TO ALL MEMBERS OF THE LEADER'S CONSULTATIVE COMMITTEE

Attached is a paper on The Economic Prospect and the Party's Political Position by Sir Geoffrey Howe, LCC/75/94, to be discussed under item 5 of the agenda for the Shadow Cabinet meeting on Wednesday, 17th December, 1975.

Mrs Thatcher.

This is G H's pre-Christmas Economic Paper which he believes could be re-used at the all-day Shadow in some form or other. You already have my note on the economic forecasters.

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THE ECONOMIC PROSPECT AND THE PARTY'S POLITICAL POSITION

(A Paper by Sir Geoffrey Howe)

THE ECONOMIC PROSPECT

1. With every month that passes it becomes clearer that the world economy is not poised on the edge of a sudden or explosive increase in production. For a variety of reasons the recovery will not get under way seriously until later in 1976 and for some time will be more marked in America and Japan than in Europe. Against that background the prospects for this country naturally remain sombre, as the following very condensed comments suggest.

Prospects for the UK

2. Production. No strong upward movement is likely before 1977. One can expect 1976 to be a second year of stagnation with GDP remaining 1-2 per cent below its level in 1974 and greater than its 1970 level by the same small amount. There will naturally be increasing pressure to reflate, though initially it will probably be milder than might be expected, except from the extreme left. Symbolic gestures in that direction are therefore almost inevitable, but as yet there are no grounds for predicting that the Government will move too far from its present policy of waiting for others to grow first. However the pressure on the Chancellor can only grow as time passes.

3. Trade balance and international borrowing. The balance of trade has almost certainly stopped improving. The current account deficit next year is likely to be worse than in 1975, in the £2-2½ billion range, and no-one is expecting much improvement the year after, despite the effects of the accelerating flow of North Sea oil. The Government are clearly set on introducing limited and selective import controls now as a gesture to the Left and a concession to certain constituency pressures. Further international borrowing is unavoidable. The Government are unlikely to be able to face two more years of substantial deficit without recourse to the IMF, which must entail a Letter of Intent and all that goes with it. Some Ministers may welcome this development since it could provide compelling pressure to follow policies which they would not have the power or courage to pursue on their own. Others may well try to use this threat to justify further moves toward a siege economy.

4. Unemployment. If production follows the path suggested above, unemployment will reach the 1¼ million level some time in the summer of 1976 and stay there for a year or so. Some observers believe that it could well settle at a still higher figure. Further selective measures to keep up marginal pockets of joblessness can be expected, probably linked with an extension of industrial training.

5. Company Finance. The short-run deterioration in company finance has ended and with the passing of the threat of widespread bankruptcy some observers have become unduly complacent. Yet, the underlying situation remains grim since there has been no improvement in profits or profitability when due

allowance is made for inflation, while the rate of return on capital needs to be raised by a factor of two or three. It is not clear how far the Government appreciate this, or how far such measures as they will take to extend selective assistance to certain firms and sectors and amend the Price Code (in the Summer) will make any material difference. It is possible that they will take further measures - such as some kind of new device for raising investment on the lines proposed by Jack Jones with the help of John Hughes of Ruskin College. Even if they do, the confidence and morale of industry is unlikely to improve very greatly, and the financial climate will be a major factor making for a slow and limited economic recovery. The sound noises and good intentions of the Chequers strategy and the Chancellor (on his better days) are in evident conflict with the Government's proposals for industrial policy in the Queen's speech and the proposals for rescuing Chrysler. Such confusion cannot but bewilder the business community.

6. Wages and Prices. The introduction of the £6 limit has been accompanied by a dramatic reduction in the level of pay settlements. However, even if the policy continues, without being challenged, the year-on year increase of retail prices is unlikely to sink to below 10 per cent by the end of 1976, particularly if import prices are moving up again, as they may well be doing by then. The purely economic pressures on the £6 limit may well be too weak to undermine it, and as yet there is no evidence that there will be a serious politically motivated challenge to it. But the next stage will obviously be a very different matter. It is easy to see the problems of obtaining union acceptance to a still lower pay limit, of allowing for a substantial correction of differentials within such a lower overall limit and of seeking both against a backcloth of exceptionally high unemployment and price increases in the 15 per cent range. Whatever happens, our inflation rate will remain higher than in almost all our competitors, probably exceeding theirs by over 55 per cent.

7. Public borrowing and the money supply. There are widely differing views about the trend of the public sector deficit (PSD), the borrowing requirement and the money supply next year. At best it is possible that the PSD for 1976/67 will form a somewhat smaller percentage of GNP than in the current year. But the share could well be significantly higher according to some observers. It seems probable * that the money supply will before long grow at a rate which is unacceptable both to the Government and outsiders such as the IMF and our other creditors. If that is the case a significant, even somewhat dramatic tightening of monetary policy is inevitable, something which can only weaken such modest expansionary tendencies as may otherwise emerge in industry. While such actions should be welcomed in itself, it could be very damaging if not accompanied by cuts in public spending borrowing. For on its own it would intensify constraints on private sector borrowing and expansion might push more firms into liquidation or the arms of the Government.

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* This is not, however, the unanimous view of outside experts

8. Public spending. We can expect the Chancellor to announce shortly, cuts rising to around £3,000 million or more by the end of the decade, beginning in 1977/78. We can also expect the admission that public spending this year has been well above forecast in real as well an money terms. There are as yet no indications that he will propose significant reductions in programmes for 1976/77 and the later and slower the prospect of an up-turn the less likely become such proposals. However, it is quite possible that he may be driven to make such cuts before very long, either to satisfy our creditors or to provide resources to "give away" in the April Budget. He ought to do so in any case.

9. The Budget and tax Changes. The Chancellor's recent remarks strongly suggest that on present intentions his next Budget will not be significantly reflationary. He may well try to moderate the burden of direct taxation somewhat to offset rising social security contributions, reduce the effective marginal tax rate and raise the tax threshold above the poverty line to which it has now descended. (Both he and the Prime Minister have suddenly begun to put forward good Conservative arguments about the dangers and imminence of over-taxation). He will only be able to achieve this if he can somehow reduce expenditure on transfers and subsidies (?food and rents) or increase revenue from higher Nationalised Industry prices, rates, health and other charges and indirect taxes and duties (probably selectively rather than across the board). Failure to mention the Wealth Tax in the Queen's Speech and even the confused report of the Select Committees does not necessarily mean that the Government do not intend to proceed with it. They may be holding back from doing so in order to extract better terms from the unions for the pay limits in the second stage of the counter-inflation policy. Major negotiations with the TUC will anyway be needed by next spring.

THE PARTY'S POSTURE

10. Our reaction should not simply consist of assessing what has to be done and saying so but also:

(a) securing general acceptance of that case;
(b) winning power with which to implement it; and
(c) having won power, securing the authority for carrying it into effect.

11. This can only be achieved if first, we identify the people to whom we have got to convey our case and with whom we have to carry conviction; and second work out the best (and probably varied) ways of getting the message through to different groups of people, e.g. "opinion-formers", management, union leaders and the TUC, and (a quite distinct target) union leadership - shop floor opinion - mass opinion. To the last in particular, we may need to address not only an exposition of the main economic diagnosis (consequences of commercial weakness, over-manning, unrepresentative trade union leadership, etc.) but also much narrower semi-populist points, e.g. harshness of taxing widows and the poor, simplification of VAT and other shoe-pinching matters.

Government Strategy and the Likely Economic Background

12. The Government's main difficulty - apart from the conquest of inflation and the resumption of even modest economic growth - is a technical one; it would seem impossible to have at the same time a deficit of perhaps £12 billion, for there to be profits, investment and expansion in the private sector, and for the money supply to be kept down to levels consistent with a lower rate of inflation. There are four possible courses of development:

(i) Allow the money supply to accelerate - as the consequence of trying to tackle the other problems - with the consequent re-establishment of high rates of inflation. Even for Labour this is probably politically disastrous.

(ii) Raise taxes or cut public spending drastically in order to reduce public borrowing. Tax increases are politically unlikely and cuts in spending on the necessary scale perhaps almost equally unlikely.

(iii) Rein back future public spending plans moderately and maintain something like the present scale of the public sector along with reasonably tight monetary policies. Even this must curb the expansion of the private sector. Banking on the possibility that North Sea oil and world trade will gradually float the economy off the rocks. This approach could be accompanied by continued failure to keep to the Chequers' approach to the private sector; tight price control and various rescue operations. Or

(iv) Economic collapse in face of the crisis for which perhaps too many of our supporters have been waiting for too long as the much-to-be-welcomed deus ex machina.

13. It is easy to see why alternative (iv) is the one on which it would be convenient to rely. It might enable us to come to power with a "doctor's mandate" and then to set about radical implementation of the most purist policies. My own belief is that this is the least likely, because the easiest, scenario. Crisis after crisis - in objective terms - has passed us by in recent years, most noticeably at the end of 1973 and beginning of 1974. Yet the Government are still there and our popularity with the electorate is not markedly greater than theirs.

14. The most important conclusion is that even if crisis is likely (and I believe not) it is far from certain. It is much more probable that the Government will follow the course suggested in paragraph 4 (iii), a kind of "muddling through".

15. The only sensible conclusion is that we cannot foresee precisely what will happen, but nevertheless should identify what will need to be done and to go on arguing that case - recognising that the time at which, the manner in which, and speed at which we might carry it into effect will depend upon when and in what circumstances we come into power. Our objectives should be not merely to win power at that time but to ensure that our general prescriptions are so well understood that we shall have the authority to carry them into effect "with all deliberate speed".

16. The main elements of our prescription should thus be:

(1) The restoration of the dynamics of a free economy - commended on grounds of political as well as economic freedom.

(2) Emphasis on the prime importance of

(a) proper management of the money supply (without much attempt to popularise this unintelligible proposition - except by arguing the case against big public spending, and big borrowing by the Government and internationally).

(b) complementary to (a), greater restraint and economy in public spending (commended not so much on arcane - but accurate - economic grounds but because it is the only way of lowering taxation and shifting resources into a profitable and productive private sector).

(c) The need to raise profits in order to generate investment and growth and conquer unemployment. The need, for similar reasons, to relax price control and, if possible, to end dividend control.

(3) Recognition that we shall not be able to achieve the necessary reduction of spending and inflation without co-operation from organised labour, who can constantly upset the economic applecart in a number of ways.

(4) Acceptance of the case against a return to unfettered free collective bargaining after the current £6 limit ends - a move which would only encourage a resurgence of inflation at the worst possible moment.

(5) Avoid as far as possible any return to a legislative approach to union power over the next few years. For the time being follow a more oblique approach: encourage more true Union democracy and thus moderation; stimulate management to inform and educate their work forces, and to introduce more participation/consultation/industrial democracy. Consideration will also have to be given - in some matters discreetly - to ways of removing certain props from Unions, such as social security benefits and tax rebates for strikers and their families and to ways of supporting industry during strikes.

(6) Present our economic strategy as a more "democratic" set of policies involving the extension of "participation" by citizens in union affairs, in fields currently dominated by Government, and in industry.

(7) Present our viewpoint in a context which discourages high expectations from government policy and accepts that Government will tinker with the economy far less and will refrain from using "fine tuners" such as VAT rates, or concertina-like treatment of the construction industry.

(8) A general commitment to the reduction of taxes, particularly direct taxes, so soon as it can be afforded. Here too, high expectations should not be encouraged. We should in fact be thinking in terms of moving more from direct to indirect taxation as a source of revenue but again at a modest pace in order to avoid disturbance of the RPI.

(9) These prescriptions can sensibly be buttressed by populist policies and not only in the economic field. Abolition of domestic rates (the cost to be transferred, without effect on the RPI, to indirect taxation) is one such policy. If this kind of strategy is generally accepted, having been argued consistently over a long period, then we can apply ourselves to the equally important question of how it is to be got across to whom and on what time scale.

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