must be remembered that as civilisation proceeds the base on which it depends becomes, proportionately to the whole community, continually smaller. In a primitive society the whole population except perhaps the King or Chief, and a

few magicians or medicine men, are employed on production of wealth - ploughing the land, tending the cattle and so forth. Such a society is like a pyramid with a very small top and a very large base. As civilisation progresses the structure turns into something more like a pillar; we have now reached the point that a modern society is more like a pyramid upside down. The top is very large and the base upon which it depends is proportionately smaller. This has been made possible by the introduction of the machine in all its various forms, with great potential benefit. Yet all the benefits of civilised life, religion, the arts, education and the like depend ultimately upon the producers of wealth. I do not know what is the true proportion now: but let us say that one man at work supports three or four employed in defence or in the social services, or in the various evidences of civilised life including administrations. But this man can only sustain the burden if his productive capacity is steadily increased. You can, of course, try to reduce the burden by cutting down the burden on the producer. This, up to a point, is sound. But it soon becomes regressive. The right course is to increase the power of the one man through the proper use of the machine so that he can exercise the creation of wealth of say $1\frac{1}{2}$ men or $1\frac{1}{4}$ men.

19. If this be the true way out, as I am convinced it is, surely the full effort should be made now to organise a real campaign in favour of productivity. This must be combined of course with some relaxation upon the pressure of investment

but it should be accepted as the main task of Government to preach to industry.

20. We should organise nationally, locally and industrially, possibly through the existing NEDDY's, or possibly by some other organisation for the purpose. Churchill was always hankering after some kind of industrial parliament for he realised the extraordinary system whereby political matters are debated fully and openly while the decisions which effect a whole nation are taken by employers and trades unions without any clear picture being given to the public for the reasons actuating their decisions. If much of the restrictive practices were argued out fully in public the whole situation might well be changed and the pressure put upon the acceptance of modern methods of production and the best use of modern machinery.

21. It is by trying to switch the controversy on to productivity and the benefits in terms of wages, hours of work, holidays and the like that can follow the adoption of modern methods, that we may hope to obtain by a return to 'consensus' politics, sneered at by some, but the essence of Tory democracy. Devisive politics in a democratic system are not likely to be applied for sufficient length of time to become effective even if such methods were desirable. Nor can permanent deflation be a credible solution to the threat of national and international recession.

H.M.

20th August 1980



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

12 August 1980

The Rt. Hon. William Whitelaw, CH, MC, MP
Secretary of State for the Home Department

Dear Willie

MINISTERIAL STEERING GROUP ON GOVERNMENT STRATEGY
(MISC 14)

.....
I thought that you and our Cabinet colleagues might find it helpful to have the enclosed copy of a note summarising proposals for further work recently agreed by the Ministerial Steering Group on Government Strategy, and also indicating the state of play of work to date.

As you will see, the Group has now decided to concentrate for the future on 5 key areas which we consider to be of vital importance to the improvement of the supply side of the economy, rather than to continue to seek to keep under supervision all the proposals originally suggested by colleagues. The areas on which we intend to concentrate for the future are summarised in Annex A to the note. I would welcome by the end of September any comments that you or Cabinet colleagues might have on this work programme and any suggestions that you might care to put forward (whether within your own sphere of responsibility or not) on measures to help the supply side of the economy, stimulate competitiveness more widely or make market forces work better. These might take the form either of specific work within the key areas, or possibly for further topics which you think the Group ought to examine. To avoid suggestions which duplicate work already in hand I am also attaching a copy of a checklist which was before the Group at its most recent meeting which sets out the latest state of play on all items.

.....

Although the Group intends to concentrate for the future on the topics listed in Annex A of the note, there are a number of other topics which the Group has under review and these are listed in Annexes B and C.

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There are two points to which I should like to draw particular attention. The first concerns paragraph 3 of the attached note. The approach sketched out there seemed to us to be particularly important if we are properly to achieve our objective of examining critically important areas of Government policy. I hope, therefore, that you and our colleagues will seek to ensure personally that these points are taken into account in any studies for which your department may be in the lead.

My second point concerns Annex D of the note. This lists work which we understand has either been completed or is in hand satisfactorily. I have no reason to doubt that this is the case, and the Group will no longer seek to include work on these topics in its future work programme. But I would like to ask colleagues to assure themselves that they are personally content with the progress of work on these issues.

I am sending a copy of this letter and of the attached papers to the Prime Minister, our other Cabinet colleagues and Norman Fowler. I am also copying to Sir Robert Armstrong, Robin Ibbs and John Hoskyns.

A handwritten signature in dark ink, appearing to read 'Geoffrey Howe', with a large initial 'G' and a horizontal line above the name.

GEOFFREY HOWE

MINISTERIAL STEERING GROUP ON GOVERNMENT STRATEGY(MISC 14):FUTURE WORK

1. The position is summarised in the attached annexes (which between them include all items originally selected by the Group) -

Annex A sets out the key areas for future work now agreed by the Group, and indicates which of the original items might now be pursued under those heads.

Annex B lists other original items on which reports back to MISC 14 under existing remits have just been made or will be made shortly.

Annex C lists other items (some original, some not) in which MISC 14 will keep a continuing interest.

Annex D lists items on which work (as appropriate) appears to the Group to be either adequately in hand elsewhere or to have been completed.

Annex E lists items where MISC 14 has accepted that there is little or no role for Government, or that action should not proceed.

2. For a summary of state of play on each of the original items, reference (if required) should be made to the checklist (at Appendix) which indicates how each item is being handled as at July 1980.

3. Whichever department is in the lead on a particular piece of work for MISC 14 should seek to ensure (a) that responsibility for progress is clearly allocated; (b) that the topic is considered in a way which allows 'conventional' wisdom to be effectively questioned; and (c) that, where there is relevant experience outside Government, suitable steps are taken to draw on outsiders' views and experience. Departments responsible for items of work should be prepared to comment on the adequacy of each study in relation to these criteria.

Key areas for future work agreed by the Group1. Fiscal incentives

Work is in hand on a number of original proposals indicated below. MISC 14 will wish to monitor progress, and it may be appropriate for some reports to come to MISC 14 for discussion.

Original items subsumed:

Tax incentives to encourage productive investment (6.3)
Reduce bias against investment in productive assets (9.1)
Tax relief for individuals investing in small firms (10.3)
Share options for senior executives (2.7)

2. Encouraging labour mobility

CPRS to report on options for improving labour mobility.

Original items subsumed:

Reform of housing policy to encourage labour mobility; examine labour mobility in depth (5.2)

3. Reducing burdens placed on industry by Government

Official Group on Impact of Government on Industry (IGI) has been asked to produce a progress report. Secretary of State for the Environment to put a paper on planning procedures to NEDC in October.

Original items subsumed:

Review of planning procedures (7.1)
Review environmental controls, building regulations, health and safety regulations (7.2)
Health and Safety Commission/Executive review (7.4). [CPRS report taken by E(EA) on 31 July].

4. Measures to help small firms

The Chancellor is circulating a progress report from the Treasury Working Group on small firms.

Original items subsumed:

Reduce administrative burdens (10.1)

Supply of premises and land (11.3)

5. Industry/training/education

MISC 14 will wish to monitor progress on a number of remits (viz. review of options on industrial training; consultation between Secretary of State for Education, Employment and Industry on various educational changes; and review of incentives for teachers of shortage subjects).

Original items subsumed:

Review training (apprenticeships, MSC, ITB's) (1.1)

Industry and education (1.2)

NOTE: numbers in brackets refer to items as listed in Appendix.

Reports to MISC 14 on existing remits

Contracting out - CPRS progress report (13.2)	}	Taken at meeting on 5 August.
Truck Acts: CPRS report (2.4)		
Local enterprise trusts (10.4 and 10.6)		
Restrictive labour practices (3.2)	-	Autumn
Worker participation in pension funds (3.5.ii)	-	When GAD survey results available.
Redundancy payments (4.3)	-	When results of DE survey available (April 1981).

Note: numbers in brackets refer to items as listed in Appendix.

Other items in which MISC 14 retains an interest

Worker involvement in firms (3.7). (Secretary of State for Employment, in consultation with No.10 Press Office, to consider scope for improving management communications, and to consult CBI; Chancellor to arrange discussion in NEDC).

Government campaign on productivity (3.1):

Stimulate shareholders to play proper role in company performance (9.5):

Promote use of non-executive directors (9.6):

MISC 14 discussions on these items led to proposals for strengthening role of institutional shareholders in improving company performance (Chancellor wrote to colleagues on 19 May, and letters from Secretaries of State for Environment and Trade of 16 and 9 June commented Chancellor discussing with Governor of Bank of England).

Define role of little Neddys and SWPs (6.1): Secretary of State for Environment to circulate his views in correspondence.

Improving management systems in central government: Secretary of State for Environment to circulate his views in correspondence.

Breaking down industry - wide bargaining: to be further considered by No.10 Policy Unit.

Note: numbers in brackets refer to items as listed in Appendix.

Items on which work (as appropriate) is either adequately in hand elsewhere or has been completed.

- Encourage able women to enter industry (1.3)
- Widening differentials through tax changes (2.1)
- Reduction of poverty trap (2.2). (Further work on incentives by officials for Ministerial discussion in autumn)
- Clamp down on malingering (2.3)
- Reduce discouragement to women to take technical and industrial jobs (2.5)
- Employee profit sharing (2.6)
- Closed shop and ACAS (3.4)
- Review Employment Protection Act (4.1)
- Powers for industrial tribunals to award costs to discourage frivolous cases (4.2)
- Product development and improved marketing (6.2)
- Change tax/depreciation provisions for companies (6.4)
- Review corporation tax (6.5)
- Phase out NIS (6.7)
- Encourage better manpower planning by firms (6.8)
- Reduce oversensitivity to environmental considerations (7.3)
- Competition policy (8.1)
- Raise threshold for referring takeovers to MMC (8.2)
- Remove tax obstacles to demergers (8.3)
- Enable MMC to examine large holding companies (8.4)
- Extend favourable tax treatment of gilts to long-term company debentures (9.2)
- Eliminate distinction between earned and unearned income (9.4)
- Elimination of exchange controls (9.7)
- Slant Government contracts in favour of small firms (10.5)
- Review enterprise zone concept (10.7)
- Review land taxation (11.1)
- Review Land Commission (11.2)
- Public sector land holdings (11.4)
- Public purchasing (12.1 and 12.2) (E to review progress in autumn)
- Public sector agencies to help private sector on exports (12.3)
- Develop nuclear power programme (12.5)

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Monopoly power of nationalised industries (13.1)
Deprivilege civil service and Academia (13.4.i and ii)
Diminish power of civil service unions (13.5)
Proposals for education of public (14.1, 14.4 and 14.6-8)
Accelerate inflation accounting (14.3)
Seek to change public attitudes to Europe (14.4)

Note: numbers in brackets refer to items as listed in Appendix.

Items where MISC 14 has accepted that there is little or no role
for Government or that action should not proceed

- Measures to improve trade union structure (3.5)
- Visits by shop floor workers to competitors abroad (3.5.ii)
- Improve management morale by discouraging compromise in industrial disputes (3.6)
- Encourage better conditions at work as incentive to productivity (3.7)
- Application procedures for investment grants (7.5)
- Equity guarantee scheme (9.3)
- Harnessing entrepreneurial skills of immigrants (10.8)
- Concentrate staff cuts to increase administrative delays to imports (12.4)
- City institutions to help finance building of universities, polytechnics, etc. (13.3)

Note: numbers in brackets refer to items as listed in Appendix.

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APPENDIX

MINISTERIAL STEERING GROUP ON
GOVERNMENT STRATEGY (MISC14)

CHECKLIST OF WORK IN HAND

Attached is an aide-memoire of the position on existing items of work, with which MISC14 has been concerned. This checklist was previously circulated as MISC14(80)18.

Cabinet Office
11 August 1980

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Item and reference in
E(79) 24

Report/recommendations in
E(79)42, September 1979 and
E(79)84, December 1979

Further action taken or in hand
(lead department(s) shown in brackets)

1.1 Review training
arrangements especially -
i. Replace apprenticeship
system with certification

i. (see 1.2 below)

ii. Review MSC/ITBs

ii. Review in hand

Report completed: Minister to review options
in early autumn (DE)

1.2 Industry and Education
(4 specific recommendations)

Recommendations on response
to Finniston, education and
'world of work', highly
qualified manpower, appren-
ticeships, and CPRS report
on education, training and
industrial performance

E to discuss response to Finniston on
6 August. Following general endorsement
of CPRS report by MISC 14 on 23 January,
(a) revised version of report has been
published; (b) checklist of points where
action is in hand and where further work
required has been prepared by CPRS and
discussed by MISC 14: Secretaries of
State for Education, Employment and
Industry are consulting on various changes
and will report late October: review of
incentives for teachers of shortage
subjects is in hand.

1.3 Encourage able women to
enter industry

Initiatives should be
pursued

Action in hand (DOI). Green paper on
taxation of husband and wife later this
year. (Treasury)

2.1 Widen differentials
through tax changes

Start made in 1979 Budget

To be considered in future budgets:
objective of 25% basic rate remains
(Treasury)

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2.2 Continued action to reduce poverty trap

Recommendations for review by officials of incentives for the lower paid

Budget announced that unemployment benefit and supplementary benefit to the unemployed to be taxed from 1982. Plans for taxing other short term benefits probably via legislation in 1981 Finance Bill. Further work by officials on incentives for Ministerial discussion in autumn is in hand. (Treasury)

2.3 Clampdown on malingering

Covered in report on 'priority' item 2.2

Claims at present controlled by home visit by lay officer or by reference to Regional Medical Service. Proposed new sick pay scheme will encourage employers to vet claim also. (DBSS)

2.4 Examine Truck Acts

Full-scale review not worthwhile but wider review of blue/white collar discrimination worth considering

MISC 14 on 18 February decided against wider study, but on reconsideration asked CPRS to report on Truck Acts. Report now before Group (CPRS)

2.5 Reduce discouragement to women to take technical and industrial jobs

Subsumed

See 1.3 above

2.6 Employee profit sharing

Officials should report in time for possible legislation in 1980 Finance Bill

Chancellor's paper of 7 December covered official report (E(79)76). A number of changes designed to encourage employee share ownership were announced in the Budget and included in the 1980 Finance Bill. DE are studying financial involvement of employees.

2.7 Share options for senior executives

Tax reliefs for savings-linked share option scheme in 1980 Finance Bill. Further examination of schemes specifically for senior executives like those in 1972 Finance Act.

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- | | | |
|--|---|--|
| 3.1 Government campaign on productivity/restrictive labour practices | Officials to consider possible ways of disseminating information on good management practices | MISC 14 considered officials' report on 18 February. Shareholders role in improving company performance (see 9.5 below) endorsed. (See also item 3.2 above) |
| 3.2 Different approaches to tackling restrictive labour practices | CPRS to review | CPRS report (MISC 14(80)5) considered by MISC 14 on 18 February: decisions - (a) DE to develop during next six months proposals on publicity, and guidance on productivity deals, and to consult MSC on training contribution; (b) Treasury to arrange further discussions in NEDO; (c) DOT to develop proposals for the use of competition legislation, and for possible amendment of s.79, Fair Trading Act. MISC 14 to review progress in autumn. |
| 3.3 Measures to improve trade union structure | No major role for Government | - |
| 3.4 Closed shop and ACAS as supply constraints | Action already in hand (in Employment legislation) represents substantial progress | Secretary of State for Employment intends to publish a draft code on the Closed Shop soon after the Employment Bill receives Royal Assent. |
| 3.5 Better communications in industry, especially - | | |
| i. Worker representatives on board of pension funds | i. No major role for Government | i. Officials to report again when Government Actuary's 1979 Survey is available |
| ii. Visits by shop-floor workers to competitors abroad | ii. No major role for Government | ii - |

E(79)24

E(79)42 and 84

Further action

3.6 Improve management morale
eg by discouraging
compromise in industrial
disputes

No major role for Government

Non-intervention policy is relevant
eg in steel dispute

3.7 Encourage greater worker
involvement in firms

Proposals coming forward
separately from Secretary
of State for Employment
(E(79)40)

Approach set out in E(79)40 endorsed by
E on 27 September. Secretary of State
for Employment to proceed accordingly
(DE)

Further work now commissioned by MISC 14
(MISC 14(80)4th meeting - item 1,
conclusion 4)

4.1 Review Employment
Protection Act

Action already in hand
represents substantial
progress

Employment Bill, nearing Royal Assent,
contains amendments to help small
firms (DE)

4.3 Good redundancy
schemes for overmanned
nationalised industries

Officials to study
possible perverse results
of redundancy payments

MISC 15 reports on 8 July to MISC 14.
MISC 14 to review again after results
of DE survey are available in spring
1981

5.1 Examine labour mobility
in depth

Partly subsumed in review
of Housing Policy (Priority
item 5.2). CPRS and MSC
studies in hand on geo-
graphical mobility

Report from MSC to DE Ministers now due.
CPRS to report to MISC 14 on options
for improving labour mobility. Threshold
for stamp duty on house transfer to be
reviewed annually (Treasury)

5.2 Sustained reform of
Housing Policy to
encourage labour
mobility
(10 specific proposals)

Major legislation this
session will help

Legislation in progress (Housing and
Local Government, Planning, Land and
Tenants' Rights etc (Scotland) Bills)
(DOE, SO)

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E(79)24

E(79)42 and 84

Further action

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|---|--|--|
| 6.1 Define what Government wants from Little Neddies and SWPs | Pressure has been applied to little Neddies/SWPs by recent review and should be maintained | Secretary of State for Environment to circulate views to colleagues (MISC 14(80)9th) |
| 6.2 Carry forward existing work on import substitution, product development and improved marketing standards | DOI to review further and report back | |
| 6.3 Tax incentives to encourage productive investment | Officials to report | E on 12 December and 13 February considered various options. The Venture Capital Scheme whereby losses on unquoted shares may be set off against taxed income was announced in the Budget and was well received. Provisions included in the 1980 Finance Bill. Further possibilities are being examined by FASE working group (Treasury) |
| 6.4 Change tax and depreciation provisions for companies to encourage profitable investment of retained capital | Subsumed | See item 6.5 |
| 6.5 Review system of corporate taxation | Under separate review | Green Paper announced in Budget speech to be published later this year (IR) |
| 6.6 Review regional policy | Review completed | Decisions being implemented over 3 years (DOI) |
| 6.7 Phase out NIS | Decision being considered separately | Under consideration (Treasury) |

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| 6.8 Encourage better manpower planning by firms | More work needed on information on highly qualified manpower, and regular summaries should be published | Action in hand: first of annual series of articles on highly qualified manpower published in March DE Gazette (DE) |
| 7.1 Review planning procedures including IDC's and ODP's | Officials to consider CPRS report. (Action taken on IDC's and ODP's) | MISC20 (official group considering CPRS report) reported to E(EA) in April and approved in correspondence. Follow-up now in hand (DOE, DOI). |
| 7.2 Review -
(i) Environmental controls | (i) CPRS were proposing to report | (i) MISC20's report to E(EA) recommends against a CPRS report and this was agreed by Ministers. |
| (ii) Building regulations | (ii) Review in progress | (ii) Public consultation document issued on 6 June. Policy approval granted by H on 30 June for legislation in 1980/81 session (DOE) |
| (iii) Health and Safety Regulations | (iii) CPRS to review | (iii) CPRS report taken by E(EA) on 31 July. |
| 7.3 Reduce over-sensitivity to environmental considerations | Not easy. MISC20 report (priority item 7.2) relevant | MISC20 reported to E(EA) in April. |
| 7.4 Health and Safety Commission/
Executive - | | |
| i. Review role | i. Subsumed | i. See item 7.2(iii) above. |
| ii. Ask CBI to play more positive part | ii. Recommendations for Secretary of State for Employment to approach CBI about this | ii. Approach already made on CBI role in both MSC and HSC, and further approach made on 30 June by Secretary of State for Employment. |
| 7.5 Remove need for separate application procedures for industrial estate corporations and investment grants | Investment grant scheme discontinued in 1970. | |

8.1 Strong and effective Competition Policy	Competition Bills this session and next but need to use powers	Competition Bill 1980 enacted. Powers of Investigation under it will be used shortly once regulations come into force. DOT considering further legislation for 1981-82 session (DOT).
8.2 Raise threshold for referring takeovers to MMC	Subsumed (priority items 8.1 above)	The threshold has been raised.
8.3 Remove tax obstacles to de-mergers	Inland Revenue considering in time for possible legislation in 1980 Finance Bill	Provision made in the 1980 Finance Bill for the easing of advance corporation tax and income tax charge on distribution of shares when a company is split. Further study of "purchase of own shares". (IR).
8.4 Enable MMC to examine large holding companies	Subsumed	See item 8.1 above.
9.1 Reduce bias against investment in productive assets	Officials to report in time for legislation in 1980 Finance Bill	Chancellor wrote to E colleagues on 14 March with first report by officials (Working Group on Tax and Savings): this group is to be expanded and outsiders brought in. Will look at case for reducing tax relief for investment in insurance, and possible new reliefs for equity investment eg. Loi Moqory (Treasury)
9.2 Extend favourable taxation treatment for Gilts to long-term corporation debentures	Will be considered by officials	To be considered before next Budget by Working Group on Tax and Savings (Treasury)
9.3 Equity guarantee scheme	Not proceeded with	
9.4 Eliminate distinction between earned and unearned income	Treasury Ministers to examine in connection with review of capital taxation	Cost of abolishing investment income surcharge large. Future changes depend on priority relative to changes in capital taxation (Treasury).

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|---|---|---|
| 9.5 Stimulate shareholders to play proper role in company performance | (a) Chancellor, with Secretary of State for Industry and Trade, to approach Institutional Shareholders Committee personally
(b) Bank of England's efforts to encourage institutional involvement to be supported
(c) Ministers (and officials) to encourage generally | Ministerial correspondence in train between Chancellor of the Exchequer and Secretary of State for Industry, Trade and Environment. |
| 9.6 Promote use of non-executive directors | Should be campaign of persuasion by Ministers, Bank and officials | Under discussion in correspondence on item 9.5. |
| 9.7 Elimination of exchange controls | Exchange controls abolished | Action complete. |
| 10.1 Reduce administrative burdens on small firms | Officials to report | Chancellor is circulating a progress report by small firms advisory group. |
| 10.2 Tax changes to benefit small firms | Officials to report in time for legislation in 1980 Finance Bill | Options discussed at E on 12 December. A number of tax changes specifically designed to help small companies were announced in the Budget and included in the 1980 Finance Bill (Treasury). |
| 10.3 Tax relief for individuals investing in small firms' equity | Officials to report in time for legislation in 1980 Finance Bill | See item 6.3 above (Treasury). |
| 10.4 Encourage large firms to help small firms | Government's role limited, but officials to consider ways of encouraging Local Enterprise Trusts | Report from DOE now available to the Group. |
| 10.5 Slant Government contracts in favour of small firms | To be covered in paper for E Committee on public spending | E Committee considered public purchasing paper on 20 February. The paper did not recommend slanting contracts in favour of |

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10.6 Dialogue with Local Government on stimulating new and small firms	Start made in speeches by Secretary of State for the Environment	small firms, but reported work in progress on informing small firms about contracts. A booklet in the DOI's small firms series on public purchasing is likely to be published shortly (DOI, Treasury).
10.7 Review Enterprise Zone concept	Subject of separate report	See 6.3, 10.2 and 10.4 above.
10.8 Harnessing entrepreneurial skills of immigrants	No need for special Government action beyond general help to small firms	First seven zones announced 29 July; one or two more may follow. Designation expected early 1981 after Local Government Planning and Land Bill is enacted this Autumn.
11.1 Review Land Taxation	Development Land Tax modified. Other aspects to be considered in review of Capital Taxation	Finance Bill makes DIT less restrictive, particularly by removing uncertainties which inhibit development. DLT now to be kept stable. The effects of the other capital taxes will be reviewed in the Budgetary context. (One important relief - rollover for capital gains tax gifts - is included in this year's Finance Bill) (DOE, Treasury).
11.2 Review Land Commission	(Land Commission abolished 1970/71. Community Land Act to be repealed)	Community Land Act being replaced by Local Government, Planning and Land Bill (DOE) (now in Lords).

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|---|--|--|
| 11.3 Inadequate supply of premises and land especially for small firms | Conclusions of existing studies (DOI, DOE) to be put to Ministers as soon as possible | Covered in progress report by small firms Working Group being circulated by Chancellor. Prime Minister is holding a meeting on small firms in autumn. (Mr Mitchell is preparing a report on "roadblocks").

A small workshop scheme, initially for three years, will enable 100 per cent industrial building allowances to be claimed on the construction of small industrial buildings. Provisions included in the 1980 Finance Bill. |
| 11.4 Public sector land holdings | Provision for register in Local Government, Planning and Land Bill | Action continuing in Local Government, Planning and Land Bill. Meanwhile first 21 authorities for registers have been announced, together with UDC area. Further list will follow in Autumn. |
| 12.1 Enlightened clientship by public purchasing | To be covered in paper for E Committee on public purchasing | Secretary of State for Industry has written to colleagues with detailed proposals on the campaigns. |
| 12.2 Arbitrary technical standards imposed by Nationalised industries | Subsumed in item 12.1 above | As for item 12.1 above. |
| 12.3 Public sector agencies to help private sector on exports | Departments (especially Trade) should give priority to this (eg through Nationalised Industries Overseas Group) particularly for railways and airports | Follow up (DOT, and other departments as appropriate). |
| 12.4 Concentrate staff cuts to increase administrative delay to imports | Not feasible without damaging exports as well | |

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|---|--|---|
| 12.5 Develop nuclear power programme | Being pursued separately | Action in hand (DEn). |
| 13.1 Reduce monopoly power of nationalised industries | Few proposals received. Officials to do further work | Being considered in E(DL). Measures affecting post, telecommunications and electricity generators recently announced. |
| 13.2 Contracting out of public sector services | Officials to report for consideration by MISCL4 via Secretary of State for the Environment | Reports taken by MISCL4 on 28 January. Decisions: (a) Central Government and NIS: Chancellor wrote to colleagues, with CPRS report, urging review of further scope for contracting out, and asking for progress report by July; (b) Local authorities: CPRS to review ways of encouraging more contracting out; CPRS report on (b) was taken by MISCL4 in April, and CPRS progress report on (a) is before the Group. |
| 13.3 Examine possibility of City institutions helping to finance the building of universities, polytechnics, etc. | Scope for more collaboration in finance for specialised buildings/equipment/chairs. Action most likely to flow from closer ties between industry and education generally (item 1.2 above) but Ministers can try to encourage | - |
| 13.4 Deprivilege | | |
| i. Civil Service | i. (a) Allowance for inflation-proofed pensions being examined

(b) Ministers should ensure that Departments identify and deal with inefficient staff | Independent inquiry under Sir Bernard Scott. Expected to report in Autumn (Treasury CSD).

Minister of State (CSD) has sought colleagues views on introducing more flexible early retirement arrangements. |
| ii. Academia | ii. DES should continue to encourage more short-term appointments and early retirements. | |

E(79)24

E(79)42 and 84

Further action

13.5 Diminish power of Civil Service unions (3 specific proposals)

CSD should ask Departments not to go beyond narrow interpretation of facilities agreement

More tightly drawn facilities agreement drafted and sent to trade union side. Negotiations continuing with a view to completion early in 1981.

14.1 14.2, 14.4 & 14.6-8
Various proposals for education of the public

Subsumed in communications exercise under Paymaster-General

Action in hand (PMG).

14.3 Accelerate introduction of inflation accounting

Official Steering Group on Accounting for Inflation to report to E(EA)

Chief Secretary's note with official report (E(EA)(80)10) discussed by E(EA) on 12 March. Decision not to legislate, but various other proposals endorsed. Report to be made to Ministers in spring 1981 (Treasury).

14.4 Seek to change public attitudes to Europe

Contingency planning endorsed for launching campaign at an appropriate time

OD(E) considered most recently on 28 July. Officials to continue to pursue modest practical measures to improve EC's image in the UK. Speaking note and supporting material on EC matters to be circulated to Ministers.

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12 AUG 1980



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

12 August 1980

The Rt. Hon. William Whitelaw, CH, MC, MP
Secretary of State for the Home Department

Dr. Williams

CONTRACTING OUT OF PUBLIC SECTOR FUNCTIONS

See Pt 5

I wrote to you and other colleagues on 11 February with a copy of the Central Policy Review Staff's report (prepared for the Ministerial Group on Government Strategy (MISC14)), on contracting out Central Government and National Health Service functions. I mentioned then that the Group had asked the CPRS to co-ordinate a short progress report for MISC14 before the summer recess. I now enclose (at Annex B) a copy of this. MISC14 considered it last week and generally endorsed its recommendations.

I very much hope that colleagues will continue to take a close personal interest in work on this issue. In particular, I hope they will consider carefully whether it might be possible to make faster progress on particular fronts, and whether there are any further opportunities for contracting out within their Departments, which have not been identified so far.

In order to help Departments pick up possibilities for contracting out which they may not have hitherto reviewed, I also attach to this letter a further short checklist (at Annex A) prepared since our meeting by the CPRS. This shows, on the basis of information made available to them, which Departments are known to the CPRS to be contracting out, intending to contract out or actively reviewing the possibilities of contracting out particular functions. (Departments should note, however, that the information on which this is based, particularly for some across the board functions, is not entirely comprehensive.)

As you will see from Annex A to the main report, work is currently in hand on a number of studies of the scope for contracting out particular public sector functions, and the

/Group



Group has therefore asked the CPRS for a further progress report early next spring.

Finally, perhaps I could draw colleagues' attention to paragraphs 12 and 13 of the CPRS report. I should be grateful if you and the others to whom I am copying this letter could ensure that the Treasury advice to which those paragraphs refer is disseminated at all relevant levels within Departments and that cost comparisons between in-house and contracted-out work are being done on a basis which excludes VAT.

I am sending a copy of this letter and of the attachments to the Prime Minister, other Cabinet colleagues and Norman Fowler. A copy of the letter also goes (without Annex B) to Sir Robert Armstrong, Robin Ibbs and John Hoskyns.

A handwritten signature, likely "John Hoskyns", is written in dark ink. Above the signature are several horizontal lines and a large bracket-like mark, possibly indicating a list of recipients or a specific administrative action.

GEOFFREY HOWE

CONTRACTING OUT PUBLIC SECTOR FUNCTIONS: PROGRESS REPORT

Checklist by CPRS of Departmental Contributions

The following is a checklist of the departments which told the CPRS that they were contracting out, intending to contract out, or actively reviewing the possibilities of contracting out at least part of the functions mentioned. It cannot be considered to be comprehensive, particularly in the case of some across the board functions, since departmental replies seem in some cases to have covered either only the most important functions, or else only those where significant change is envisaged. Therefore, the fact that a department is omitted from the list does not necessarily mean that it is not contracting out a least part of the function in question. The list does not show the departments which told the CPRS that they had considered and rejected the possibility of contracting out the various functions.

1. Contract cleaning

Civil Service Department (CSD)
 Ministry of Defence
 Department of Employment
 Department of Energy
 Foreign and Commonwealth Office (FCO)
 Overseas Development Administration (ODA)
 Departments of Industry and Trade
 Northern Ireland CS
 Northern Ireland Office
 National Health Service (NHS)

2. Management Consultants

CSD
 Department of Industry
 Department of Energy
 ODA
 Northern Ireland (DOCS, NHS)

3. Agency Staff

CSD
 Department of Employment
 Departments of Industry and Trade

4. Computing Services and Staff

CSD (CCTA)
FCO
ODA
Department of Energy
Departments of Industry and Trade
Northern Ireland (DOCS, NHS)

5. Training

CSD
Departments of Industry and Trade
Northern Ireland (NICS, NHS)

6. Security Staff

CSD
Department of Trade
FCO
Department of Industry
Northern Ireland CS
Northern Ireland Office

7. Catering

Home Office
Ministry of Defence
Northern Ireland Office
NHS

8. Reprographic Services

HMSO
Department of Energy
Northern Ireland CS

9. Architectural and Building Design Work

PSA
Northern Ireland (DOF, DHSS)
NHS

10. Architectural R and D Work

Department of the Environment (DOE)

11. Other R and D

DOE
ODA
Department of Energy
Ministry of Agriculture, Fisheries and Food (MAFF)
Department of Industry

12. Building Maintenance

PSA
DOE
Scottish Office
Northern Ireland (DOF)
Northern Ireland Office
NHS

13. Transport Services

PSA
DOE
ODA
Department of Industry
Northern Ireland (DOCS)

14. Vehicle Fleet Maintenance

PSA
FCO
ODA
Northern Ireland (NHS)
Northern Ireland Office

15. Cartographic Services

DOE
PSA
ODA
Scottish Office
Department of Energy

17. Other Specialists

Northern Ireland (DHSS)

19. Design and Supervision of Major Road Schemes

Ministry of Transport (MOT)
Northern Ireland (DOE)

20. Testing of Heavy Goods Vehicles and Passenger Vehicles

MOT
Northern Ireland (DOE)

21. NHS Functions: use of outside health contractors
laundry services
manufacture of blood products
hospital services (Northern Ireland)

22. Censuses and Surveys

OPCS

23. Foreign Travel and Allowances

FCO

24. Publishing

HMSO
MAFF
Departments of Industry and Trade

26. Advance Factory Programme

Department of Industry

27. Advisory Schemes

Department of Industry

28. Loans to Farmers and Fishermen

Northern Ireland (DANI)

29. Maintenance of Minor Watercourses in Rural Areas

Northern Ireland (DANI)

30. Quarantine Services

Northern Ireland (DANI)

CONTRACTING OUT PUBLIC SECTOR FUNCTIONS
(excluding functions of local authorities
and nationalised industries)

A Progress Report by CPRS

1. At the beginning of the year the CPRS submitted a report (MISC 14(80)2) to the Ministerial Steering Group on Government Strategy on the scope for contracting out public sector functions to the private sector (other than functions of local authorities and nationalised industries). The CPRS was not itself able to carry out a detailed investigation of the opportunities in each department. It had necessarily to rely on department's own assessment. Then, on the basis of the short note provided by departments, the various functions were grouped by CPRS into one of three categories:-

- A - Scope for further contracting out
- B - Existing balance about right
- C - No scope for contracting out.

The allocation of functions to each category is summarised in the table on page 7 of the CPRS report. On a crude count 18 functions were in Category A, 14 in Category B and 10 in Category C.

2. The CPRS recommended that in order to maintain the impetus departments should be asked to submit progress reports later in the year; and that departmental Ministers should be asked to take note of the results of the study so far, to satisfy themselves that opportunities for more contracting out were not being overlooked, and to take a personal interest in continuing work within their own departments and in the progress reports.

3. In February the Chancellor wrote to his colleagues enclosing the CPRS report. He asked them to consider critically, so far as their own Departments were concerned, the categorisation of functions. He hoped that further consideration in the light of wider interdepartmental experience might lead to some re-assessment of the possibilities. So that MISC 14 could have the opportunity to review progress before the summer break, he asked for short progress reports to be made to CPRS by each department.

RESTRICTED

with GSD co-ordinating the replies on certain general functions. He suggested that these reports should set out progress made, or in prospect, towards more contracting out of departmental functions (including not only those assigned to Category A in the CPRS report, but also those assigned to Categories B or C, or other functions not covered in the report, where it was found that progress could in fact be made).

4. This report and its Appendices are based on these progress reports. It is, at the outset, worth mentioning that GSD suggested that a proper evaluation of progress towards greater contracting out really needs to take place over a longer period of time, and that if a further review were to take place towards the end of the year, this would give a greater opportunity for positive trends to become apparent. Nevertheless progress has been made in some fields, and in other cases departments have told us of new areas for investigation.

5. The key points from departments' replies are summarised in Annex A which shows the previous categorisation of each function and any change. It also lists some functions in particular departments which were not previously included (these are asterisked). The categorisation is as before - ie categories A, B and C as in paragraph 1 above - except that a question mark indicates that an investigation is proceeding to see whether further contracting out will be possible.

6. It will be seen from Annex A that three functions have been moved into category A (NHS laundries (21(b)) from category C, DOE Architectural R & D work (10(c)) from B, and the Building Research Establishment (11(a)) from B). Of the departmental functions added since the last report investigations into the possibilities are still proceeding in four cases, otherwise they all fall into category B.

7. Full details of progress, extracted from departments' replies, are given under functional heads at Annex B.

8. Departments' response to this call for progress reports has been varied. Some departments conducted a wide-scale review at the time of the original exercise, and have had little to add. Others have used the earlier CPRS report as the basis for a careful reconsideration of the options, eg FCO and CDA, and the Department of Industry (though this report is based only on the DI's interim response, and further details are expected later). Some departments have concluded in both rounds that there is little scope for contracting out the functions under their control. In some, but not in all cases, there is evidence of close Ministerial interest.

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9. A notable example of a full-scale review of departmental functions is that carried out in Northern Ireland by the Northern Ireland office and the Department of Finance (NI). Their report, which we commend, is based closely on our summary for Great Britain and deals with the complete range of functions. We have not been able to summarise its many details in the attached Annexes, but it is available to other departments on request.

10. In a number of departments reviews of particular functions are proceeding in other contexts. For example:-

- (i) In DOE the Secretary of State is currently reviewing functions and manpower for the whole department (including PSA) in the Ministerial Management Information System (MMIS) exercise.
- (ii) Three major MOD studies - into the Royal Dockyards, R and D establishments and Supply Management - have recently been considered in E(EA).
- (iii) The future of HMSO has similarly been considered by E(EA).
- (iv) The CSD are committed to provide the Treasury and Civil Service Select Committee with reports on contracting-out in areas where associated staff savings can be expected. Accordingly, departments have been asked to submit to CSD reports for the period January - 1 July 1980, and thereafter quarterly.
- (v) ODA suggest that the forthcoming Rayner Scrutiny of the Directorate of Overseas Surveys can be expected to indicate any further possibilities in relation to cartographic services.

11. DHSS report that their Ministers have reviewed various possibilities against the background of strong NHS Union opposition to use of contractors, the pre-occupation of NHS management with the priority task of restructuring the NHS and, in some cases, the shortage of suitable and interested contractors. They say that decisions must be left to the Health Authorities. But the following general

action has been or is being taken by the DHSS:-

- (i) discussions have been held with Chairmen and senior officials of Regional Health Authorities;
- (ii) references will be included in forthcoming Ministerial speeches, press briefings etc, to increase awareness of the potential benefits and further to encourage Authorities : the main emphasis will be on use of non-NHS hospitals and, in the case of NHS hospitals, on domestic (mainly cleaning) services and laundry;
- (iii) the DHSS is considering the possibility of developing standard contracts for catering and domestic services, including pest control;
- (iv) Ministers and officials are having discussions with cleaning and laundry firms to identify and if possible help to resolve technical and costing problems, and to encourage them to expand their capacity where necessary and to "sell" their services more effectively to Authorities;
- (v) Following the various discussions, further guidance to Authorities will be considered.

DHSS report that there are signs of increasing interest among Authorities, particularly as regards cleaning; but many have not properly considered the potential advantages of using contractors. They conclude, however, that progress can only be gradual. Authorities will need to judge the potential benefits locally against the likely strength of Union and staff objections.

12. Ministers may remember that in our last report we pointed out that we had found that cost comparisons between in-house and contracted out work can be distorted by the incidence of VAT. As a result of our report the Treasury issued a letter to Departmental Accounting Officers (DAO2/80). This demonstrated that comparisons should properly be made excluding VAT. Departments which contracted out might as a result have to pay more VAT, but since changes in VAT liability represent price rather than volume changes any increase should be met in the revaluation of volume figures to cash terms during each public expenditure survey. An adjustment on these lines cannot be made once the cash limits for the next year have been set, but, since it should normally be possible to foresee any substantial switching to contracting-out before the cash limits are set, this should not be much of a problem in practice.

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13. We should note, however, that despite this letter there are still references to the "VAT problem" in departmental progress reports, ie in that by MOD dealing with cleaning, and the DHSS report on the NHS. We recommend, therefore, that departments ensure that the Treasury's advice is known to all those who may be in a position to make these decisions. One problem may be that managers in particular areas must be assured that their own budgets will be adjusted to reflect the changes which the Treasury will make to their department's overall expenditure total.

14. Ministers may like to be aware of the following general points which came out of departments' replies:-

- (i) there were a number of mentions of resistance by the unions;
- (ii) the smaller departments had the greatest difficulty in finding suitable areas for contracting out;
- (iii) the Department of Industry mentioned that functions involving public accountability cannot be contracted out without Parliamentary authority (which when granted usually results in the setting up of a Quango);
- (iv) some departments mentioned security problems - this was, of course, particularly important in Northern Ireland;
- (v) there were several mentions of the lack of present capacity in the private sector: as the Northern Irish report said, "limited capacity also means that there is difficulty in retrieving the situation if the private contractor is not providing a satisfactory service"; but steps to promote the private sector can also be taken (eg cleaning and laundries in the NHS - see paragraph 11(iv) above).

Recommendations

15. The CFRS recommends:-

- (i) that Ministers should ask for a further progress report in about 9 months' time;
- (ii) that the Chancellor should write to colleagues with a copy of this progress report, and should ask for their close personal interest in further developments in their own departments;

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(iii) that departments should ensure that the Treasury's advice concerning VAT is known at all relevant levels and that their internal budgets are constructed in such a way that any additions to cover higher VAT payments are returned to the relevant division.

CPRS

70 Whitehall

ANNEX A : SUMMARY OF PROGRESS

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FUNCTION	PREVIOUS CATEGORY	CHANGE IN CATEGORY (WHERE APPROPRIATE)	BRIEF COMMENT (WHERE APPROPRIATE)
1. Contract cleaning	A		Continued progress. Some problems with security. Suitable contractors not always available for small offices.
2. Management consultants	B		Number of outside commissions is increasing.
3. Agency staff (typists etc)	B		Use generally confined to short-term or special needs.
4. Computing services and staff	B		New work going to private sector.
5. Training	B		May be some scope for <u>gradual</u> increase in use of outsiders.
6. Security staff	B		Use of contract staff generally more expensive. NIO considering the possibility of contracting out the Civilian Search Unit.
7(a) Catering (CISCO)	C		
7(b) Catering (NHS)	A		Use of contractors in NHS has fallen markedly in last decade. DHSS think there is little prospect of change, but will exhort RHA to consider the option.
7(c) Catering (HO Residential Training Establishments)	-	?	HO studying the scope for contracting out domestic services in these establishments

(RESTRICTED)

FUNCTION	PREVIOUS CATEGORY	CHANGE IN CATEGORY (WHERE APPROPRIATE)	BRIEF COMMENT (WHERE APPROPRIATE)
*7(d) Catering(MOD)		?	Some 50 service messes being considered for contracting out.
8. Reprographic Services	B	?	Future of HMSO services under review.
9(a) Architectural and Building Design Work (PSA)	A		35% of major work contracted out in 1979/80 compared with 25% in 1978/79.
9(b) Architectural & Building Design Work (Home Office)	B		
9(c) Architectural & Building Design Work (NHS)	A		DHSS to discuss possibilities with RHAs.
10(a) Architectural R & D Work (DES)	B		
10(b) Architectural R & D Work (NHS)	B		
10(c) Architectural R & D Work (DOE)	B	A	DOE continuing their efforts to reduce in-house capability.
11(a) Other R & D (Building Research Establishment)	B	A	DOE examining possibility of increasing BRE's independence. ODA phasing out support for BRE Overseas Division.
*11(b) Other R & D (Energy)	-	B	Virtually none of D. Energy's non-nuclear R & D is undertaken in-house.
*11(c) Other R & D (Agriculture)	-	B	MAFF planning to use any additional funds to increase external commissions (already the majority)
*11(d) Other R & D (Industry)	-	B	DOT already contracts out 85% of research work.

RESTRICTED

FUNCTION	PREVIOUS CATEGORY	CHANGE IN CATEGORY (WHERE APPROPRIATE)	BRIEF COMMENT (WHERE APPROPRIATE)
12(a) Building Maintenance (PSA)	A		Reduction in direct labour force on target.
12(b) Building Maintenance (Home Office - prisons and quarters)	B		
12(c) Building Maintenance (NHS)	A		DHSS to encourage Authorities to review the balance of in-house and contracted out work.
12(d) Building Maintenance (Ancient Monuments)	A		In-house work is being run-down. In Scotland scope for contracting out further being investigated.
*12(e) Building Maintenance (Scotland)	-	?	Maintenance of training schools may be put to tender.
13(a) Transport services (PSA)	A (Regional cars and road haulage) C (London cars and IDS)		Regional car fleet being reduced. Scope for privatisation of road haulage fleet being assessed.
13(b) Transport services (MOD)	C		
13(c) Transport services (NHB)	C	?	Under consideration by NHS Working Party.
13(d) Transport services (OSD)	A (Service vehicles) C (function vehicles)		DOE/PSA interdepartmental despatch service being investigated. Case for car hire being considered at two ODA out-stations.
14(a) Vehicle fleet maintenance (PSA)	A		Staff numbers being cut
14(b) Vehicle fleet maintenance (MOD)	C		

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CHANGE

PREVIOUS
CATEGORY

IN
CATEGORY
(WHERE
APPROPRIATE)

FUNCTION

BRIEF COMMENT (WHERE APPROPRIATE)

14(c) Vehicle fleet maintenance (NHS)

B

14(d) Vehicle fleet maintenance (CSD)

A

FCO transport already maintained by private garages.
ODA out station switching from PSA to local garage.

15 Cartographic services

A

DOE, PSA, ODA, SO all investigating scope for further
contracting out.

16 Legal services

C

17 Other specialists

C

18 Inland Revenue Valuation Office

B

Wider review of the Valuation Office has begun.

19 Design and Supervision of Major Road Schemes
(England)

A

Detailed proposals for contracting out being drawn
up

20 Testing of Heavy Goods Vehicles and Passenger
Vehicles

A

Legislation to enable DOT to transfer testing to
private sector is proposed.

21(a) NHS Functions: Use of outside Health contractors

A

DHSS encouraging HA to use outside contractors,
but rapid progress cannot be expected.

21(b) NHS Functions: Laundry services

C

A

Industry showing interest.

21(c) NHS Functions: Manufacture of Blood Products

A

DHSS exploring whether industry interested.

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FUNCTIONS	PREVIOUS CATEGORY	CHANGE IN CATEGORY (WHERE APPROPRIATE)	BRIEF COMMENT (WHERE APPROPRIATE)
22 Office of Population Censuses and Surveys	-	B	Rayner reviews may affect the public/private balance.
*23 FCO Foreign Travel and Allowances	-	?	FCO considering use of private company to handle foreign service allowance system. Already use British Airways for travel bookings.
24 Publishing	-	?	Under review by Treasury, CSD, HMSO.
*25 Business Statistics Office	-	?	If BSO cannot reduce data preparation costs consideration will be given to contracting out non-commercially confidential work.
*26 Advance Factory Programme	-	B	Almost entirely contracted out.
*27 Department of Industry Advisory Schemes	-	B	In part covered in the Quango Report, otherwise little scope for more contracting out.

ANNEX B

DETAILED NOTES ON FUNCTIONS

1. The numbering of functions in this Annex follows that in Annex A to the CPRS Report "Contracting out public sector functions" (MISC 14(80)2).

1 CONTRACT CLEANING - category A

2. CSD report that some progress towards further contracting out has already been made. Some 200 directly employed cleaning staff (part-timers counting as half) have left the Civil Service over the past 12 months and have not been replaced, although the numbers saved directly through privatisation alone can not readily be identified. Report from particular departments are as follows:-

- (i) In MOD the 80 or so MOD/Service establishments with the largest cleaning complements have been examined to assess the non-financial implications of changing to contract, and to obtain cleaning contract tenders. This work is still continuing, but 34 of the 35 establishments which have completed the exercise show a clear cost advantage to contract. The Department will be proceeding to contract wherever it is shown to be cheaper, provided that there are not other overriding considerations. In some cases local SSTU have been told of the results: SSTU consultation at Departmental level has still to take place. The results so far show potential staff savings of just over 1,000 (lower than expected because of the effects of the recruiting ban and other manpower constraints) plus potential recurring financial savings of about £1.3M per annum. CSD report that staff savings in MOD are expected to rise to 5000 in 1983.
- (ii) In the Department of Employment a three year programme of review has been introduced to implement conversion to contract cleaning in 336 Unemployment Benefit offices where it is more economical

to do so; and an extension of contract cleaning in Skill Centres is currently being examined. In the Health and Safety Executive, it is general policy to contract out office cleaning and virtually all office cleaning in ACAS is contracted out

- (iii) In Department of Trade there are 22 directly employed cleaners the bulk of whom are employed on a part-time basis. Directly employed labour is used because many of the offices are very small (eg Official Receivers' Offices, Mercantile Marine Offices). Contractors have little interest in small offices, and would be likely to charge a very high premium for the work.
- (iv) The Department of Energy employs only 2 or 3 cleaners, the main cleaning effort being provided by private landlords.
- (v) The FCO employs contract cleaners for all its buildings except the Main Building (Downing Street West, Downing Street East, and King Charles Street) where civil servants will continue to be employed. This is the most sensitive building for security, and there are security requirements of all staff there including cleaning staff. Contractors have a high rate of turnover in their staff and there are considerable difficulties in obtaining from them any sort of worthwhile vetting.
- (vi) Maximum use of contract cleaners is made in all ODA buildings. There is a small number of directly employed cleaners at ODA headquarters. Their costs, with judicious use of the bonus incentive scheme, are below those of contract cleaning services.
- (vii) In Department of Industry the scope for further contracted out is small since most of this work is already carried out under contract. All cleaning in the Headquarters buildings is contracted out with the exception of computer rooms where direct departmental supervision is necessary. Elsewhere in the Department of Industry direct labour is used where there are special cleaning problems such as in Industrial Research Establishments in which accommodation is mainly other than conventional office space. However, at the National Engineering Laboratory serious consideration is being given to a change to contract cleaning.

3. DHSS, SO and NIO report that there is significant scope for using contractors in the NHS for domestic services (mainly cleaning). DHSS say that efficiency can be improved where the contractor is not precluded from reducing staff by the terms of transfer agreed locally with the Unions. They say that there are signs that, under financial pressures, more Health Authorities are considering contracts; and that contractors are beginning to "sell" their services more actively. However contractor capacity is limited. DHSS are arranging discussions at Ministerial level to see what expansion the main cleaning firms are planning, or are willing to consider, for NHS work and to encourage them to approach Authorities. The Department is also considering the possibility of standard contracts for domestic services and pest control, as an aid to NHS management.

2. MANAGEMENT CONSULTANTS - category B

4. CSD report that during the coming months the number of assignments commissions from outside is expected to increase. This is partly because of Ministerial interest in applying commercial practices into departmental and related functions (eg into some research establishments), and partly because new technology is likely to generate more demand for specialist advice. For the most part, however, this increase will arise where particular specialised skills are not available in the departments concerned. Where the necessary skills are available in-house, the criteria of cost, time, staff attitudes, and the need from time to time to seek an independent external view suggest that the present balance between departmental and external resources remains broadly sensible. The Department of Industry suggests that the trend towards the greater use of consultants is likely to continue, brought about by a rapidly increasing sophistication of the technological environment, bringing to birth new skills and new expertise which Government and Industry alike wish to use, coupled with a widening range of problems, on which Government is looking for specialist advice.

3. AGENCY STAFF - category B

5. CSD confirm that the extent to which agency staff are used remains "about right". Apart from Post Office telephonists (where on cost grounds there is often little to choose between them and directly employed staff) agency staff are generally confined to covering short-term needs (eg temporary recruitment difficulties) or for special needs (eg verbatim writers in the Department of Employment).

4. COMPUTING SERVICES AND STAFF - category B

6. The decision to use external computing services and the spending power rests with departments. Consequently, the CSD, through its Central Computer and Telecommunications Agency, can do little to influence aggregate levels of usage not least because it is significantly more expensive man-for-man to contract out.

7. However, in the 1979/80 financial year, expenditure on outside computer bureaux services showed an increase of nearly £3m (or some 60%) as compared with 1978/79. Rather than work taken out of the public sector in favour of the private sector, this represents new work going directly to the private sector to take advantage of the available facilities, together with some expansion of existing work. Expenditure this year on computer consultants is expected to be broadly the same as in previous years. All evidence suggests that the present extent of contracting out remains "about right".

8. There were the following reports from departments:-

- (i) FCO say that the present balance is probably about right, but that as the need grows for more computer project evaluation they will consider carefully the choice between keeping the proportion more or less as it is, or increasing the amount of contracting out. The most recent example of contracting out is a Price Waterhouse evaluation of computerisation in the Passport Office.
- (ii) The Department of Energy have in the past put most computer work out to commercial bureaux. But a decision was taken about 18 months ago (in consultation with the CCTA) to provide an in-house capacity. One mini-computer had already been installed and another is scheduled to be installed during the current year. As a consequence the Department expect their use of bureaux services to decline, eventually to very modest proportions.
- (iii) ODA envisages some limited continued use of consultancy and commercial bureau services in the computer field to supplement in-house resources in terms of both specialist personnel and equipment.
- (iv) Within the Departments of Industry and Trade consultants are used to undertake special tasks or when no staff are available in-house within the timescale governing the work in question; but there is little scope, if any at all, for a significant change in the present balance between domestic resources and external consultancy.

9. The Department of Industry is the sponsor department for the computing services industry, and say that they could make the case on industrial policy grounds that Government should endeavour to make more use of the industry so as to provide the private sector with experience of good quality Government work as a means to obtaining more public sector work in other countries. However, contracting-out is normally more expensive than in-house facilities and there is need to supervise closely contracted-out computer systems/programming work to ensure that it can be satisfactorily operated and maintained subsequently on in-house equipment.

5. TRAINING - category B

10. Further enquiries by CSD involving all except the smallest departments have broadly confirmed the findings of the earlier studies. These are that there is already significant use of outside contractors (over 20% of all training); that they are employed mainly in the area of vocational training for professional/technical staff; that the scope for extended use of contractors in other areas of training is limited; but that in any case in planning training programmes departments actively consider this possibility against the crucial criteria of quality, relevance and cost. The broad conclusion therefore is that the present use of outside contractors in training is 'just about right'; that there may be some scope for gradual expansion in some areas if the crucial criteria are met; and that departments are alert to this possibility.

11. ODA report that there is no scope in terms of cost savings to be gained from contracting out on the administrative training front. On professional and technical training, where they could not meet a particular request from our own resources, they would first look to other Departments or centrally to the Civil Service Department.

12. In the Departments of Industry and Trade the private sector is used in three ways:-

- (i) individuals are sent to courses at business schools and other external institutions;

- (ii) outside organisations are commissioned to run complete courses for the Branch;
- (iii) external speakers are used on internal departmental courses.

In the period August 1978 to July 1979 the student costs of contracted out training were £1.2m, compared to £1.4m on departmentally provided training and £0.2m at the CS College.

6. SECURITY STAFF - category B

13. CSD believe that the present extent of contracted out is about right. The use of contract staff is generally more expensive. Reports from particular departments are as follows:-

- (i) Department of Trade say that scrutiny guard work is already contracted out at the Companies Registration Offices at Cardiff and London. The only area where scope may exist for further contracting out is in large buildings where the Department of Trade is the sole occupier (eg the Patent Office).
- (ii) The FCO report that a certain amount of contracting out already takes place in the guarding of the Old Public Offices, paid for by PSA, and in emergency baggage searches at Clive House, but as the FCO is a wholly PVD Department it would be impractical to contract out more than is done at present.
- (iii) ODA say that substantial savings are unlikely to arise from contracting out this function because the same number of hours must be worked whether or not it is contracted out.
- (iv) Department of Energy have only recently recruited their own small team of 7 security guards. Out of hours building security is provided by the PSA Custody Service.

- (v) In Northern Ireland a rough comparison with a commercial security company suggests that it would be cheaper to contract out the Civilian Search Units work. (The function of the CSU is to search vehicles, and persons entering the security sector in Belfast City centre.) This would allow the NIO to reduce the number of civil servants of 308 in addition to eliminating the considerable management problems which NIO now experiences with the CSU. Despite the problems which the contracting out of this function might entail (legal, operational and of security), the possible gains justify giving the project further study.
- (vi) The Northern Ireland Department of Finance report that despite the special security problems in Northern Ireland there is scope for further contracting out the security services in departments.

7(a) CATERING (CISCO) - category C

14. The work, mode of operation, and future of in-house catering in the Civil Service have been examined in detail over the past 9 months. CSD have concluded that the present arrangements are economical and that it would be much more costly to use private contractors in place of CISCO.
15. CISCO's use of up-to-date catering and management techniques enables it to operate to standards of cost and quality that compare very favourably with those of large catering organisations and contractors in the private sector. It has a management team of highly experienced commercial caterers and, except that it is required to manage its restaurants, taken together, on a break-even basis within the approved subsidies scheme, it operates as a normal commercial operation, anticipating rising food costs, wage awards, and other operating expenses by planned rises in the cost to consumers of meals and snacks.
16. In any particular establishment, the decision whether to use outside caterers is taken on its merits. This will be underlined by the proposal that departments should repay CISCO for all the services it provides.

7(b) CATERING (NHS) - category A

17. DHSS report that during the last decade the number of hospitals using contract caterers has fallen from about 60 to 1. This reflects a strong preference within the NHS for directly provided services, together with improvements in NHS catering management following changes in pay differentials and in-house training. (Inability to attract good managers, was, they believe, the chief reason why Authorities used contractors.)

18. Factors inhibiting use of contractors are:

- (i) hospital catering is specialised. There are no firms with special expertise in the field. All specialised training is done within the NHS and contractors have largely depended on managers recruited from the NHS.
- (ii) contracts have not proved cheaper or more efficient than directly provided services. Contractors are at a financial disadvantage because they cannot take advantage of favourable NHS contract prices for food. (Suppliers will not agree to this.)
- (iii) contractors have not been able to offer improved standards. Even in the case of staff catering there have been cases where sales have fallen under contractors and risen again where a directly provided service has been restored.
- (iv) union and staff opposition.

19. DHSS think that there is little prospect of persuading Authorities to invest management time and incur industrial relations problems in an area where their own experience points away from contracting. Use of contractors is likely only where there are specific local problems which cannot be solved "in-house". Catering services will therefore be included in general exhortations to Authorities to consider use of contractors, but will not be identified as a high priority area. No immediate discussions are proposed with catering firms. The DHSS is nevertheless considering the possibility of a standard contract as an aid to an interested Authorities.

20. Both SO and NIO consider that NHS catering should be placed in category A.

7(c) CATERING (HOME OFFICE RESIDENTIAL TRAINING ESTABLISHMENTS)

21. As part of the current exercise to reduce the size of the Civil Service by 1 April 1984, the Home Office have put in hand a study to consider the scope for contracting out domestic services in their residential training establishments.

7(d) CATERING (MOD)

22. Some 50 Service messes are being considered for contract catering. Tenders are being invited, but the exercise has not yet got to the stage where any estimate of the outcome can be made.

8. REPROGRAPHIC SERVICES - category B

23. There is some contracting out of reprographic work from departments normally through HMSO. The decision to carry out work in the department or in HMSO or by outside contractors rests on the need for speed, available facilities and in some cases security. The current consideration of the future of HMSO services include the future of reprographic services. There may therefore be developments to report when consideration of the retention or disposal of HMSO printing and reprographic production facilities has been carried forward over the next six months.

9(a) ARCHITECTURAL AND BUILDING DESIGN WORK (PSA) - Category A

24. 35% of major design work contracted out in 1979/80 compared with 25% in 1978/79. It is anticipated that this might increase to about 40% by the end of 1980. More generally, the handling of PSA design work and the scope for increased contracting out is currently under review.

9(c) ARCHITECTURAL AND BUILDING DESIGN WORK (NHS) - Category A

25. Current DHSS advice is that "in house" design should not exceed 50% of the annual capital programme. Current practice among Regional Health Authorities varies from around 25% to 60% - though the percentages have tended to rise as the capital programme has been reduced. An "in house" capacity is necessary for briefing work; the effective supervision of contracted design work; and

appraisal of tenders and supervision of work under construction. To attract and retain good staff, and to maintain their skills, it is necessary to offer them some direct design work. However DHSS judge the currently advised limit of 50% to be unnecessarily high and propose to reduce it to 35-40%. This proposal is to be discussed with REAs. The main advantage of using contractors is likely to be increased flexibility rather than reduced costs of designing individual schemes.

10(a) ARCHITECTURAL R & D WORK (DES) - Category B

26. DES have looked again at this but see no scope for change.

10(c) ARCHITECTURAL R & D WORK (DOE) - Category A (reassigned from category B)

27. DOE are continuing their efforts to ensure that work is contracted out wherever possible and the in-house capability reduced. Since last November five extra-mural contracts have been let, total value £105,000, and a sixth will be let shortly. In the same period only one in-house project has been started.

11(a) OTHER R & D (BUILDING RESEARCH ESTABLISHMENT) - Category A (reassigned from B)

28. An examination is being put in hand in DOE of the possibilities for establishing BRE in a more independent role outside the Civil Service. In the meantime the Establishment will be expected to recover as much as possible of its costs from customers outside Government.

29. ODA financial support for the Overseas Division of the BRE will be phased out and terminated by 31 March 1983; it is expected that this will provide more opportunities to firms in the private sector to participate in the building research work of ODA.

11(b) OTHER R & D (ENERGY)

30. The Department of Energy have a fairly substantial and growing programme of non-nuclear R & D, but virtually none of this work is undertaken in-house, though it is of course directed and financed by the Department. A large part of the work is let through the aegis of the Harwell-based Energy Technology Support and Marine Technology Support Units. All the work is let to the contractors considered most fitted to undertake it and a substantial portion of it falls to the private sector.

11(c) OTHER R & D (AGRICULTURE)

31. MAFF are giving special attention to this area of activity. At present some 60 per cent of MAFF's R & D funds go to external contractors and the Department are planning to use any additional funds to increase external commissions, particularly in the food sector.

11(d) OTHER R & D (INDUSTRY)

32. Through the Requirements Boards, the DOI already contracts out roughly 85% of its industrial research work. A comparison between unit costs of work in-house and outside can be made at the Computer Aided Design Centre. Nearly all the work is carried out under contract and costs about 30% more per man than at DOI's own Establishments. DOI has reviewed its contracting out policy and has decided to convert an in-house organisation - the National Maritime Institute - into an external one which will do contract research. The scope for further contracting out is being considered. But since most of the Department's research facilities are unique, this may be limited to hiving off to the private sector.

12(a) BUILDING MAINTENANCE (PSA) - category A

33. Two thirds of PSA building maintenance is undertaken by private firms, the remainder by Works DEL force. DEL manpower has fallen by 12% from 18,000 in April 1979 to 15,950 in May 1980, and is on target to achieve planned 50% reduction over five years.

12(d) BUILDING MAINTENANCE (NHS) - category A

34. For operation reasons (eg emergency cover) some maintenance is best undertaken by direct labour; and considerations of efficiency demand that staff should then be fully employed. DHSS policy is that in general DEL should not be used if it is more expensive than contract labour. It is proposed to remind Authorities of this policy; to tell them that Ministers believe the amount of contracting out could with advantage be increased; to invite them to initiate regular reviews of relative costs. However industrial relations difficulties are likely to limit the pace of advance. The DHSS is trying to achieve general implementation of a nationally agreed productivity scheme for NHS works staff. Staff are looking to increase productivity by taking work back from contractors.

12(d) BUILDING MAINTENANCE (ANCIENT MONUMENTS) - category A

35. In-house work on both design and execution of maintenance schemes is to be run down as quickly as possible in favour of contracting out. Some limited in-house capacity will however have to be retained for certain special works eg royal residences. In Scotland the scope for further contracting out is being investigated.

12(e) BUILDING MAINTENANCE (SCOTLAND)

36. Scottish Office report that building maintenance work on buildings like the Scottish Police School and Scottish Fire Training School might be put to competitive tender with PSA competing with private contractors.

13(a) TRANSPORT SERVICES (PSA) - category A (regional cars, road haulage) and category C (London cars, IDS).

37. The Regional Car Service fleet will be reduced from a total of 176 at 1 April 1976 to 33 by the end of 1980. The possibility of making further reductions will be considered as part of the DOE's Ministerial Management Information System (MINIS) review.

38. Only 33% of the Road Haulage fleet's capacity is used for PSA purposes. Consultations are therefore taking place with principal clients in order to assess the scope for privatisation and these should be completed shortly. The service will also be considered as part of the MINIS exercise.

13(b) TRANSPORT SERVICES (MOD) - category C

39. MOD remain of the view that there is no scope for privatisation/commercialisation in this area for the reasons given before.

13(a) TRANSPORT SERVICES (CSD) - category A (service vehicles) and category C (function vehicles)

40. CSD report that policy in this area is for departments individually. They have no machinery for monitoring departmental practice on a day-to-day basis. Reports from individual departments were as follows:-

- (i) DOE/PSA interdepartmental despatch service will be examined as part of the MINIS exercise.
- (ii) Department of Energy report that their departmental vehicles comprise one van.
- (iii) Department of Trade say that HM Coastguard has in the region of 200 vehicles, located throughout the various search and rescue regions. These are specialised vehicles (fitted with various items of equipment, eg winches). They are used for operational purposes, and thus have to be available 24 hours a day. There is no scope for contracting out.

(iv) It is the practice at ODA headquarters to hire from the private sector when Government transport is not available. No service vehicles are held at ODA headquarters. Vehicles are used by two of the Scientific and Special Units, namely the Centre for Overseas Post Research and the Tropical Products Institute. The case for vehicle hire is being investigated.

14(a) VEHICLE FLEET MAINTENANCE (PSA) - category A

41. PSA report that the workload is being cut through a reduction in services, and privatisation. Staff numbers have so far been reduced from 521 at 1 April 1976 to the present total of 294. Further reductions will be made as and when natural wastage allows; substantial further reductions would depend on redundancy agreements being made.

14(b) VEHICLE FLEET MAINTENANCE (MOD) - category C

42. MOD remain of the view that there is no scope for privatisation/commercialisation in this area for the reasons given before.

14(d) VEHICLE FLEET MAINTENANCE (CSD) - category A

43. Again CSD have left it to individual departments to reply. The replies received are as follows:-

(i) FCO transport is already maintained at outside garages. At posts overseas mechanics are only employed directly where there are compelling reasons for so doing.

(ii) The ODA's Centre for Overseas Pest Research has in the past used PSA on a repayment basis to service its vehicles, but a local garage will now be used instead.

15. CARTOGRAPHIC SERVICES - category A

44. Departmental replies were as follows:-

(i) DOE report that the possibility of contracting out all cartographic services to the private sector is being examined as part of MINIS follow up, and in relation to the Government's response to the Report of the Ordnance Survey Review Committee. In PSA the results of further investigations on the potential for contracting out of cartographic services will be available shortly. (PSA would however expect to follow the lead of DOE Central which has the major interest.)

- (ii) ODA say that both the Directorate of Overseas Surveys (DOS) and the Land Resources Development Centre (LRDC) have in recent years put substantial amounts of work out to contract. In accordance with the recommendations of the Lane Review in 1971 some 45 contracts have been awarded to the private sector over the past nine years by DOS and the staff complement reduced by 25%. Moreover, DOS' operations are to be the subject of a scrutiny under the direction of Sir Derek Rayner starting in July and any further scope for contracting out will be considered then.
- (iii) SO are investigating the scope for further contracting out Cartographic Services (Planning).
- (iv) Department of Energy say that their cartographic section totals little more than a dozen people of all grades and provides mainly "one off" services over the full range of the Department's activities.

18 INLAND REVENUE VALUATION OFFICE - Category B

45. Inland Revenue have continued to review the work done by the Valuation Office on recoverable service terms but have found no reason to change their view that it is properly regarded as falling within Category B. A wider review (with CSD involvement) of the structure of the Valuation Office has begun and among other things it will examine the basis on which the Office provides services to other Government Departments and Government-sponsored bodies. This will relate not only to recoverable service work but also to the much larger and more important area of work done under allied service arrangements.

19 DESIGN AND SUPERVISION OF MAJOR ROAD SCHEMES (ENGLAND) - Category A

46. The report of the study of Road Construction Units carried out in consultation with Sir Derek Rayner announced the Minister of Transport's decision for the planned phasing out of RCU sub-units. Following the publication of the Roads White Paper in June which set out the future trunk road programme, an "action study" is now under way to draw up detailed proposals for transferring individual trunk road schemes from the 16 sub-units and closing them. The DOT is consulting the main organisations concerned. The aim is to complete the action study within three months.

47. The "ground rules" for the action study, which have been sent to the main organisations, develop Ministers' policy framework, announced in the RCU Report, that the transfer of schemes will usually be to consultants, and to county-councils as agent authorities only where there is a special case for doing so.

20 TESTING OF HEAVY GOODS VEHICLES AND PASSENGER VEHICLES - Category A

48. After consideration of the options, the Minister of Transport is now proposing subject to colleagues' agreement to transfer the annual testing of both heavy goods vehicles and public service vehicles to the private sector. Legislation for this purpose is proposed for the next session of Parliament.

49. The Minister intends to divide the present network of 91 testing centres between a small number of different private sector companies, each running a chain of centres. The companies will not be paid by the Department, but will make their money from the test fees paid by vehicle operators.

50. Transfer to the private sector on this basis will reduce civil service manpower and introduce an element of competition into the provision of testing services which should promote efficiency. The testing system already covers its costs, but there may be benefits to the PSBR from the disposal of the assets of the system. The size of any such benefits depends on market response and on the scale of payments which will have to be made for pensions and redundancy compensation.

51. The proposals are likely to be controversial, with opposition from the unions and from vehicles operators concerned that a private sector testing system may not be impartial

21(a) NHS FUNCTIONS: USE OF OUTSIDE HEALTH CONTRACTORS - Category A

52. The Government as part of its policy of encouraging the private sector of medicine, is easing controls on the building of independent hospitals and promoting the concept of partnership between independent hospitals and the NHS. This may include the mutual provision of particular services, by local government. In particular Authorities have been asked to consider the scope for extending the use of contractual arrangements whereby independent hospitals treat NHS patients, paid for in full by the Authority. A draft circular, drawn

up in consultation with the private sector interests, was sent to Authorities for comment in June and will be issued later in the year. As well as encouraging use of contractors, including for the first time non-charitable hospitals, the draft gives guidance on forms of contract as an aid to local negotiation. In principle the scope for use of contractors in this way is considerable, but Authorities will have to meet the cost out of cash limits. Rapid progress cannot therefore be expected.

21(b) NHS FUNCTIONS: LAUNDRY SERVICES - Category A (reassigned from Category C)

53. The number of commercial firms equipped to meet specialized NHS needs has diminished, but the industry is now showing considerable interest in moving into the NHS field. Industry's main interest is in the building of new laundries for the NHS or the major upgrading of existing laundries. Ample capital is said to be available, but industry would be looking for guaranteed contracts of 7-10 years. However, interest in either the commercial management of NHS plant and staff, or taking over of NHS plant and staff, is limited by the industry's anticipation of trade union problems.

54. Health authorities' use of contractors has been inhibited by the shortage of suitably equipped firms, by the often cheaper cost of in-house services, and by the heavy investment represented by existing NHS laundries. Discussions are still taking place between officials and the industry, but it seems clear that the outcome will justify including laundry among the services which Authorities are asked to consider further.

21(c) NHS FUNCTIONS: MANUFACTURE OF BLOOD PRODUCTS - Category A

55. Blood products are prepared for England and Wales mainly at a central laboratory from raw materials supplied by Regional Transfusion Centres. The laboratory is sub-standard - it was recently the subject of an adverse report by Inspectors under the Medicines Act - and its output falls well short of demand. Supplies are augmented by purchases by Health Authorities of imported products which are very expensive and carry a higher risk of hepatitis. Options are to redevelop or rebuild the laboratory within the NHS or to hand the whole operation over to industry. The DHSS is exploring whether industry would be interested and on what terms. Preliminary soundings have not been encouraging, but a formal approach has been made to the firm judged most likely

to be suitable and interested. Their response is still awaited.

22 OFFICE OF POPULATION CENSUSES AND SURVEYS

56. The situation regarding household survey research remains much the same. As a result of the various reviews carried out under the direction of Sir Derek Rayner a number of proposals will be made which may affect the balance between public and private sector. Some further developments are as follows:-

- (i) OPCS plan to carry out the next EEC Labour Force Survey (to be held in 1981) by contracting out the interviewing in England and Wales to private sector firms. Previous surveys have relied on directly recruited (casual) interviewers and supervisors. This is a large survey covering some 90,000 households in England and Wales.
- (ii) As part of the present round of economies OPCS are investigating the feasibility of merging the continuous Family Expenditure Survey (FES) with the continuous National Food Survey (NFS). If this succeeds, then the private sector would lose the annual contract for the NFS.
- (iii) It is likely that the Department of Transport will ask OPCS to carry out future National Travel Surveys rather than contract the private sector as has been the practice for the past two surveys.

23 FCO FOREIGN TRAVEL AND ALLOWANCES

57. British Airways already have an office in FCO's main administration complex (Gurtis Green Building) and do all travel bookings, both air and surface. Hogg Robinson, the Government Freight Agents, arranges shipment overseas of the baggage of DS personnel. The FCO and the CSD are considering whether Employment Conditions Abroad Ltd, who specialise in setting rates of payment for staff of private companies abroad, could meet the demands of the Foreign Service Allowance system.

24 PUBLISHING

58. The future arrangements for government publishing are under review by Treasury, CSD and HMSO following the report of the Inter-Departmental Group on Tying. MAFF report that they are keen to have discretion to use private sector publishers.

59. Department of Trade report that the printing, and where applicable advertisement selling operations for their "Coastguard" magazine are in the hands of private contractors already. The same is true of the staff newspaper "Ti-Line". The printing, physical distribution and advertisement selling operations on 'British Business', which is a joint Department of Industry and Department of Trade weekly magazine, are already in the hands of private sector contractors and consideration is being given to the possibility of transferring responsibility for publishing the magazine from HMSO to the Department of Industry so that the remaining publishing functions, particularly the subscription selling and management operation, can be transferred to a suitable private sector contractor.

25 BUSINESS STATISTICS OFFICE

60. The work of the Business Statistics Office was reviewed within the Rayner study of the statistical services of the Departments of Industry and Trade. Contracting out commercially confidential information is unacceptable. However, the review report recommended, and it has been agreed, that if BSO cannot put forward proposals, by the end of 1980, to reduce data preparation costs to figures much closer to those of the private sector consideration should be given to contracting out work which is not commercially confidential.

26 ADVANCE FACTORY PROGRAMME

61. The central government advance factory programme for England, administered by the Department of Industry as part of regional policy and carried out by the English Industrial Estates Corporation is almost entirely contracted out. The Corporation acts only as a general project programme manager and landlord. Private sector contractors do all legal work, all architectural design, prepare specifications and designs for tender by private sector builders, issue and evaluate tenders, and supervise the work of the successful building contractors on site.

27 DEPARTMENT OF INDUSTRY ADVISORY SCHEMES

62. Four schemes have been considered:-

- (i) The Industrial Technologies Education and Training Programme is due to finish its work (a great deal of which is contracted out) in 1982, or possibly earlier. It was reviewed in the Quango Report.

- (ii) The Small Firms Service costs £1.7 million per year, half of which is accounted for by Information Centres for small firms and half by Counselling. The latter is already provided by retired and semi-retired businessmen on contract to the Department. There is no obvious organisation to take over the Small Firms Service. The small firms associations or the CBI are not sufficiently well organised across the country. Similarly the strength of chambers of commerce varies from place to place and moreover most enquiries to the Service are from very small firms which are least likely to belong to a chamber. Certainly it would be impossible to guarantee a national service for small firms under private management without a heavy subsidy. In addition the Department of Industry would lose the feedback from the direct interface with small firms.
- (iii) The future of the Waste Management Advisory Council, covered in the Quango Report, is under consideration by the Secretaries of State for Industry and Environment who have joint responsibility for it. The future of the National Anti-Waste Programme will be decided at the same time.
- (iv) Almost all the work in energy conservation is already contracted out to consultants, research associations and private industry; little more can be sensibly contracted out.

12 AUG 1980



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NOTE ON CHEQUERS MEETING, FRIDAY EVENING, 8 AUGUST 1980

Present: The Prime Minister
David Wolfson
Douglas Hague
Terry Burns
John Hoskyns
Norman Strauss

The purpose of this note is to "capture" the points that came out of our discussion on Friday evening, 8 August. Much of it looks fairly superficial, but some ideas did emerge.

1. Objectives 80/81. Key areas were: (a) economic; (b) presentational; (c) free society.

We were dependent on indicators showing results, ie unemployment figures, money supply, interest rates, inflation rates etc. The turn-round to "creativity" depended on interest rates. The foundation of the economic turn-round is built on the strategy being successful.

2. We should provide more information on the world background - what is happening elsewhere. For example, all Western economies are car economies and the car market worldwide is saturated.
3. Future problems. Our real problem would be to resist the premature demand to reflate. Policy needed to ensure it was easy for small businesses to start and grow. Does our macro-strategy extinguish the micro seedlings?

How do we differentiate between the start-up vs. expansion needs for capital for businesses?

Is there a need for a "banks business venture committee"?

What are the lags and speeds of response in this start-up process for new small businesses?

4. Important presentationally to make pre-emptive strikes before all the figures are published, eg on unemployment. One answer here was for Government policy for youth to be called The Youth Employment Programme - YEP.

Here we can involve the unions in agreeing to lower wages for youth. But necessary to win public opinion first before embarking on dialogue with the unions.

5. Because of limited media attention, speeches would only contain one point during recess, in not more than 250 words.
6. Must be role for big multiples with YEP. Their function in society is to provide school-leavers with jobs.
7. Need to end incremental salary scales for teachers.

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8. Need for Government powers to overturn results of compulsory arbitration?
9. The Personal Sector has done well at the expense of the Corporate Sector. Transfers of resources are needed from Personal as well as Public Sectors.
10. If a PSBR emergency looks imminent, a need to get more money which is not to be called TAX and which must not go through the RPI. So the National Health Service contribution could be raised or there could be an increase in national insurance surcharge on the employees, not the employers.
11. Need to put VAT on imports at the ports, especially components, in order to redress the servicing capital requirements of people who use foreign components vis-a-vis those who use home purchases.
12. Index-linking seen as off the Government's strategy.
13. Need to get at use of savings money for investment. At the moment, housing crowding out industry. (But this is all secondary market investment, so not that important.)
14. General speech intro. on unemployment:
"In the interests of employment, we must do the following . . ."
15. Gas. People don't understand why they are paying for increased gas profits with gas price rises.
16. Industrial use of gas as feed stock. When renewal contracts come up, we should give gas to industry on very advantageous prices; ie unweight their price. Helping industry thus could cause oil prices to fall in competition.
17. Youth employment surcharge. If we make a surcharge on firms, etc, for youth employment or, indeed, any other moral purpose, we should always state precisely what the money is for in a way which engages people's moral sense. Then people can't reasonably ask for compensating pay rises. They are being immoral so to do.
18. Gas. Can gas be negotiated on bulk purchase terms? Look at the statutory liabilities.
19. Europe. Need to fight subsidies through, eg, Germany and Holland horticultural subsidies.
20. Unemployment. "Lucky to have a job, let alone a pay increase. Your increased pay is someone else's job loss."

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21. Competition policy - nibble away at monopolies continuously.
22. Prime Minister had told Anthony Rawlinson to reject volume and go cash. Need for tight cash limits. In future, call them Departmental budgets. Thus "this is your budget for next year". The higher the budget, the more the unemployment. Inevitably there would be some excess and this is met ex-post facto from a contingency reserve. Need to question the assumption that a seriously overspent budget would "destroy the system". Rather, it should damage the records of the people involved. If cash limits (or "the Departmental budget") are relaxed enough to be unbreakable, what are they for?
23. Need to get the private sector and public sector mutually reinforcing each other in wage negotiations. Government has a role in this as an employer of the public sector. The private sector should be handled by Ray Pennock going to talk to Ford about their wage claim and BP about the tanker drivers' claim in order to set a strong line right from the start. We must not allow a high norm to emerge in these early settlements.
24. Need to continue selling as many council houses as possible. How else can we encourage the capital-earning democracy? Eg: the French loi Monory scheme. Is there a way people can manage their own pension? Should we lose the insurance tax incentive? Is there a way to give marginal advantage to individuals? Can we introduce a stock-broker into works canteens? Prime Minister to talk to Nicholas Goodison at the Stock Exchange. Can we have brokers for individuals using the familiarity and wide distribution of building society outlets? People trust them, and they are accessible. In a sense, they are investing there already. They are behaving as mini-capitalists.
25. Need for priorities for nationalised industries. If necessary, can we let them go bust? Nevertheless, we have to get pay increases in the public sector down voluntarily and by persuasion so that we never have to "come out of a freeze" again. Perhaps explain to people what unthinking behaviour means: higher inflation, fewer jobs, and you are fighting the democratically-elected Government. What do you prefer? No salary increase or no job?
26. Need to widen the debate onto Fear, Fairness, Morality. Thus providing further understanding and motivation. People need to be given the information to help them work out what they could do/should do/want to do. Norman Strauss agreed to write note to Prime Minister on this subject of 1½ pages.
27. Douglas Hague to write a 1½ page note to the Prime Minister on topic of a "siorthold" in employment.
28. Part of freeing society is to loosen job tenure, wherever it exists. This has an effect on the Pay Research Unit numbers and should be quantified. Thus, all civil servants have security of tenure, relative to industry. Their salaries should be reduced to reflect this.

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29. Monopoly is bad for people, whether labour, capital, or nationalised industries. Can we bring the trade unions up before the Monopolies Commission in some way? Need to break down the problem of "us and them" vs. "we" at the level of the firm. Three large company unions colluding over a pay claim is a form of monopoly, against that company.
30. In order to deter NUM, is it worth dual-firing CEGB power stations for gas (which does not have to be stored) as well as for oil? What is the speed of building?
31. NCB wages. Need to split those who have worked underground (and suffered) from surface workers who have always worked on the surface. They should not be paid in the same way. The coal mines were nationalised to serve the nation. They are now milking the nation. Should we build more nuclear power stations? Speed of building? Should we give grants to factories to generate their own electricity?
32. Need for R&D project for a mini power source to provide an energy alternative to the power station in an emergency. Small fuel cells? David Howell says progress is encouraging.
33. Government R&D should have the twin objectives of both focussing strategic direction and making a profit. There is a differential strategic role in new products which are deterrents against union monopoly behaviour vs. those which are an insurance against the consequences of that behaviour. Thus a fuel cell is an insurance against a power strike, though its existence in each home may not act as a deterrent. A deterrent would be making it illegal to strike.
34. Employment Bill Green Paper. Need for Boardman to write to JP now with the Chamber of Commerce Submission. John Hoskyns to arrange.
35. Inevitably, there will be pain in the next months. We either have to justify that pain in presentation, or equalise it fairly across society. Oil price increases are a major cause of pain. How do we decide where to be fair and equalise, against where we should let the pain hurt? One thing is clear: public sector is too protected, and that is unfair. The choice is not between pain and no pain. The choice is where the pain is felt and whether people understand the reasons, and believe them to be fair?

NORMAN STRAUSS
13 August 1980

PERSONAL

MR. LANKESTER

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Outline Notes on Economic Strategy

Introduction - Summary of Strategy

BURNS

PRESENTATION

1. I would like to begin with a summary statement of the economic strategy.
2. Then to move on to some background indicators comparing UK and world performance.
3. Then to look at monetary and inflation performance in some detail. Examine problems of high interest rates and the high exchange rate.
4. Then to look at some alternative policies that are suggested by some observers.

[1]

(1)

FINANCIAL STRATEGY

1. PERMANENT REDUCTION OF INFLATION REQUIRES A MONETARY STRATEGY
2. EXACT TIME PATH AND LAGS UNKNOWN - AVERAGE LAG ABOUT 2 YEARS BUT CAN VARY
3. A CONSISTENT FISCAL POLICY REQUIRES THAT THE PSBR IS REDUCED AS PERCENTAGE OF INCOME
4. CUT PSBR BY CUTTING SPENDING. TAXES TOO HIGH

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

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

3. In order to achieve this monetary strategy without excessive interest rates it is necessary to have a consistent fiscal policy. This implies a reduction in Government borrowing as a percentage of output. Again we do not know the precise relationship. It almost certainly varies over the business cycle.

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

The Background

5. This strategy is being implemented against a difficult background. Judged by conventional measures of the growth of output, inflation and unemployment the economic performance of the industrial countries has deteriorated sharply in recent years. UK performance has also deteriorated; but whereas growth has deteriorated in line with the rest of the world; in the case of inflation the deterioration here has been much worse than elsewhere.

[2]

(2)

World and UK Inflation BackgroundINFLATION

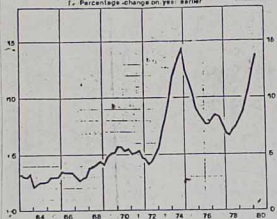
	<u>1963-69</u>	<u>1970-78</u>
U.S.	3.0	6.7
JAPAN	5.0	9.8
W.GERMANY	2.5	5.2
FRANCE	3.6	9.0
ITALY	3.4	13.1
U.K.	4.2	12.8
WORLD	3.4	8.0

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

[3]

(3)

WORLD CONSUMER PRICES
Percentage change on year earlier

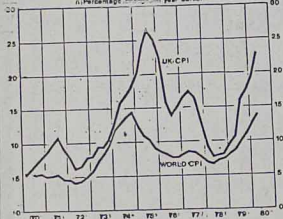


7. This underlying acceleration of world inflation can also be seen by comparing the rate of inflation at the same point of successive cycles. The low point of the cycle has been at higher and higher rates of inflation. The UK has the same pattern of upward drift of the underlying inflation rate.

[4]

(4)

Percentage change on year earlier



8. If we concentrate upon the 1970's we can see that the timing of the broadsweep of inflation movements is the same in the UK as in the world as a whole. Since mid 1978 the OECD inflation rate has risen from 6½ per cent to 14 per cent; at the same time the UK rate has risen from 7½% to 22%. The rise in world prices is largely the effect of

the further doubling of oil prices which has had a direct effect upon inflation equivalent to the increase in 1974. In addition world demand has been growing rapidly since mid 1978 and this has contributed to inflationary pressure.

[5]

(5)

World and UK Output

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

NB
ErrorGROWTH RATES

	<u>1963-69</u>	<u>1970-78</u>
WORLD	5.3	3.6
USA	5	3.3
JAPAN	4.8	5.3
GERMANY	8.4	2.7
U.K.	2.9	2.3

[6]

(6)

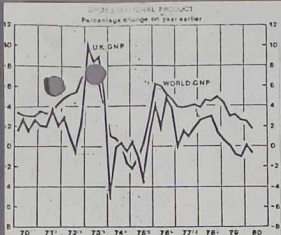
10. The UK growth rate has been systematically worse than average for a hundred years. Throughout the post war period the gap has been about 2%. We are not intending today to discuss this 2% gap but simply to note that the supply side measures are aimed at this problem.

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

(7)

Overlap

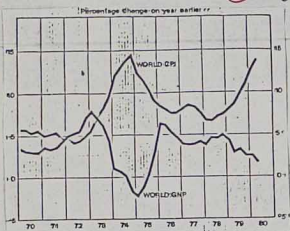
11. Looking in more detail at the cyclical pattern of output in the 1970's we can see the close correspondence of the UK and



world output changes. Recessions in the UK tend to be strongly associated with recessions in the world as a whole. Similarly the periods of rapid growth also tend to coincide.

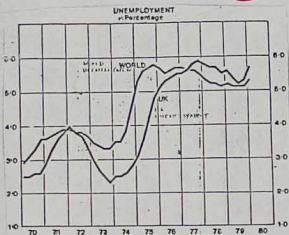
8 12. A comparison of growth and inflation

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



9 World/UK Unemployment

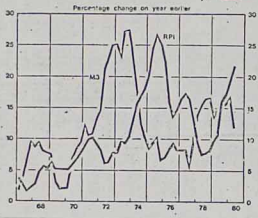
9 13. The UK unemployment rate has been rising each cycle since 1960. Again there is close correspondence with the average of the major countries. There was a major increase in unemployment in 1970; then again in 1974/5; and we now seem to be about to surge again. I shall return to this problem again.



Monetary Strategy

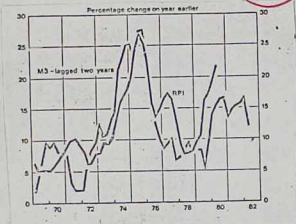
14. I would now like to look at the monetary strategy in some more detail.

[10]



15. The foundation of the monetary strategy is that in the medium term inflation rates are determined by monetary growth. If we chart the growth of money supply and the inflation rate over the past 10 years the relationship comes out clearly after a longish lag. Moving the monetary growth rate forward 2 years shows the relationship even more clearly.

[11]



16. Between mid 1977 and mid 1979 monetary growth was about 15% compared to around 7% between 1975 and 1977. We can see how this pointed to an upturn in inflation. There is some suggestion that the time lags are shortening. In the mid 70's the time lag was about 2½ years. Recently the lag between the upturn in monetary growth and the upturn in inflation was only 18 months. This is not surprising as people become more aware of inflation. But we must emphasise that these lags can and often do move in either direction.

[12]

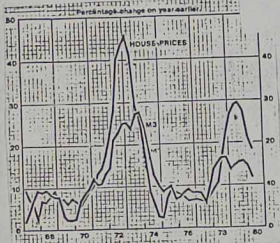
INFLATION

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

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

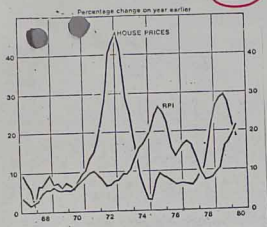
- oil prices and world prices clearly have a major effect.
- the rise in VAT has had a sharp short run effect
- the timing and extent of nationalised industry prices, rates, rents and food prices all matter and
- the timing and extent of pay settlements is crucial and affects the time lags of the inflationary process.

[13]



18. I have emphasised the way in which inflation lags behind monetary growth. Of course some prices move immediately; these are the markets that are most sensitive to monetary changes. Important examples are the foreign exchange market and the housing market. Both usually signal well in advance the likely course of inflation in general. We can see the historical correspondence between monetary growth and house prices. There

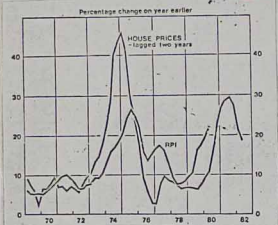
[14]



is clear overshooting with house prices rising by a multiple of monetary growth during booms but the broad movement coincides. Similarly we can see how the movement of house prices clearly leads the inflation rate.

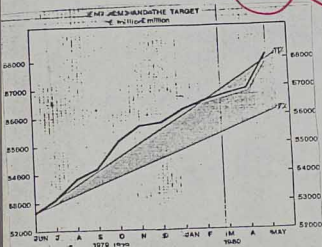
19. We saw earlier that the latest bout of inflation shows up in the monetary figures from the end of 1977. In 1978/79 when general inflation was still modest house prices were beginning to accelerate reaching an annual growth of 30% in mid 1979. The increase in general inflation followed just as the inflation in 1974/75 followed the monetary growth and house price explosion of 1972. If we move the house price chart forward two years as we did with money we can see that it is a good indicator of future inflation.

[15]



20. There are now indications that the whole sweep of inflationary pressure is about to be reversed. There is increasing evidence that money supply is coming under tighter control - all the monetary aggregates point in this direction. In the first part of 1979/80 there were still problems of monetary control:

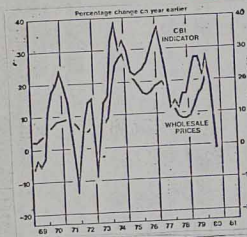
[16]



- (i) the PSBR was biased with a large deficit in the first half of the year
- (ii) there were considerable lags in tax payments due to industrial disputes. However the rise in MLR to 17% in November and a more favourable budgetary position has brought us back towards the target.

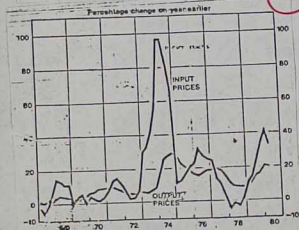
21. Just as monetary growth is now slowing down so is the growth of house prices. This all points to a slowdown of inflation in general.

[17]



22. Another important indicator is the CBI indicator of firms planning to put up prices in the following four months. The last figure is the lowest since 1973 i.e. before the first oil price increase. The high exchange rate and monetary deceleration is clearly affecting profit margins.

[18]



23. Another indicator of future price movements is the behaviour of wholesale input prices. These show the price increases that are paid by manufacturing industry. Recently there has been some sign of easing; in the months since February world prices have been falling and even oil prices have been rising less

rapidly. In time this should be translated into lower output prices and then lower inflation.

24. To summarise, the indications now point towards a significant slowdown in the inflation rate as we move through 1980 and into 1981.

Interest Rates

[19]

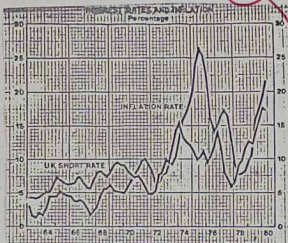
25. I would now like to turn to the difficulty of the high rates of interest that we have faced over the past year. There are several important influences upon the level of interest rates:

(i)

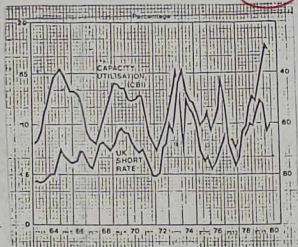
We can see a clear relationship between inflation and interest rates. Potential savers need to have compensation for the likely fall in the purchasing power of their savings. Even with interest rate at 17% savers are getting no real return, even before tax.

(ii)

The next chart also shows that interest rates tend to be bid up in a boom when companies



[20]



are building up stocks and pressure is reduced when destocking reduces companies need for cash. So interest rates tend to move with the economic cycle.

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

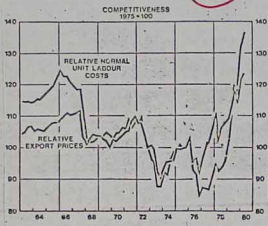
26. During 1979 and early 1980 each of these factors was pointing towards higher interest rates as government borrowing was high, domestic demand was strong, inflation rising and the monetary target tight. I will look at the prospects in a moment.

Exchange Rate

[21]

27. But first I would like to say a little about the exchange rate. Since May 1979 the effective exchange rate has risen by about 10%. At the same time UK inflation has been 10% faster than competitors inflation and costs. The result has been a massive 25% loss of cost competitiveness simply in the last year. Since 1976 the loss is about 40%.

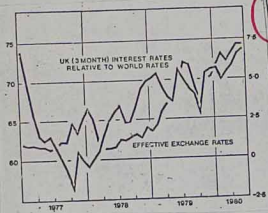
It is very difficult to identify precisely the reason for the recent strength of sterling in the face of our high inflation rate.



[22]

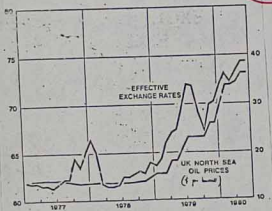
(i) Confidence in the government strategy has almost certainly contributed.

(ii) Interest rates have been high compared to other countries and this has attracted money. We can see that as the gap between UK interest rates and world interest rates has widened the exchange rate has strengthened.



[23]

(iii) The rising oil price damages UK balance of payments less than other countries and appears to have turned us into a petro-currency. This can be seen by



the relationship between the movement of sterling and the price of the North Sea oil.

28. The effect of the oil price increase upon the UK is unlike its effect on other countries. As we are virtually self-sufficient there is no direct change in the terms of trade and oil price changes damage UK national disposable income much less than major net oil importers. This makes sterling particularly attractive.

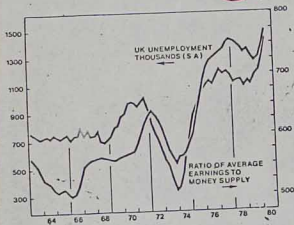
29. The result has been a much higher exchange rate than forecasters expected. The effect has been to put considerable downward pressure on prices but as pay settlements have continued at excessive levels this has created problems for companies. The effect of the loss of competitiveness is very uncertain but could be damaging to manufacturing if unit costs are not reduced relative to other countries.

Unemployment

30. To summarise; the anti-inflationary policy is putting considerable pressure upon the economy in the short run particularly for interest rates and the exchange rate. The benefit from the strategy should emerge in

the defeat of inflation. But in the process of monetary deceleration it is inevitable that output and employment will suffer if pay and prices do not move rapidly into line with monetary growth. The pattern of unemployment over the next few years will be determined by the time lags in the response of wages and prices to the monetary deceleration.

24



31. An examination of the past 10 years shows that the movement of unemployment is closely related to the movement of earnings relative to money. When earnings rise faster than money supply unemployment goes up. There have been two stark examples of this behaviour in the past 10 years when unemployment rose rapidly.

- The first is between the end of 1968 and the end of 1971 when earnings grew by more than money supply as income policy breakdown collided with the post IMF monetary control.
- Secondly between end 1973 and the beginning of 1977 earnings grew substantially faster than money supply as post income policy earnings explosion coincided with monetary deceleration.

32. The reverse is also true. Unemployment has fallen when earnings have grown less rapidly than money supply. Again there are two vivid examples over the past decade when unemployment has fallen

- between end 1971 and end 1973 earnings grew by less than money supply largely because of rapid monetary acceleration.

Of course the cost of the monetary growth was felt later in terms of higher inflation but this suggests that unemployment can be brought down if earnings growth is kept below monetary growth.

- between early 1977 and end 1979 earnings grew by less than money; again this was partly due to accelerating money and pay restraint. Again unemployment fell.

33. Earnings have now been growing faster than money supply since the end of 1978. Again unemployment is rising rapidly. Obviously it is not possible to be precise about this kind of economic relationship but it gives an indication of the kind of process at work. Our estimates suggest that for each

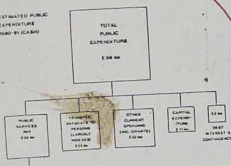
1% excess earnings in relation to the monetary target unemployment may rise by between 20 and 40 thousand.

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

[25]

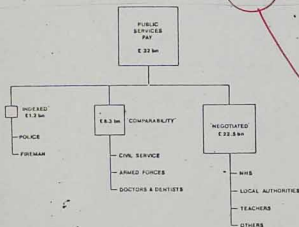
25

ESTIMATED PUBLIC EXPENDITURE YEAR 81 (£1000)



[26]

26



It is important that public sector pay should also decelerate. The size of the problem in the public sector is shown by Mr Hoskyn's chart. Out of a total public expenditure of around £100b more than £30b represents public services pay. Of that £30b only £1 b is fully indexed and a further

£8.0b is subject to comparability. That leaves £22b to be negotiated but if the comparability awards are effectively indexed and backward looking it will be very difficult to prevent the same increases being negotiated in the NHS, local authorities and teachers. In turn this will damage progress in the private sector where it is so vital that pay begins to move in line with monetary growth. The private sector needs the assurance that the public sector will not pull the rug out from beneath their feet.

Outlook and Options

- 27 35. This is the background to the Chancellor's paper on the outlook for the economy and the medium term financial strategy. The MTFS set out a framework for the reduction of monetary growth based upon a steady reduction of the PSBR to 1% of GDP. This was made possible by the plans for lower public spending, and the rising revenue from North Sea oil. The assumption was for 1% per annum growth in 1981-83. As a result of this strategy inflation was expected to fall well into single figures by 1982-83 but the short term unemployment problem would be severe.

RANGES FOR GROWTH OF MONEY STOCK (£M3)

% CHANGE DURING YR LN	78-79	79-80	80-81	81-82	82-83	83-84
—	—	—	—	—	—	—

PUBLIC SECTOR BORROWING - 1978-79 PRICES, £BILLION

TOTAL EXPENDITURE	74.0	74.1	74.1	73	71	70.1
TOTAL RECEIPTS	-85.0	-88	-87.1	-87.1	-88.1	-71
IMPLIED FISCAL ADJUSTMENT	—	—	—	—	3.1	3.1
OSBR	0.0	0.1	7	8.1	4	3
PSBR	0.3	8	6	8	3.1	3.1
PSBR AS % OF GDP	0.1	4.1	3.1	3	3.1	1.1
	78-79	79-80	80-81	81-82	82-83	83-84

[28]

28

EFFECT OF RELAXING MONETARY POLICY
 EG. FISCAL EXPANSION AND/OR LARGE CUT IN INTEREST RATES:
 RAISE MONETARY GROWTH TOWARDS CURRENT GROWTH OF EARNINGS
 SHORT TERM REDUCTION IN UNEMPLOYMENT (AFTER LAGS)
 BUT
 HIGHER INFLATION BUILT INTO ECONOMY WITH DAMAGING CONSEQUENCES
 UNEMPLOYMENT BENEFIT TEMPORARY
 REDUCTION IN INTEREST RATES TEMPORARY

36. Within this framework we can examine some alternative policy suggestions that are often made. Some argue that we should relax the monetary target by fiscal expansion and/or a large cut in interest rates. It is argued that one possible route to lower unemployment is an upward revision of the monetary target so that the clash with earnings is reduced. It is argued - along the lines of my earlier logic - that after a lag this would reduce unemployment. The problem is that

- its effects on unemployment would be short lived and
- it would keep the inflation rate at 20%; further more if it was clear that monetary policy would accommodate earnings growth then we can expect that higher figures would likely emerge. Initially such a policy might ease interest rates as credit was relaxed but soon the higher inflation would increase interest rates.

It is our aim and our expectation that rates of interest, both at the short end and at the long end, should be reduced at a rate compatible with the maintenance of monetary discipline. It would be quite irresponsible to cut interest rates if it

put monetary control in jeopardy. Confidence in the gilt-edged market would be eroded and after a time the demand for credit would rise. This combination would almost certainly mean that monetary control would become very difficult in the course of next winter.

29

37. An alternative way of closing the earnings/monetary gap is to attempt to bring wages and prices into line by statutory means. In the past this has had some short term success but all experience suggests that it will not last for long. The longest possible period is two years. The result of this might be to hasten the reduction in inflation and reduce the unemployment problem. But when the breakdown occurs a pay explosion would take place reversing the progress that has been made. This could occur in 1982/83 and lead to a surge of inflation and unemployment. The important prize is to bring inflation down by market means; this has a much better chance of being maintained.

30

38. A further course of action might be to relax fiscal policy whilst attempting to maintain monetary control e.g. a cut in the NIS is a popular example. Almost certainly this would involve higher interest rates.

[29]

STATUTORY INCOMES POLICY

-POSSIBLY REDUCE UNEMPLOYMENT
AND INFLATION INITIALLY

BUT

-EFFECT ONLY TEMPORARY
EXPLOSION IN 1982/83

[30]

RELAX FISCAL POLICY BUT KEEP MONETARY TARGET

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

- MAY HELP COMPANIES CASH FLOW
AND REDUCE COSTS

BUT

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

The fall in interest rates that we are expecting is conditional upon our success in controlling the PSBR and public expenditure. Although monetary pressures might be expected to ease as recession emerges and inflation is reduced, the monetary target remains tight relative to the current inflation rate. This year's budget has been designed to help the process by reducing the PSBR and the public expenditure plans are designed for the same purpose. A reduced requirement to sell government debt is crucial if we are to get interest rates down; this means lower government borrowing. So far this year there have been PSBR problems emerging with an overrun of expenditure; it is vital that this should be reversed and that the original targets for the PSBR this year are maintained. Any attempt at fiscal relaxation would damage the outlook for interest rates and the prospect of opening up the capital market to private companies. The company sector will be much better off with access to long term debt finance than with some general fiscal relaxation that would be indiscriminate in its effects: it would help banks as well as engineering companies. In addition of course a reduction of NIS would possibly reduce the incentive of companies to resist unrealistic pay claims.

Exchange Rate

31

REDUCE EXCHANGE RATE

3 POSSIBLE ROUTES

- INTERVENTION : WILL IT WORK?
: HOW MUCH WILL BE NEEDED?
: EFFECT ON MONEY SUPPLY AND INFLATION
 - INFLOW CONTROLS (HAVE ALREADY ABOLISHED OUTFLOW CONTROLS)
: CAN THEY BE MADE TO WORK
: MEANS LOWER BOND SALES AND HIGHER INTEREST RATES OR LOWER PSBR
 - LOWER INTEREST RATES
: REQUIRES LOWER PSBR IF WANT TO KEEP MONETARY TARGET
- BUT :** DAMAGES SHORT TERM INFLATION OUTLOOK

39. It is often argued that we should take action to reduce the problems of high exchange rate and the loss of competitiveness. A variety of schemes are put forward.

(i) The first is intervention in the exchange market. How useful this would be is open to question. Experience in 1976 and 1977 suggests that enormous flow across the exchanges can be generated by an attempt to hold the exchange rate in the face of sustained market pressure. During 1977 the authorities intervened heavily and reduced M/R sharply throughout the summer and autumn of that year. The attempt to 'cap' the exchange rate was unsuccessful and the large inflows plus the low level of interest rates at the end of 1977 was probably the main cause of expansion of sterling M3 in the following year.

(ii) the second course of action mentioned is inflow controls. Ideas flow in abundance; from 2 tier interest rates to barring non-resident purchasers of sterling

to 2 tier exchange rates and restrictions on company borrowing abroad for domestic use. All schemes have the fundamental problem of making the controls effective. This could possibly be done for a few months but beyond this requires increasingly elaborate and comprehensive regulations. Such schemes also make it more difficult to finance the PSBR and this could mean higher interest rates and pressure from companies in a different direction. Of course we have taken the major step of abolishing all exchange controls in an outward direction and we have not yet seen the full effect of that adjustment.

- (iv) A third possibility is to attempt to get the exchange rate down by getting interest rates down.

Of course, the lower interest rates would require a reduced PSBR compared to present plans. However such a strategy is by no means certain to reduce the exchange rate as other aspects of

the economy will change. In particular a more restrictive fiscal policy can be expected to push up exchange rate expectations if a lower PSBR reinforces ^{further} the credibility of the Government's Financial Strategy. We see very good reasons for a low PSBR to help interest rates and the capital market but it is by no means certain that it will reduce the exchange rate.

40. We must also bear in mind that some sustained squeeze on competitiveness is probably an inevitable consequence of a determined anti-inflationary strategy. The present squeeze is much greater than was ever imagined but there are beneficial effects as well as difficulties. Although unplanned the stronger exchange rate can still be welcomed as a help to reducing inflation faster. It can be argued that we should attempt to get this stage over as quickly as possible. We believe that it would be extremely dangerous to attempt to engineer a fall as this might be taken to signify a retreat from the principle of sound money. On the other hand some exchange rate fall need not be an issue for too much concern. The pressure on competitiveness would still be substantial.

47. Conclusions

To summarise

- (i) Money supply growth is now under control.
- (ii) There are now signs that inflation is about to turn.
- (iii) To maintain this it is vital that we maintain control over the PSBR and government spending.
- (iv) Unemployment is rising rapidly because of excessive pay settlements. This will continue until pay brought down to monetary growth rate.
- (v) Slowdown in pay and inflation within the monetary target will lay basis for growth and reduction in unemployment.

None of the alternatives are attractive or offer much hope for a sustained improvement in the outlook.

10

FINANCIAL STRATEGY

PERMANENT REDUCTION OF INFLATION REQUIRES
A MONETARY STRATEGY

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

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

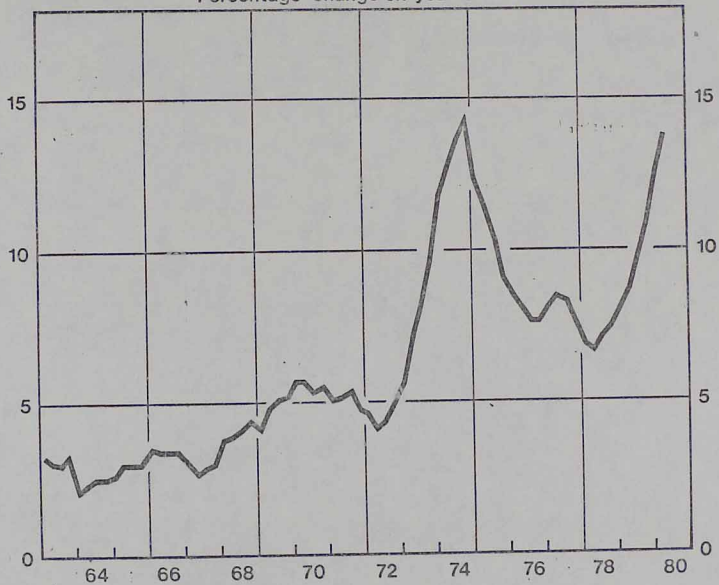
CUT PSBR BY REDUCING SPENDING, TAXES TOO HIGH

INFLATION

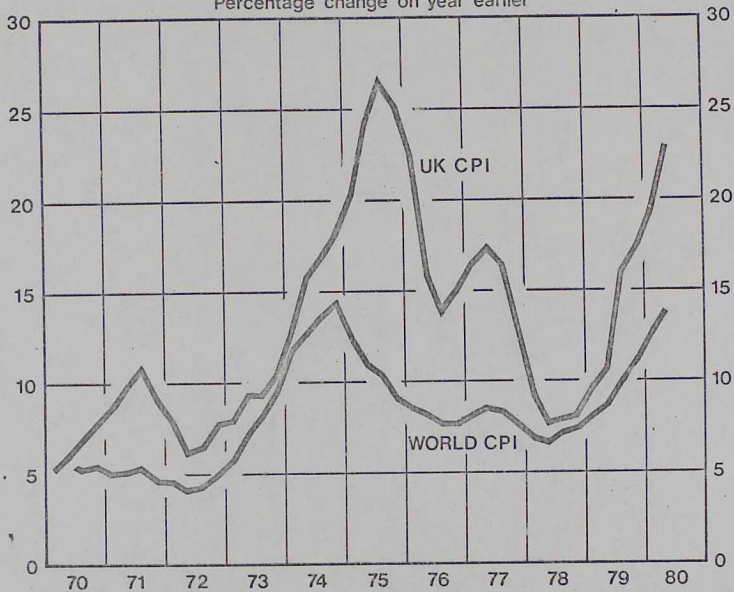
2

	1963-69	1970-78
USA	3.0	6.7
JAPAN	5.0	9.8
W GERMANY	2.5	5.2
FRANCE	3.6	9.0
ITALY	3.4	13.1
UK	4.2	12.8
WORLD	3.4	8.0

WORLD CONSUMER PRICES
Percentage change on year earlier



Percentage change on year earlier

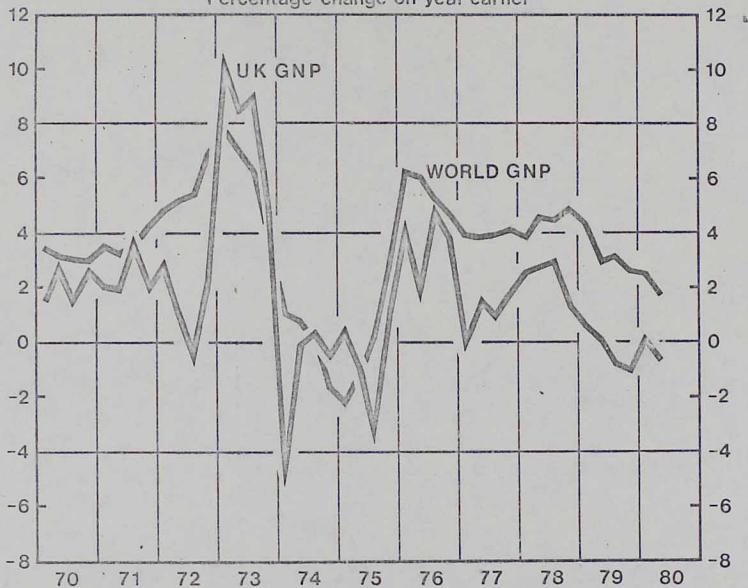


GROWTH RATES

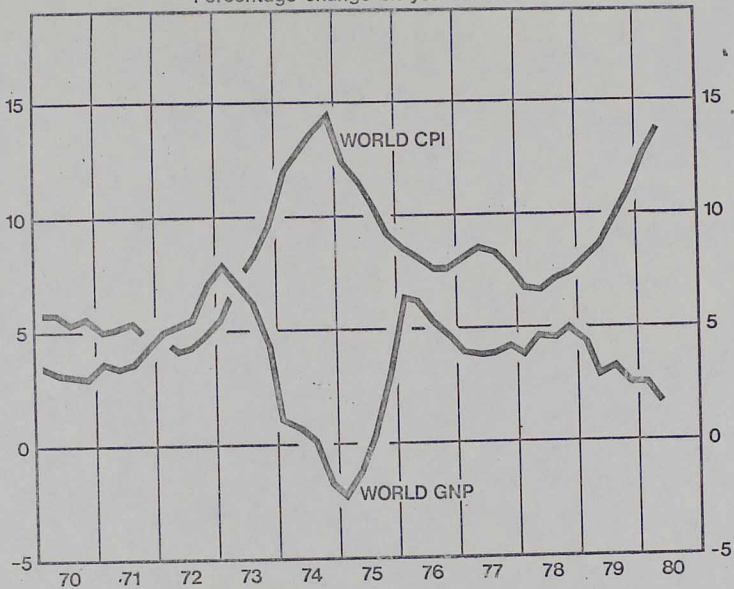
	1963-69	1970-78
WORLD	5.3	3.6
USA	5	3.3
JAPAN	4.8	5.3
GERMANY	8.4	2.7
UK	2.9	2.3

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

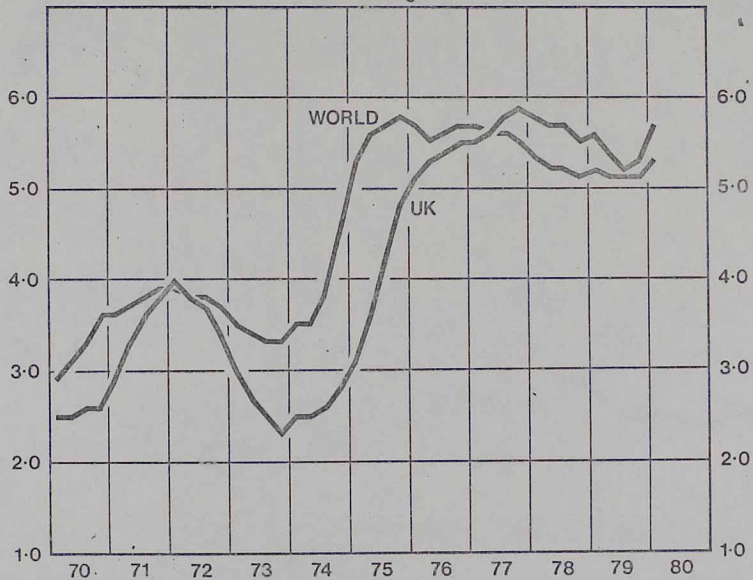
GROSS NATIONAL PRODUCT
Percentage change on year earlier



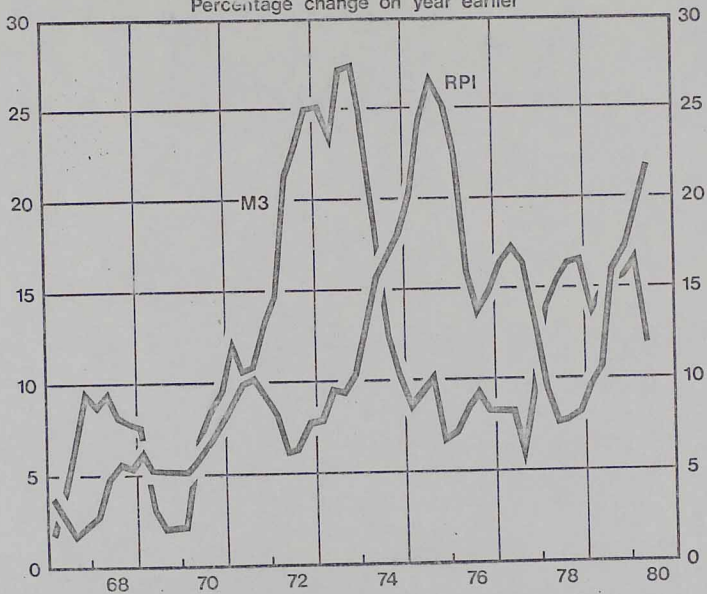
Percentage change on year earlier



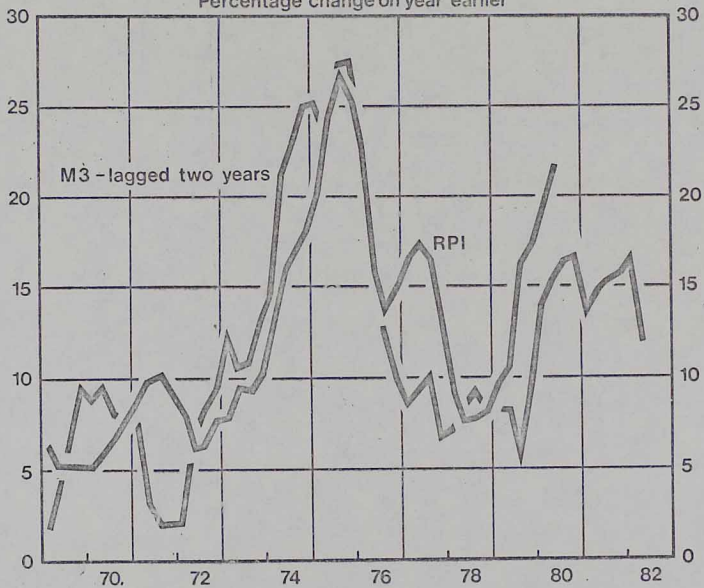
UNEMPLOYMENT Percentage



Percentage change on year earlier



Percentage change on year earlier



INFLATION

UNDERLYING FORCE IS MONETARY GROWTH

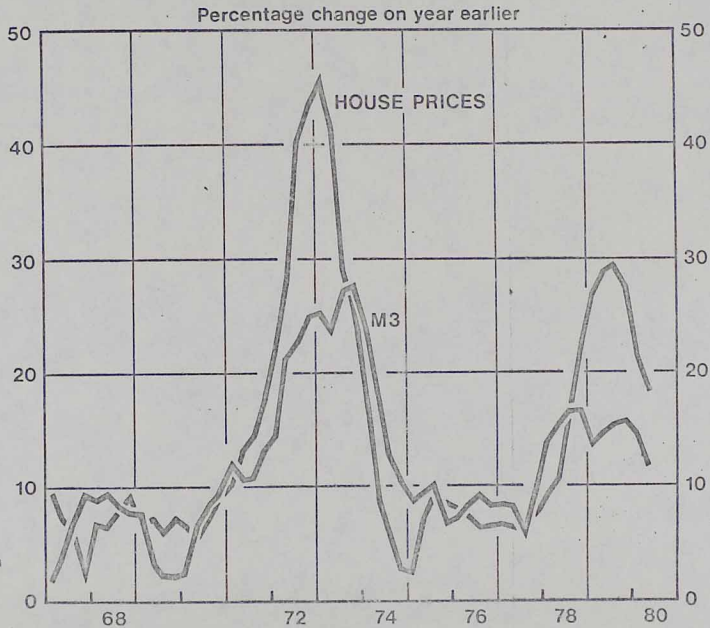
TEMPORARY FACTORS CAN ALSO BE IMPORTANT

OIL PRICES AND WORLD PRICES

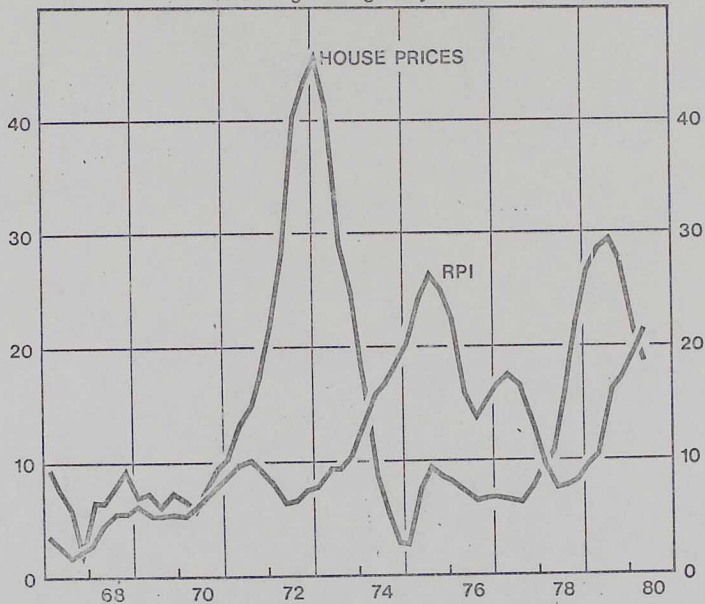
RISE IN VAT

TIMING OF NATIONALISED INDUSTRY PRICES

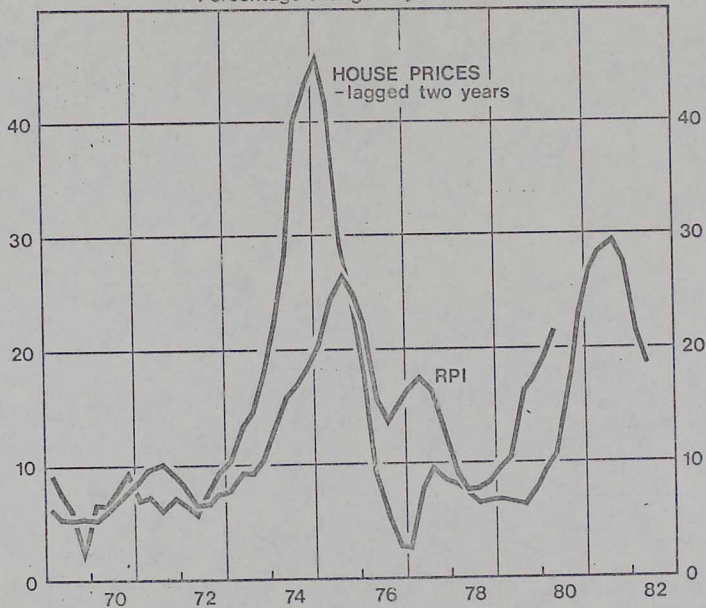
TIMING OF PAY SETTLEMENTS



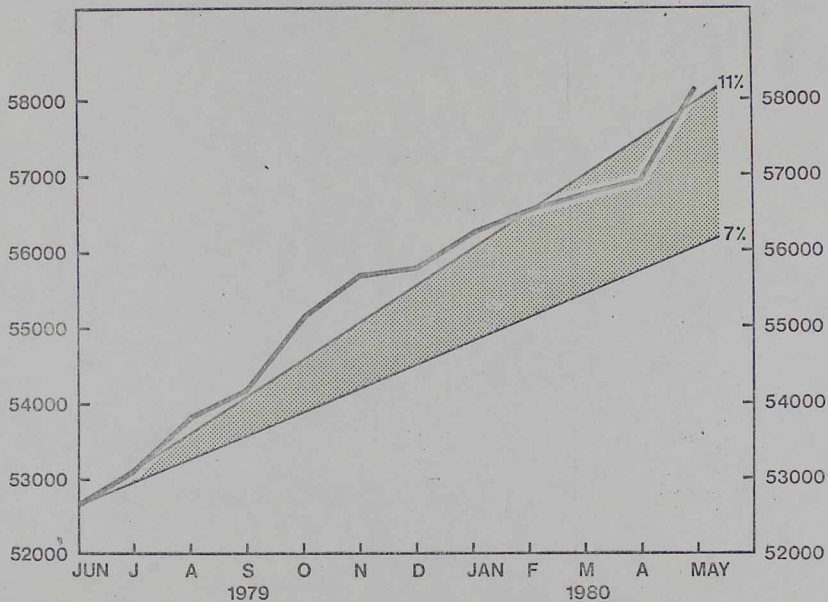
Percentage change on year earlier



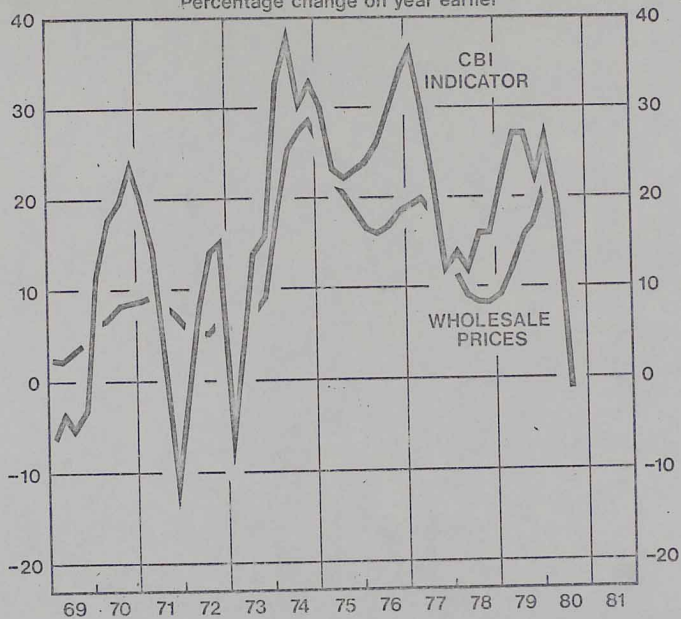
Percentage change on year earlier



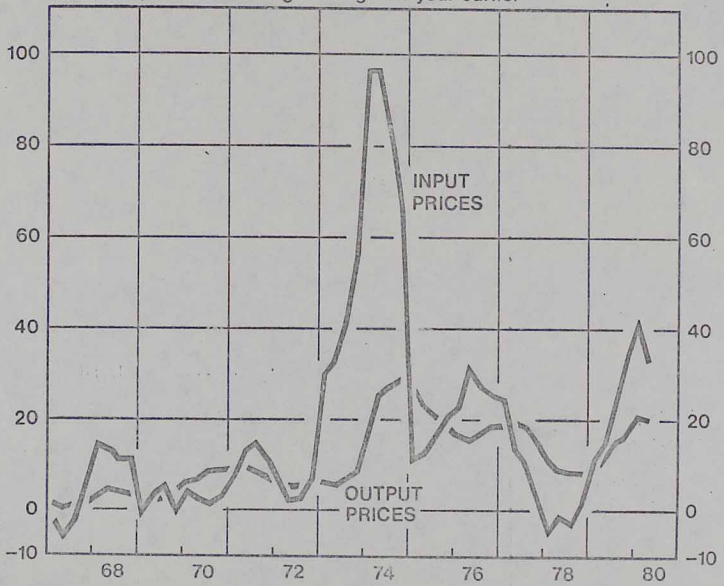
£M3 AND THE TARGET £ million



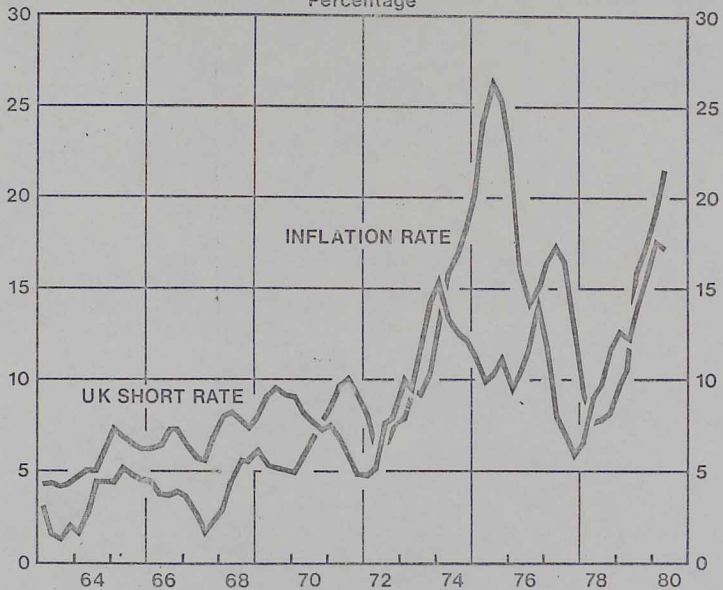
Percentage change on year earlier



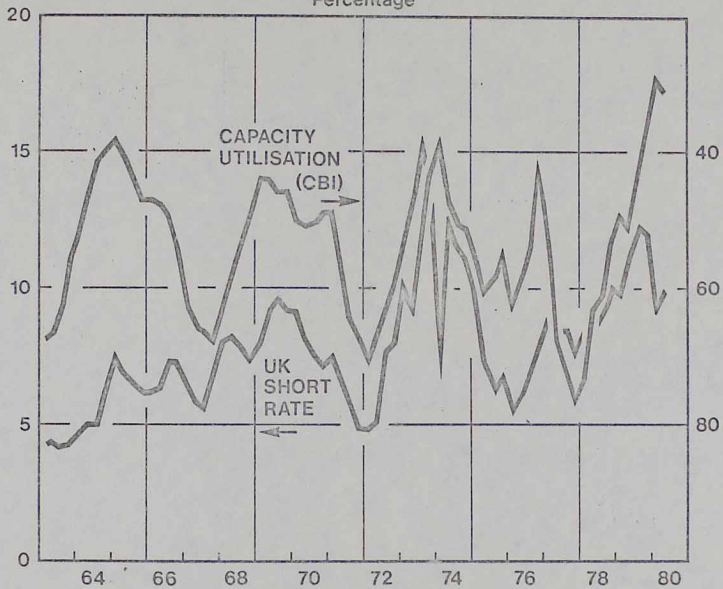
Percentage change on year earlier



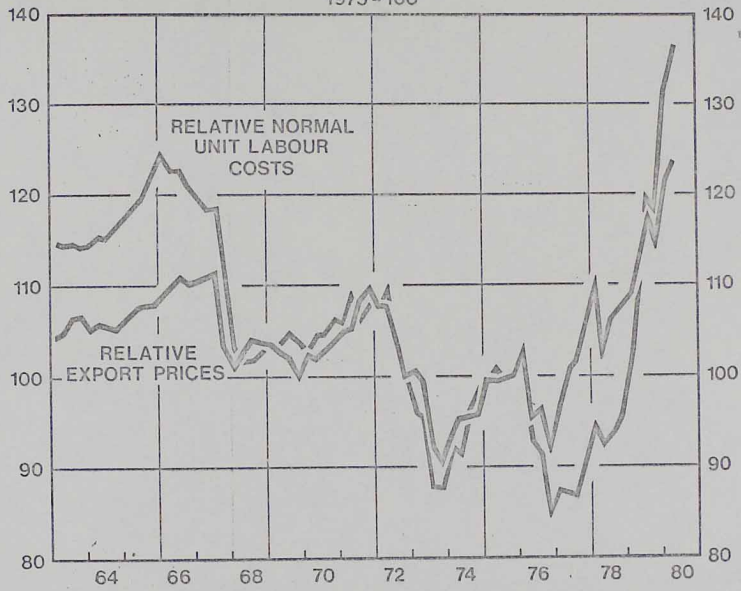
INTEREST RATES AND INFLATION
Percentage

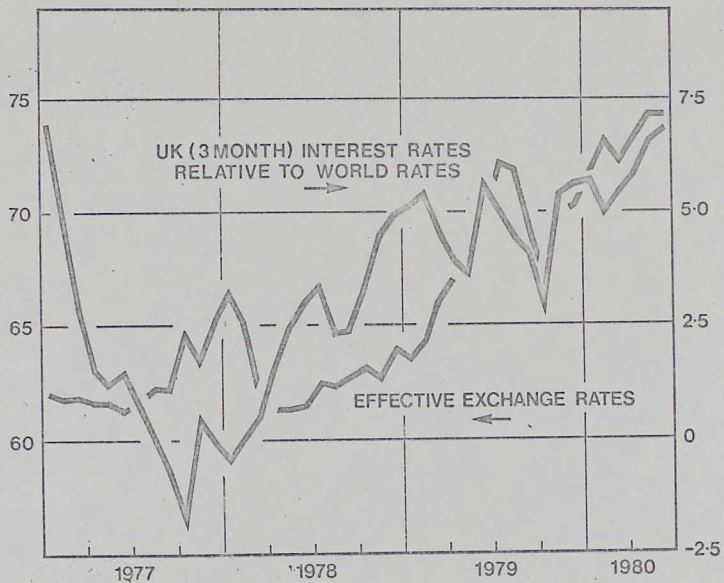


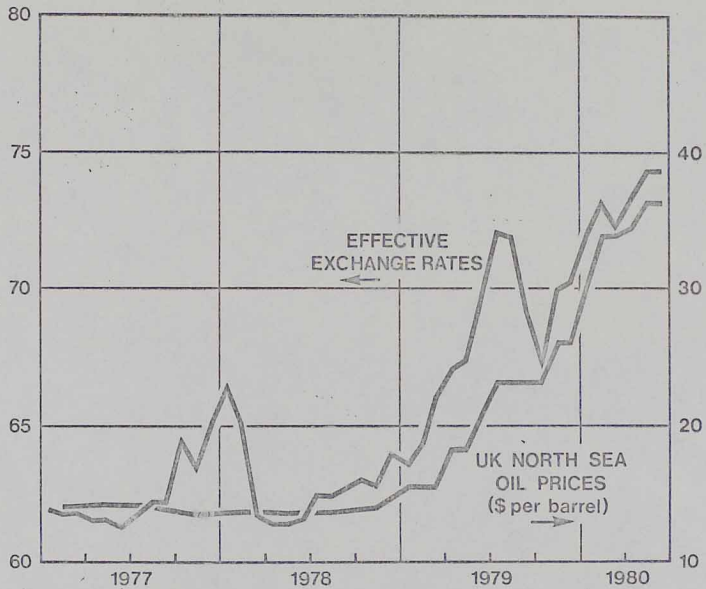
Percentage

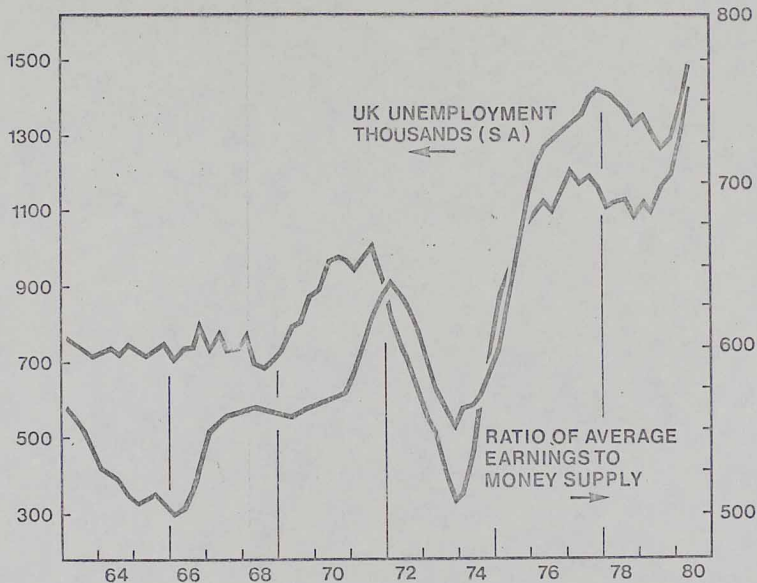


COMPETITIVENESS
1975 = 100









ESTIMATED PUBLIC
EXPENDITURE
1980-81 (CASH)

25

TOTAL
PUBLIC
EXPENDITURE

£98 bn

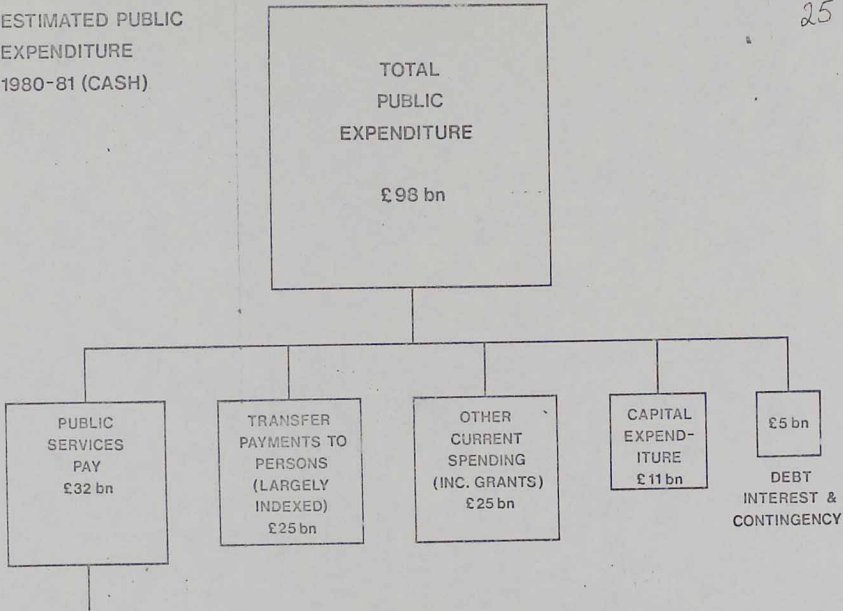
PUBLIC
SERVICES
PAY
£32 bn

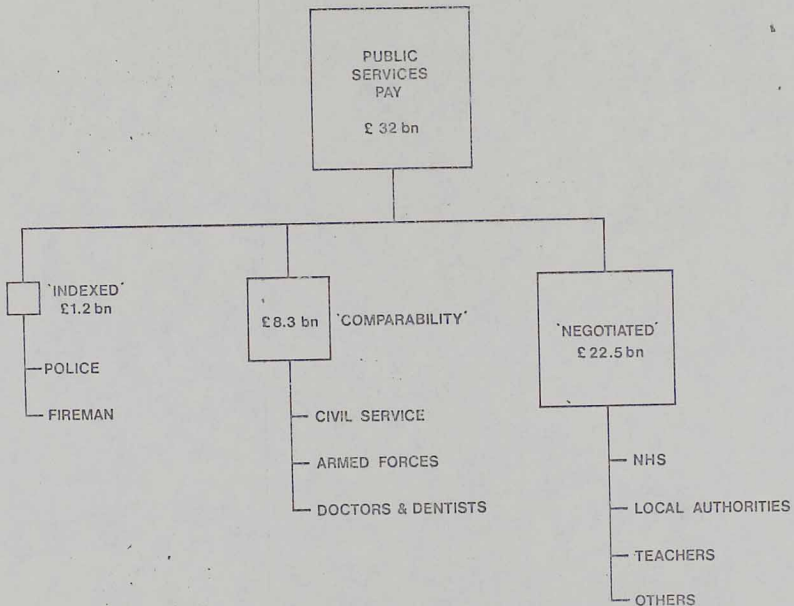
TRANSFER
PAYMENTS TO
PERSONS
(LARGELY
INDEXED)
£25 bn

OTHER
CURRENT
SPENDING
(INC. GRANTS)
£25 bn

CAPITAL
EXPEND-
ITURE
£11 bn

£5 bn
DEBT
INTEREST &
CONTINGENCY





RANGES FOR GROWTH OF MONEY STOCK (£M3)

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

PUBLIC SECTOR BORROWING - 1978-79 PRICES, £BILLION

TOTAL EXPENDITURE	74.0	74½	74½	73	71	70½
TOTAL RECEIPTS	-65.0	-66	-67½	-67½	-69½	-71
IMPLIED FISCAL ADJUSTMENT	—	—	—	—	2½	3½
GGBR	9.0	8½	7	5½	4	3
PSBR	9.3	8	6	5	3½	2½
PSBR AS % OF GDP	5½	4¾	3¾	3	2¼	1½
	78-79	79-80	80-81	81-82	82-83	83-84

EFFECT OF RELAXING MONETARY POLICY

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

RAISE MONETARY GROWTH TOWARDS CURRENT GROWTH OF EARNINGS

SHORT TERM REDUCTION IN UNEMPLOYMENT (AFTER LAGS)

BUT

HIGHER INFLATION BUILT INTO ECONOMY WITH DAMAGING CONSEQUENCES

UNEMPLOYMENT BENEFIT TEMPORARY

REDUCTION IN INTEREST RATES TEMPORARY

STATUTORY INCOMES POLICY

-POSSIBLY REDUCE UNEMPLOYMENT
AND INFLATION INITIALLY

BUT

-EFFECT ONLY TEMPORARY

EXPLOSION IN 1982/83

RELAX FISCAL POLICY BUT KEEP MONETARY TARGET

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

- MAY HELP COMPANIES CASH FLOW
- AND REDUCE COSTS

BUT

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

REDUCE EXCHANGE RATE

3 POSSIBLE ROUTES

- INTERVENTION : WILL IT WORK?
 - : HOW MUCH WILL BE NEEDED?
 - : EFFECT ON MONEY SUPPLY AND INFLATION
- INFLOW CONTROLS (HAVE ALREADY ABOLISHED OUTFLOW CONTROLS)
 - : CAN THEY BE MADE TO WORK
 - : MEANS LOWER BOND SALES AND HIGHER INTEREST RATES OR LOWER PSBR
- LOWER INTEREST RATES
 - : REQUIRES LOWER PSBR IF WANT TO KEEP MONETARY TARGET

BUT

DAMAGES SHORT TERM INFLATION OUTLOOK



DEPARTMENT OF INDUSTRY
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123 VICTORIA STREET
LONDON SW1E 6RB

TELEPHONE DIRECT LINE 01-212 3301
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PS/Secretary of State for Industry

Tim Lancaster Esq
Private Secretary to the Prime Minister
10 Downing Street
LONDON SW1.

28 July 1980

Prime Minister

at the Lyham

A gloomy

Dear Tim,

catalogue.

mb Very - low cost
industries - this
state effort
to support
so many
gloom
members
in

Following the Prime Minister's discussion with Lord Trenchard at lunchtime today, my Secretary of State promised to let her have a note giving examples of the range of circumstances of various sectors of industry. I attach a note which classifies industries into four categories ranging from those sectors that are particularly hard hit to those who can be described as successful. I should emphasise that the note is partial; for example it excludes vehicles and clothing. More importantly, it excludes food, drink and tobacco and pharmaceuticals, sectors which are not sponsored by this Department but which are relatively successful.

2 I should also emphasise that one crucial point which needs bearing in mind throughout is that the variability between companies within a sector may well be as great as the variability between sectors. Finally, I should say that the note is intended as background briefing rather than as material which can be drawn on in any speech.

Yours ever,
Pete

PETER STREDDER
Private Secretary

Would it
help industry
if we reduced
D.O.I. numbers
?!

mb.



SITUATION AND PROSPECTS OF INDUSTRIAL SECTORS

A. Sectors Particularly Hard-hit

Sectors such as textiles, cutlery and newsprint have been in difficulty of one kind or another for many years, and are clearly in no position to withstand the current combination of high domestic inflation compared to that in competitive countries, relatively high interest rates, a strong and rising pound and falling demand. The decline of these sectors was, perhaps, never reversible except through disproportionate state support; but this decline has now accelerated with consequences we might have hoped to avoid.

2 On the other hand, sectors such as consumer electronics, where in many cases the UK was quite successful until fairly recently, are succumbing to the "deadly cocktail" of economic circumstances. Such sectors, which were thought to have a basic capacity for success, may be debilitated to the point of no return.

PAPER AND BOARD

3 With a few exceptions such as tissues, this is a sector in long-term decline which will be accelerated by the recession. We are at a severe disadvantage to competitors with large timber supplies and hydro-electricity. Products abandoned: we are being driven out of newsprint production. Company Closures: Bowaters, Ellesmere Port may well close down. There have already been several other closures. Measures taken: short-time working is widespread. About half the sector is losing money. About 5,000 redundancies can be expected, though most of the sector will survive.

LEATHER

4 This sector was thought to be viable on the whole, but is now in serious difficulty. Practically all companies are operating at a loss. Only a handful will survive another 12 months of present conditions. 11,000 jobs may be lost.

TEXTILES AND CARPETS

5 - This sector is suffering a long-term decline which the present climate is accelerating. All of the carpet industry and 95% of textiles is loss-making. About 85% of the sector can survive another 12 months of difficult conditions, provided the Temporary Short-time Working Compensation Scheme is extended. About 55,000 jobs will be lost.



CUTLERY

6 This is another sector suffering long term decline, and its problems are well known. About 60% of companies in the sector are making losses but about 70% of the sector can probably survive for a year, with a job loss of 1,000.

CONSUMER ELECTRONICS

7 The low-technology end of this sector, eg portable radios, had already succumbed to low cost Far East competition and its decline cannot be blamed on current adverse conditions. The effect on the up-market sectors is rather more worrying. The whole sector is loss-making. About 10,000 jobs are at risk.

LOW TECHNOLOGY CONSUMER ELECTRONICS

8 This sector is in long-term decline which will be accelerated by the recession. Far East producers have captured the market by low cost mass production and import penetration is over 80 per cent. Products abandoned: we have virtually withdrawn from portable radios and cassette recorders. In-car entertainment is little better off. We are rapidly being driven out of monochrome televisions and music centres. Company closures: Rank Radio International (Music Centres) has closed. So have Thorn Consumer Electronics' monochrome TV factory and Grundig's Belfast factory. There have been redundancies and lay-offs throughout the sector. Measures taken: there seems relatively little scope for remedial action by management.

COLOUR TELEVISION

9 This sector has been thought to be viable but is likely to be severely damaged by the recession. It has invested heavily to restore its competitiveness but is now threatened by market conditions. The proposed increase of taxation on TV rental companies will exacerbate the problem. The industry believes that import protection is essential to tide it over until it is re-established.

SPECIALIST HI-FI

10 This sector has been thought viable but is likely to be damaged by the recession. It is a sector of low volume, export dependent business with many small firms. We have been competitive in the past but present conditions put the sector at risk. Measures taken: there have been redundancies and lay-offs, for example, at KEF and Celestion, two manufacturers of high quality loud-speakers, an area where the UK has been a leader.



B. Sectors of Varied Experience

11 Mechanical engineering is a representative sector of very mixed experience both as regards sub-sectors and firms. A few examples follow from which generalisations should not be made.

MECHANICAL ENGINEER - MACHINE TOOLS

12 This sector is thought to be viable and on the whole will not be seriously damaged by the recession. The advanced sectors eg numerical control, robots, show good signs of an improved technological position which can be exploited when the upturn comes. But there is heavy reliance on the motor industry for demand and the traditional sectors, such as heavy power presses, have a poorer outlook. The situation is very mixed: Jones & Shipman, for example, are working overtime. Products abandoned: gear grinding and jig grinding machine tools production is at risk. Company closures: Herberts have collapsed; some parts of large groups are closing, eg Stirk (Elliott Group) and Staveley's Asquith plant. KTM is being starved of funds by its parent Vickers. Measures taken: the following measures are being taken across a broad band of the mechanical engineering industry. These remarks therefore apply also to the following five industrial sectors of the mechanical engineering industry. De-manning and stock reductions have occurred. Efforts are being made to preserve product development programmes. There is a determination to contain pay settlements to 12 per cent compared to the 16 per cent conceded last pay round. There is still a great deal of confidence both in Government policies and in the business outlook throughout a broad swathe of the mechanical engineering industry. 10% of the machine tools sector is loss-making and 6000 jobs may be lost.

MECHANICAL ENGINEERING - SPECIALISED MANUFACTURING MACHINERY

13 This miscellaneous sector has been thought viable but is likely to be damaged by the recession. These are industries where it is essential to preserve a technological lead. The ability to do this is being seriously weakened by pressure on liquidity. Products abandoned: injection moulding machinery is at risk but management action at the main UK company is now being taken. Company closures: Vickers heavy engineering interests are in decline. Profitability varies from food processing machinery (10% loss-making) to textile machinery (55% loss-making). About 5000 jobs may be lost.

MECHANICAL ENGINEERING - MINING MACHINERY

14 This sector is viable and should not be seriously damaged by the recession. A history of successful exporting and the prospect of greater worldwide emphasis on coal are favourable factors. The sector is profitable.



MECHANICAL ENGINEERING - OFFICE EQUIPMENT

15 This sector has been thought viable but is now likely to be damaged by the recession, though there will be exceptions. Major firms with advanced products eg Rank Xerox should have little difficulty but smaller, technology-based firms as well as firms with mechanical products are at risk. Products abandoned: we no longer make office typewriters. Chubb is likely soon to cease production of cash registers.

MECHANICAL ENGINEERING - METAL PRODUCTS

16 In this sector are included products like industrial fasteners and bearings which are heavily dependent on the declining UK automotive industry and such sectors will tend to survive only on a reduced scale. Bearings are still performing surprisingly well. It is difficult to generalise about so diverse a sector. Company closures: the closure of GKN's remaining industrial fastener companies is possible though those which GKN has already sold off are doing quite well.

MECHANICAL ENGINEERING - MISCELLANEOUS CONSUMER GOODS

17 This sector has been considered viable but is likely to be damaged by the recession. Some sectors such as gas appliances, clocks and watches and hand tools are faced with individual problems on top of the downturn in demand. But these sectors are so diverse that an overall judgement is almost meaningless. Products abandoned: domestic sewing machines are no longer made here.

C. Sectors which are "holding their own"

ELECTRONIC COMPONENTS

18 With one exception, this sector is viable and should not be seriously damaged by the recession, but prospects will be weakened if new developments are not exploited. Products abandoned: we are likely to be driven out of discrete passive components by high volume producers like Japan. Only about 5% of companies are loss-making.

TOYS

19 This sector is thought to be viable and should not be badly damaged by the recession. Despite the gravity of the situation, the industry is vigorous and entrepreneurial. In the past it has proved its ability to overcome setbacks. At present, however, most companies are loss-making. Company closures: Dunbee-Combex-Marx has gone into receivership. Measures taken: redundancies are widespread; there have been 2,000 at Lesney.



MECHANICAL HANDLING EQUIPMENT

20 This sector is mostly viable and will not be seriously damaged by the recession. There has, however, been a sharp decline in orders. Products abandoned: heavy fixed crane production may be on the way to discontinuation. Company closures: Stothert & Pitt and Herbert Morris (Davy Group) are at risk. Measures taken: there have been redundancies and short-time working is common. Most of the sector is profitable and about 95% of jobs should be preserved this year.

21 Numerous other sectors could be included in this category. Examples, without going into detail, are industrial electrical equipment, scientific instruments, private steelmaking and foundries.

D. Successful Sectors

COMPUTERS

22 This sector is viable and should not be much harmed by the recession. Growth is reduced from the 20 per cent which firms might have expected, to a level of 10 per cent which many other sectors would find more than satisfactory. But profits are being squeezed and there is a shortage of resources for market and product development in this sector, which requires to spend substantial sums. The smaller firms are the worst affected. Government procurement is an important factor in demand. Company closures: one small company has gone into liquidation and another is in difficulties. Measures taken: ICL will have to reduce its R&D spending unless the situation improves. Nearly all of the sector is profitable and there are still many job opportunities.

AEROSPACE

23 This sector is viable and should not be badly damaged by the recession. It has full order books but is highly dependent upon Government purchasing, which is possibly a more important factor than the short-term economic climate. Measures taken: no measures are needed, there is no short-time working, no lay-offs or closures are in prospect. Rolls Royce is the only loss-maker.

VARIOUS CHEMICAL, PLASTIC, RUBBER AND OTHER GOODS

24 Covered in this paragraph are tobacco, man-made fibres, rubber goods, asbestos, industrial gases, bulk organics, plastics, paints, toiletries, soap and detergents. These sectors are regarded as viable and should emerge from recession in a reasonable state. Certain areas are being badly affected by low US feedstock prices. Company closures: several firms are at risk eg Nypro (Nylon 6 Monomer), Turner & Newall, Steetley, Ilford. Measures taken: lay-offs, short-time working, redundancies, cut-backs in stocks, R and D and capital investment have all occurred in order to minimise the effect of the recession. It is hard to generalise too much but despite pockets of unprofitability this sector is quite successful.



TELECOMMUNICATIONS

25 This sector is generally viable and not likely to suffer severely from the recession although there are exceptions. It is in the process of changing from analogue to digital technology. An example of this is the development of System X, for which British Telecommunications' investment programme is crucial. The export potential of System X, which will not be ready for delivery until 1982/83, is threatened by Western European and Japanese competition. The end of the Post Office monopoly poses both a challenge and a threat to UK makers of terminal equipment. The sector is making profits and the great majority of jobs will be retained.

BROADCASTING EQUIPMENT

26 This sector is viable and is unlikely to be seriously damaged by the recession. However, the industry depends on the public sector and on exports. So far our competitiveness has been adequate but further deterioration could make the overall assessment above optimistic. The industry will be buoyed up by work for the fourth television channel and by public sector orders for short-wave radio transmitters. Considerable investment will be needed for the change to digital technology.

Department of Industry

July 1980

SECRET

25 July 1980

Policy Unit

*Original returned
to J. Hoskyns*

PRIME MINISTER

THE PAY ROUND DEBATE AND THE "FEAR OF NORMS"

On Wednesday 23 July, E discussed comparability, cash limits and influencing national pay behaviour for the next pay round.

The attached paper examines some of the issues, and conclusions reached, at that meeting.

I have copied it to members of E and other colleagues present, to Robin Ibbs and also to Sir Robert Armstrong.

JH

mt.

JOHN HOSKYNs

SECRET

THE PAY ROUND DEBATE AND THE "FEAR OF NORMS"1. INTRODUCTION

- 1.1 On Wednesday, E discussed the closely interrelated subjects of comparability, cash limits and influencing national pay behaviour for the next pay round.
- 1.2 We are in danger of missing an opportunity to influence expectations. A clear message about the pay outturn we wish to see in the public services could be added to the events or announcements (high unemployment, Clegg) which are or will be focussing attention on the next round.
- 1.3 The discussion at E was confused because we were talking at cross purposes about norms. We ended up rejecting the idea of mentioning any figure, because this was seen as constituting a "norm". There was, in fact, no definition of what a "norm" meant. This confused our thinking on public services pay and the extent to which the Government, as principal paymaster, is trying to influence the prevailing mood, rather than allowing itself to be influenced by whatever mood happens to prevail.
- 1.4 This paper attempts to dispel some of this confusion, and suggests that the Government has much to gain and nothing to lose by stating a figure or a narrow band.

2. WERE WE TALKING ABOUT A NORM OR AN OBJECTIVE?

- 2.1 The word "norm" means different things to different people, depending on their past experience and whether they have really thought about it: whether, at one extreme, they see it as a challenge to the unions or, at the other, simply as a stated objective, a desired outcome.
- 2.2 A norm can either be a command or a call for voluntary restraint. A 9% case-by-case public service norm would mean that this figure must be achieved in every public service negotiation, whether voluntarily or by order. The dangers of such a norm are obvious.

SECRET

The Government has everything to lose by "issuing orders" which are not readily obeyed and which in some cases could never be enforced. It has a great deal to lose even by making an appeal which is ignored (hence our repeated advice that anything which sounds like exhortation should be avoided).

- 2.3 An objective is quite different. The MTFS itself embodies certain objectives. We are not ordering people to deliver the MTFS objectives. We cannot guarantee their fulfilment. But we have to commit ourselves unequivocally to going all out for their achievement, because that commitment itself makes the achievement more likely. So it is with the cash limits and pay outturns which flow remorselessly from the commitment to MTFS.
- 2.4 If we don't answer the question, "What would the Government like to see as the pay outturn for the public services?" we are effectively saying that we do not know what the implications of the MTFS are for cash limits and pay; or else that we know, but for some reason will not say.
- 2.5 We have already agreed, internally, our objective for the aggregate outturn. It is 9%. Is that figure roughly right (leaving aside for the moment whether it is attainable)? Does it fit the M_3 targets and the MTFS? The next Section looks briefly at this question.
3. HAVE WE GOT THE IMPORTANT NUMBERS RIGHT?
- 3.1 If this 9% objective is to apply to pay outturn, then it must broadly apply also to cash limits, of which pay is the major component in most cases. It must therefore, by extension, apply to the Government's total expenditure of £98bn (1980/81 cash). If it does not do so, then the public sector is not bearing its share of the monetary deceleration. A 9% increase on £98bn is £8.82bn. But about £34bn of that (most transfer payments plus defence) will be fully-indexed. As we understand it (and we may have got this wrong) the "forward-looking" basis for this indexation is really backward-looking. The past year's RPI increase is applied "forward" to the coming year. If this is correct, and if we assume 15% rather than PESC 80's 17%, this £34bn would be increased by £5.1bn. Thus, only the difference (£8.82bn-£5.10bn), ie £3.72bn, would be available

SECRET

for increasing the un-indexed balance of £64bn. That £64bn could therefore only increase by 5.8%. If we regard other parts of public expenditure (eg health and education) as effectively indexed as well, then the increase available to the un-indexed part becomes much smaller.

- 3.2 If our concern about the indexation of large parts of public expenditure is based on a misunderstanding, then no new problem arises, and we can go straight onto Section 4 below. If, however, we are right, then not only are we talking about a public services pay outturn objective of less than 6%, but other more fundamental questions about public expenditure arise. The indexing problem (if it is a problem) stems from an almost unquestioned assumption that the Government is merely another participant in the economic process, and must therefore protect itself against inflation as best it can, just like any private party. This can't be right.
- 3.3 Perhaps we will eventually have to consider turning the whole process upside down: doing all the forecasting in cash terms, based on forecast inflation, as in PESC 80; establishing cash limits, in exactly the same way as the monetary targets in MTFPS; adjusting cash limits downwards only, if inflation turns out to be lower; but not upwards if inflation turns out to be higher.
- 3.4 In our paper on "Public Sector Pay" of 18 July, we said:

"It won't even be possible to say what a realistically achievable result is, until that team has done the sort of thinking suggested in this paper "

If the above analysis is right, the task is more daunting than we had realised. But that is not an argument for not doing some preparatory thinking, on the grounds that "grand strategies never work" etc! If we are about to scale Everest single-handed without oxygen, we might as well know before we start.

4. THE E DISCUSSION WAS ABOUT NORMS NOT OBJECTIVES

- 4.1 The conclusion of E assumed that any number used would be a norm, a "command", amounting to a brittle, all-or-nothing strategy. At its

simplest, our thinking consisted of three propositions:

- "1. We tried a norm last time and it ended in disaster.
2. Anything which involves the Government stating a number is a norm.
3. What is being suggested here involves stating a number. Therefore it's a norm. Therefore it will end in disaster."

There was reference to the miners in 1974. But that was a different situation involving a definite norm, for the whole country, and a near-monopoly nationalised industry, in the immediate aftermath of the first massive OPEC price rise. In the coming round, there would be no norm, no formal national pay policy, nearing the end of its tether; money supply would be decelerating not accelerating; RPI falling not rising; very different trade union attitudes; a greater readiness by employers to ballot (in the public services too, if we try); £12 deeming. But Government would state an objective for aggregate public services pay. Almost everything that matters would be different. We really have to think carefully before concluding that we are comparing like with like.

- 4.2 It was suggested that it would be easier to mention the figure in a couple of months' time when we have "a better idea of what the pay bargaining climate will be". But are we trying to set that climate or simply respond to it? We suggest that, since the Government is disposing of £98bn in the current year, of which public services pay is £32bn, and another £34bn is indexed, the Government is the climate - or a large part of it.

- 4.3 There is, of course, a case for preserving flexibility so that the Government does not nail its flag to the mast for a precise figure in a particular negotiation, where even marginal defeat is seen as a blow to the Government's credibility. We must have flexibility in order to move at the margin, both under negotiating pressures and under supply and demand requirements. But we're not, in any case, proposing a deliberate and rigid challenge. We are proposing that we should state an objective, a desired outcome, and then conduct the debate in such a way that trade union threats or promises to exceed that figure, far from becoming evidence of virility and

SECRET

leadership, become marks of shame and stupidity, incurring public odium.

- 4.4 It has frequently been said, at E meetings, that we wish to see a "scatter" of outcomes, as greatly preferable to a single figure. Why? In the event, we certainly will get a scatter, because we would be using our flexibility to drive down the weak bargaining units in order to compensate for surrender to the strong ones. But we shouldn't fall into the trap of thinking that such a range of outcomes proves the existence of a market. A real market would certainly produce a range of outcomes; the reverse is not true! In the public services, except at the margin and in particular areas where the employer is free to try to match supply and demand, the scatter of outcomes is evidence not of a market, but of the precise opposite: conflict between more and less powerful labour monopolies.

5. HOW TO USE A STATED OBJECTIVE FOR PUBLIC SERVICES PAY

- 5.1 Even if the objective is "only" 9%, rather than 6% or less, the task is formidable. As we said in our earlier paper:

"We only have to look at Annex A to see what we're up against; the great variety of different bargaining groups, with their negotiations spread right out through the year giving maximum opportunity for each group to search for "upward comparators"; improve its own negotiating technique; make the best use of its disruptive powers."

We still believe that, while efforts at "grand strategy" cannot guarantee success, an unthinking serial approach, taking each case as it comes, without any attempt to think a few moves ahead, is most unlikely to produce an outcome compatible with the MTFS objectives. The fact is that when people do a bit more thinking, they tend to think of things they wouldn't have otherwise have thought of! That's all. We saw this with the decision to reduce MPs' pay to less than 10%. We came very close to missing this opportunity as a result of not thinking our way through to the 9% objective for public services pay early enough to influence our thinking about the TSRB. We then had second thoughts - fast.

SECRET

- 5.2 This paper proposes that negotiations should be dealt with, case by case, but with an overtly stated objective for the pay outturn, which the Government cannot enforce, but hopes to see and will try to achieve, so that all parties know the ball park in which the employers will be negotiating, and the economic justification for it.
- 5.3 E's present position is that there should be case-by-case negotiation but with no publicly-stated pay objectives. We regard this as an unsustainable position. First, a number or a narrow range is bound to emerge sooner or later, and is indeed already doing so. Second, if the Government continually refuses to acknowledge such a number, it appears not to know what it's doing, or else to have decided to follow events, rather than lead the way in changing expectations.
- 5.4 If there's going to be a figure, make sure it works for us
- 5.4.1 We should be using the high unemployment figures, and the dissolution of Clegg together with a stated pay objective, to do two things: first, to open up the debate and change attitudes especially among public service workers (whose opinions are never "tracked" by their employers, we would guess); second, to establish clearly that the last pay round is now over. This is important, because with an "endless belt" of 11 months, it is very difficult for the public to realise, for example, that the British Telecommunications 20% increase belongs to the same pay round in which the local authority manuals settled last November for 13%.
- 5.4.2 What the debate can cover. Here are some of the messages which can come over during the debate:
- (1) The less we spend on public service pay, the more we can do for those who need help (1% on pay translated into hospitals, old people's homes, schools, Youth Opportunities Programme). So those who want to force us to pay more want to take away from relief of unemployment and other hardships.
 - (2) Ensure greater awareness of the net cost of striking. Public service employers can prepare the information. The net cost of the steel strike to the individual strikers should be explained. The media could be encouraged to put across the facts.

- (3) Relate the falling RPI to the Government's strategy and the limits of public sector cash. Show people how the whole thing hangs together. They either help to make it work faster, or try to stop it working. Which do they want? Which do their union leaders want? Why?
- (4) Heighten the conflict of interest between public sector and private sector workers. Point to the lower settlements, the mounting bankruptcies and unemployment in the private sector. Open up the moral issue for public sector workers in strong positions. How do they justify their high claims? Where is the money to come from? Which weaker groups will have to pay for it? Is it fair?
- (5) Expose the intellectual and moral bankruptcy of the trade union position. The greater the rumpus, the more damage they tend to do themselves, provided we are prepared to take them apart, honestly and objectively, when they talk nonsense. For example, on television on Tuesday, Len Murray argued that high pay was not the cause of Britain's problems. He then said: "If high pay was the cause of the problem, Germany would be flat on its back by now". He was allowed to practise this deliberate disinformation, despite the responsibility of his position. No-one in Government or the CBI challenged him. No-one asked him whether he really meant that German workers were more productive because they had higher pay, rather than vice versa. This sort of rubbish will continue as long as it is not challenged.
- (6) Answer "what if" questions about inflation and unemployment, for different levels of pay settlement.
- (7) We can deliberately take out insurance against failure to achieve our 9% outturn by frankly admitting that we can't win them all; that there are some groups with enough power, if they are sufficiently unscrupulous, to get a higher settlement paid for by others. This achieves two things: first, it insures against our staking everything on case-by-case success; second, it puts increasing moral responsibility on powerful groups and, by close association, on the unions

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in monopoly nationalised industries whose pay settlements we are not trying to curb directly, but which can have serious knock-on effects in both the public services and the private sector. But this moral pressure can only work if the Government shows that it does care about the human aspects of unemployment.

6. MISCELLANEOUS POINTS

6.1 Public service expectations

6.1.1 In our next opinion research, we will be checking to see what public service workers are expecting in the next pay round. At an anecdotal level, we happen to know that in one particular fire station, the general expectation was that the Government would impose single figures on firemen, as it had done on MPs.

6.2 Greater synchronisation of pay bargaining in the public services

6.2.1 There was some discussion of this at E. The difficulty of preventing leapfrogging, with a year-long public services bargaining process, is increasingly recognised. For example, the following large groups would all be negotiating at the end of the coming pay round, so that their actual awards will run well on into the following round when we would be hoping for settlements to be lower (in other words, there is already an element of "backward-looking" for these groups): Civil Service industrials (July); NHS nurses and midwives (April); local authority non-manuals (July); British Rail (April).

6.2.2 Greater concentration of bargaining, over a shorter period, might also give trade unions less excuse for not doing something more positive with the rest of their year.

6.2.3 In recent opinion research by CRD, the following question was put and answered at our request:

SECRET

"It has been suggested that a law should be passed which would make it necessary for pay talks for everyone to start on a fixed date and be finished by a set date, a month later. Do you think this would be a good idea or a bad idea?"

	<u>All</u>	<u>Con</u>	<u>Lab</u>	<u>Lib</u>
	%	%	%	%
A good idea	70	69	72	73
A bad idea	21	23	19	23
Don't know	10	8	9	5

These answers suggest that there is a strong desire, non-party political, for order instead of chaos in pay bargaining. This need for order is the reason why incomes policy is often electorally popular, even if economically disastrous. Synchro-pay happens to be something which is both electorally popular and - subject to any thinking that has been done on the topic - economically sensible.

7. CONCLUSION

Slowly but surely the size of the public services pay problem, and the numbers we should be aiming for, are coming into focus. It would be a pity to stop the thinking process just at the point where the size of the problem is apparent, but the tactics and mechanics for solving it are not.

SECRET

~~CONFIDENTIAL~~ 1 July 1980

MR LANKESTER

I have prepared a paper about the self-indexing tendencies of public expenditure - something we discussed with Christopher Foster the other day.

I would be very grateful if you could comment on it, though I realise time is short and it is fairly long. The sooner the better, and I wait to hear from you.



JOHN HOSKYNS

PS: The typing has not yet been checked.

IS PUBLIC EXPENDITURE SELF-INDEXING?

- And does it matter if it is?

1. INTRODUCTION

1.1 In earlier papers on public sector pay, we have emphasised the danger that the process of Transition from high to low inflation could end with further resources transferred from the private sector to the public, rather than vice versa.

1.2 We have a nagging suspicion that public expenditure may be to a large extent self-indexing so that, even if inflation is brought down, this switch of resources is extremely likely. A natural response to this suggestion may be to say that, given the will to set the right cash limits and stick to them, they cannot be a problem. But self-indexing could still take place despite the system of cash limits because:

- (1) Only about two-thirds of all expenditure is cash-limited.
- (2) Cash limits could in the event be set to accommodate full indexation in order to avoid the "humiliation" of (3) below.
- (3) Powerful economic and institutional forces could ensure that cash limits are exceeded (eg BSC).

or B. Tel.

2. ARE WE THINKING STRAIGHT ON PUBLIC EXPENDITURE DURING TRANSITION FROM HIGH TO LOW INFLATION?

2.1 It is Transition which makes self-indexation a potential problem

2.1.1 As we have stressed in earlier papers, Transition is different from Stable State. It poses distinctive problems, calling for different solutions, because it requires deceleration in the nominal increase of public expenditure as well as real cuts. With the present balance of the economy, we would still need to cut public expenditure and reduce the PSBR as a percentage of GDP, even if we had zero inflation. (Of course, there are, in the real world,

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all sorts of aggravating causal links between high public expenditure, high PSBR and the rate of inflation. But they should not be allowed to observe the crucial systemic difference between Transition and Stable State.)

2.1.2 If public expenditure lags in accommodating to the MTFs, while the private sector leads, then the private sector will be damaged in several ways:

- Higher PSBR with both interest rates and exchange rate higher; or PSBR on target, but higher taxes.
- Higher nationalised industry prices.
- Cuts in public sector capital spending.
- Public sector pay knock-on encouraging private sector to damage itself further with high settlements.

2.1.3 This passing of the bill from the public to the private sector deepens the private sector recession, so that a larger bill for unemployment is passed back to increase public expenditure and reduce revenues still further.

2.1.4 We have heard it argued that no problem arises, provided the PSBR target is met; and that buoyant tax revenues will ensure that this is the case. We may have misunderstood this argument, but it seems to us that, if our fears are correct, the public sector will lag behind the private in adjusting to the MTFs. One of two things can then happen: either the private sector is damaged, via the PSBR, by recession (as described in Section 2.1.2 a-ove) because the monetary contraction prevents the hoped-for buoyancy; or the buoyancy is provided by monetary accommodation - so that in effect both sides of the PSBR equation are multiplied by some higher GDP deflator. In other words, the struggle against inflation is relaxed.

2.2 Are we clear who should bear the burden of monetary deceleration?

2.2.1 The Government urges people to settle for pay increases which are well below the current inflation rate because, if they do not, transitional unemployment will be unnecessarily high. The

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Government has accepted in principle that it must practise what it preaches as regards the Civil Service. But it is worth remembering that, only a few weeks ago, the Chancellor had to push hard to get this principle accepted. Although we have now established the right principle for the Civil Service, can we make it stick throughout the public services, with their 11-month pay round?

2.2.2 There is still an implicit suggestion in some of the public expenditure papers that inflation is something beyond Government's control, something which (even though it is caused by Governments) simply "happens" to the Government, just as it happens to, say, a medium-sized engineering company, making the fulfilment of its programmes unnecessarily difficult. It is a short step from that assumption to the further assumption that Government should therefore be free to adjust its own nominal spending to take account of inflation. Government is the only party to the whole economic process which can lead the way, by cutting its own spending and thus reducing the money supply without forcing the private sector into the vicious circle of high interest rates already described. And yet it treats itself as the one party which can effectively escape from the effects of the inflation it has helped to cause. In doing so, it either perpetuates the inflation or increases the damage of Transition.

interest rate high
how cut out?

2.2.3 All this is obvious enough, and the simple answer is that we must cut public spending. But we need to dig a little deeper. About £34bn of the total public expenditure of £98bn (1980/81 cash) is formally indexed (transfer payments and defence), and there are other less firm commitments to index other large parts of public expenditure. What will be the result of this in the eventual pattern of public expenditure, as planned in the White Paper, as present expressed in constant prices? Will that pattern itself affect the chances of achieving the PSBR target? By how much more must we reduce the pay outturn for the public services in order to compensate?

2.3 Even if we are clear that "public expenditure must bear its share", what does that really mean?

2.3.1 What are the effects of selective indexation? The Public Expenditure White Paper shows all categories of expenditure in constant

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prices. Does the real eventual distribution reflect any advantage in being indexed rather than un-indexed? How do the White Paper plans, expressed in constant prices, reflect the difference in outcome between public services pay settling at, say, 9%, and transfer payments being indexed on a forward-looking basis at, say, 16% for this year and with similar differentials for following years? (This raises further questions addressed in Section 3.1 and 3.3 below.)

- 2.3.2 What is to be learnt from past experience? Social security was effectively indexed on an ad hoc basis from the early Seventies until about 1975, and thereafter formally indexed. During that period, total social security expenditure rose significantly as a percentage of public expenditure. Is there a connection between the indexation and the increase? Did indexed transfer payments lead the way during the acceleration of inflation, just as we fear that it may trail behind during deceleration? Do we expect this to happen again over the period of the MTFS? Are the figures in constant prices adjusted to show that?
- 2.3.3 If we believe that the MTFS will reduce inflation to negligible proportions, should there really be any fully-indexed exceptions to the rule? Should not everything within Government's control be de-indexed (or, to be precise, consistently and partially indexed) in line with our exhortations to the private sector and in line with the monetary deceleration to which the whole of the economy must in the end accommodate? After all, when we have no inflation, everyone enjoys a stable pound; there are no exceptions then. If we mean to end inflation, should we be so worried about protection of particular groups, as if inflation is going to continue for ever? Why, at this point of all points, are we about to commit ourselves to full indexation of child benefit, rather than a deliberate ad hoc increase if that is called for, followed by a partial indexation in line with MTFS and the monetary targets? Our thinking does seem confused. Either we wish to increase transfer payments by deliberately indexing them fully during Transition; or we are tacitly assuming that the rest of public expenditure, in aggregate, will in the event index itself fully in the same way - in which case, the whole question of the resulting damage to the private sector rears its ugly head.

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3.4 Is indexation (both as policy and as phenomenon) confusing our thinking about public expenditure cuts? Are we cutting in order to get the real cuts called for in the White Paper? Or to get the monetary deceleration called for by the MTFs? Are we cutting to get the desired switch of resources from the public to the private sector, or to avoid the perverse switch in the other direction caused by the sheer momentum of self-indexing behaviour within the system? The underlying problem is obvious the moment you bring together the White Paper and the PESC Report. For example, in 1981/2, our total expenditure is expected to be £73bn, instead of £74½bn in the current year (1979 survey prices) - a fall of 2%. But the GDP deflator and RPI are expected to rise by 12.1%, and 10% respectively, during the same period (Annexes H and M of 1980 PESC). Is it possible to do PESC in cash terms, even if this forces early disclosure of cash limits?

2.4 Where do we go next?

2.4.1 The questions asked so far either have simple answers which show that there is no real problem, or else they lift the veil off a deeper problem and expose further underlying questions. On the assumption that this is the case, the next section looks at some of those underlying questions.

3. UNDERLYING QUESTIONS WE NEED TO ASK

3.1 How different are the processes of inflationary acceleration and deceleration?

3.1.1 Can self-indexing public expenditure be a problem when inflation is accelerating? Will it tend to make the acceleration faster? Perhaps it makes no difference because, by definition, inflation means that all prices, all pay, all expenditures, are rising in money terms and public expenditure is no different from anything else. In that situation, the social reason for ad hoc indexing is understandable, even though it may end up by helping to perpetuate the very process which made it necessary. Perhaps the problem only emerges when one faces deceleration, the Transition downwards, as we are now doing. If we look at social security spending as a percentage of total public expenditure, over the period of the Healey deceleration, we see that it rose from 21.1% in 1975/6 to

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25.3% in 1978/9. Was this the result of indexation, or rising unemployment, or deliberate changes in programme volumes? In the Public Expenditure White Paper, the proportion is expected to rise from 26% in 1980/81 to 27.5% in 1983/84. Again, is this the result of the indexation process, or a planned increase in volume? Or both?

- 3.1.2 What is the effect of inflation coming down quicker or slower than anticipated in PESC? What is the relationship between the GDP Deflator/RPI paths in PESC and the monetary targets in MTFs? If faster, does that increase the squeeze on the private sector, or does the nominal increase in public expenditure simply grow more slowly, so that the effect as between the two sectors is neutral? If slower, does that ease the squeeze on the private sector (although obviously at great inflation cost in other ways) or does the public sector simply absorb the extra money in the system by indexing its own expenditures?
- 3.1.3 We should, however, be clear that even if inflation comes down in line with the MTFs, public expenditure could still trail the deceleration process, with greater consequent damage (through the processes described at Section 2.1.2).
- 3.1.4 Is it possible to calculate the impact of inflation falling by, say, 3 percentage points less each year than was assumed? Is it possible to work out the effect of zero average growth over the next three years? Just so that we know what we might be up against.

3.2 Dealing with the different bits and pieces

- 3.2.1 Once we are clear about the processes at work, then we can decide how to deal with the different parts of public expenditure.
- 3.2.2 Fully-indexed expenditure. This includes most transfer payments, defence spending, possibly health spending, police pay, and armed forces pay. How far are these indexed on a forward-looking basis? Does the relationship between the monetary targets, cash limits and inflation rate, make this a satisfactory basis? Is it indeed a self-fulfilling prophesy? What happens with such indexed expenditures if the inflation rate falls more, or less, slowly than

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expected). Would a partial and backward-looking basis be better? Or even partial - backward-looking or forward-looking, whichever is the smaller? (This should not present any political problems, once people realise that the indexation process is part of the Transition to a stable currency, not a device for living with perpetual inflation, which is the way many people at present see it.)

3.2.3 Pay which is negotiated and "de-compared". In the light of this discussion, what sort of outturn are we aiming for? Do we really know what we're up against in trying to achieve such an outturn on a case-by-case "do the best you can" basis with dozens of different groups negotiating in a virtually unending succession over the 12-month period? What percentage is compatible with the MTFs after we have satisfied those parts of public expenditure which are formally or effectively indexed, or better-than-indexed? (This question was examined more fully in our paper of 18 July on "Public Sector Pay".)

3.2.4 The remainder. How far can we go in de-indexing other current expenditures? What is the effect of a defence budget which is fully-indexed and then increased in real terms by 3%? How far should we resist the easy solution of further cuts in the public sector's capital spending? Has any work been done to estimate the long-term costs - political and economic - from such cuts? How do we prevent monopoly, trade union-controlled nationalised industries - Coal, Gas, Rail, Post Office, Electricity - from acting like a home-grown (but at least recycled) mini-OPEC exacting special levies by way of prices, increased subsidies, broken EFLs and reduced investment leading to lower future value for money?

4. CONCLUSION

4.1 This paper suggests that the very way in which we are conditioned to think about public expenditure may contain some dangerous optical illusions. In particular, we may not yet appreciate just how large the cuts in public service pay will have to be. Our fear is that it will not be possible to get a pay outturn which is sufficiently low, and, because it is difficult to shed manpower

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in the way that the private sector would have to do in such circumstances, the cash limits will be simply broken or expanded. The probability is therefore that the public sector will help itself to a greater proportion of the available cash in the system, passing the consequences, as already described, to the private sector.

- 4.2 All the thinking at present, from the original reluctance in some quarters to publish an MTFS at all, through to the present reluctance to publish early cash limits, suggests an implicit assumption that what must be endured by the private sector simply can't be endured by the public. Achieving the MTFS involves an approach to the public expenditure arithmetic which displays absolute commitment to results. We wonder whether the way forward might be to turn the present process upside down. To do all the forecasting in cash terms, based on forecast inflation; to forecast cash limits, in exactly the same way as the MTFS; to adjust cash limits downwards only, if inflation turns out to be lower; but not upwards if inflation turns out to be higher.

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2 PP
Econ PS
2

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

18 July 1980

T.P. Lankester Esq.
10 Downing Street
LONDON
SW1

Announcement

*To note that
Tony Benn's presentation
has now been
circulated to
Departments.*

Dear Tim,

ECONOMIC STRATEGY

Following the Cabinet discussion of economic strategy on 3 July, a number of Ministers have expressed interest in the material on which the Treasury's Chief Economic Adviser drew in his presentation. The Chancellor thought that it would be inappropriate for this material to be widely circulated in the form in which it was originally used, although he has drawn on it, for example in his speech to the House on 10 July, for the purposes of public presentation.

TL
2/7

He thought it would be helpful, however, if the material were available in full to his Cabinet colleagues; and he would be content for them to show it in confidence to their junior Ministers and appropriate Senior Officials.
..... Accordingly a copy is attached to this letter.

The Chancellor has it in mind to draw on this material in the preparation of a paper for next month's meeting of NEDC, which could then be more widely used for the purpose of securing greater public understanding and acceptance of the Government's strategy.

I am sending copies of this letter and the attached paper to the Private Secretaries to Cabinet Ministers, the Minister of Transport, the Chief Whip and Sir Robert Armstrong.

*yours
John*

A.J. WIGGINS
Private Secretary

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cc NJS

Econ PD
✓
MS

PERSONAL

HM Treasury

Parliament Street London SW1P 3AG

Direct Line 01-233 3016

Switchboard 01-233 3000

J B Unwin

Under Secretary

18 July 1980

Tim Lankester
10 Downing Street
LONDON SW1

Dear Tim,

Further to my letter of yesterday, I attach a possible speaking note on pay settlements. It is the best we can produce here at the moment, though I hope the Department of Employment can be persuaded to produce rather more if the need arises.

John
Bun
J B UNWIN

PERSONAL

REALISM IN PAY SETTLEMENTS

1. There are growing signs of realism in pay settlements. CBI figures indicate that half the workers in manufacturing are settling for 15% or less, and another CBI report last week told of many single figure settlements in the West Midlands. At large firms like BL (5½%) and small firms like Catnic components in Wales (reported pay cut), people are realising that excessive pay increases mean lost jobs, and they have taken the sensible course, and lowered their sights. In the engineering industry and the textile industry, there are numerous examples of low settlements which have been influenced by concern about lost markets and redundancies. At Talbot and Lucas, management have said that they cannot afford more than 8 and 10 per cent respectively while at Lesney the workforce have accepted 10% to avoid further redundancies. At Rolls Royce aeroengine plants the latest agreement provided only for pay increases in line with productivity. So people are beginning to put jobs before pay increases by concluding realistic settlements.

2. As an awful warning we have the case of the steel industry, where workers stuck out for higher pay increases than could be afforded. They gained higher increases, but in so doing ^{helped to} price their industry out of markets and themselves out of jobs. This is a harsh illustration of the fact that increased wages without improved performance means closures and lost jobs.



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000 18 July 1980

Richard Dykes Esq
Private Secretary
Department of Employment

Dear Richard,

THE OUTLOOK FOR PAY

.... The Chancellor thought your Secretary of State, and other interested Ministers, would like to see the attached letter he has received from the President of the CBI, before the E Committee discussion on pay on Wednesday 23 July.

I am copying this letter, and the letter from Sir Raymond Pennock, to the Private Secretaries to the members of E and E(NF) Committees, and Sir Robert Armstrong.

yours sincerely

John Wiggins

A J WIGGINS

Confederation of British Industry
Centre Point
103 New Oxford Street
London WC1A 1DU
Telephone 01-379 7400
Telex 21332
Telegrams Cobuistry London WC1

From the President
Sir Raymond Pennock



sent 8/6/7

CH/EXCHEQUER	
REC.	16 JUL 1980
ACTION	<i>Mrs HEATON</i>
COMES TO	<i>CST</i>
	<i>PSS</i>
	<i>Sin & LMS</i>
	<i>M. PULLIN</i>

16th July 1980

PRIVATE

M. RIDLEY

M. P. RAWANA

Bring to all

Mr E colleagues

Refer E?

M. MIDDLETON

Dear

Geoffrey

*M. DIXON
M. J. J. J. J.*

James + W. N. C. G.

You will remember that at our meeting on 13 June, I mentioned that we were intending to hold two conferences of chief executives and key industrial relations personnel from selected companies and employer organisations to consider the outlook for pay. The conferences were held on 20 and 23 June, and have been followed by further discussions with members of our Employment Policy Committee and the President's Committee.

Perhaps the three most important points emerging from the conferences were these:

first, a growing determination to secure a substantial reduction in the level of pay settlements in the months ahead and a clear recognition that pay increases cannot continue to match price increases. Although we would like to see more concrete evidence, there were clear indications in the conferences of a decline in settlement levels, particularly in engineering;

secondly, there was a strong feeling that concessions on hours and holidays should be minimised and that it was essential to avoid leapfrogging on these issues between manual workers and staff;

thirdly, considerable concern was expressed about pay in the public sector.

In bringing this concern to your attention in a private letter, I would emphasise that we have no desire to interfere in a matter which is the responsibility of employers in this sector, but I feel I should write because of the impact of public sector pay on our members - both through its effect on pay in their own companies, and through its effect on government expenditure and hence interest rates.

/ ...

While our members are determined to play their part in reducing the rate of pay increases, they believe that there are a number of steps which government might take that would be extremely helpful.

The first would be to bring the work of the Clegg Commission to an end as soon as possible. We appreciate that the Commission has still to complete work on a number of references. We are concerned, however, that even though these references cover relatively small numbers of employees, the Commission's report may attract public attention and, if the awards are for substantial pay increases, raise the expectations of other employees in the early stages of the next bargaining round. There may, therefore, be advantages in government reviewing the remaining references before the Commission to see if they can be withdrawn with the agreement of the parties concerned, and settled more quickly by negotiation.

We believe that there is a case for re-examining the whole role of comparability in determining pay in the tax-dependent public services. This is, however, a complex question, and might best be dealt with by means of a wide-ranging enquiry covering the institutional arrangements for determining public service pay, including the levels at which bargaining takes place and the timing of settlements; the role of comparability; and, if comparability is to have an important role, which groups should be covered by comparability mechanisms, what these mechanisms should be, and the methodologies on which comparability should be based.

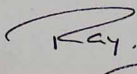
Pending the outcome of this enquiry, we suggest that, with the possible exception of those covering the police and armed services, the work of the existing pay research and review bodies should be suspended, and the pay of the groups concerned should be negotiated between the employers and the unions involved in the light of the government's overall economic objectives and within the discipline of cash limits.

We have also considered further whether there would be advantages in government making a single comprehensive statement detailing the financial targets of all the nationalised industries, making clear the responsibilities of both government and boards of the nationalised industries to see that these targets are achieved and spelling out the implications of these targets for pay bargaining between the managements of the nationalised industries and their unions. We feel that this would have attractions, and shall be discussing it with the nationalised industries' chairmen later this month.

As I have already mentioned, our members are determined to do all in their power to moderate the level of settlements. I believe that government action on the lines I have suggested will help them succeed.

Yours sincerely,

The Rt. Hon. Sir Geoffrey Howe, QC, MP,
Chancellor of the Exchequer,
H.M. Treasury,
Parliament Street, SW 1.





21 JUL 1980

CONFIDENTIALECONOMIC STRATEGYFigure 1

FINANCIAL STRATEGY

PERMANENT REDUCTION OF INFLATION REQUIRES
A MONETARY STRATEGY

EXACT TIME PATH AND LAGS UNKNOWN
- AVERAGE LAG ABOUT 7 YEARS BUT CLN VAR/

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

CUT PSBR BY REDUCING SPENDING, TAXES TOO HIGH

Summary of Strategy

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

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

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3. In order to achieve this monetary strategy without excessive interest rates it is necessary to have a consistent fiscal policy. This implies a reduction in Government borrowing as a percentage of output. Again we do not know the precise relationship. It almost certainly varies over the business cycle.

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

The Background

5. This strategy is being implemented against a difficult background. Judged by conventional measures of the growth of output, inflation and unemployment the economic performance of the industrial countries has deteriorated sharply in recent years. UK performance has also deteriorated; but whereas growth has deteriorated in line with the rest of the world; in the case of inflation the deterioration here has been much worse than elsewhere. In the remainder of this presentation 'world' is taken to be the industrial countries; on some occasions it refers to OECD; sometimes to the major 7 or major 10 industrial countries.

Figure 2

	INFLATION	
	1963-69	1970-78
USA	3.0	6.7
JAPAN	5.0	9.8
W GERMANY	2.5	5.2
FRANCE	3.6	9.0
ITALY	3.4	13.1
UK	4.2	12.8
WORLD	3.4	8.0

World and UK Inflation

6. The underlying rate of inflation has been increasing since the early 1960's. Figure 2 shows that world inflation in the 1970's was double what it was in the 1960's. For the UK the acceleration was worse. After keeping within 1% of the world average inflation rate in the 1950's and 1960's the UK inflation rate moved significantly ahead of our major trading partners in the 1970's.

Figure 3

WORLD CONSUMER PRICES
% Percentage change on year earlier

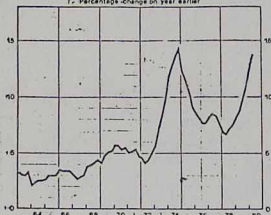
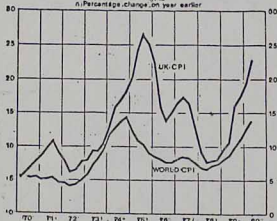


Figure 4

% Percentage change on year earlier



7. This underlying acceleration of world inflation can also be seen by comparing the rate of inflation at the same point of successive cycles (Figure 3). The low point of the cycle has been at higher and higher rates of inflation since 1960. The UK has the same pattern of upward drift of the underlying inflation rate.

8. If we concentrate upon the 1970's we can see that the timing of the broad sweep of inflation movements is the same in the UK as in the world as a whole (Figure 4). Since mid 1978 the OECD inflation rate has risen from 6½ per cent to 14 per cent; at the same time the UK rate has risen from 7½% to 22%. The rise in world prices is largely the effect of the further doubling of oil prices which has had

a direct effect upon inflation equivalent to the increase in 1974. In addition world demand has been growing rapidly since mid 1978 and this has contributed to inflationary pressure.

Figure 5

GROWTH RATES		
	1963-69	1970-78
WORLD	5.3	3.6
USA	5	3.3
JAPAN	8	5.3
GERMANY	4	2.7
UK	2.9	2.3

World and UK Output

9. There is widespread agreement that the underlying growth of world output has fallen; opinions vary but it is possible to place the point of major change in the late sixties or early seventies. The average growth for the period 1963-69 is contrasted in Figure 5 with the growth rate from 1970-78. Growth rates of total output have virtually halved. For individual countries the results vary in degree but the underlying pattern is similar.

Figure 6

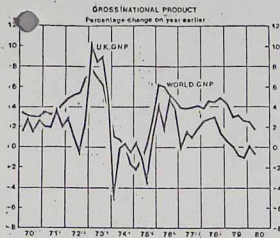
	UK GROWTH	OECD GROWTH	DIFFERENCE
1900-13	1.9	2.9	1.0
1921-38	1.7	2.4	0.7
1950-60	2.5	4.2	1.7
1960-70	2.7	5.2	2.5
1970-80	1.3	3.5	2.2

10. The UK growth rate has been systematically worse than average for a hundred years (Figure 6). Throughout the post war period the gap has been about 2%. We are not intending today to discuss this 2% gap but simply to note that the supply side measures are aimed at this problem.

11. Looking in more detail at the cyclical pattern of output in the 1970's (Figure 7) we can see the close correspondence of the UK and world output changes. Recessions in the UK tend to be strongly associated with

Figure 7

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recessions in the world as a whole. Similarly the periods of rapid growth also tend to coincide.

12. The comparison of world growth and inflation in Figure 8 points up a very sharp lesson. A similar pattern emerges in the UK data. When the inflation rate accelerates growth slumps; and when it decelerates the growth rate picks up. The recent rise in inflation is now beginning to have its effect upon the growth rate this year and early next. A world recession is now emerging. When inflation is reduced we can expect growth both here and the rest of the world to recover although the extent of the recovery will depend upon the underlying strength of the economies.

Figure 8

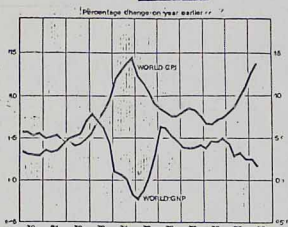
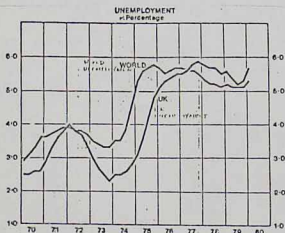


Figure 9



World/UK Unemployment

13. The UK unemployment rate has been rising each cycle since 1960. Figure 9 shows the close correspondence with the average behaviour of the major industrial countries. There was a major increase in unemployment in 1970; then again in 1974/75; and we now seem to be about to surge again. I shall return to this problem again.

Monetary Strategy

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

Figure 10

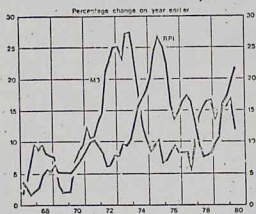
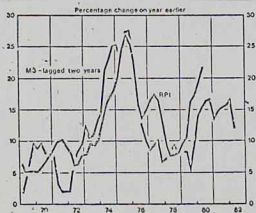


Figure 11



15. The foundation of the monetary strategy is that in the medium term inflation rates are determined by monetary growth. In Figure 10 we chart the growth of money supply and the inflation rate over the past 10 years; the relationship comes out clearly after a longish lag. Moving the monetary growth rate forward 2 years (Figure 11) shows the relationship even more clearly.

16. Between mid 1977 and mid 1979 monetary growth was about 15% compared to around 7% between 1975 and 1977. We can see how this pointed to an upturn in inflation. There is some suggestion that the time lags are shortening. In the mid 70's the time lag was about $2\frac{1}{2}$ years. Recently the lag between the upturn in monetary growth and the upturn in inflation was only 18 months. This is not surprising as people become more aware of inflation. But we must emphasise that these lags can and often do move in either direction.

Figure 12

INFLATION

UNDERLYING FORCE IS MONETARY GROWTH

TEMPORARY FACTORS CAN ALSO BE IMPORTANT

OIL PRICES AND WORLD PRICES

RISE IN VAT

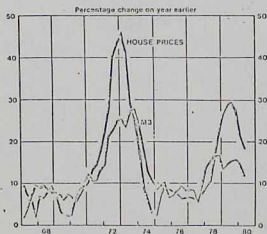
TIMING OF NATIONALISED INDUSTRY PRICES

TIMING OF PAY SETTLEMENTS

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

- oil prices and world prices clearly have a major effect
- the rise in VAT has had a sharp short run effect
- the timing and extent of nationalised industry prices, rates, rents and food prices all matter and
- the timing and extent of pay settlements is crucial and affects the time lags of the inflationary process.

Figure 13



18. I have emphasised the way in which inflation lags behind monetary growth. Of course some prices move immediately; these are the markets that are most sensitive to monetary changes. Important examples are the foreign exchange market and the housing market. Both usually signal well in advance the likely course of inflation in general. In Figure 13 we see the historical correspondence between monetary growth and house prices. There is clear overshooting with house prices rising by a multiple of

Figure 14

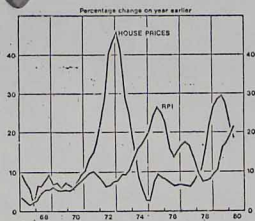


Figure 15

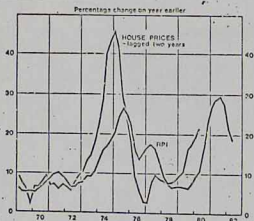
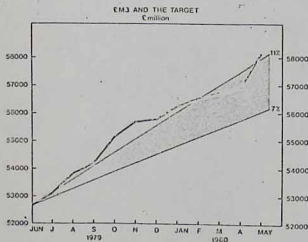


Figure 16



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monetary growth during booms but the broad movement coincides. Similarly we can see how the movement of house prices clearly leads the inflation rate.

19. We saw earlier that the latest bout of inflation shows up in the monetary figures from the end of 1977. In 1978/79 when general inflation was still modest house prices were beginning to accelerate reaching an annual growth of 30% in mid 1979. The increase in general inflation followed just as the inflation in 1974/75 followed the monetary growth and house price explosion of 1972. In Figure 15 we move the house price growth forward two years as we did with money; clearly it has been a good indicator of future inflation.

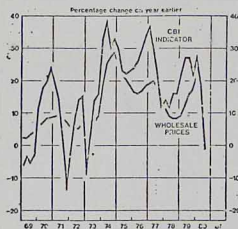
20. There are now indications that the whole sweep of inflationary pressure is about to be reversed. There is increasing evidence that money supply is coming under tighter control (Figure 16); all the monetary aggregates point in this direction. In the first part of 1979/80 there were still problems of monetary control:

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- (i) the PSBR was biased with a large deficit in the first half of the year
- (ii) there were considerable lags in tax payments due to industrial disputes. However the rise in MLR to 17% in November and a more favourable budgetary position has brought us back towards the target.

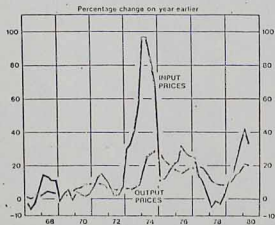
21. Just as monetary growth is now slowing down so is the growth of house prices. This all points to a slowdown of inflation in general.

Figure 17



22. Another important indicator is the CBI indicator of firms planning to put up prices in the following four months (Figure 17). The last figure is the lowest since 1973 i.e. before the first oil price increase. The high exchange rate and monetary deceleration is clearly affecting profit margins.

Figure 18



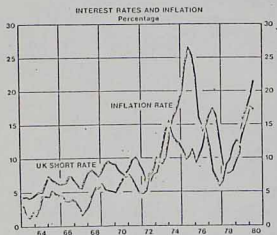
23. Another indicator of future price movements is the behaviour of wholesale input prices. (Figure 18) These show the price increases that are paid by manufacturing industry. Recently there has been some sign of easing; in the months since February world prices have been falling and even oil prices have been rising less rapidly. In time this should be translated into lower output prices and then lower inflation.

24. To summarise, the indications now point towards a significant slowdown in the inflation rate as we move through 1980 and into 1981.

Interest Rates

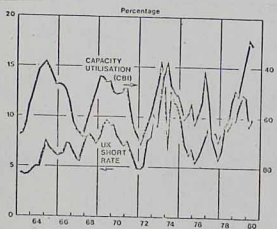
25. During the past year we have experienced the difficulty of high rates of interest. There are several important influences upon the level of interest rates:

Figure 19



(i) Figure 19 shows a clear relationship between inflation and interest rates. Potential savers need to have compensation for the likely fall in the purchasing power of their savings. Even with interest rate at 17% savers are getting no real return, even before tax.

Figure 20



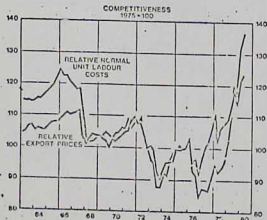
(ii) Figure 20 also shows that interest rates tend to be bid up in periods of high capacity utilisation when companies are building up stocks; similarly pressure on interest rates is reduced when destocking reduces companies need for cash. So interest rates tend to move with the economic cycle.

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

26. During 1979 and early 1980 each of these factors was pointing towards higher interest rates; government borrowing was high, domestic demand was strong, inflation was rising and the monetary target was tight.

Figure 21



Exchange Rate

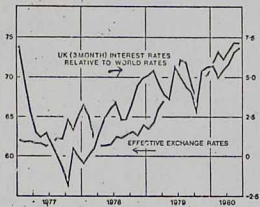
27. During the past year the exchange rate has been much stronger than forecasters expected. Since May 1979 the effective exchange rate has risen by over 10%. At the same time UK inflation has been 10% faster than competitors inflation and costs. The result has been a massive 20-25% loss of cost competitiveness simply in the last year (Figure 21). Since 1976

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the loss of competitiveness is about 40%. It is very difficult to identify precisely the reason for the recent strength of sterling in the face of our high inflation rate.

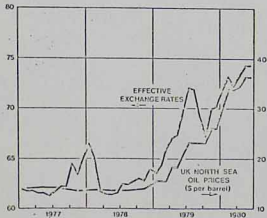
(i) Confidence in the government strategy has almost certainly contributed.

Figure 22



(ii) Interest rates have been high compared to other countries and this has attracted capital inflows. Figure 22 shows that as the gap between UK interest rates and world interest rates has widened the exchange rate has strengthened.

Figure 23



(iii) The rising oil price damages UK balance of payments less than other countries and appears to have turned us into a petro-currency. This can be seen in Figure 23 which shows the relationship between the movement of sterling and the price of the North Sea oil.

28. The effect of the oil price increase upon the UK is unlike its effect on other countries. As we are virtually self-sufficient there is no direct change in the terms of trade;

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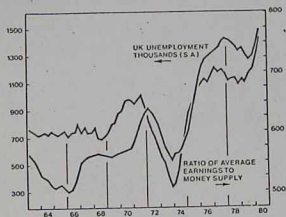
oil price increases damage UK national disposable income much less than is the case for major net oil importers. This makes sterling particularly attractive.

29. The result has been a much higher exchange rate than forecasters expected. This has put considerable downward pressure on prices but as pay settlements have continued at excessive levels this has created problems for companies. The effect of the loss of competitiveness is very uncertain but could be damaging to manufacturing if unit costs are not reduced relative to other countries.

Unemployment

30. To summarise; the anti-inflationary policy is putting considerable pressure upon the economy in the short run particularly for interest rates and the exchange rate. The benefit from the strategy should emerge in the defeat of inflation. But in the process of monetary deceleration it is inevitable that output and employment will suffer if pay and prices do not move rapidly into line with monetary growth. The pattern of unemployment over the next few years will be determined by the depths of the world recession and the time lags in the response of wages and prices to the monetary deceleration.

Figure 24



31. An examination of the past 10 years (Figure 24) shows that the movement of unemployment is closely related to the movement of earnings relative to money supply. When earnings have grown faster than money supply unemployment has risen. There have been two stark examples of this behaviour in the past 10 years when unemployment rose rapidly.

- The first is between the end of 1968 and the end of 1971 when earnings grew faster than money supply as income policy breakdown collided with the post IMF monetary control.
- Secondly between end 1973 and the beginning of 1977 earnings grew substantially faster than money supply as post income policy earnings explosion again collided with monetary deceleration.

32. The reverse is also true. Unemployment has fallen when earnings have grown less rapidly than money supply. Again there are two vivid examples over the past decade when unemployment has fallen

- between end 1971 and end 1973 earnings grew by less than money supply largely because of rapid monetary acceleration. We now know that the cost of the monetary growth was felt

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later in terms of higher inflation; nevertheless this suggests that unemployment can be brought down if earnings growth is kept below monetary growth

- between early 1977 and end 1979 earnings grew by less than money supply; again this was partly due to accelerating money and pay restraint. Again unemployment fell.

33. Earnings have been growing faster than money supply since the end of 1978. Again unemployment is rising rapidly. Obviously it is not possible to be precise about this kind of simple economic relationship but it gives an indication of the process at work.

34. On the basis of previous time lags it will be some time before the gap between earnings growth and money supply is removed; although it is important to recognise that even though time lags may be expected on the basis of previous behaviour this does not justify a slow adjustment of earnings to money supply growth. The transitional problems of bringing inflation down are much reduced if wages and prices move rapidly into line with monetary growth. The market forces for pay deceleration are being felt in the traded goods sector; labour intensive manufacturing will continue to be most affected.

Afterwards the non-manufacturing private sector should follow the deceleration in manufacturing pay as the labour market weakens although it is important to overcome the institutional resistance to accepting pay increases below the going rate of inflation.

Figure 25

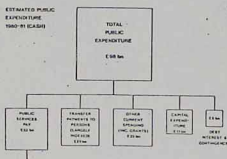
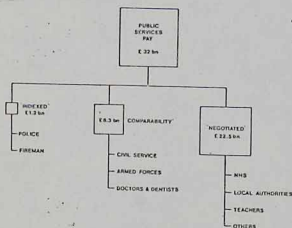


Figure 26



It is important that public sector pay should also decelerate. The importance of the public sector is shown in Figure 25. Out of a total public expenditure of around £100b more than £30b represents public services pay. Figure 26 shows that of the £30b only £1b is fully indexed and a further £8.0b is subject to comparability. The remaining £22b is negotiated but if the comparability awards are effectively indexed and backward looking it is likely that the same increases will be negotiated in the NHS, local authorities and teachers. In turn this will damage progress in the private sector where it is so vital that pay begins to move in line with monetary growth. The private sector needs the assurance that the public sector will not pull the rug out from beneath their feet.

Figure 27

RANGES FOR GROWTH OF MONEY STOCK (CM3)						
% CHANGE DURING YR IN	75-79	79-80	80-81	81-82	82-83	83-84
TOTAL EXPENDITURE	14.0	14.1	14.1	13	11	10.1
TOTAL RECEIPTS	+83.0	+68	+67.1	+67.1	+59.1	-7.1
IMPLIED FISCAL ADJUSTMENT	—	—	—	—	1.1	1.1
GGBR	9.0	8.1	7	5.1	4	3
PSBR	9.3	8	6	5	3.1	1.1
PSBR AS % OF GDP	1.1	1.1	1.1	1	1.1	1.1
	78-79	79-80	80-81	81-82	82-83	83-84

Figure 28

EFFECT OF RELAXING MONETARY POLICY	
E.G.	FISCAL EXPANSION AND/OR LARGE CUT IN INTEREST RATES:
	RAISE MONETARY GROWTH TOWARDS CURRENT GROWTH OF EARNINGS
	SHORT TERM REDUCTION IN UNEMPLOYMENT (AFTER LAGS)
BUT	HIGHER INFLATION BUILT INTO ECONOMY WITH DAMAGING CONSEQUENCES
	UNEMPLOYMENT BENEFIT TEMPORARY
	REDUCTION IN INTEREST RATES TEMPORARY

Outlook and Options

35. This is the background to the Chancellor's paper on the outlook for the economy and the medium term financial strategy (Figure 27). The MTFS set out a framework for the reduction of monetary growth based upon a steady reduction of the PSBR to 1% of GDP. This was made possible by the plans for lower public spending, and the rising revenue from North Sea oil. The assumption was for 1% per annum growth in 1981-83. As a result of this strategy inflation was expected to fall into single figures by 1982-83 but the short term unemployment outlook would be difficult.

36. Within this framework we can examine some alternative policy suggestions. Some argue that we should relax the monetary target by fiscal expansion and/or a large cut in interest rates. It is argued that one possible route to lower unemployment is an upward revision of the monetary target so that the clash with earnings is reduced. It is argued - along the lines of my earlier logic - that after a lag this would reduce unemployment. The problem is that

- its effects on unemployment would be short lived and
- it would keep the inflation rate at 20%; further more if it was clear that monetary policy would

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accommodate earnings growth then we can expect yet higher figures to emerge. Initially such a policy might ease interest rates as credit was relaxed but soon the higher inflation would increase interest rates.

It is our aim and our expectation that rates of interest, both at the short end and at the long end, should be reduced at a rate compatible with the maintenance of monetary discipline. It would be quite irresponsible to cut interest rates if it put monetary control in jeopardy. Confidence in the gilt-edged market would be eroded and after a time the demand for credit would rise. This combination would almost certainly mean that monetary control would become very difficult in the course of next winter.

Figure 29

STATUTORY INCOMES POLICY
-POSSIBLY REDUCE UNEMPLOYMENT
AND INFLATION INITIALLY

BUT
-EFFECT ONLY TEMPORARY
EXPLOSION IN 1982/83

37. An alternative way of closing the earnings/monetary gap is to attempt to bring wages and prices into line by statutory means. In the past this has had some short term success but all experience suggests that it will not last for long. The longest possible period is two years. The result of this might be to hasten the reduction in inflation and reduce the unemployment problem. But when the breakdown occurs a pay explosion would take place reversing the progress that has been made. This could occur in 1982/83 and lead to a surge of inflation and

unemployment. The important prize is to bring inflation down by market means; this has a much better chance of being maintained.

Figure 30

RELAX FISCAL POLICY BUT KEEP MONETARY TARGET

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

- MAY HELP COMPANIES CASH FLOW
AND REDUCE COSTS

BUT

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

38. A further course of action might be to relax fiscal policy whilst attempting to maintain monetary control; a cut in the NIS is a popular suggestion. Almost certainly this would involve higher interest rates. The fall in interest rates that we are expecting is conditional upon our success in controlling the PSER and public expenditure. Although monetary pressures might be expected to ease as recession emerges and inflation is reduced, the monetary target remains tight relative to the current inflation rate. This year's budget has been designed to help the process by reducing the PSER; the public expenditure plans are designed for the same purpose. A reduced requirement to sell government debt is crucial if interest rates are to be safely reduced; this means lower government borrowing. So far this year PSER problems have emerged with an overrun of expenditure; it is vital that this should be reversed and that the original targets for the PSER this year are maintained. Any attempt at fiscal relaxation would damage the outlook for interest rates and the prospect of opening up the capital market to private companies. The company sector will be much better off with access to long term debt finance than with some general fiscal

relaxation that would be indiscriminate in its effects: it would help banks as well as engineering companies.

Figure 31

- REDUCE EXCHANGE RATE
- 3 POSSIBLE ROUTES
- INTERVENTION
 - : WILL IT WORK?
 - : HOW MUCH WILL BE NEEDED?
 - : EFFECT ON MONEY SUPPLY AND INFLATION
 - INFLOW CONTROLS (HAVE ALREADY ABOLISHED OUTFLOW CONTROLS)
 - : CAN THEY BE MADE TO WORK
 - : MEANS LOWER BOND SALES AND HIGHER INTEREST RATES OR LOWER PSBR
 - LOWER INTEREST RATES
 - : REQUIRES LOWER PSBR IF WANT TO KEEP MONETARY TARGET
- BUT - DAMAGES SHORT TERM INFLATION OUTLOOK

Exchange Rate

39. It is often argued that we should take action to reduce the problems of high exchange rate and the loss of competitiveness. A variety of schemes are put forward.

- (i) The first is intervention in the exchange market. How useful this would be is open to question. Experience in 1976 and 1977 suggests that enormous flow across the exchanges can be generated by an attempt to hold the exchange rate in the face of sustained market pressure. During 1977 the authorities intervened heavily and reduced MLR sharply throughout the summer and autumn of that year. The attempt to 'cap' the exchange rate was unsuccessful and the large inflows plus the low level of interest rates at the end of 1977 was probably the main cause of expansion of sterling M3 in the following year.

- (ii) The second course of action mentioned is inflow controls. Ideas flow in abundance;

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from two tier interest rates to barring non-resident purchasers of sterling to two tier exchange rates and restrictions on company borrowing abroad for domestic use. All schemes have the fundamental problem of making the controls effective. This could possibly be done for a few months but beyond this requires increasingly elaborate and comprehensive regulations. Such schemes also make it more difficult to finance the PSBR and this could mean higher interest rates and pressure upon companies from a different direction. Of course we have taken the major step of abolishing all exchange controls in an outward direction and we have not yet seen the full effect of that adjustment.

- (iv) A third possibility is to attempt to reduce the exchange rate by getting interest rates down. Lower interest rates would probably require a reduced PSBR compared to present plans. However such a strategy is by no means

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certain to reduce the exchange rate as other aspects of the economy will change. In particular a more restrictive fiscal policy can be expected to push up exchange rate expectations if a lower PSBR reinforces further the credibility of the Government's Financial Strategy. We see very good reasons for a low PSBR to help interest rates and the capital market but it is by no means certain that it will reduce the exchange rate.

40. We must also bear in mind that some sustained squeeze on competitiveness is probably an inevitable consequence of a determined anti-inflationary strategy. The present squeeze is a good deal greater than forecast last year but there are beneficial effects as well as difficulties. Although unplanned the stronger exchange rate can still be welcomed as a help to reducing inflation faster. It can be argued that we should attempt to get this stage over as quickly as possible. We believe that it would be extremely dangerous to attempt to engineer a fall as this might be taken to signify a retreat from the principle of sound money. On the other hand some exchange

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rate fall need not be an issue for too much concern. The pressure on competitiveness would still be substantial.

CONCLUSIONS

41. To summarise

- (i) Money supply growth is now under control.
- (ii) There are now signs that inflation is about to turn.
- (iii) To maintain this it is vital that we maintain control over the PSBR and government spending.
- (iv) Unemployment is rising rapidly because of excessive pay settlements. This will continue until pay brought down to monetary growth rate.
- (v) A reduction of inflation and the growth of pay within the monetary target will lay the basis for growth and reduction in unemployment.

None of the alternatives are attractive or offer much hope for a sustained improvement in the outlook.

22 JUL 1980



A02509

PRIME MINISTERThe Economic Prospect

(C(80) 35)

BACKGROUND

The Chancellor of the Exchequer's memorandum offers a general description and analysis of recent developments and the outlook immediately ahead. He suggests that current developments are not substantially different from what had been expected. But he points to two important qualifications to this - both familiar to members of E from recent discussions. First, pay increases have been bigger than expected; second, there are the expected difficulties in containing the PSBR in 1981-82. The PSBR problems are attributable to the problems of controlling borrowing by all three parts of the public sector - Government Departments, the local authorities and the nationalised industries - and to forecasts of North Sea oil output. In addition interest rates are also under pressure because of the continuing high demand for credit from industry.

2. The Chancellor goes on to explain that there are different views among forecasters about the likely depth and duration of the United Kingdom economic recession - a good deal turns on our cost competitiveness at a time of world recession. But he concludes, in his paragraph 9, that the company sector may remain in substantial financial deficit through the period to 1983; that unemployment will rise steeply and beyond the level of 1.8 million previously assumed by Autumn 1981; and that while inflation will decelerate this will not be as quickly as hoped. He nevertheless believes that in the later years of the period there should still be scope for tax reductions.

5. He concludes, in his paragraph 12, that faced with the difficulties of containing the PSBR in 1981-82 and with the high risks and uncertainties which he has set out, it is more than ever imperative to hold to the Government's economic strategy. It is only in this way that we can create the conditions for growth in the medium term.



4. Beyond this general invitation to endorse the present strategy, the Chancellor does not invite specific policy decisions. Proposals on these will be put forward in papers which the Chief Secretary will be circulating for the first discussion of the 1980 Public Expenditure Survey on 10 July, which would probably be followed by a further discussion later in July and again in the Autumn.

HANDLING

5. I suggest you open the discussion yourself by explaining that the aim is a general stock-taking of the economic strategy on the basis of a presentation by the Government's Chief Economic Adviser (Mr Burns) and the Head of the Central Policy Review Staff (Mr Ibbs) and of the Chancellor's paper. This discussion will usefully establish the background to the discussions of the 1980 Public Expenditure Survey which will start on 10 July, on the basis of the papers which the Chief Secretary will be circulating for that meeting in a few days time. It would be as well to emphasise that decisions on specific public expenditure proposals, and the general approach to the exercise, will be reserved until then.

6. You might then invite Mr Burns and then Mr Ibbs to give their presentations. Mr Burns is planning to speak for about 20 minutes and will review the financial aspects of the strategy, rather than supply issues. He will set out the background of current slow growth in world trade; discuss the impact of the monetary strategy on inflation; and discuss the reasons for high interest and exchange rates. Mr Ibbs will supplement this briefly by bringing out a few central issues. The Chancellor of the Exchequer could then be asked to follow to amplify his own paper and Mr Burns's presentation. Each Minister will then no doubt wish to give his own views and to ask questions. You may wish to hold the Chief Secretary to the end of the discussion when he can sweep up and deal in particular with any public expenditure points which might have been raised.

7. It is difficult to say what questions will be raised in a free-ranging discussion of this sort. The main worries are likely to be the debilitation of British industry, rising unemployment and the social strains which follow. The key general question to which they give rise is how quickly can the turn-around come and is the prospect politically sustainable? This in turn may lead



some colleagues to question whether the problems should be met by fundamental reversal of the present strategy or, as the Chancellor proposes, by holding firmly to the strategy. If any colleagues argue for a change of course it will be for them to explain precisely what they mean and their grounds for thinking that their alternatives will work. It is perhaps more likely that some Ministers will argue that, while the broad thrust of the strategy is right, they want to see changes in particular aspects of it. In the discussion of the impact on British industry there are likely to be questions, with which the Chancellor and Mr Burns can deal, on interest rates and the exchange rate, and on whether it is indeed imperative to hold to specific PSBR targets at a time of recession and weak demand. There may well be proposals for relaxation on the public expenditure front by way of, for example, more regional assistance and more expenditure on training measures to assist in redeployment. The Secretary of State for the Environment has given notice, in his minute to you of 27 June on transport investment in the docklands, that he will wish to argue that excessive consumption is destroying capital investment.

CONCLUSIONS

8. In the light of the discussion you will wish to -

- i. establish a consensus that the Government should continue with its existing strategy for managing the economy - ie endorsing the approach in paragraph 12 of the Chancellor's paper, C(80) 35;
- ii. note any public expenditure points and specific proposals but reserve discussion and decision on them until the 1980 Public Expenditure Survey Cabinet next week;
- iii. note any further specific proposals and remit them, where appropriate, for further examination and discussion in due course.

Handwritten signature of Robert Armstrong, consisting of the letters 'RA' in a stylized, cursive font.

ROBERT ARMSTRONG

2 July 1980



10 DOWNING STREET

Dear Sirs

If we decide to
move on MLR, I suggest
it would be best to
for the Chamber to
take colleagues before
Tony Burns starts. But
you will want to
discuss this with the
Chamber.

R
2/7/80



10 DOWNING STREET

1 July 1980

Terry Burns Esq
Chief Economic Adviser
HM Treasury
Parliament Street
LONDON SW1

Dear Terry,

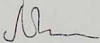
Thank you for sending us a copy of the draft of your presentation to Cabinet. I am sure this exercise will help a great deal in getting a fuller understanding of the Government's central economic objectives and the measures needed to achieve them. In particular, it should help to set the stage for the difficult Transitional Phase that we are entering and the need to anticipate both the political and economic problems of the adjustment process.

As you know, we are particularly concerned that if further adjustments to public spending are necessary, current spending - especially public sector pay - should bear its fair share without excessive reliance on capital spending cuts. This point was well made in a recent letter from the Federation of Civil Engineering Contractors to the Economist (copy attached).

I hope you will find some of the enclosed comments helpful: they include a few suggestions for extra points and some of the questions one might anticipate - most of which I am sure will already have occurred to you.

If there is anything I can do to help, please do not hesitate to ring.

I am copying this letter to Robin Ibbs and Tim Lankester.

Yours ever,


JOHN HOSKYNs

1 July 1980

COMMENTS ON DRAFT PRESENTATION TO CABINETObjectives

1. The objectives of the presentation could be summarised as:
 - (a) To explain to a wider Cabinet audience the diagnosis of inflation and the financial strategy for conquering it.
 - (b) To reassure the audience that the plan stands a good chance of delivering the objective within the timescale required. In particular to reassure anyone who thinks that the plan has not been thought through or is based on an unproven theory.
 - (c) To convince colleagues that the risks associated with any alternative policy would be even higher.
 - (d) To prepare colleagues for a difficult adjustment process.

Comments

2. Paragraph 1. The brief reference to supply side measures could include the need to free-up the labour market. This is especially important not only to economic recovery when inflation is controlled, but also because the excessive rigidities of trade union bargaining power can make the transitional process longer and more painful.
3. Paragraph 3. The logical connections between each sentence of this paragraph are not immediately clear. We think the second sentence requires a little explanation.
4. Paragraph 9. The recent increase in inflation is attributed here to the further doubling of oil prices and the increase in world demand. This will prompt the audience to ask whether the inflation could have been avoided with correct monetary policies.
5. Paragraph 11. It might be best not to refer to a debate about whether the gap between UK and world growth is increasing. This seems to add one more area of serious uncertainty which does not help the achievement of the second objective. It might also be useful to say explicitly that you were not intending to discuss today the explanation of the 2% growth gap.
6. Paragraph 15. (iii) holds out the prospect of assessing the way the strategy unfolds in the period ahead. However, the rest of the presentation does not include any illustrative forecasts. Would it not be useful to quote the Medium-Term Financial Strategy and the forecast circulated recently to Chief Economic Advisers?

7. Paragraph 17. The last two points refer to the timing of NI price increases and pay settlements. The emphasis on timing could be wrongly taken to devalue the importance of requiring NIs to become more efficient - rather than simply pass on their poor performance and excessive pay settlements through price increases. Similarly, the level of pay settlements is surely important as well as the timing.

Should "expectations" appear in this list?

8. Paragraph 19. Does the last sentence contain any implications for changes in other lags in the system?
9. Paragraph 20. Would it be possible to express more certainty about the reversal of inflationary pressure?

How far do industrial disputes mentioned at (ii) represent a potential Achilles Heel in the future?

10. Paragraph 22. In addition to the movement of house prices, the CBI indicator and wholesale prices, could you also quote the evidence of export prices? Tim Congdon's analysis in the Times a few weeks ago seemed to show firm evidence of export prices only having risen by 5% during the last year, under competitive pressure which we are expecting to spread to other sectors. This might be a useful piece of evidence that inflation has already started coming down in this sector.
11. Paragraph 24(iii). Even when Government borrowing has been reduced, will it still be necessary to keep interest rates high in order to dissuade potential borrowers from banks?
12. Paragraph 28. When referring to firms exposed to international competition, it might be worth spelling out that this can be either at home or abroad.
13. Paragraph 30(i). Does the process of squeezing balances depend on continued high interest rates to ration the limited amount of money available?
14. Paragraph 34. The third sentence suggests that the rest of the private sector will follow the deceleration in manufacturing pay as the labour market weakens. It might be worth qualifying this by the importance of overcoming the institutional resistance to this spread of the deceleration process. No matter how many manufacturing jobs are lost, bank clerks are likely to feel that it is irrelevant in determining their wages when the banking sector is profitable. We think there could be a little more emphasis on the importance of public sector pay moving

in line - stressing the absolute size of the sector, and the fact that excessive pay awards can only be financed through increasing taxes or charges or the PSBR.

15. Paragraph 36. Would option (i) keep inflation at 20% or tend to accelerate it? We think you will need to spell out the objections to option (ii) a little more.

We are not sure that the limited life of a statutory incomes policy will seem a sufficient argument against it. Two years would presumably take us to the point where inflation was very low and the pressures on re-entry to a free market would be much less. The second objection quoted needs spelling out a little. If an explosion could be avoided at the end of the period, a statutorily-induced reduction in wages would presumably help to keep unemployment lower during the transitional process.

16. Paragraph 37(vi). Is it possible to quantify (on the basis of the relationship described at paras. 31 and 32) the extent of unnecessary unemployment that would be associated with excessive pay settlements? A few examples might help to quantify the risks if the pay round goes badly wrong.
17. Paragraph 37(vii). It would be useful to indicate the likely timing of resumed growth and reduced unemployment.

LETTERS

Civil service

Sir—Your leading article (May 17th) about the need to press on with civil service reductions is particularly apposite from the standpoint of the civil engineering industry, which depends on the public sector for 90% of its work.

We have long maintained that it is only if cuts are directed at current spending rather than capital investment that the vital work of maintaining and developing the country's infrastructure—roads, railways, ports, and water and sewerage systems—can be adequately funded.

In order to back up this argument, my federation recently commissioned and published a report "The British Economic Base" by Mr W. A. P. Manser, economic adviser to Baring Brothers. The report contains some startling evidence on the extent to which, in recent years, bureaucracy has flourished at the expense of public investment spending.

The following are among the most relevant facts to emerge:

- (1) While private investment spending has gone up by 26.5% in real terms over the period 1972-1978, public investment has declined by 19.5%.
- (2) Between 1961 and 1978, employment in the public sector rose by one and a half million workers. Of these, the great bulk went into central and local government service, and specifically into the health service, education service and the social services; the number in these services actually doubled. At the same time, the number of beds available to the general public fell by 14% and the number of full-time pupils in schools rose by only 26%.

In your article you point out that local

government bodies have "slashed capital expenditure rather than hit the pockets of the public-sector unions". It is, in our view, high time that the unions with membership in the private sector (and in particular that part of it which produces capital works) realised that it is their members who are paying the price through unemployment for the bloated and overbearing public-sector unions.

The prime minister's campaign deserves the wholehearted support, not only of your newspaper, but of all who believe that current spending must be slashed if the capital assets upon which our national future depends are to be preserved and developed.

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PART 5 ends:-

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PART 6 begins:-

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