Economic Policy

10 DOWNING STREET

From the Principal Private Secretary

SIR KENNETH BERRILL

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

A copy of this goes to Sir John Hunt.

K.R.S.

8 May 1979

Covering CONFIDENTIAL

CABINET OFFICE
Central Policy Review Staff

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

From: Sir Kenneth Berrill KCB

Qa 04093

4 May 1979

Dear Ken,

The CPRS Paper on the Economy of the United Kingdom

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

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

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

I am sending a copy to John Hunt.

Yours ever

Ken

KENNETH BERRILL

K R Stowe Esq CB
10 Downing Street
S W 1

Att

Prime Minister.

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

K.R.S.

Covering CONFIDENTIAL

Qa 04092

To: PRIME MINISTER

From: SIR KENNETH BERRILL

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

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

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

KB

4 May 1979

Att

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

Note by the Central Policy Review Staff

Introduction

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

Problems

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

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

Inflation, Industrial Performance, Unemployment

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

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

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

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

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

External Constraints

World Trade

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

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

Protection

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

Exchange Rate

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

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

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

Balance of Payments

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

The EEC

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

Opportunities

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

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

Incentives

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

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

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

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

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

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

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

Industrial Performance

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

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

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

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

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

Public Sector

Nationalised Industries

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

Public Expenditure

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

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

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

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

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

Cash Limits

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

Specific policy issues

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

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

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

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

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

28. Three general points:

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

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

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

Employment measures/regional policy

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

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

Energy

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

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

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

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

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

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

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

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

Pay Bargaining and labour relations

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

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

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

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

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

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

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

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

<u>Summary of some main points</u>

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

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

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

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

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

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

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

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

Conclusion

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

4 May 1979

SOME ECONOMIC INDICATORS FOR SEVEN MAJOR OECD COUNTRIES

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

Source: OECD

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

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

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