

PRIME MINISTER

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Original returned to S. Harkness*

DE-INDEXATION

Some general points for this afternoon's meeting. Indexation and de-indexation is a big and complex subject. In my view, the Treasury team under Douglas Wass is still extremely confused about it.

1. Any de-indexation (eg X-3) must not be permanent. We need to reduce the absolute figures for public expenditure purposes. But the principle of full indexation thereafter must be wrong. There is, in economic logic, an argument for saying that it could be linked thereafter to prices or pay, whichever is the lower - something no-one seems to have thought about. But we should avoid giving the impression that, having made this once-for-all change, we are committed to indexation thereafter.
2. It is fallacious to compare, from the point of view of social justice, the indexation of tax bands and allowances with the partial indexation of benefits. If (or when) benefits are taxable, then the beneficiaries will have the advantage of whatever indexation of taxes there may be. The comparison is between the gross pay of those not on benefits, to the extent that that is indexed, and the benefits themselves.
3. Following directly from 2 above, if Government takes the view that, in the end, aggregate pay increases and benefits must all come below the going rate of inflation, if inflation is to be cured, then Government must control what it can (eg benefits) and must exert pressures (monetary discipline through the market) on pay where it can't control directly. In the past, the bit that Government can control has in fact been the most inflationary, because it has been fully indexed. We've got it exactly the wrong way round.
4. Public sector pay. In principle, yes perhaps this should be partially indexed (we proposed this more than two years ago, because, again in the event, it will have to be, at least during the time that inflation is squeezed out of the system). However, we begin to get into deep water here and it can probably only be done when the thinking about indexation is much clearer, and in the context of a properly developed and sold stabilisation programme.
5. Public sector pensions. Not such big money. Raises issues of principle - can one really break contracts? Politically attractive because indexed pensions are unpopular. I suspect it will raise very big and complex questions, involving the private sector insurance industry and pension funds, in turn raising questions about their indexation of pensions, and whether or not there would be indexed gilts. In many ways, much more important to concentrate

on squeezing out inflation so that indexed pensions are not such a big issue. Beyond those comments, we have no view. The subject is big, deep water, not properly thought through yet.

The whole area of indexing and de-indexing is much more subtle and complex than it at first appears. It lies absolutely at the heart of stabilising the currency. We have to be very careful that we don't take measures which look on the face of it sensible, in a hurry, and then find that they have closed off any chance of getting the right answers in the longer-term. The Douglas Wass committee, on which I sit, has only just started in time. It should have been in action years ago.



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