10 DOWNING STREET

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Some notes on the Treasury Paper by Croper are attached.

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NOTES ON MR. CROPPER'S PAPER ON FINANCING MORE INVESTMENT TO NATIONALISED INDUSTRIES

The argument of Mr. Cropper is essentially the standard one that additional investment by nationalised industries will cause the crowding out of either other private investment or private consumption (that is assuming that private consumption is unaffected). In the face of the standard Keynesian objection that there are large unemployed resources and in fact more public expenditure should simply see the absorption of additional unemployed factors into production, he gives something like a standard argument that it is likely the additional demand will be reflected in price inflation rather than in increased output. This is largely due to the rigidities in the economy caused by trade union practises, among other things. On financing, he says essentially that financing by means other than selling gilt edged will not help. It's the underlying reality that matters. What he is arguing is that no variations in financial arrangement will have any effect on that reality.

This is the normal Treasury position that there should be a complete divorce between the financing of public expenditure and the use of that expenditure. It is quite a different approach from that of business where the financing of a project or firm is often related to its particular needs. Indeed the self liquidating nature of many private financial operations is an essential counterpart to the reality of production schedules and cash flow arrangements.

The Treasury I think would argue that in theory the Treasury can always do better by having on the one hand a spending programme that is unfettered by financial constraints and on the other hand the freedom to raise cash from the market in a way that, subject to the constraints imposed by monetary policy, so that it can obtain the money as cheaply as possible.

I think, however, we should argue that the very divorce of finance and spending, which the Treasury defends so vehemently, is the source of many of our problems. What we should do is tailor our financial arrangments so that they match the reality of managerial decisions. (Indeed, I would suggest that one of the main reasons why the programme of privatisation is so behind schedule is that there has been such a marked divorce between financial arrangements and managerial decision-making.)

One particular example is the Treasury objection to leasing arrangements. (The Treasury insists on the capitalised value of the lease as well as the payments in each year being debited against the EFL; this effectively precludes any nationalised industry adopting lease form of finance.) Yet clearly leasing has enormous advantages to a nationalised industry and can be used very efficiently. One example is that the nationalised industry can enter into not merely leasing contracts but also maintenance contracts with the supplying firms. Some arrangement of this kind is often a natural twin of leasing. I have seen this operate very effectively in the newly nationalised bus system in Bankok where they leased their buses and required the bus owners to maintain those buses on the road. The effective turnout of buses per diem was over 98%. The normal outturn in countries of this kind where there is no such leasing arrangement tends to be between 50% and 70%. The point is that the private sector adopts leasing arrangements and other forms of finance because they are efficient and it seems unlikely that the nationalised corporations could not improve their efficiency by adopting similar forms of finance.

Probably the most marked divergence between private finance and public is the fact that in any concern one would tailor the financial arrangements to the maturing obligations and cash flow of the operation. So far as I can see this is never done in nationalised industries. It seems rather silly for example to borrow 20-30 year money at extraordinarily high interest rates, at least compared with the Government's announced policy on inflation, when one need not get locked into such long term obligations. If the amortization programme of the nationalised industries allows for the amortization of debt in 5, 7 or 10 years, why not arrange one's borrowing accordingly? This, however, cannot be done.

Turning to the argument that the increase of public spending would increase the degree of inflation, one finds something of an inconsistency in the Government's spending policy. If, as Cropper says, the problem is that spending will primarily generate trade union wage demands, as he may very well argue is the case in British Telecom, and will not absorb unused resources, then the whole spending policy of Government should be cast in terms of the trade union effect and effect due to any other rigidities which the Treasury have identified. Some consequences of this would be for instance that one should spend on road rather than railways because of the road haulage industry and probably also the road contracting industry is much less unionised than the railways. While I agree that there has been some policy moves in this direction, such as the small business incentive programme in the recent budget, one must admit that there is no systematic effort on the Treasury's part to identify those areas of expenditure where there is likely to be no rigidity encountered.

There are also a number of problems which are not addressed in the Cropper memorandum. The first clearly is that new forms of financing might be able to tap rather cheaply sources of finance which would otherwise not have gone into either private or public sector finance. He presumably thinks that the Treasury offer a wide enough variety of financed instruments to absorb any savers assets that he wishes to place in financial markets. Thus any new sort of instrument will only impoverish the proceeds of others. Perhaps so. But I cannot see why additional variety should be rejected, because at the very least it will not diminish the attraction of the instruments and, one never knows, it might just fill an undiscovered niche. We will never know unless we try. The main arguments for allowing British Telecom, Electricity and maybe Gas to issue their own debt or to tap savings of the household sector, is that they already have an established and computerised account with everyone, or at least virtually every household, in the country. The administrative costs then would be rather small, and I think far smaller than those of the existing national savings institutions. These do not have existing accounts with everyone in the country and consequently the administrative costs of additional accounts are very considerable. In the case of the utilities the additional cost would be quite small. Thus it seems likely that these methods may enable the acquisition of fairly cheap finance from the household sector.

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