R.

Treasury Chambers, Parliament Street, SW1P 3AG
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22nd June, 1979

Dear Tim,

TUC ECONOMIC COMMITTEE

..... I enclose briefing, as requested in your letter of 19th June to Tony Battishill.

Copies go to Ian Fair and Martin Vile.

Yours ever,

MA

(M.A. HALL)
Private Secretary

T.P. Lankester, Esq.,
Private Secretary,
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22 JUN 1979

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BRIEF FOR PRIME MINISTER'S MEETING WITH TUC ECONOMIC COMMITTEE ON 25 JUNE

THE BUDGET AND THE GOVERNMENT'S ECONOMIC STRATEGY

The TUC will do doubt complain that the Budget takes little account of their own representations, which they will regard as having been ignored. The Prime Minister might therefore wish to open the discussion with a brief description of the main thrust of the Budget and its place in the Government's overall economic strategy.

Line to take

2. Although there is understandable disagreement about the means, the Government and the TUC agree on many of the main objectives for the economy and the Government's intentions were clearly foreshadowed in their Manifesto. The main objectives underlying the Budget may be summarised as :-

(i) Providing a means of easing the supply constraints which have hampered our industrial performance for years. There is no single solution to these deep-seated problems - they must be tackled by a variety of measures including:-

(a) to raise productivity, strengthening incentives at all income levels by a switch from tax on incomes to tax on spending;

(b) preventing an excessively large public sector borrowing requirement from pre empting the financial requirements of industry;

(ii) ensuring that an excessive growth of money supply does not fuel inflation and so discourage investment and the growth of employment;

(iii) reducing the role of the State so as to give greater freedom of choice to individuals in the way they spend their money;

(iv) ensuring that those who take part in collective bargaining have to face the consequences of their actions - excessive pay means fewer jobs;

(v) in addition - though not part of the Budget itself - promoting competition policy and reducing subsidies for inefficient firms.

ECONOMIC EFFECTS OF THE BUDGET

3. The TUC will doubtless argue that the Budget is excessively deflationary, drawing attention to the Government forecast of a 1% fall in GDP and a 2½% drop in manufacturing production this year. In their annual Economic Review the TUC argued for a Government commitment to 3% growth this year.

Line to take

4. The following points could be made in reply:-

(a) By conventional standards the Budget does imply some initial costs in terms of lower output and employment. The Government have never sought to disguise this. But conventional forecasting models cannot take account of the effects of such a major step change in policy on general confidence and expectations; nor can they fully reflect the way in which the Government are confident the Budget will improve supply side relationships in the economy;

(b) [if pressed] for this reason it makes no sense to try to quantify the effect of the Budget on unemployment, although in the short-term unemployment may well rise;

(c) no alternative policy offers a brighter prospect. Last year's experience shows that to inject a fiscal stimulus at present would simply mean higher inflation - with little prospect of reversing the trend - and even more imports. Indeed, the previous Government were well aware of this - with their own commitment to a £8.5 billion PSBR this year they clearly had no more intention of introducing a expansionary Budget than the present Chancellor.

(d) This does not mean the Government do not see the need for more growth in the economy - far from it. They only wish they could achieve the TUC's 3% growth target. But what is needed is <u>sustained growth</u>, not a succession of "stop go" policies; and the foundations for this cannot be laid overnight or without some pain in the short term.

(e) The slow down in output growth has in any case been apparent for some time, with the end of the mini-consumer boom last year, the slow down in the world economy, and the adverse effects of higher inflation. This is what the Government inherited - not the consequence of the Budget which is designed to lay the foundations for sustainable output growth in the longer-term.

DISTRIBUTIONAL EFFECTS OF THE BUDGET

5. Union leaders have predictably criticised the Budget for favouring those on higher incomes and giving insufficient relief to the low paid.

<u>Line to take</u>

6. Points in reply include:-

(a) it is only natural for the Government and the TUC to have different priorities within the tax field, but the Budget measures were those on which the Government were elected.

(b) Nevertheless, the long overdue relief given at the top end of the income scale should not blind the TUC to the very substantial help given by the Budget to those on lower incomes. The TUC themselves attach first priority to raising the tax thresholds. This the Government has done by <u>doubling</u> the increases in personal allowances provided for in the April Finance Act - taking <u>1.3 million</u> people out of tax altogether.

(c) Of course this does not directly help those not paying tax before the Finance Act was passed. But the November Social Security uprating will cover about 60% of this group. Of the rest, those in employment must generally have been earning about £30 to £40 a week if married (or less than £20 if single) to have escaped tax last year. Few such people can be supporting families or be the principal breadwinner in their household. Where they are, they may well be entitled to Family Income Supplement which will also be substantially increased in the autumn.

(d) To finance such large reductions in income tax increases in indirect taxation are unavoidable (and the previous Government also accepted the need for such a switch). In considering which of the indirect taxes to raise, the Government deliberately chose VAT which, unlike the specific duties, is not regressive in its impact on households. The Government also deliberately decided not to increase NIS, which would directly affect employment; nor to raise the duties on drink and tobacco.

(e) The indirect tax increases will of course increase the RPI. But this will be a once and for all effect and the underlying rate of inflation will begin to come down next year (the Government's forecast for the third quarter of 1980 is 13½%). Moreover, during the rest of this year the fact is that almost all households will be better off when the effects of the direct and indirect tax changes and the social security uprating are taken together.

(f) [If this is raised] the effects of the VAT increase on Motability (an organisation set up by the last Government to help disabled people) is under study.

SPECIFIC BUDGET MEASURES

(a) Exchange Control

7. The TUC may argue that the exchange control relaxations announced in the Budget will encourage investment abroad at the expense of

investment and jobs at home and so export jobs at a time when UK unemployment is in any case likely to be rising.

Line to take

8. The Prime Minister can reply that the evidence does not support this view. On the contrary, it shows that much of the additional overseas investment is likely to be in the creation of distribution outlets overseas and other export-promoting sectors. This will by its very nature create demand abroad for other UK products, so increasing employment at home.

(b) Public Expenditure: General

9. The TUC will no doubt attack the Government's decision to cut public expenditure this year by a total of £4 billion in current prices, suggesting that this will have a disproportionate impact on employment. They will probably focus attention on the reductions in industrial and employment subsidies.

Line to take

10. Points to make include:

(a) some expenditure cuts were inevitable whichever party was returned to power (the previous Prime Minister made this clear) given the common desire to make substantial reductions in the income tax burden and keep inflation under control by offsetting the effects of excessive pay awards and so limiting the size of the PSBR.

(b) In deciding which areas of expenditure to cut Ministers are concentrating on the elimination of waste and inefficiency and, by reducing subsidies to industry and employment, the provision of resources for creating more lasting jobs. Increases in charges have also been kept to a minimum: prescription and dental charges (two-thirds of which are already dispensed free) may be up, but the cost of school meals will remain as planned by the previous Government and the fuel industries have been asked to avoid further price

and still lower in real terms than when originally set in 1971.

increases as far as possible. Most of the Nationalised Industry price increases in prospect were already in the pipeline as a result of the cash limits policy laid down by the previous Government.

(c) A substantial proportion of the public expenditure savings (£1 billion) will be achieved through asset disposals. While the TUC may not favour this ideologically, they must accept that it will have a negligible effect on activity and employment.

(d) The Government are not interested in cuts in public expenditure for their own sake. They too want to see improvements in public services; but these simply cannot be sustained until the economy itself is back on its feet.

(e) [If the TUC renew their request to participate in the medium term public expenditure discussions] the Chancellor is always ready to listen to the TUC's ideas about public expenditure as about other things and would have no objection to putting public expenditure on the agenda for one of his meetings with them.

(c) Social Security

11. The TUC will criticise the Government's decision to break the link with earnings in uprating long-term benefits, as also the decision not to increase child benefit in the autumn.

Line to take

12. Points in reply include:

(a) This will be the biggest ever increase in pensions - £3.80 for the single person and £6.10 for the married couple. The uprating will not only fully protect pensioners and other beneficiaries against the rise in prices since last year's uprating, but also take account of the amount by which that uprating underestimated the actual movement in earnings in the year before.

(b) Changing the uprating rule does not rule out further real improvements in future. TheGovernment hopes these will be possible. But they have to be paid for by those in work and therefore must depend on the strength of the economy.

(c) A Christmas bonus will be paid again this year and the Government are taking powers to make it a permanent feature.

(d) Many pensioners will also be helped by the increase in the threshold of the investment income surcharge and by the Government's decision to exempt war widows' pensions from tax entirely. These changes have been widely welcomed by the various pensioner organisations.

(e) Child benefit: It was increased by £1 in April and 70p last November. The Government have concluded that another increase this autumn simply cannot be afforded. The amount and timing of any future increase in child benefit will have to be considered in the light of what we can afford. In this autumn's uprating we have concentrated help on the poorest families through the increases in child additions to benefits and the 50p increase in the lone parent premium.

A NATIONAL ECONOMIC FORUM

13. The TUC will have noted the Prime Minister's remarks in the House on 19 June that the Government proposed to set up a national forum "wider than the TUC and CBI" to discuss economic issues. This will have helped to correct the impression given by an earlier F.T. report that the Government had dismissed the idea of any forum.

14. No decisions have been taken and Ministers will be considering the subject on the basis of a paper by the Chancellor at a meeting of E Committee next month. While, therefore, it is important to keep options open and not to give the TUC any impression of a "brush off", there is little more that the Prime Minister can say at this stage. It is probably better, therefore, not to take the initiative in raising the subject at this meeting but to leave it to the TUC to raise it themselves if they wish to do so. If so, the Prime Minister

could refer to her statements but indicate that Ministers had not yet been able to consider together the appropriate form that any forum might take. If the TUC themselves have any views, she would, of course, be glad to have them.

UNION ATTITUDES ON PAY

(a) Private Sector

15. Trade unions are firmly committed to free collective bargaining. In particular, Mr Moss Evans has stressed the need for pay settlements to be based on what companies can afford. But union negotiators have a very different idea of 'what firms can afford' from that of the employers (or indeed the Government): they look only to the short-term position of the company, in particular the profits made in the immediately preceding year: they are in general unwilling to admit any relationship between excessive pay settlements and price increases.

Line to take

16. The following points could be made:

(a) Pay bargaining in the private sector is a matter for employers and union negotiators. The Government's role is to set the economic and financial climate - and the Budget has made a start on this. But bargaining must be responsible. Given the Government's commitment to strict monetary and fiscal policies excessive settlements can only lead to lost jobs - either through redundancies, as the financial consequences of settlements come home, or through lost opportunities for creating new jobs, if profits, and thus investment, are squeezed.

(b) Our productivity record and our international competitiveness is lamentable. If we are to revitalise the economy and create the higher standard of living we all want, we must improve our productivity and efficiency. This alone can create real increases in wages.

(b) Public sector

17. Union leaders believe that recent pay policies have discriminated against the public sector, and in particular the public services, because of the direct influence Government can bring to bear. The figures support this belief. Hence the pressure for 'comparability' or restoration of position in the 'earnings league' (normally on the basis of the most favourable comparison). The Government's firm stand on financial realism and cash limits is seen as yet further discrimination against the public sector.

Line to take

18. The following points could be made:-

(a) The Government will not discriminate unfairly against the public sector in pay matters. Indeed, public sector pay and conditions, taken together, must remain broadly competitive if the public sector is to recruit and retain capable staff.

(b) But where comparisons are used to determine public services pay they must be genuine and up-to-date, based on a proper evaluation of all terms and conditions - not a blind restoration of past relativities.

(c) The public sector cannot be insulated from financial and economic pressures - cash limits are simply a reflection of this. In reaching settlements, negotiators will have to trade off pay increases for increased efficiency (including reductions in job numbers), just as in the private sector.

d) The Government are committed to accepting the Clegg recommendations on the ~~existing~~ outstanding five references due for completion in August. TL

(c) Effect of recent pay awards

19. Union leaders have argued that recent pay awards for the police, armed forces, and particularly doctors and dentists and groups covered by the Top Salaries Review Body, have set a new going rate. (They will no doubt emphasise the effect of the recommendations on Ministers' and MPs' pay.)

Line to take

20. The following points could be made:-

(a) Independent review has found that the pay of all these groups has fallen far below what is justified. Increases required to make good the increases that other groups have already had cannot be used as a justification for yet further increases for those groups. If the 'catching-up' element is deducted, the increases recommended for doctors and dentists and TSRB groups at 1 April (about 12% and 11.7% respectively) were below the level of increase in the average earnings index at the time (14.9% for March).

(b) Such arguments are a version of the 'going rate' argument. The Joint Statement by the TUC and the previous Administration, issued last February, said:

> 'But we do accept that there are dangers inherent in the concept of a "going rate" for the year; this does not, in our view, form a proper part of real collective bargaining, which should have regard to the merits of the particular situation. The "going rate" concept can be highly ambiguous and destabilising - it has the disadvantages from the trade union standpoint of a pay norm, coupled with the inflationary effect of successive groups building a higher "going rate" on the basis of settlements previously made.'

(d) Effect of Budget on pay bargaining

21. Union leaders have reacted strongly to the Budget increases in indirect taxation and the resulting increases in the Retail Price Index.

Line to take

22. The following points could be made:-

(a) The Budget changes have not affected the underlying rate of inflation which will come down next year (paragraph 6(e) above);

(b) Pay negotiations must take account of the full Budget package including the effect of the income tax cuts, which result in a net improvement in take home pay for the great majority of people (paragraph 6(e) above);

(c) The Government are determined to use fiscal and monetary policies to reduce inflation. Against that background excessive pay claims can only lead to loss of jobs and no real advantage in the longer-term. The faster earnings growth comes down, the sooner output growth will be resumed.