

PRIME MINISTER

John Hoskyns has prepared the attached paper for you and the colleagues concerned to use as a basis for discussion at your Ministerial meeting on strategy on Monday at 1100. We ought to send it out in good time for them to read and I think it would be right to do this under cover of a minute from you indicating that you want Ministers in their Departments to have done their homework on it before the meeting. I attach a draft for this purpose.

Are you content for the paper to go forthwith, under cover of your minute?

Yes - but it
will take a

whole day

K.R.S.

13 June 1979

do discuss it even on the
basis of the "possible
Appendix" note.

GOVERNMENT STRATEGY

1. INTRODUCTION

This paper is intended as background to our Strategy Meeting on 18 June. The purpose of that meeting is to answer the following questions:

- (1) What are the Government's main objectives?
- (2) What essential intermediate objectives - or "sub-objectives" - must be achieved, if we are to reach those main objectives?
- (3) What actions must which people put in hand, starting when, if we are to begin moving towards those sub-objectives?

The structure of the paper is as follows:

Section 2: OBJECTIVES AND STRATEGY. This Section briefly recapitulates the Stepping Stones thinking of the last two years, for those who were not involved in it.

Section 3: STABILISATION. This Section looks at some of the sub-objectives which must be achieved over the next 2-3 years, if we are to prevent our present instability from undermining all our other plans.

Section 4: REBUILDING THE REAL ECONOMY. This Section lists some of the measures needed if the long process of economic recovery is to start.

Section 5: INNOVATION. This Section briefly discusses the need for new ideas in policy, whether novel measures or familiar ones assembled in new ways.

Section 6: COMMUNICATIONS. This Section discusses the importance of communications to support policies, and as part of a programme, which starts now, to ensure that we win a second term in 1983/4.

Section 7: CONCLUSION. Summary; suggested agenda at Appendix A.

2. OBJECTIVES AND STRATEGY

2.1 The Stepping Stones Project

2.1.1 The purpose of the Stepping Stones project was to develop a coherent approach to the task of turning round the British economy. The emphasis was not on the developing of a comprehensive list of measures, but rather on ensuring that we understood the structural and systemic nature of the problem. We agreed that, if we could do this before coming to office, we would have a better chance of concentrating our limited resources of thinking time, administrative effort, political capital, money, on the root causes of Britain's malaise, rather than doing "a little bit of everything", in treating the symptoms.

2.1.2 The reason why previous Governments have had virtually no success in halting Britain's decline is that the nature of that decline has not been fully understood. In particular:

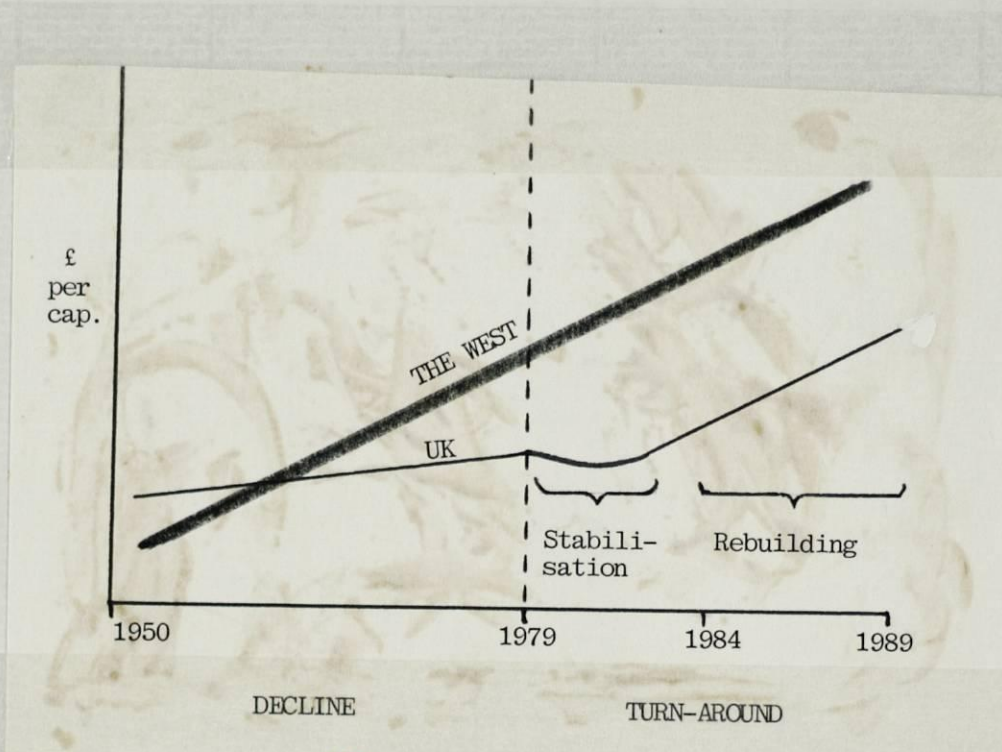
- (a) The problem is a single problem with a large number of interconnected bits and pieces. The interconnections cross departmental boundaries, and comprehending the problem in its entirety is difficult.
- (b) The decline process is a network of vicious circles, which are continually generating fresh momentum. The process is thus, at any given moment, always more powerful than it looks. Governments have found themselves vainly chasing after an accelerating decline, instead of preparing to intercept it.
- (c) We are dealing with social systems, not mechanical ones. The expectations within the system tend to be self-fulfilling. Government therefore has to persuade people to think and feel differently, before the behaviour of the system can change.

2.1.3 We found it helpful to distinguish between categories of policy. In particular:

Good Housekeeping - All those sensible economic policies (included in our Manifesto), whose gradual abandonment over the last 20 years has been responsible for most of our problems. Economic recovery will not be possible without a resolute and single-minded return to Good Housekeeping. But Good Housekeeping alone will no longer be enough to arrest the decline momentum.

Turn-Around - These are the new measures which must arrest that momentum and get the economy back to a stable state, in which Good Housekeeping policies can become effective. In this paper I have suggested that the process of Turn-Around should itself be divided into Stabilisation, and Rebuilding.

We can represent the whole process as follows:



Stabilisation is the difficult bit. It is what people mean when they say "You can't get there from here". That part of the journey is likely to take most of our first 5 years. There is likely to be a noticeable J-curve effect over the first 2 or 3 years, when economic deterioration, as judged by the traditional indicators - growth, unemployment, inflation - will all look worse than they did in 1978/9. Hence the need for careful design of the stabilisation programme and its successful communication to the electorate. The electorate, and the media commentators, have experienced 20 years of Government exhortation, new dawns, belt-tightening, all without any discernible effect on our fortunes. The resulting scepticism is now one of the main obstacles to recovery.

After Stabilisation, we will need to get back to a growth rate which is roughly similar to that of the other Western countries. The alternative is to continue to drop slowly out of the Western world in political, social, and military terms.

- 2.1.4 In reality, of course, the Stabilisation and Rebuilding policies will merge together. It is neither necessary nor desirable that measures for Rebuilding should wait until the Stabilisation process is achieved. In fact, the more credible the Stabilisation programme looks - and thus the more quickly confidence is restored - the sooner the Rebuilding process can start. But it is important, in our own minds, to separate

the two. While Stabilisation is possible, with or without subsequent Rebuilding, Rebuilding will not be possible without Stabilisation. To attempt it would be like trying to pitch a tent in the middle of a landslide. This is what Governments have tried to do in the past and have been surprised as their efforts keep getting swept away by the latest instalment of bad news.

2.1.5 In the original Stepping Stones report, we listed our Stabilisation objectives as follows:

- (a) Zero, or near-zero, inflation.
- (b) ! Zero inflationary expectations. In other words, people must be sure that there will either be no further inflation; or else that they would neither gain nor lose, if there were.
- (c) Private sector and "market" public sector pay systems. The process of pay bargaining should no longer be capable of either raising prices or reducing investment. It must instead be based on past real economic performance.
- (d) Non-market public sector pay systems. These systems must in aggregate be non-inflationary, in the same way, following real GNP growth rather than triggering monetary expansion. (There will of course be wide variations within the public sector reflecting labour supply and demand.)
- (e) Restoration of personal incentives (involving a significant reduction in Government's share of GNP).

What-

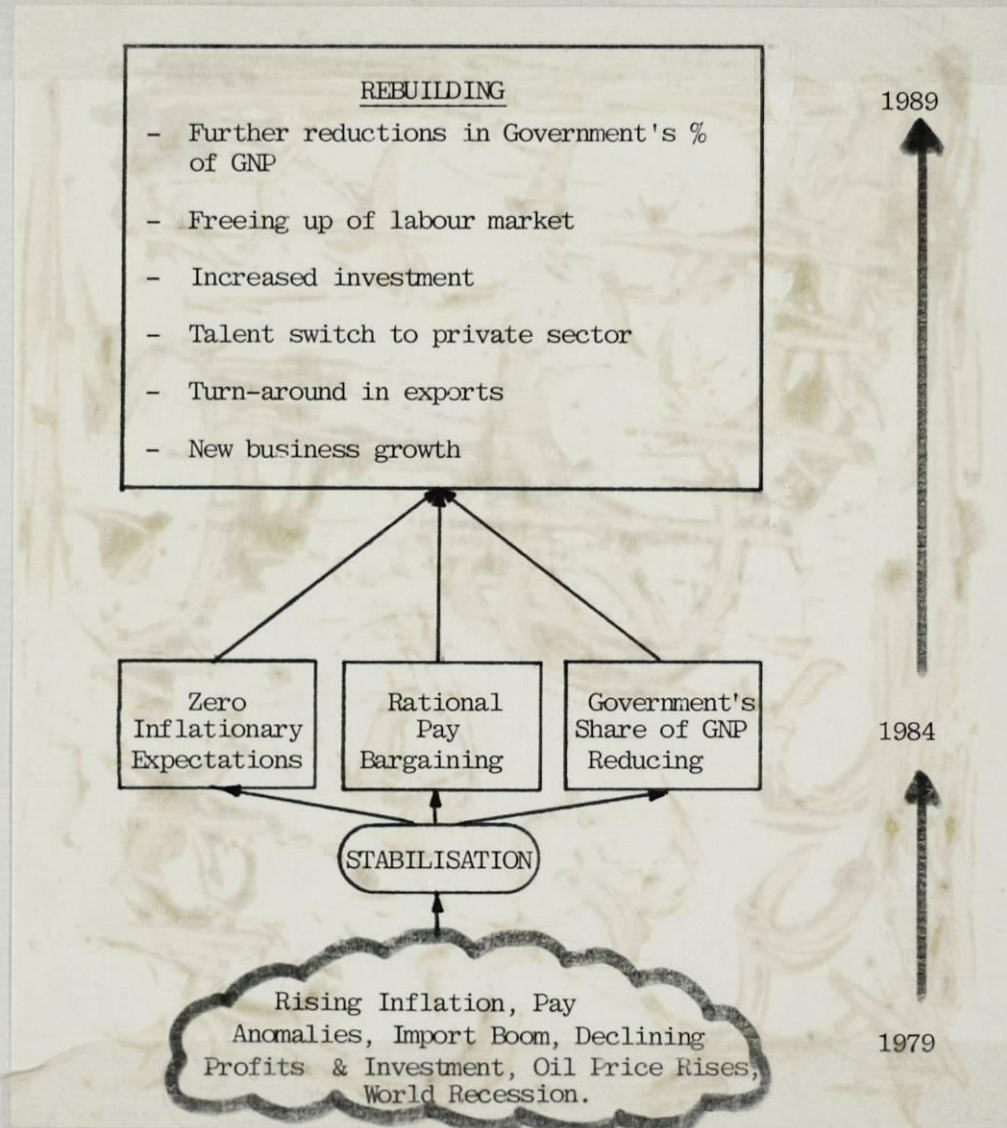
To this we should now perhaps add:

- (f) Stabilisation of the exchange rate, if that is possible at all, at a level which allows British exporting companies to bootstrap themselves back to real international competitiveness, given other structural changes.

This is the sort of stability we should be aiming for. We have a large task of economic rebuilding to do, and we need a high degree of stability if we are to do it. But these objectives do no more than allow the process of Rebuilding to start. On their own, they will do no more than stabilise the rate at which we drop out of the Western world, in relative economic terms. For Rebuilding requires fundamental changes in both the quality and the financial arithmetic of the private sector.

Strategy requires the setting of objectives and working back from those objectives to find possible routes from the present situation.

If we now take a 10-year view of our long-term objectives, intermediate objectives and strategy, we could get a simple picture that looks like this:



3. STABILISATION

3.1 Which Comes First, Stability or Confidence?

3.1.1 Stabilisation requires "reasonable behaviour!" It is difficult for Governments to stabilise the economy while individuals or groups behave irrationally or irresponsibly. But if the economy is unstable - especially with a combination of inflation, inflationary expectations and accumulated distortions and

grievances as a result of past failure to index - everyone is forced to take action to protect himself, even though it is obvious that those actions help to perpetuate the instability. The most obvious example of destabilising behaviour is that of trade unions trying to pre-empt each other's attempts to anticipate the future inflation rate.

- 3.1.2 Reasonable behaviour depends on confidence about the future, so that people are prepared to plan ahead, and to make present sacrifices for future benefits.

Confidence will always be a relative matter. It can never be complete, because the future is uncertain. But the additional uncertainty caused by a high and rising inflation rate can be relied on to produce the "unreasonable" behaviour which will itself make that inflation much harder to eliminate.

If these circular forces are likely eventually to drive us to some sort of interim pay freeze or guideline, it is important that we see it coming and build it into our Stabilisation strategy, as a properly thought out option.

- 3.1.3 Business confidence is also a complicated matter, because a businessman only feels confident when he senses that other businessmen also feel confident. Confidence comes - as people who have worked in the United States know - from direct experience of successful operations, and from seeing many other examples of spectacular business success. It cannot come from the assurances of politicians or the increase of investment grants. It is therefore a long drawn out chicken-and-egg process. After all, most businessmen have been living, like everyone else, with economic disappointment for 15 years. (It is very much easier to recreate economic confidence in an economy which has nowhere to go but up: eg Western Europe after the war or South Korea, Singapore, Taiwan today.)

A realistic objective would be for British businessmen to begin to think like their foreign counterparts by the time Stabilisation has been achieved - in other words, about 1983 or 1984.

3.2 Where do we Start?

- 3.2.1 Past efforts to revive the economy have consisted of Government exhortation (management must be bolder, unions must be more co-operative, consumers must tighten their belts) coupled with steadily growing public expenditure, and fiscal and monetary adjustments of various kinds. In the absence of any sustained programme to restabilise the system and then repair its structure, these efforts have amounted to no more than fighting with the controls of an aeroplane that can no longer fly.

3.2.2 The present unstable situation includes:

- (a) High inflation and inflationary expectations. Further post-dated cheques in the pipeline. Still growing public expenditure.
- (b) Unresolved pay anomalies, especially in the public sector.
- (c) Import boom, with falling company profits, aggravated by an over-valued pound.
- (d) Likelihood of world recession, with further oil price rises.

3.3 Main Components of a Stabilisation Programme

3.3.1 It was suggested in Section 2.1.5 above that a successful Stabilisation programme would achieve five things: zero inflation/inflationary expectations; performance-related pay bargaining in the private sector; GNP-linked pay bargaining in the non-market public sector; the restoration of personal incentives; and a stable and appropriate exchange rate.

3.3.2 Here are some of the questions we have to ask before trying to assemble a programme to achieve such objectives:

(1) Inflation

- (a) What is our target rate of inflation? Is there an inflation rate (say 3%) which does not inhibit the economic rebuilding process, and might even lubricate it?
- (b) Given that it will take time to squeeze inflation out of the system, are there any ways in which we can reduce inflationary expectations (which will otherwise make the elimination process harder) in the meantime?
- (c) To what extent should we index in order to reduce further distortions, anomalies and injustices during the squeezing-out period?

Not

(2) The Role of the Trade Unions

- (a) Will the changes in union law now in hand be sufficient to prevent the strong unions from gaining at the expense of the rest of society, under a regime of tight monetary discipline?

- (b) Is there any other mechanism, apart from a transitional period of pay freeze or pay restraint, by which we can prevent unions trying to get ahead of each other and repeating the 1974 disaster?
- (c) More generally, are there other ways in which we can persuade unions to bargain in ways which do not inevitably lead to some combination of lower investment/higher prices/fewer jobs?
- (d) How do we get the "union debate" started properly, as proposed in the original Stepping Stones report? We need to force union leaders to address their members in the language of the real world, so that rational debate about the role of the unions over the next vital years can begin. The predictable reactions of union leaders to the Budget could provide the opportunity.

(3) Exchange Rate

- (a) In the past, devaluations have been, faute de mieux, the only actions Government have taken to try to rescue British industry from its own failure. Attempts at real structural change, (eg tax, union reform) have either not been attempted, or have come unstuck. We now have no option but to go for structural change. Is there such a thing as an optimal exchange rate for that period of change? Is there in fact anything we can do to help bring about such an exchange rate?
- (b) What are the present predictions for the exchange rate, in the light of the Budget? If the pound remains high, to what extent can exporting companies adapt to it? What is the process by which they would do so? What is the likely effect of the relaxing of exchange controls?

(4) Reducing Unnecessary Risk

- (a) We know that macro-economic management will be extremely difficult, because the real economy is now so fragile. Even if we get all the main decisions right, turning the economy around will be a close-run thing. In every major decision, therefore, we have to be clear about what we are trying to achieve; are we trying to maximise the benefits of a correct decision, or to minimise the cost (political as well as economic) of a wrong one? They are two different objectives, usually, though not invariably, requiring different approaches. Perhaps the most obvious example of a complete lack of this sort of perspective was the introduction of museum charges in 1970/71.

- (b) Purely as examples, we may take a high-risk technical decision on nuclear power technology, which may have extremely serious consequences if we are proved wrong, and only modest benefits if we are proved right. Similarly, the political disadvantages of BNOC may be less (especially once some of its privileges are trimmed back) than its usefulness in preventing predictable future oil shortages from interrupting Britain's struggle for economic recovery. How does the pay-off from abolishing BNOC, and being proved right, compare with the penalties from abolishing it and being proved wrong? How central is that decision to Britain's recovery? There will be many such decisions.

3.3.3 Pay Freeze, Incomes Policy, etc

Previous Governments have drifted into incomes policy, either because their strategic thinking had proved wrong, or else because they had no strategy at all. There are very strong arguments for avoiding a freeze or pay policy; the irresistible challenge to militants or dissenting union leaders; the headline publicity given to any successful breach, representing a further similar challenge to other union leaders; the continued distortion of the economy and the paralysing of an already rigid labour market; growing resentment and frustration preparing the way for an explosion when the period of restraint ends.

Despite the scars of the past (and the UK has experienced the worst of all worlds; the flat-rate Jack Jones increase, together with a refusal to index tax bands) it is not impossible that we will find ourselves, once again, having to choose between three evils:

- (1) Holding fast to our monetary targets, while powerful unions (public or private sector) get their way, putting other people out of work and bankrupting small firms.
- or: (2) Avoiding (a) above by relaxing control of the money supply, cash limits in the public sector etc, and thus accepting a further surge of inflation which will bring the whole problem round again in 18 months' time.
- or: (3) Hastily putting together a pay freeze or guideline, knowing it will prove to be just another cul de sac.

As soon as possible, therefore, we should try to establish the circumstances in which we might find ourselves facing such a choice and being driven towards option (3). If we conclude that these circumstances are likely, then we should do some preliminary "design work" on a system which will help

us to get from instability to long-term stability. Its requirements would include:

- (i) It must be inflation-damping, not inflation-aggravating (as ill-conceived threshold systems have been in the past).
- (ii) It must be minimally distorting (in other words percentage-based and accompanied by appropriate indexing of tax bands etc).
- (iii) It must provide for easy exit to the type of stable system we will need for Rebuilding, rather than, as in the past, a sudden mass return to the same chaotic instability from which we were originally trying to escape.
- (iv) It must embody, as far as possible, features which will make it politically saleable.

3.4 What are the Relevant Issues or Decisions now Facing Ministers?

For example: European Monetary System; exchange rate policy and exchange controls; oil shortage (impact on unemployment, prices etc); public sector pay settlements, comparability etc; EEC contributions. *and effect on prices*

4. REBUILDING THE REAL ECONOMY

- 4.1 I have suggested that the task of Stabilisation is not only urgent but, due to its Catch-22 nature, extremely difficult to perform. This is why the major part of this paper has been devoted to that part of the programme.

The task of Rebuilding is in some ways more straightforward, though it involves many different actions and a long time-scale. This Section does no more than comment briefly on its main elements.

- 4.2 There is a large number of technical measures the Government can take to make economic revival, and especially the regeneration of the private sector, quicker and easier. Many of them require no legislative changes. Most of them can start early, while the process of Stabilisation goes on.

Many of these measures are in hand or will shortly be put in hand.

4 Getting the Economic Arithmetic Right

4.3.1 Cutting Government spending and eliminating waste

This is a long-term programme. We have not yet succeeded in communicating to the public that we have no option in this matter, that the economy simply cannot fly, in its present debilitated state, unless the welfare and public services pay load can be lightened, and the private sector engines made more powerful.

4.3.2 Public Sector pay

We have already said that getting this onto some systematic basis is an essential part of the Stabilisation programme. However, we need to work in the longer-term towards more imaginative arrangements, whereby people can be positively motivated to improve value for money, as the real way to higher pay.

4.3.3 Freeing up the labour market

The first steps will soon be taken, with amendments to the Employment Protection Act. The sale of council houses should also help. There is still, however, a familiar vicious circle to unwind here: high unemployment, a low birth-rate of new businesses, skilled labour shortages in growing companies, high manning levels especially in obsolescent businesses, with strong trade union resistance to their reduction.

4.3.4 Improving company performance

Although investment levels are by no means the sole determinant of profitability, the present vicious circle is well enough known: overmanning leading to low profits and cash flow; leading to low investment and obsolescent plant; leading to low output, low pay, low profits, low investment, low growth; leading back to defensive union attitudes and over-manning.

4.4 Getting the Management and Technical Talent into the Right Places

4.4.1 This is another long-term programme, requiring a profound cultural change. Perhaps the important thing for us to recognise is that fashion follows money. As the American academic said at the end of his lecture, "Don't clap. Throw dollars!". Previous Governments have been constrained by union power in industry and by the prevailing egalitarian mood. They have therefore resorted to the commissioning of studies and the publication of papers about how to encourage more people to study engineering instead of pottery or sociology. Everyone knows that industrial management is very hard work, made harder by industrial relations problems, badly paid, highly taxed, in the wrong geographical areas. The whole package is simply unattractive.

4.4.2 The only way to change this is to make management and engineering a better way of accumulating personal capital. Prestige and social status will follow the money soon enough. There may be other things we can do to encourage movement between the Civil Service and industry, but it probably won't happen until managers are so prosperous and so lightly taxed that they begin to attract the attention of other parts of the population. The reverse is at present the case.

It may be possible to accelerate things by giving special grants to engineering students and so on, but what is really needed is 10 years of vulgarly pro-business and pro-industry policies.

4.5 Winning Export Markets

Businessmen know that, other things being equal, it is much easier to concentrate their efforts on the domestic market. It follows that in most countries (but not perhaps in Britain) there is considerable pressure and incentive, together with close Government partnership and support, for exporting companies. Similarly, foreign governments erect all sorts of unofficial barriers in the way of imports. I suspect that there are many things we could do - all relatively simple and perfectly legal - which would help us to export more and import less.

Our difficulty is, first, that Britain in the past has tended to play by Queensberry rules, without realising that everyone else is doing catch-as-catch-can wrestling; and, second, the Civil Service has concentrated on being "fair" in its dealings with British companies, preferring them all to be relatively unsuccessful, rather than that one or two should enjoy unfair good fortune. This is one area where Government can "back the winners", and should do so.

4.6 Breeding New Businesses

4.6.1 The two most important spurs to the growth of new businesses are, first, the abundant and visible evidence of entrepreneurial success (not much of that around in Britain these days) and, second, large numbers of individuals with enough surplus wealth to be able to take the very high risk of investing in a new business. Government agencies to back small companies or Government exhortation to the financial institutions to do so are not really the answers because the overheads in using highly-paid analysts to investigate tiny investment projects are disproportionate. In the United States, especially, such analysis is often done (with great care!) by business executives (often retired) risking their own money and their spare time.

4.6.2 There must be many things, however, that can be done to speed up the process. For example, allowing people to set new

venture investments against income for tax purposes. We have to make this type of risk-taking extremely attractive. Once we can get over our traditional British hang up - the lurking fear that a few individuals might make a lot of money out of it - a lot of good things will start happening.

5. THE NEED FOR INNOVATION

5.1 Complex Problems Don't Have Obvious Answers

Everyone knows that the UK economic problem is one of structural fatigue, not simply bad navigation. It follows that, as suggested earlier, feverish twiddling with control knobs - subsidies, taxes, regulations - will be ineffective. Repairing the structure is a quite different task and it will involve generating and trying out novel ideas; or assembling familiar ideas and measures into novel "configurations". That will require a blend of realism and technical and political imagination, together with a lot of patience.

5.2 Innovation is Unpopular

Innovation will run into many obstacles. People often resist new ideas because they feel they should have had them themselves. New ideas may threaten local interests, or conflict with Departmental views. Thirty years of decline have persuaded many of our political and administrative elite that nothing can really be done about anything. The British are particularly inhibited about generating new ideas, for fear of looking foolish. Innovation involves risk. People feel safer trying old remedies which may not work, but which at least fail in familiar and predictable ways. Since doing nothing is always the least stressful option, they tend to dismiss familiar ideas as unoriginal, and original ones as naive. All this must apply to innovation in Government as it does in industry.

5.3 We will not innovate successfully, unless we organise for it

5.3.1 We need to give some thought to the best way of tapping analytical and creative talent within the Departments so that (making appropriate use of the CPRS) we can start to design some prototype solutions, especially for the Stabilisation programme. As with any other entrepreneurial activity, political innovation must be an act of faith. Only when we have built something new will we be able to see how difficult it would have been to do without it.

5.3.2 Necessity is the mother of invention, and it is perhaps worth remembering that wartime produces innovation on a massive scale; an endless list of technical and logistical achievements which everybody thought were impossible. Innovation is only attempted when it is clear that the consequences of failure to solve a particular problem will be very grave indeed.

6 COMMUNICATIONS

6.1 Supporting Policy

Communications means not just the conveying of information, but persuading people to change their minds, to see things in a different light. The more carefully thought out our broad strategy is, the easier it will be to focus our communications effort on the issues that really matter, if our policies are to succeed.

Already, since the election, we have seen examples - understandable in the pressures of taking office - of obvious failures of communication. Conscious preparation and co-ordination will be necessary if we are to get it right in the more difficult months ahead. Top of this list, as already suggested, is the debate about the role of the trade unions.

6.2 Winning a Second Term

Since the next two years will be hard going, and we are not likely to be able to show the electorate a great deal for our efforts by 1983/4, we have to think now exactly how we are going to win the next General Election. I have had preliminary discussions with the Chairman of the Party and the Director of CRD on a communication programme to pave the way. Such a programme might have the following elements:

- (a) Sustained and imaginative education on the economic facts of life so that, by 1983/4, a larger percentage of the electorate is beginning to see that our policies are hard-headed, rather than hard-hearted; that the real problems have been tackled at last, and that much of the necessary pain is over.
- (b) Steady erosion of Labour's claim - virtually unchallenged until last winter - to a monopoly of all the human virtues.
- (c) Similar erosion of the stereotype Tory image so carefully maintained by Labour.
- (d) Constructive debate about political reforms (eg Bill of Rights etc) which will help to symbolise the general spirit of national renaissance and appeal to those Tory voters who might be tempted to swing Liberal after 3 years of hard slog.

7 ● CONCLUSION

7.1 This paper can be summarised as follows:

- (1) Our 10-year objective is to "rejoin the West", in terms of economic stability and growth rate.
- (2) We won't get there unless we have a well thought out strategy - a series of stepping stones - for doing so.
- (3) } There is no change in our original view that a positive role for the trade unions is a central - perhaps the central - element in that strategy.
- (4) The strategy must integrate all the major elements of policy, and their supporting communications, into a coherent whole. If it does not, (a) we'll get confused and lose our way; (b) the electorate won't let us do it anyway.
- (5) If we fail to achieve Stabilisation, as our first objective, we can forget the rest. We will simply be on the run till we're chucked out.
- (6) We can do no more than make a start in the next 5 years. A second term is essential but we will need a sea change in the electorate's grasp of economic reality and the limited real powers of the State. The count-down to the 1983/4 election has therefore already started, in communication terms.

7.2 A suggested Agenda for 18 June is at Appendix A.

A POSSIBLE AGENDA

It would be quite unrealistic to try to discuss all aspects of Strategy in a single 2-hour meeting. I therefore suggest we make a start by considering the following key questions:

1. Is the case for concentrating on Stabilisation accepted?
2. If it is, what is our position in principle on the question of pay policy, freezes etc? Should we be examining such options or do we regard them as politically (or technically) unthinkable?
3. Do we agree the other Stabilisation measures suggested on pages 7-9 of the paper? What other Stabilisation measures are called for, and what work should be put in hand to develop them?