[redacted]

LCC/76/115

SECRET

COPY NO. 1 ....

BACKGROUND TO THE OPERATION OF THE PRICE CODE OVER THE PAST 2 YEARS AND IMPLICATIONS OF LIKELY (PROPOSED) CHANGES

(Paper by Mrs. Oppenheim)

BACKGROUND:

The Price Code has undoubtedly provided minimum consumer appeal and satisfaction at the same time as imposing maximum bureaucracy and economic damage upon business and industry.

It has been unequal in its effects on different sectors of business and industry - its adverse effects ranging from disastrous to fairly harmful, while in a few sectors it has been positively advantageous.

Shirely Williams described the Price Code as partly "Daft" in a speech on 17th March, 1976.

The present Price Code comes to an end in July but can be extended for a further year under the Counter-Inflation 1973 Act.

THE PAST 2 YEARS:

The Code was of course designed to operate in tandem with the Pay Code, which was abolished (ironically) under the Prices Act 1974.

Therefore the Price Code operated between mid-1974 until Autumn 1975 without any pay restraint, which meant that at a time when wage costs were soaring, a substantial proportion of these costs could not be passed on in increased prices, under the provisions of the productivity deductions.

Thus Company profits were greatly eroded during this period.

Even during the subsequent period of the £6 limit, for those companies already hardest hit, this meant wage cost increases of approximately 20%, much of which still had to be absorbed. While all companies faced huge Nationalised Industries cost increases and sharply rising rates.

The Government constantly claim that they have been responsible for granting considerable investment reliefs over the past 2 years, which we did not give.

While this is true, at the same time the Government cut distributors' gross margins by 10% and only marginally amended the productivity deduction at the time of the wage explosion. They also lengthened the price increase pre-notification period as well as increasing company taxes during this period.

The cumulative effects of the operation of the Code over the past two years have led to a massive erosion of profitability, of return on capital, and of the capacity and will to invest.

It is no exaggeration to say that some companies, depending on their nature, could have been better off, under the circumstances, to liquidate their assets, dismiss their work force and put the proceeds on deposit in the bank.

...../ During

During the past year, evidence in a recent Price Commission report shows that on average every Category 1 Company has had to avail itself of safeguard provisions about five times, and Category 2 Companies not much less often. This means that profitability was intolerably eroded on each of those occasions.

Other side effects have been:-

1) For those companies who have fallen into the safety net the Code has already done its damage and relief has come too late. In the present economic climate competition prevents them from recovering full profitability and even if it did not, the Price Code would.

2) Thresholds for each Category and reference levels are no longer relevant, neither are reference levels. Methods of valuing of stocks and assets have been rendered equally irrelevant by inflation.

3) Investment reliefs have been variable in their effects on different industries.

4) Business distortions have been great. According to the C.B.I. "an investment proposal which without the Price Code would have given an estimated profit of £1 million (was rejected) because under the Code it would have resulted in a loss of £300,000". Examples such as this are numerous and well documented in the C.B.I. memorandum of April 1976. There are also other business and marketing distortions illustrated.

5) Productivity deductions have been particularly penal.

6) Efficiency has been discouraged and a good deal of investment has been lost forever.

EFFECTS OF TOTAL ABOLITION OF CODE:

It can be justifiably claimed that the Code is itself inflationary, since it costs Category 1 Companies about £35 million a year to administer, also because the three month prenotification period causes some companies to apply earlier than they would otherwise do, for price increases.

It has not been denied by the Government that, under the present economic circumstances the effect on the R.P.I. of total abolition would be about 1%.

However, during a period of economic upturn the effect would be greater as companies would need to use such a period, not only to return to full profitability, but to recover some of the lost profitability of the past two years. Once this restoration had taken place there would be a natural readjustment and levelling off period. Therefore the short term effect of the total abolition of the Price Code on the R.P.I. would be practically nil, followed by a medium term bulge that should flatten out and then diminish in the longer term.

C.B.I. ATTITUDES:

The C.B.I., having originally demanded the total abolition of the Price Code, subsequently decided (following a confidential survey showing that Consumers neither understood the Code, nor thought that it controlled prices) to call for the abolition of Price Controls with the retention of some form of Profit Control, as they thought the latter would be popular with the TUC.

...../ I pointed

I pointed out to the C.B.I. most strenuously, the dangers of their continuing to accept the implications of Profit Controls and of the precedents that they would appear to be upholding, also that it was up to them to sell profitability and not to martyr it. These warnings were in vain.

Apparently the Government turned them down flat on the abolition of Price Controls, upon which and in the light of the current pay agreement the C.B.I. agreed to face "the political realities" (their euphemism, not mine) and to continue to negotiate with the Government on the basis of an extended Price Code.

They also actually went on record as saying (in the April Memorandum) that they would rather have statutory controls than some informal, largely cosmetic alternative, because the latter would not lay down clearly defined criteria.

THE MAIN RELIEFS IN THE PRICE CODE REQUIRED BY THE C.B.I. ARE:

1) 100% investment relief (see appendix 1).

2) Provision both for inflation accounting and for taking account of inflation in valuation of stock and assets.

3) A review of the Productivity Deduction.

4) A rise in the threshold on turnover in defining each Category.

5) Change in the basis of reference levels (best out of five years instead of average of best out of two).

6) Safeguard clauses improved.

7) Companies to have the option to adjust current margins by deducting notional interest charges in respect of any increase in equity capital, since controls introduced.

8) The option to exclude from reference levels the results of companies taken over since the base for profit margins were first calculated.

9) Technical changes to simplify administration of the Code.

The D.P.C.P. agreed to consider these requests. Since then the C.B.I. have also asked for a revision in the calculation of allowable costs so that these could be calculated on an input basis (allowing companies to benefit from increased efficiency). This would give them greater flexibility in pricing. Savings on Labour, materials and increased producitivity could benefit the company instead of being passed on in price reductions.

The benefits of this would depend on volume, and Shirley Williams turned this down at a meeting on 28th March 1976, on the basis of disadvantage to low volume companies.

It should be remembered that the C.B.I. tend to represent mainly the largest companies and the Retail Consortium were certainly not in favour originally of the abolition of price controls at the expense of the retention of profit controls.

If all the C.B.I. requests were met in full the result could be the retention of what would become merely a phantom Price Code, for public relations purposes, capable of liberal and flexible interpretation, an approach apparently favoured too by Shirley Williams.

...../ However,

However, the C.B.I. in welcoming such an approach appear to overlook the fact that by retaining the basic structure of the Price Code they are keeping in existence a weapon that can easily be amended at any time to become more rigorous in its effects.

Nor should we overlook this fact, although it may appear superficially attractive to some, to uphold the existence of a "Phantom Code".

THE CALLAGHAN PROPOSALS:

The Callaghan proposals announced and received so rapturously at the C.B.I. dinner appeared to be broad in scope, covering nearly all the points made by the C.B.I. but indefinite as to detail and degree. (These may be known by the time colleagues receive this paper).

Subsequently various newspaper reports of DPCP/CBI meetings have indicated that the scope is to be narrowed (no doubt following TUC reaction). Already several Trade Union leaders have spoken of the need for any reliefs to be directly linked with investment, and some have accused industry of an investment strike.

OUR ATTITUDE:

As a result of the C.B.I. attitude and pronouncements there would appear to be very little political advantage in our continuing to call for the total abolition of the Price Code. Equally, a positive policy commitment to abolish the Code at this precise moment would be inappropriate and politically disadvantageous.

However, my Price Code Alternative policy group have decided to recommend that we should not support the concept of a Phantom Price Code in the long or medium term, but that the Price Code should be completely abolished as soon as economic and political circumstances permit, and that an alternative should be provided with maximum political appeal, but with no statutory control either of prices or profits. Final conclusions and details of the alternative will be pre ented in due course.

Meanwhile we should carefully examine the proposed amendments to the Code when they are known, and criticise them strenuously where they are deficient, inadequate, or inappropriate, warning of the irrevocable damage that has already been done and that will result.

If the proposals are sufficiently inadequate we might consider voting against these, although such a course of action could have the effect of delaying any reliefs that were proposed.

We should also be careful not to appear to relate the need for profitability only to investment and jobs.

APPENDIX 1

In a recent letter to me Shirley Williams indicated that 100% investment relief, if passed on in increased pri es would come to £10,000 million. Research Department have calculated that this would add 16% to the R.P.I. in one year.

This is a typical red herring as it assumes:

(a) that finance for investment would not be available from any other source, and that every company would avail themselves of the relief by way of price increases within one year.

...../ (b)

(b) that the Government's own estimate and that of the C.B.I. that the total abolition of the Price Code would add about 1% to the R.P.I. at present is a meaningless calculation.

(c) that companies would seek to recover all investment expenditure through prices, ignoring the disadvantages in tax relief and the effects of competition.

S.O.

Retain – simpler code.

Welcome. – P & Un

Price. 1 in 5.

Warton R. Grp.
– [illegible]
[illegible]

Conservative Research Department,
24 Old Queen Street, London, S.W.1

SO/MEM
9.6.76