ECONOMIC RECONSTRUCTION GROUP

Minutes of the 8th meeting held at 11.00 a.m. in Interview Room D at the House of Commons on Thursday 6th November 1975.

Present: Sir Geoffrey Howe, MP (in the Chair)
Mr Gilmour, MP
Mr Griffiths
Mr Heseltine, MP
Mr Howell, MP
Sir Keith Joseph, MP
Mr Ridley (Secretary)
Miss Bulloch
Mr Gilbert

Apologies: Mr Biffen, MP
Sir Leonard Neal
Mrs Oppenheim, MP
Mr Prior, MP

1. Introduction

The Chairman reported that the British Council had increased their expenditure by 24 per cent during the previous year and had quoted the Chancellor's Guildhall speech in support of their action. Members of the Group might like to table questions on the budgets of similar bodies.

Sir Keith Joseph drew attention to Professor Myddleton's powerful indictment of the Sandilands report, of which he had been sent a copy.

2. Inflation and Investment

The Chairman suggested that an article by Professor Walters, and notes by David Lomax and Brian Griffiths which would be circulated later, should be read alongside Mr RidleyIs paper 'Inflation and Investment' (PG/10/75/15).

Discussion of the sections on inflation should be postponed until Mr Prior was present. A paper on this would be prepared by Mr Gilbert for Mr Prior's committee. Attention was drawn to Sir Geoffrey Howe's speech and to the new IEA paper by John Wood on measuring unemployment.

3. Investment

Introducing the paper, the Secretary drew attention to the limited propositions set out on page 4: agreement on the diagnosis set out there was a necessary prerequisite to any policy which we might want to advocate.

David Lomax was arguing that expansion of investment and production in the private sector would be impossible with ongoing inflation at 10 per cent per annum. So the Government could allow the money supply to accelerate, but this would lead to inflation of the order of 30 per cent

per annum. They could raise taxes and cut public expenditure to reduce the acceleration of money supply, but their statements indicated that this was ruled out. Or they could deliberately slow down the rate of money supply - but this would mean sluggish recovery and high unemployment. A version of this last strategy, encompassing tighter controls and perhaps 'doctored' unemployment figures (which would see the Government through until 1979 when oil venues would be flowing at £2½ billion per annum) might be the most reasonable approach.

Brian Griffiths, however, said that even when tax revenue was buoyant because of North Sea oil, the problem of the borrowing requirement would remain. In the short term, interest rates must rise and Government expenditure would have to be cut. As the recovery begins, controls on banks could be expected to provide subsidised credit to key sectors of the economy, such as industry and housing.

Every analysis indicated that no situation was envisaged in the short term in which industry would be self-financing. An investigation of the last three trade cycles indicated that investment cycles were progressively feeble. Firms would only invest when a decent rate of return was likely: an adequate rate of return was both the incentive and the provider of cash needed to sustain investment. It was theoretically possible to cut taxes to provide the private individual with more resources which would allow him to tolerate higher prices from producers which were essential if profits were to be increased. But it was difficult to raise prices in a recession, particularly with the present Price Code. So money for investment must inexorably come from the public sector in the first instance.

It was suggested that expansion of the money supply was inevitable as the borrowing requirement was not going to fall during the next 24 months. Movement in the M_1 might indicate that the acceleration had already begun. The implications for the year after next were inescapable, and the possibility of an electoral dash in the interim should be noted.

The Chairman identified three dilemmas faced by the Government. The first was the prospects for the balance of trade: were import controls inevitable? Secondly on price control, Healey and Wilson seemed to be facing one way, and Shirley Williams another: they were calling for relaxation, whilst she was endeavouring to keep rises down to 5 per cent per annum. Finally, did the need for reduced public expenditure wholly exclude tax cut incentives, perhaps of the kind which could influence the RPI favourably during negotiations on the next stage of the attack on inflation?

4. Taxation

The Group considered possible developments on the tax front, and what we should be pressing for. Sir Keith Joseph felt that in principle tax cuts must cover all income levels, including the lowest. Something must be

about tax thresholds. Mr Heseltine, however, felt that this would be acting to boost spending rather than investment. It was pointed out that the assumption of continuing high public expenditure was likely to rule out the possibility of relaxing tax thresholds in line with the movement in the RPI. But Sir Keith argued that if action on thresholds was deferred, it might never be taken at all.

An estimate of the possible courses of action open in the next budget was needed to see whether there was likely to be sufficient latitude to give to the personal as well as the industrial sector. Mr Ridley felt that this was unlikely to be possible, unless the necessary revenue could be raised from elsewhere, for example from nationalised industries.

The Chairman raised the question of whether the Group would support any revenue neutral scheme designed to ease the tax burden at the top end of the earnings scale for the budget debate next year. Sir Keith felt it necessary to move funds from the 'social wage' to the pocket and handbag. Mr Heseltine wondered whether the acceptability of such changes could be improved by the assumption of enabling powers in the budget to vary tax rates, but the Chairman felt that this could be a dangerous precedent.

It was agreed to put down a number of Parliamentary questions to indicate what income tax would raise on a number of assumptions about inflation and the tax threshold. A further question should be tabled to discover the inflation and threshold assumptions behind the Chancellor's statement.

Any reduction of indirect taxation in the spring would be reflationary and should be opposed.

5. Profits

Mr Griffiths felt that whilst taxation was important, the matter of underlying importance for a 5 - 10 year strategy must be profitability as the source of investment. Points (a) to (f) on page 4 of the paper could not be seen as a total strategy for the long term.

Mr Heseltine reminded members that the repeated problem in the years since the war had been to kindle sufficient investment at an early stage in the economic cycle. In the present circumstances, industry would hoard funds rather than invest. The only compelling reason to spend was profitability. He drew attention to the scheme he had advocated whereby tax rebates would be given to profitable companies, perhaps with a rider attached that the money must be invested in new equipment within 12 months.

Mr Howell thought that the scheme had attractions as it would reinforce success and reduce public expenditure. Whilst its immediate impact would be limited, it would improve confidence. Presentation would be most important.

Sir Keith Joseph also observed that giving aid to Chrysler, for example would immediately reduce rather than increase confidence. He doubted whether it was realistic to ask firms to invest with 15-20 per cent inflation. Further, it was likely to be 2 or 3 years before investment materialised, coinciding with the next boom and produce overheating. The scheme could not work unless there was a reciprocal agreement from the unions on manning levels and strikes. It should be compared with the Swedish counter-cyclical scheme and Jack Jones' proposals.

Mr Heseltine felt that whilst 12 months was too short a time in which to build complete new plants, it could be sufficient to renew production lines or diversify in a minor way.

Mr Ridley noted that what was being proposed was pump priming. Profitable companies were to be given the cash flow corresponding to higher profits than it was in fact possible to earn. Cash resources were to be handed over in return for an understanding that the money would be used for investment. If the scheme was to be quick acting, it must be fairly automatic. Investment grants had taken 1 year - 18 months to process: this suggested that there could be no discretionary strings attached such as conditions about the reduction of overmanning. He felt that, given the likelihood of a reduced world boom and an abortive British boom, it was the very least that could be suggested. Mr Griffith felt it could only be seen as a short-term scheme and hence was insufficient.

Sir Keith felt that the question was how prices could be raised without wages following. Mr Griffiths suggested that recent figures provided hopeful pointers that this was happening. It was generally agreed that it was necessary that a major enterprise would have to be allowed by the Government to go into bankruptcy. The assumption that bailing out would always follow had to be attacked. Mr Heseltine stated that the problem was often that the owners 'opted out' of responsibility. Perhaps the little 'neddies' should be given a role in carrying out a management audit in some companies.

Reservations were expressed about the proposed extension of EDC powers to carry out management audits. The Chairman pointed out that an alternative would be to encourage the City institutions to play a more active part in companies.

It was suggested that Mr Heseltine should examine the experience of the National Board for Prices and Incomes and talk to Ian Fraser and Lord O'Brien. The Group would be interested to see the results of the Industry Committee's deliberations on his suggestions.

6. <u>"Economic Development over the Coming Year" (PG/10/75/16)</u>

The Group turned briefly to the paper. Introducing the paper, Mr Ridley said that thoughts on this subject

were urgently needed by the Shadow Cabinet. Mr Griffiths felt that the paper was possibly too pessimistic. 1976 Q IV might look reasonably good in comparison with 1975 Q IV. There could be some growth and a reduction in the rate of inflation, but this would mean very great pressures for monetary expansion. Mr Ridley felt that the real question was whether the rest of the world believed that we had inflation under control at the time of the next negotiations on pay between the Government and the TUC. It was agreed to return to the paper at the next meeting.

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