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PRIME MINISTER

DOUGLAS HAGUE'S PAPER

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

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

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

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

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

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

JOHN HOSKYNS

1 June 1980

THE CENTRAL PROBLEM OF PUBLIC EXPENDITURE

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

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

Assumptions

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

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

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

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

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

Results

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

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

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

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

The reason why national output is four units less than on the earlier assumptions is that eight units of labour have moved from the private

to the public sector. Since they there produce only one unit each as against the 1.48 in the private sector, output falls by a net 0.48 units for each unit of labour that moves.

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

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

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

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

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

Qualifications

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

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

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

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

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

inflation averages only 0.6% p.a. In years 91 to 100, it averages 3%, and is rising.

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

Consequences

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

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

Conclusion

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

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

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

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

DOUGLAS HAGUE

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