Sir Keith BOX JOSEPH M.P.

From THE RT. HON. SIR KEITH JOSEPH, BT., M.P.

KJ/SMC

Rt. Hon. Mrs. Margaret Thatcher, M.P.,
House of Commons,
Westminster, S.W.1.

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For information. This is the letter going to colleagues as shown.
Keith.

As you know, I think we need to state our views on incomes policy, putting it into context both of the economy as a whole and of the Party battle. As I have tried to explain, if we simply go silently along with the general assumption that incomes policies will defeat inflation, then we are tacitly giving the game to Labour.

Anyway, incomes policy is not going to end inflation nor be totally accepted. On both counts, it seems to me that we need to state the facts so as to have a coherent base on which to meet developments as they occur and the needs of the country.

I attach a draft and will be glad to discuss any particular points with you. Copies are being sent to Geoffrey Howe, Jim Prior, Ian Gilmour, Angus Maude, John Biffen, as well as to Chris Patten and Adam Ridley at C.R.D.

DRAFT IV

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INCOMES POLICY

The tumult and the shouting dies - for the moment. We have an incomes policy. Ministers assert that it will cure inflation. It is widely thought that incomes policies are good. The public are said to think so. The C.B.I. thinks so. Many Conservatives think so. The great and the good think so. Even overseas sterling holders think so - or so we are told.

When so many people agree it may be useful for an unfashionable opinion to be expressed. Then at least some other arguments can be borne in mind. I want to-day, quietly, to set out some of those arguments.

I shall argue that inflation is caused by governments - and can only be cured by governments: and that trades unions do not cause and cannot cure inflation, whatever they may do to tempt governments to cause inflation.

What is inflation? The classic definition is "too much money chasing too few goods". Higher prices do not in themselves constitute inflation. An excess of demand over supply constitutes inflation: and a general and sustained rise in prices is its symptom.

Of course, rising costs - due to wage claims or to import prices or to rising overheads or inefficiency - can lead to higher prices.

But, insofar as individual prices are forced up, consumers have the choice of either paying more for some goods and services or buying less of them, and if they pay more /then - unless the supply of money has been proportionately expanded - they will have less money for all the rest of their purchases. Thus, other prices will fall or people will buy less or a combination of both.

Most people would accept this analysis so far, but many would go on to assert that governments are, in fact, forced to accommodate price increases by allowing the supply of money to expand appropriately. These people - and they include many officials in the Treasury and the Bank of England - believe, therefore, that the way to prevent inflation is by direct control of wages and prices.

This, say the so-called monetarists, is to tinker with the symptoms rather than to tackle the cause of inflation - which is excess demand - and will suppress the symptoms, driving the excess demand into bigger price increases in the uncontrolled sector; have damaging side-effects, neither be maintainable nor achieve its purpose, so that in the end there would be inflation and unemployment and low growth or worse.

The cure, say the monetarists, is to control the level of demand, the money supply. And whose responsibility is this?

The answer can only be - the government's. It may be that wage claims are high - higher than can be absorbed by higher productivity without rises in prices: it may be that commodity prices are high: but it ~~is~~ remains for the government to decide whether or not to adjust the money supply to accommodate the same volume of demand at the higher prices.

No doubt it is difficult to control the money supply. But there are equal difficulties in other countries and yet in many the money supply has been much better controlled than here. Given the will , the job can be done.

I am not denying that the task of government can be made more or less difficult - by a world boom, by rising commodity prices, by high wage claims - but that doesn't alter the truism that the soundness of money is one of the most important responsibilities of government.

But, you may say, the analysis I have given must be wrong because here we are with inflation and no excess demand. How can there be at one and the same time rising unemployment - normally the sign of inadequate demand - and inflation? The answer is that there are time lags of between one and two years at work, and that the general increase in prices that is the symptom of inflation follows anything from one to two years after the excessive expansion of the money stock, that is to say, demand.

In this country demand has been increased and supply diminished by extravagant central and local government services: by excessive subsidised rents: by over-manning in the public and in the subsidised lame-duck sectors: and by increasing discouragement of enterprise, productivity and indeed, work.

~~Because,~~ Paying more while producing less has created the inflationary gap between demand and supply.

This gap between demand and supply - the gap which must cause inflation - has been with us to a greater or lesser extent ever since the end of the War.

More recently Labour inherited the lagged results of the Tory expansion of demand in the early 1970's - an expansion which Labour, themselves, had clamoured for: an expansion designed with the best of intent by Conservative Ministers in order, as we thought, to reduce unemployment.

During our last months of office, the Conservatives had already acted to contract the rate of growth of demand, that is of the money supply. The contraction started by Lord Barber, under Mr. Heath, was continued by Mr. Healey, under Sir Harold Wilson.

The result of the contraction over the last two-and-a-half years has, in fact, been with the expected lags, to cause the reduction of inflation, which we are experiencing. It is not the pay policy which has caused the fall in inflation. The latest Bank of England report says (page 6, paragraph 2) "Inflation in the United Kingdom began to slow down sometime before the new incomes policy could have had a direct effect."

I do not think that any one denies these general relationships. It is common ground that the stock of money (demand) and the supply of goods and services have to be brought closer to each other if inflation is to be squeezed out of the system.

This is the monetarist policy which Sir Harold Wilson and Mr. Healey have denounced, but which they have, in fact, been putting into practice, while simultaneously following policies based on contradictory ideas.

~~But,~~ At the same time as they have contracted the money supply in real terms, they have been expanding public spending. We have criticised the destructive contradiction between their monetary de-celeration and their budgetary acceleration/ - between monetary rectitude and budgetary profligacy. The results have been that the government is having to borrow on a huge scale and that all the force of the declining rate of growth in real terms in the money stock has been and is focused on the private sector. The private sector is milked while the public sector is bloated. That has been the picture - even though the sharply reduced level of private sector stocks and activity has made the corporate sector temporarily liquid - for the duration of the recession only.

But the key to curing inflation remains the bringing together of supply and demand. Inflation will be reduced no further than the degree to which the supply/demand gap is closed, whether there be a prices and incomes policy or not. Some prices and some incomes may be controlled for some time. But if, as with the last Conservative government's prices and incomes policy, there remains excessive demand, it will spill over into those sectors that are not controlled - and cannot be controlled in a free society - for instance, into building costs, engineering rates, land and property, secretaries' pay, antiques , jewellery and, of course, into imports.

It is the trend in reducing or not reducing excess demand that will affect inflation, not any prices and incomes policy.

On incomes policy, very few politicians - and I am not one - have consistent records. Let me quote from a magisterial lecture to the Manchester Business School in April 1973 by a very senior civil servant, the late Sir Richard Clarke: "The problems of incomes policy and inflation goes on year after year, decade after decade, absorbing immense amounts of time and effort by governments, unions and employers, with very little practicable success across the years."

I am not going to develop my argument against incomes policy at length here. For it is well known that incomes policies never last long: are easier first than later: easier in a recession than in an upturn: are increasingly evaded: create anomalies, conflicts, shortages and distortions: squeeze differentials and damage incentives dangerously: help militants: lead to explosions in the "catching up" stage afterwards, unless money supply is contained. In Sir Richard Clarke's words, again from the same lecture, "There is no great problem in launching the spaceship incomes policy, or indeed getting it around the moon, but in every case so far the re-entry has been a total failure, and the spaceship (and its occupants) has been destroyed." I am not going to dilate on these well known factors.

Instead, I shall ask why incomes policy has gained such widespread acceptance despite experience and logic. For a start, why is it that trades unions agree to tolerate an incomes policy?

Trades unions are, after all, creations of capitalism. They exist to bargain with employers. Their independence depends upon the existence of independent employers with whom they negotiate. An incomes policy removes their main function.

And yet trades unions agree to incomes policy. Why should this be so?

Trades union <u>leaders</u> agree for a combination of reasons. First, the negotiation of an incomes policy gives them political power - extra power. For group wage bargaining, plus political bargaining - their normal function - they temporarily substitute general wage bargaining plus a much increased political bargaining.

Trades union leaders are bargainers, and many, being political, bargain across a wide spectrum.

They bargain about the economy - import controls, price controls, dividend controls. They bargain about government expenditure - subsidies, more public spending or less cuts in public spending: rent levels: pensions: school meal prices: industrial rescues etc. They bargain about the closed shop, job protection and nationalisation and, heaven help us, defence.

I am not saying that trades union leaders are not entitled to their views, but the pursuit of a voluntary incomes policy leads to bargaining on a far wider than incomes basis or economic policy generally.. It becomes political and the resulting package invades the sphere of many other interests and of Parliament.

Look what has happened recently. In return for the so-called social contract - now seen as a disaster, leading to a vast increase in public spending, a surge in unemployment and the bankruptcy, or the near-bankruptcy of many firms - the T.U.C. exacted first a whole range of legislative commitments, giving trades unions much increased power: secondly, a series of subsidies - housing, food and the nationalised industries: thirdly, the continuance of dividend and price control.

The total price to be paid to the trades unions in return for backing what was called incomes policy was in fact inflationary. In addition it had, is having and will continue to have a devastating effect on prosperity, jobs and individual freedom. When the chickens began to come home to roost in rocketing unemployment, the trades unions shifted quietly out of the social contract and settled for a £6 general increase - more than most individual wage earners could have got in the then market conditions, in return for further concessions which, in turn, have created more inflation and more feckless foreign borrowing.

Now we have a new pay policy formula. But the T.U.C. cannot guarantee results. We are, mercifully, still a free country to that extent. It can only try to persuade.

Yes, I may be told, but if all you say is true, why does the C.B.I. also favour incomes policy? Well, it appears superficially attractive to management because, in theory, it saves them from excessive wage claims, wage bargaining, leap-frogging, strikes, strike threats, etc. Of course, experience does not bear out this optimism: in or even before the upturn, the pay controls cause nightmare difficulties: and the cost in price and dividend controls has been crippling.

Price control - which is exacted by trades unions in return for pay controls - is a particularly savage two-edged weapon, working inexorably against the very investment and jobs which trades union leaders are always clammering for. Price control - by making goods cheaper than they should be even in a competitive market - actively makes inflation worse by increasing spending power. Price control leads to suppressed inflation - and suppressed inflation is even worse than open inflation. The only effective price control without harmful side-effects is competition. Where competition does not bite, it should be made to bite. Competition stimulates the search for efficiency: price control discourages efficiency by removing its reward. Price control, particularly, in an upturn, reduces the profits on which employment, expansion and investment depend.. Price control removes from the decision-makers the prospect of profit on which they can prudently make investment decisions. Yet, it is price control that trades union leaders demand as one of the trade-offs for incomes policy.

The pitYof it is that price controls, even if they worked, and even if they had no ill-effects, could not possibly reduce inflation. For, as I argued at the outset, price increases are the result of inflation, the symptom of inflation, and you do not cure an ill by tampering with the symptoms.

Most people, including supporters of incomes and prices policies, would agree with much of this.

The question is not only, therefore, whether incomes should be regulated in a free society, not only whether incomes can be regulated, especially in an upturn, but what the price of regulating them turns out to be.

We must also surely consider whether pay and price controls are, in fact, the only way to adjust to a level of demand that rises only as the level of supply rises. I believe that they are not. There used to be a spontaneous way. It used to be widely understood that pay, output and jobs were closely linked: that pay claims, unmatched by equivalent extra productivity, would put up prices and/or erode profits and that, other things being equal, either of these would threaten jobs. That was the generally perceived truth. It used to be taken for granted.

Only the recent combination of excessive growth in money supply and of government rescues of public and private lame-ducks has destroyed the traditional and general restraint of union leaders, designed to avoid pricing people out of jobs.

The restraint was weakened by the combined effects of excess demand, the gradual erosion of the money illusion, and the accepted commitment to what was called full but was, in fact, overfull employment ever since the War. The result has been severe inflation rising dramatically as the overload on the economy increased.

The restraint needs to be re-learned - through firm government control of demand and firm government refusal to rescue - if this country is going to be saved from a future of high inflation, high unemployment and declining living standards.

Is not this - a return to stable and modest growth in demand and no more rescues - what the C.B.I. and the T.U.C. should be seeking? In the short-term, union leaders may enjoy the drama and the political bargaining and the power that incomes policy brings them. But their members will not for long think that there is much point in paying union leaders who are not free to bargain specifically for them, and will not long endure the inflexibility and the compression of differentials which incomes policy involves.

C.B.I. leaders may feel that it is their duty to play a collective role in shaping the economy, but where has it brought industry after half a generation of restraint? Nothing, in a free society, can for long save managers from the slog and burden of negotiating pay and productivity. The idea that workers will continue to accept an identical flat rate or percentage formula in a world of varying skills, efforts, shortages, profits, losses is an illusion.

The skilled lion will not for long lie down with the unskilled lamb. The attempt to cover middle and top management, perhaps by the same formula as the shop floor worker, will increasingly infuriate managers and will simply lose us our best talent.

But the old restraint will only return if all employers maintain, as many are already effectively doing, face-to-face dialogue with their employees about the realities of the market and the balance sheet and the profit and loss account. Then the workers will more and more take into account the state of the market, the employers profit and profitability, the risk of job loss and the importance of productivity in their wage claims and their attitude.

But for this to be true it is crucial that they should know that the government will not rescue jobs if the men concerned cripple their employers nor expand the money supply to float firms or employers out of trouble.

Unfortunately, governments have taught precisely the opposite lesson. Look at British Leyland, Chrysler and the sequence of rescue operations - not all for companies which have been crippled by excessive wage claims or lack of co-operation, but including some which have.

Preventing gratuitous job loss is a responsibility that can legitimately / be placed on trades unions. Some of them, undoubtedly, cause some unemployment when they price or strike or obstruct their members out of jobs. Though they are not directly responsible for inflation, they do bear some responsibility for unemployment.

The Chancellor should say to the T.U.C. "We shall continue to contract the money supply, to squeeze out inflation, so that we can revive prosperity and fuller employment. We shall not rescue jobs put at risk by wage claims or lack of co-operation. We shall pin on you, the trades unions, the responsibility for any such job losses."

This is much more within the power of trades unions to deliver. It is valid, and, far more than an arbitrary pay limit, it both is and is seen to be in the interests of trades union members that they should be warned of the risks of pricing themselves or others out of jobs.

And for this to be achieved, it is necessary for the government to sit on its hands a few times and allow excessive wage claims to demonstrate their results. There is no short cut back to health.

If governments lack the resolution to do this, they will certainly not be able to impose wage settlements on the unions lower than what the workers and their unions think they can exact. For whatever the political difficulties entailed in control of money at the centre, it will always be politically more feasible, far more feasible, than interference in specific private sector wage settlements and strikes.

True, the nationalised industries are a special case because the resources of the employer - the government - are thought to be infinite. But insofar as the government is the employer, it does not need incomes policy to balance its books. It must argue qua employer that the wages fund at its disposal cannot permit wage increases without causing unemployment.

It is the more important therefore for governments to phase out subsidies and leave each nationalised industry to finance its own costs, wage costs included: and to introduce competition, to erode their monopoly wherever practicable.

In this way, government can help to make it clear how far it is the unions which create unemployment. We have found ourselves in the irrational situation where unions are charged with maintaining price stability and governments with preventing or at least not causing unemployment, whereas it should be exactly the reverse. If governments perform their prime duty of maintaining the currency instead of actively debasing it, unions can be saddled with their share of responsibility for avoiding the creation of unemployment.

It is said that there are times when the introduction of an incomes policy may seem necessary to short-circuit inflationary expectations, so as to avoid an even worse situation - when wage claims are feverishly accelerating. But this only occurs when demand has been previously allowed far tc exceed supply - and we should, surely, have learnt to avoid this.

A bringing together of demand and supply, ~~A fall in the real money supply~~ and the certainty that there will be no rescues, are the best incomes policy and the least politically abrasive. For though it is said that expectations can be modified by incomes policy, they are far more surely modified by experience.

It has been argued by some advocates of incomes policy that though what they call the monetarist case may be true, nevertheless, given the rigidities in the labour market and the level of wage expectation, an anti-inflationary monetary policy would be accompanied by unacceptable levels of unemployment and economic recession. This is a dangerous half-truth, which needs answering.

Of course, it is true that given rigidities of the labour market, unrealistic wage demands and other unrealistic demands on the economy, you will have substantial unemployment and stagnation when the money supply is contracting in real terms. But, and this is what the incomes policy panacea proposal ignores, given labour rigidity and unrealistic demands you will have the unemployment and stagnation in anything but the shortest of short ter whatever monetary and fiscal policies are followed. The main difference is that expansionary monetary policies produce a short-lived boom and full employment followed, as we are seeing, by far deeper and longer unemployment and recession in the middle-term - and inflation as well.

Of course, there need be no surge in unemployment if the unions would accept lower real wages while the adjustment in demand occurs - and to some extent they will, and do.

Whichever, policy we follow, we shall have to tackle the rigidities if we are to regain and retain a high and stable level of employment.

One of the main arguments put in support of an incomes policy is that, during a period of monetary de-celeration, it will rescue people from pricing themselves out of work. But, surely this is best demonstrated to them by argument, not imposed. Moreover, since the unions would be acting in self-interest, surely there is no need to pay a heavy blackmail to get their agreement. Unions used to be restrained without self-awareness just as M.Jourdain talked prose.

But to mitigate unemployment the norm would have to be at a level which the bulk of employers can pay even in the context of declining demand without reducing their labour force.

And I must ask fellow Conservatives and indeed all non-socialists to consider that were it true that inflation can be abated to the slightest extent by wage or price control - which I dispute - then Mr. Jones and his colleagues must unquestionably rule the roost. This would not only mean a blackmail price in all sorts of ways - exacted from government and imposed on the country - but it would indeed make Labour the natural party of government.

Even were we Conservatives to improve our relations with the trades unions - which incomes policy was a major factor in exacerbating - we should never be in the same dimension as their Labour movement colleagues with their party hat on. For the Labour Party is part of a movement of which the trades unions are the other major pillar. And inside the Labour movement and Party it would make the unions even more the arbiters.

If co-operation with Mr. Jones were the key to price stability, then Labour must have the edge on us Conservatives. If, however, you believe, as I do, that incomes policies cannot abate inflation then neither we, nor the country, are so dependent on Mr. Jones.

Of course, Labour Ministers will present incomes policies to the public as the indispensable cure for inflation, because this makes their fraternal relations with the trades unions even more important. Yet, they know or half-know that, in fact, it is only by bringing demand and supply into balance - that is, in present conditions, by cutting public spending - that they can really eliminate inflation. So Mr. Healey accepts both mutually incompatible approaches - monetary policy and incomes policy, with no internal intellectual coherence in what he says.

Labour Ministers have persuaded trades union leaders to accept that inflation is caused by wage claims so as to allow them both to pose together as indispensable partners against inflation. True, there is the little matter of interfering with collective bargaining, but for many Socialists that is a price worth paying for greater political power and for obtaining long-sought advances in union control.

Moreover Socialists qua Socialists see all the paraphernalia of incomes, prices, dividend control - quite correctly - as weakening the free enterprise system. To them, the controls lead away from the market - and that is the right direction in their eyes. They see that prices and incomes policies strike at the mechanism of a free economic system - and they ~~rejoi~~ rejoice.

And, remember, all these controls bring another great advantage to Socialists: insofar as they appear to work for the time being they can be hailed as another victory for the British road to Socialism, while when their failure becomes obvious, as it will, this is held up as further proof that capitalism cannot work and must be superseded.

Indeed, the opening scenes for the next crisis are already being set and with them a further turn of the screw. The unions will resist any reluctant Labour efforts to secure the necessary public spending cuts - which alone can make way without an inflationary surge in the money supply for a revival of the private sector.

There will be demands for import control and other features of a siege economy. These would reduce our competitiveness and encourage the overmanning and the low productivity which are already our bane.

All this at a time when - just because the money supply has been contracting in real terms for two years or more - the rate of inflation is coming down. Ministers will no doubt not grant all they are asked for, but, they will be weakened in what resolution they have to continue the salutary contraction, and will be tempted, in order to gain or keep the precious prize of trades union leaders agreement, to relax the fundamental control that really does work, that of the linked money supply and public spending.

Mr. Healey claims to have learnt the lessons of 1970-74. He attacks us for having over-spent. Yet he is overspending on a far far, vaster scale. The government has already had to borrow heavily from the banks in order to pay for its public spending. By doing so, it has expanded the credit base of the banking system - the familiar source of an explosion in the money supply when, as is bound to happen before long, there is increased demand for credit from industry and private individuals.

There is no such demand yet. The expanded credit base is lying like a powerful bomb with the fuse yet unlit - high-powered money or overhang as it is called in America.

By refusing to cut public spending as much or as soon as is necessary, Mr. Healey faces the need for huge further public borrowing. In his letter to the I.M.F., he has already envisaged a ceiling to domestic credit expansion which implies a growth in the money supply greater than the desirable trend - a growth of 15%. That growth rate itself implies that inflation will surge up again in 1977/78 after its dip in 1976.

Unless government cuts public spending sharply and very soon, this resurgent inflation is inevitable - when the bloated public spending and consequent public borrowing collides in its demand for credit with any resurgent demand for credit coming from an upturn in the corporate sector.

Prices and incomes policies end in tears. In our particularly dangerous inflationary condition, the bargains that are struck to obtain union agreement are undesirable in themselves and may be explosive in their effects on inflation and, through inflation, on unemployment.

I give this talk at this time not because I think that I shall persuade the country - or indeed every one of my colleagues - at this stage, but because incomes policy will break down whatever we say or do - and therefore the Opposition needs to be ready to explain how to pick up the pieces. This will include the necessary sharp cut in public spending, to reduce borrowing and then taxing, and a return to free negotiations - reflecting the varying needs and conditions of various employers, with prices and dividends free to reflect competitive reality, and with the government unwilling to rescue companies crippled by excessive wage claims or lack of co-operation in productivity.

It is a truism worth recalling that those who cannot learn from experience are bound to repeat it. We must learn this. The price of not learning now will be unbearable.

I hope for our country's sake that all parties will learn. For a start, I hope that they will watch with grave care the price that will have been exacted for incomes policy. I hope that pressure on the government to cut public spending sharply and soon will grow from all sides - its own ranks included - and there have been critical voices raised on the Labour side, let us not forget. For prices and incomes policies do not, cannot, abate inflation.