The Rt. Hon. Terence Higgins, M.P.

cc IG

HOUSE OF COMMONS
LONDON SW1A 0AA

July 11, 1980

Dear Margaret,

As you know I have argued throughout the series of articles I have sent you over the last three years or so that a monetary policy can only be effective if the Government takes a firm and coherent line over public sector pay. Otherwise, since pay is almost 50% of the expenditure covered by cash limits, the PSBR will rise and the money supply can then only be controlled by the use of a very high MLR and other interest rates.

At present we still do not have what I have described as a "true" monetarist policy based on a low PSBR which only requires low rates of interest to control the money supply but a "phoney"monetarist policy with a high PSBR which demands high interest rates to control the money supply. This is difficult to distinguish from a real old-fashioned deflation.

I am glad the importance of this crucial difference between the two ways of controlling the money supply now seems to be generally understood, but unless we get a grip on public sector pay, attempts to get our policy right will fail. I thought, therefore, I should send you this copy of an article covering related points which I wrote a short time ago.

I understand that both Geoffrey and John accept the criticisms I make in the article about the present system of cash limits and public sector pay. In addition a further device for circumventing effective control has now emerged. We are told that Civil Service pay increases of more than 20% are to be brought within the cash limits by delaying the starting date for the increases. This is a dangerous subterfuge. Either it raises the base on which next years pay increases are calculated, when we are getting closer to the General Election, or, alternatively, if we continue with pay research and tight cash limits the gap between the two will get larger and larger and increasingly difficult to defend.

Although some of the arguments I have put forward are now understood, I remain gravely concerned about the apparent lack of coordination of Government opposition to inflationary public sector pay claims. We are continuing to fudge the issue and pile up problems for the future. When we were in Government

before, no one contributed more by way of example to the "N-1" or "De-escalation" policy (which halved the rate of pay and price increases in less than two years), than you did as Secretary of State at the Department of Education. But I fear I may have been mistaken in thinking you knew all the details of how this policy worked from an over all point of view. There are a number of vitally important lessons to be learned from our experience then, which are of immediate relevance to our present situation, and I shall be glad if we could meet to discuss them.

As ever,

[signature]

The Rt. Hon. Mrs M. Thatcher,
The Prime-Minister,
10, Downing Street,
London SW1.

GUARDIAN AGENDA

Conservative MPs argue for urgent changes in the Government's strategy for bringing down i

Action now—or the election is lost

TERENCE HIGGINS

THE PRIME Minister in a much publicised speech a short time ago said that the Conservative Government was determined to pursue the right economic policies even if it meant it lost the next General Eelection. Such a statement of principle is welcome. But it is also true that unless the Government carries out the right economic policies it is bound to lose the next election.

Time is running out. The economy takes about two or three years to respond to any major change in policy and the Government has wasted a year by failing to take sufficiently positive action in cutting public expenditure and exercising control over public sector pay. At most the Government has 18 months in which to have a significant impact on the situation which will exist on polling day.

The announcement that a special Cabinet meeting will be held to discuss economic policy has encouraged press speculation about a "U turn." This is neither likely nor necessary. What is needed is greater determination to make the existing policy work effectively. Why is it not doing so now?

There is dispute over whether control of the money supply is a sufficient condition for curing inflation but general agreement that it is essential. The crucial question is how the money supply is controlled. There is a fundamental difference in doing so by covering a very large Public Sector Borrowing Requirement (PSBR) by borrowing at very high interest rates and doing so by cutting public expenditure, substantially reducing the PSBR and thus paying much lower interest rates.

The Government ought to have been doing the second but in practice has been doing the first. At present we do not have a true monetarist policy but what I have called "phoney monetarism." It is difficult to distinguish this from an old-established deflation.

The Government has taken too long to cut the total of public expenditure in real terms. True, the latest White Paper is an improvement on the original plans for 1980/81 published last autumn, and the success of the EEC negotiations is a help. But increases in charges do not have the same economic impact as real cuts.

It is optimistic to hope to squeeze an additional £700 million out of public expenditure over the year by the strict application of cash limits and still expect a substantial shortfall in actual spending compared with the limits. And the credibility of the "medium term financial strategy" is open to doubt when about half the expenditure cuts towards the end of the period are expected to come from a massive, unspecified, turnround in the profitability of the nationalised industries.

Most important, the public sector pay which constitutes almost half the total expenditure covered by cash limits is rising dangerously.

Déjà vu has become the hallmark of the pay debate. It is difficult to think of any form of "incomes policy," broadly defined, that has not been tried. So we must learn the lessons of the past as well as analysing the serious flaws in the present pay/cash limits system.

First, there is no hope of controlling inflation if ministers, perhaps reacting emotionally against the catch phrase "incomes policy," fail to take a tough line against excessive pay settlements in the public sector. Public sector pay is not something ministers are powerless to influence. They have a duty to do so. The change in climate generated by the Prime Minister during the last few days is welcome. But collectively the Government will only succeed in de-escalating pay claims if each one is analysed fully to determine what the true percentage increase is and which particular components, such as shorter hours, will have damaging repercussions on other claims and settlements. The role of ministers in this field is particularly important because, unlike managers in the private sector, they are not inhibited by the level of demand. What they settle for inevitably has repercussions in the private sector. The private sector is affected by the demand. So profits, employment, investment and growth are potentially, and at present actually, vulnerable to a two-way squeeze.

Secondly, it must always be remembered that if, because of ministerial neglect, inflationary public sector pay settlements are granted then the Government deficit and PSBR rise correspondingly and (unless interest rates are raised even higher) so does the money supply. The Government's overall policy then faces disaster. Both public and private sector pay claims explode together.

The cash limit system has not proved as effective in solving these problems as many hoped. Its reform is of more than technical interest. It is vital. Two major flaws must be corrected. Their importance is shown by the fact that this year when the cash limit has been 14 per cent, the central Government pay bill (which affects the PSBR) is going up 23-25 per cent.

The first problem arises from staged pay settlements (including those resulting from Clegg reports). Staging enables settlements to be reached in one year within the cash limit for the "global increase in pay" by promising more to come next year, and sometimes the year after as well. Then when we reach the next year the promised increase is already covered by the departmental cash limits. It isn't controlled by the so called "global pay increase" for either year.

This is a marvellous device for buying peace one year at the expense of anguish the next, but it drives a cart and horses through the practical operation of cash limits. Given the need to get a grip on the present situation it is for consideration whether past staging should be paid up now (with suitable adjustments) but at the very least the Prime Minister should impose an immediate ban on any more staging in the public sector and ensure the system itself is sorted out in time for the forthcoming pay round.

The second major problem arises from the fact pay settlements of more than say 18 per cent have been said to be brought within cash limits of 14 per cent on the pay bill because of a reduction in numbers. At a time when the declared Government policy is to reduce the size of the bureaucracy as much as possible this can't be right. There is obvious double counting.

If the Government really accepted the logic of the argument it would mean every cut made in the Civil Service would justify a proportionate pay increase for those who remain in it. The fact is that this year the issue has been fudged. It mustn't be allowed to happen again.

Recent statements by the Prime Minister on interest rates have attracted so much attention it is necessary to stress that a significant reduction in interest rates would only represent a policy "U turn" if it were made before public expenditure has been reduced and its most important component, public sector pay, had been controlled. This article specifies some of the most important areas in which ministers must act now in order to achieve this.

● *Terence Higgins is Conservative MP for Worthing.*

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