ECONOMIC STRATEGY

Note by the
Chancellor of the Exchequer

June 1981

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This paper is intended to help us to take stock of our first two years of office and to identify the key issues we need to face in the remainder of this Parliament and in preparation for the next.

2. Our objectives are clear

- We aim to break out of the circle of high inflation, low productivity, poor market disciplines and responses, poor management and progressive devaluation. These are all closely linked.

- Success in this is essential for a sustainable growth of output, employment and living standards.

  This means ...

- we must substantially improve the efficiency and the competitiveness of the economy. And ...

- we must bring inflation down and keep it down.

3. As we made clear in our Manifesto, bringing about the necessary fundamental changes - not least changes in attitude on the part of management and labour towards the disciplines of competition and honest money - is not easy. This is especially so given the years of neglect, the tougher world setting and the competition we face from economies overseas which are much fitter than our own. We have made significant progress already. We have to consider the next stage.

I Setting the scene

4. Throughout the industrial world inflation accelerated and growth slowed down during the 1970s. Almost everywhere this was accompanied by sluggish productivity and rising unemployment.

5. The second oil price shock (oil price $17 a barrel on polling day and about $34 early this month) has seriously worsened the prospects for the world economy over the next few years. Growth prospects for the 1980s have been scaled down markedly. Earlier hopes that, once the first oil price shock had been absorbed, the

world economy would regain the growth rates enjoyed in the 1960s have long since been abandoned. In most industrial countries there are doubts whether growth in the 1980s will reach even the level recorded in the 1970s. In short, the world setting is much harsher than expected when we came into office.

6. The acceleration of inflation and slowdown in growth has been especially bad in Britain. Chart A shows how, through two decades, money incomes grew increasingly fast - much faster in fact, than in other industrial countries - while growth of real output slowed down. Between 1970 and 1980 output grew only 16 per cent. But money incomes increased by 335 per cent. In other industrial countries the increase in earnings over the period of the second oil shock was much more moderate than in the UK.

A

7. We are thus badly handicapped by a serious decline in our ability to compete. As Chart B shows, this is because our wage costs have risen much more steeply than those of our competitors and, to a much lesser extent, because North Sea oil has prevented them from being accommodated to the same extent as in former years by a continuously declining exchange rate. Chart C compares our performance on pay and productivity in manufacturing with that of other countries. If our productivity was up to French or German standards, we could have getting on for twice the output from our existing labour force.

8. As the decline in our ability to compete has gone on for a number of years, its causes are plainly deep-seated. We cannot therefore expect a speedy recovery from our industrial problems.

9. Britain, like other countries, has reacted to rising inflation by taking measures to limit the growth of total money expenditure; and to reduce inflationary expectations by persuading people to accept and adapt to the lower growth of money, especially in wage demands. This has included setting targets for the growth of the money supply. The effect is similar to establishing a cash limit for the whole economy, within which cash limits for the public sector are a natural consequence. The object must be to reduce from year to year the rate at which these cash limits grow until inflation is under control. Within that framework the total increases will be divided into the part taken by inflation and the part that represents real growth of output. Our task must, of course, be to reduce the former and increase the latter.

Inflation

10. Control of inflation, which was the first task in our Manifesto, must then remain first:-

- Because, if not controlled, inflation tends to accelerate and lead to an economic "stop".

- Because the attitudes which go with high inflation also produce poor productivity, poor management and loss of competitiveness, so reducing growth and employment.

- Because inflation is unjust and unpopular.

- Because our success or failure in reducing it is one of the main things by which we shall be judged.

11. Inflation was accelerating when we came in. We have reversed that trend. Inflation is now about 12 per cent, compared with about 22 per cent a year ago.

12. As Chart D shows, in the past year inflation has fallen much more quickly in Britain than in the rest of the OECD. And productivity has improved in some industries. But

- Our inflation is still above the OECD average and far too high.
- We must bring down our costs substantially, to help reverse our loss of competitiveness.
- The progress so far made will be hard to maintain.

13. This last point is important. Although most projections show inflation continuing to fall, there is a real risk of some temporary reversal, even if, by firm control of the money supply, we can prevent this from going too far. This could come about because of such factors as:-

- A faster rise in some world prices, as activity recovers.
- Pressures when our economy picks up, as profit margins recover and employers bid for skilled labour.
- The recent fall in the exchange rate and the possibility of further fails.

14. Some of these factors are inevitably beyond our control. So it is all the more important not to ease up on what we can do. We must take the expenditure and tax decisions that are necessary if we are to achieve our monetary targets and be in a position to help industry, for example on interest rates. We need also to lighten the burden of rates and taxes and to improve incentives.

15. In addition we must:-

- take all possible steps to secure a reduction in unit labour costs and in the cost of the public sector;
- maintain and strengthen expectations that inflation will continue to fall, despite short term difficulties.

I Output

16. To repeat, over the past 10 years prices have risen by 275 per cent and money incomes by 335 per cent, but real output by only 16 per cent. Since the first half of 1979 output has actually fallen by 5 to 6 per cent.

17. In part this recent fall in output reflects world-wide developments, as most major economies experienced recession following the oil price rises. Output in all the major countries of the European Community, for example, has fallen during the past year and is expected to remain roughly flat for the rest of the year.

18. But the recession has been deeper in Britain, reflecting:-

- The underlying weakness of our economy, much of it over-manned and uncompetitive.
- Excessive pay increases over many years.
- An uncomfortable side-effect of North Sea oil, through the impact of the high exchange rate on some manufacturing industry.
- The need to bring down inflation by more than other countries have had to do.

19. Chart E shows that real industrial profitability has fallen from about 14 per cent to virtually nil in the past 20 years. The rate of new investment (after allowing for the replacement of old plant) has also fallen. Chart F shows the contrast in recent years between falling company incomes - down by 25 per cent - and rising personal incomes - up by 18 per cent.

20. There are signs that, with the rundown in stocks coming to an end, and retail sales high so far this year, we are nearing the end of the recession; a number of recent indicators suggest that the fall in output is levelling off and that in some industries activity is increasing. There are encouraging reports of improved productivity. Recent CBI and other reports offer evidence of some improvement in business confidence.

21. But as with our success on inflation the improvement here is fragile. If we are to have the basis for sustainable growth we must resist any temptation to relax. The world economic setting is unfriendly and intensely competitive.

22. In this difficult setting, any upturn in the economic cycle will take us only a small part of the way. Essentially it will be up to business and industry to create or win new markets and to increase market share, at home as well as abroad. Government must help and not hinder this process. We still need much wider understanding, above all in the public sector where several effective labour monopolies exist, of the importance of combined effort in purusit of better productivity. There are still too many obstacles to economic change and flexibility, probably above all in the labour market. But not only there.

IV Employment

23. Chart G shows the recent very sharp rise in unemployment, following a long upward trend.

24. Most of the actions required to improve productivity and competitiveness - cost cutting, removal of restrictive practices, increasing efficiency - necessarily increase unemployment at first. We face the consequences of years of over-manning. In the longer run improving productivity and so competitiveness leads to faster growth and more jobs. That is the clear lesson of, for example, the Japanese experience. It is in fact confirmed by the record of some successful parts of the British economy. The need is to bring our average performance nearer to what our most successful firms and industries have shown to be possible and at the same time to promote the expansion of real and sustainable new employment opportunities.

25. Nevertheless, we must recognise that, because of the big improvements needed in our competitiveness and of a growing labour force, unemployment is likely to continue to rise for some time yet, although at a slower pace. It will take a long time for business and industry to develop and exploit new markets on a sufficient scale.

26. There is another point. As Chart G shows, recorded unemployment has for some years been increasing out of line with other indicators of the pressure of demand for labour. Chart G also shows how over time each cyclical peak of unemployment is higher than the last. This implies that even when the economy recovers and the demand for labour improves, unemployment is quite likely to stabilise at a higher level than in earlier decades. We need to do all we can, without provoking renewed inflation, to speed the sustainable expansion of productive activity and real output. But we must also seek ways of containing unemployment meanwhile.

27. We need to consider the needs of particular groups, such as the young. But any such action cannot be allowed to jeopardise the need to control total public expenditure. Once again we see the need for more flexibility within the labour market. The higher the cost and the greater the difficulty of taking on new labour, the smaller will be the number of new jobs.

V

Tax and public expenditure

28. So far in our period of office the tax and public expenditure burdens have both risen, as Chart H shows. We have reduced the PSBR as a proportion of GDP - but only by covering higher public expenditure by even higher taxes.

29. Within the limits of the very tight fiscal situation we have been facing, we have made significant improvements in the tax system so as to encourage growth and enterprise: thus we have dramatically reduced the confiscatory top rates of income tax, and we have introduced an array of new incentives to promote the establishment and growth of small businesses. But nonetheless the tax burden has sharply increased since 1978-79:-

- Although some switch has been made from taxes on personal income to taxes on expenditure, both direct and indirect taxes are heavier than when we came to power. Excluding the effects of the North Sea, this year taxes (including National Insurance and rates) will take 39½ per cent of the nation's income compared with 35 per cent in Labour's last year.

- A married man on average earnings now pays 48½ per cent of his income in direct and indirect taxes and contributions compared with 45½ per cent when we came to office.

- We have made only moderate progress in easing capital taxes and in lightening company taxation.

Moreover, on the projections published at Budget time (based on our plans for declining public expenditure, as set out in the White Paper) the tax burden in 1983-84 would still be 38 per cent of GDP - 3 points above the level we inherited.

30. This falls well short of what is expected of us by our supporters and indeed by the country as a whole. For economic as well as political reasons we have to do better.

31. On public expenditure we set out to reduce the total substantially as a proportion of GDP. Business and industry still rightly regard

this as an essential objective. We have had some success. We held the ratio steady for our first year in office. Expenditure during the current year is expected to be £5 billion less than our predecessors were planning, despite the additional costs of unemployment benefit and employment support due to the recession, for which their plans included no provision. For next year, our March plans represent expenditure nearly £10 billion less than they were planning. In achieving these reductions from previously planned levels, we have not shrunk from some very difficult decisions. But:-

- In 1980-81 the total as a proportion of GDP shot up - both because GDP fell and because expenditure was higher than we intended (less than half of this excess can be explained by the fact that the recession was worse than expected).

- This year the ratio could approach the peak reached in the early years of the last Labour Government. In cash terms expenditure by central and local government in 1981-82 is estimated to be about £6 billion higher than forecast a year ago.

- This represents an increase of more than 60 per cent between 1979-80 and 1981-82, compared with an increase in retail prices of 49 per cent.

32. Public expenditure must be paid for by the private sector, either through taxes or through the high interest rates that accompany higher borrowing. To improve the outlook for the private sector we have to reverse the growth of the public sector. Charts I and J show the present breakdown of spending. They demonstrate the programmes we shall have to look to for this. And because we want to do this without adding to inflation, the apparently easy option of further increasing public sector, particularly nationalised industry, prices beyond the levels currently envisaged is not open to us.

33. We have already recognised, and said publicly in the last Public Expenditure White Paper, that the present expenditure programmes are higher than we wish in relation to financial and economic objectives.

Nothing has happened to invalidate that judgement. The need is clear to reduce the public expenditure totals for the years ahead below the equivalent of those in the last White Paper.

34. Yet there are already pressures for increases in certain programmes, notably for nationalised industries (relatively little for investment), for industry generally, for unemployment related programmes, and for defence.

35. There is a case for changing the composition of our spending programmes to create room for public sector investment which gives a good return and which would also improve the relative prospects for private sector output and employment. Within the total increase of 60 per cent in public expenditure between 1979-80 and 1981-82, fixed investment was static in cash terms. We should certainly do all we can to ensure that the public investments we undertake are those which will contribute most to making the economy more productive and competitive. The best way to finance profitable public investment is to cut out unprofitable public investment.

36. We could go further and increase public investment at the cost of current expenditure. But to the extent that we increase public expenditure on investment (or indeed increase any other programme) we have to forego the chances of lower taxes or lower interest rates which might otherwise result from cuts in other programmes. (This is discussed at more length in the note attached at Annex B.) There are already signs of a repetition of last year, with difficult reductions being required simply to hold the total against increases which we may find unavoidable, let alone to reduce it as we need.

37. As well as reducing the size of the public sector we must make every effort to contain costs. This year pay in the public services - but not in the nationalised industries - is in general rising less rapidly than pay in the private sector. We need to do better still - especially in the nationalised industries - and at least to ensure that we hold the improvements so far made.

38. To repeat, on present spending plans, even on optimistic assumptions about the growth of the economy, we shall enter the election with an overall tax burden much heavier than the one we inherited. Not only politically, but also economically, that is not tolerable.

VI The way ahead

39. Recovery is bound to be slow, unemployment will go on rising for some time yet - although more slowly - and the fight against inflation will grow harder, particularly since we may no longer have the benefit of an appreciating exchange rate. A sustained expansion of output and jobs will only be possible if we maintain progress against the deep-seated weaknesses of the economy - poor productivity and competitiveness, resistance to difficult changes, a large public sector and, perhaps above all, monopolistic and selfishly used power in pay bargaining.

40. What the Government can do directly is limited. It is a job for everyone, Government, management, unions and individuals. But we must go further towards creating the right climate for bringing about the needed changes. The need for perseverance over a relatively protracted period poses a formidable political problem.

41. What should we be doing? There are plenty of blind alleys. Thus:-

- Relax our money stance? An inappropriate cut in interest rates would lead to excessive monetary growth and even more inflation, and any effects on unemployment would be small and short-lived. And it would worsen the long-term problem of securing a proper balance between output and inflation.
- Formal incomes policy? We certainly need to ensure that the rate of growth of money incomes continues to fall. But experience shows that any success achieved by formal control is always short-lived and counter-productive when its distorting effects unwind.
- Import controls? For a major trading nation like Britain retaliation would be inevitable, and any short-run benefits to output and employment would be purchased at the expense of efficiency and so of consumers and of higher inflation.
- Bring down the exchange rate? It has recently moved sharply down against the dollar, but remains much higher against the D-mark than when we came into office.

Although it will help sales of UK exports in the US, the recent movement is bound to cause some anxiety about the effect of higher import prices on inflation.

- Putting North Sea revenues to "better" use? A North Sea Oil Fund perhaps? But North Sea revenues, which by 1983-84 are expected to amount to only about 6 per cent of general Government revenues (about half of annual defence spending and less than we are already spending on investment by publicly owned industries) are already helping to keep down the PSBR, and so interest rates. And in any individual year uncertainties over output levels, oil prices and the exchange rate affect actual receipts. Any new accounting device would at best be cosmetic and, given the uncertainties, could constrain our freedom of action.

- A straight increase in public expenditure? In order to prevent this leading to higher inflation, it would entail higher taxes or higher interest rates, neither of which would help the recovery of the private sector. This would be so even if the extra public spending took the form of capital investment. The effect would be to discourage private spending, including investment. Yet in the long run private sector investment decisions would almost certainly create more wealth than extra public spending.

42. Clearly we must avoid the mistakes of the past and be willing to sustain the right policies for long enough to secure a lasting improvement in underlying performance. This certainly means maintaining firm control on the amount of money available in the economy, the national cash limit. By making clear our determination to stick to this discipline we can sustain the change in expectations and attitudes within industry. There are encouraging signs. But we need to build on them and not risk dissipating them.

43. To repeat, the vital need, in economic terms, is to go on reducing the share of the rising national cash limit that is absorbed by inflation and to increase the share that represents

real growth of output. I set out below some of the difficult areas where we need to concentrate our thinking.

Changing the patterns of economic behaviour

(a) How can we secure much wider understanding of the scale of our problems and of their real causes?

(b) What more can we do to convince people of the need - and of our determination - to maintain the fight against inflation, if unemployment is to begin to yield? And to secure a sustained change in the attitudes of pay bargainers, in public and private sectors alike?

(c) In particular, what more can we do to create the climate for a moderate rate of pay increases, well down in single figures, especially in the public sector, in the coming autumn and winter?

Improving the supply side of the economy

(d) How should we continue increasing and improving opportunities for the private sector and, most of all, for new and expanding businesses?

(e) What more should be done to remove obstacles to mobility and efficiency, for example in the housing market and in the labour market?

(f) How do we handle the prospect of a continued growth in unemployment, particularly amongst the young?

(g) Should we be doing more to tackle monopolies and restrictive practices, whether in private or state industry or in the labour market? In particular, what more could we contemplate doing to tackle the problems of union power and union behaviour?

The balance of fiscal policy

(h) How do we make faster progress in reducing the size - and cost - of the public sector and so ensuring further progress towards lower interest rates and reducing the tax burden on the private sector?

(i) How much importance do we attach to securing significant cuts in the present tax burden? And how important are other commitments if we are to make room for tax cuts?

44. These are difficult questions for difficult times. Popular expectations remain high and people are (understandably) impatient for success. Yet we can restore the economy to health only if we are determined, for some time to come, to sustain the policies needed to achieve a fundamental change in attitudes and institutions.

VII CONCLUSIONS

45. I invite my colleagues to:-

(i) note the need to <u>maintain</u> the Government's present general approach to the economy;

(ii) offer their views on how best to promote the changes in patterns of economic behaviour and in the working of markets essential if we are to improve the performance of the economy; and how best to adapt our fiscal and other policies to contribute to these objectives.

(iii) Plans to train and occupy young people

G.H.

H.M. TREASURY
11 June 1981

ANNEX A

Technical note on figures and concepts used in the charts

CHART A Money Income is gross domestic product (GDP) at current market prices. Output growth is the change in GDP measured at 1975 prices.

CHART C Productivity is measured by change in output per man-hour in manufacturing. Pay is hourly earnings.

CHART E Relates to industrial and commercial companies, excluding North Sea activities. Profitability is the estimated gross trading profits plus rent less stock appreciation and capital consumption at current replacement cost expressed as a percentage of net fixed capital stock at current replacement cost plus the book value of stocks. Net Investment measures the growth of the companies' capital stock.

CHART F Real disposable income is gross income less direct taxes and contributions deflated to real terms by the GDP deflator. For companies this is equivalent to retained income plus dividend payments.

CHART G "Skilled labour shortage" in Chart G is the 'skilled labour constraint' index in the CBI business trends survey showing the percentage of respondents reporting skilled labour shortage as a factor holding back output. It is plotted in the chart with the scale inverted so that it can be more readily compared with movements in unemployment.

CHART H As paragraph 29 says the tax burden is calculated excluding the effects of the North Sea. More specifically, it embraces all taxes (including local rates) and contributions except taxes on North Sea operations, and is expressed as a percentage of GDP excluding the contribution of North Sea oil and gas. The "national income" denominator for the tax burden thus differs from that used for calculating the ratio of public expenditure to GDP. For this reason the absolute levels of the two lines in the chart are not directly comparable. The chart is designed to bring out the movements of the tax burden and public expenditure over time.

CHART I Total expenditure in this chart relates to general government (i.e. central and local government) and is divided into the main economic categories. Total expenditure on goods and services comprises the three right hand segments. "Lending to nationalised industries etc" is lending by general government only; it excludes public corporations' direct borrowing from the market and overseas.

CHART J Breaks down the main programmes into their major economic categories. Sales of council houses and land have been netted off "subsidies, grants and loans" (rather than off "fixed investment"); fees of general practitioners have been included in health pay. Programmes are on a UK basis; for example, "social security" includes the Northern Ireland expenditure (whereas "social security" in Chart I does not.

CHART A

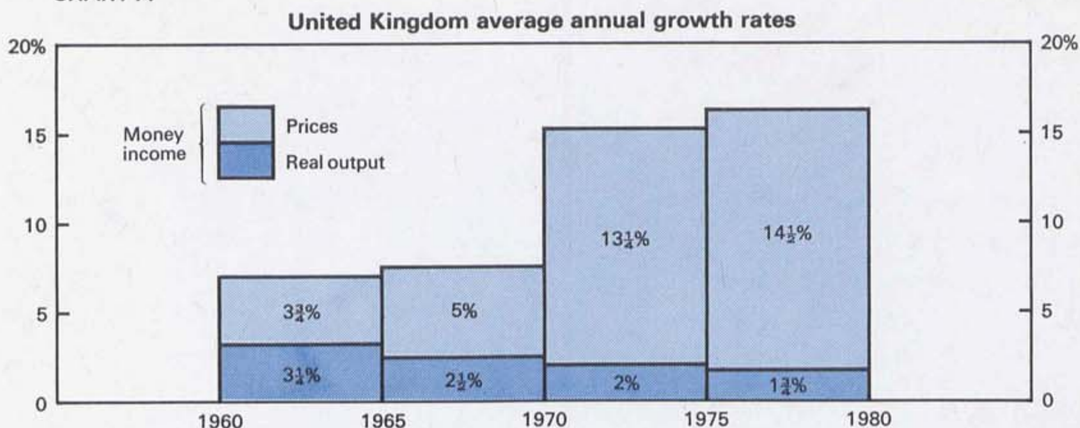


CHART B

CHART C

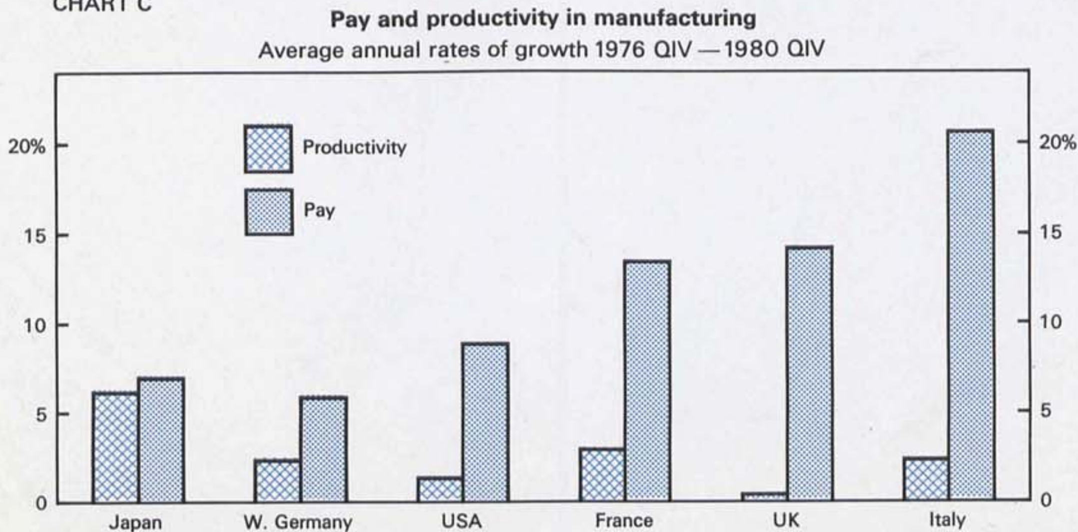
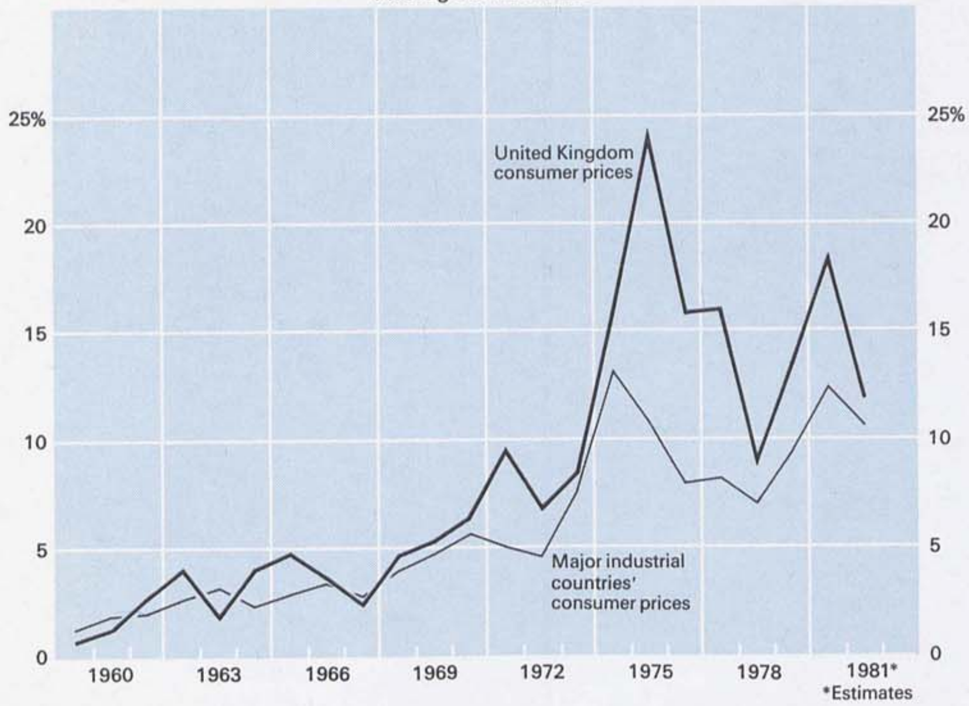


CHART D

Inflation
Average annual rates



Ratios of RPI

CPI.

CHART E

Profitability and Investment

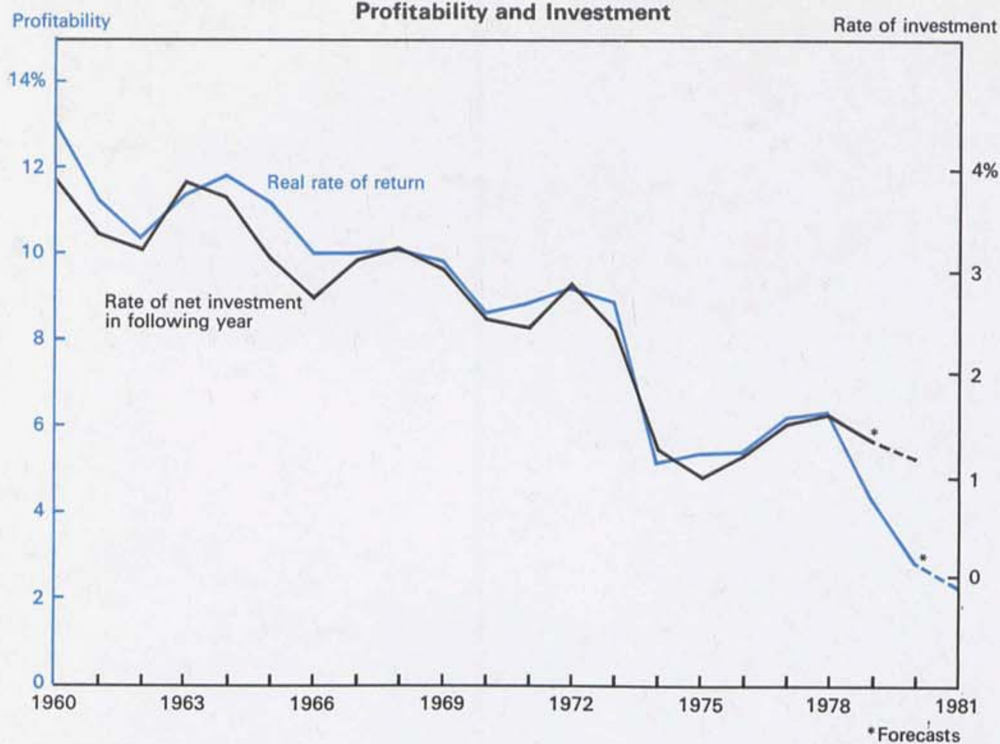


CHART F

Personal and company disposable income

£billion, 1975 prices

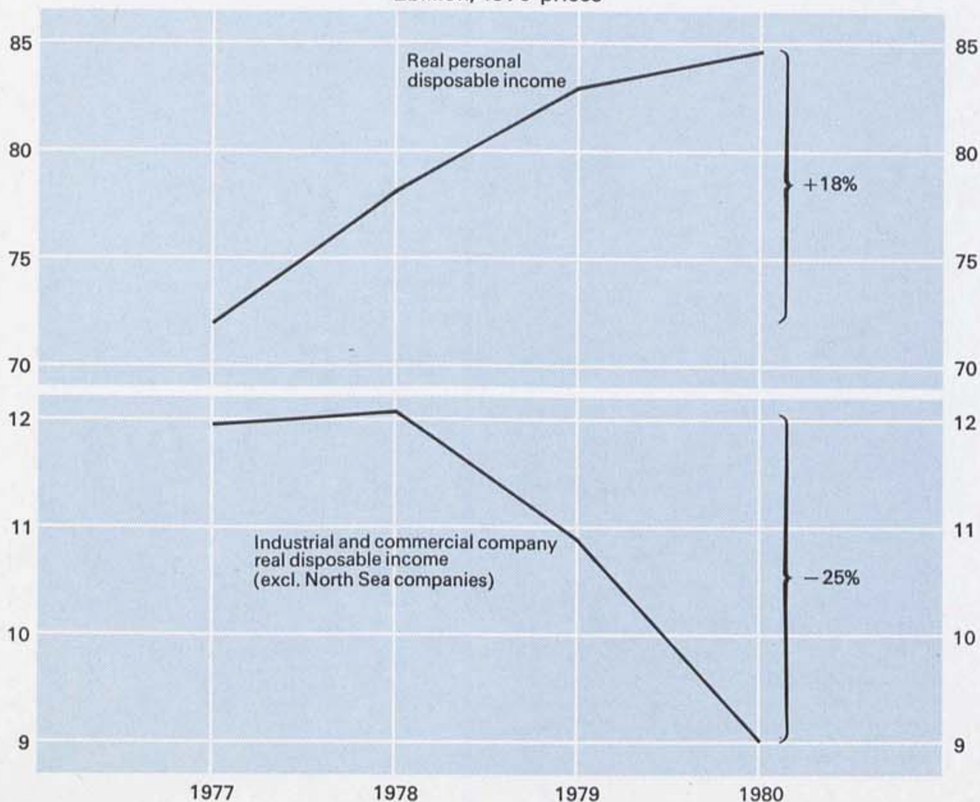


CHART G

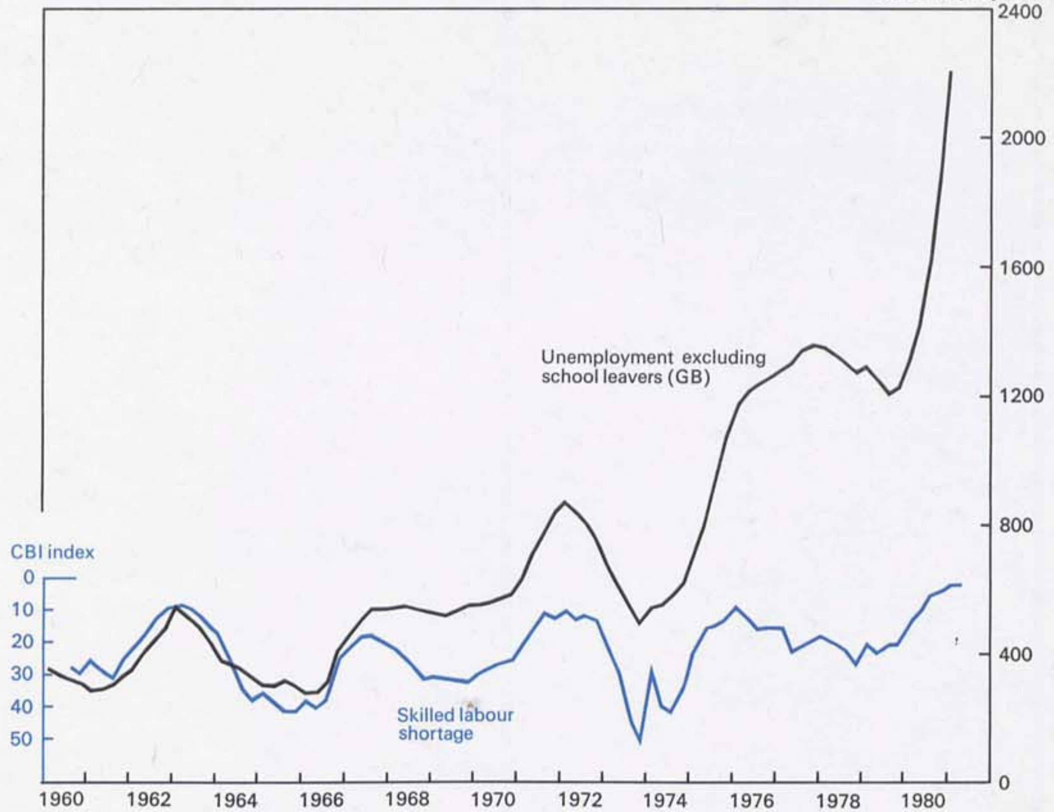


CHART H

Public expenditure and non-North Sea taxes as a proportion of national income

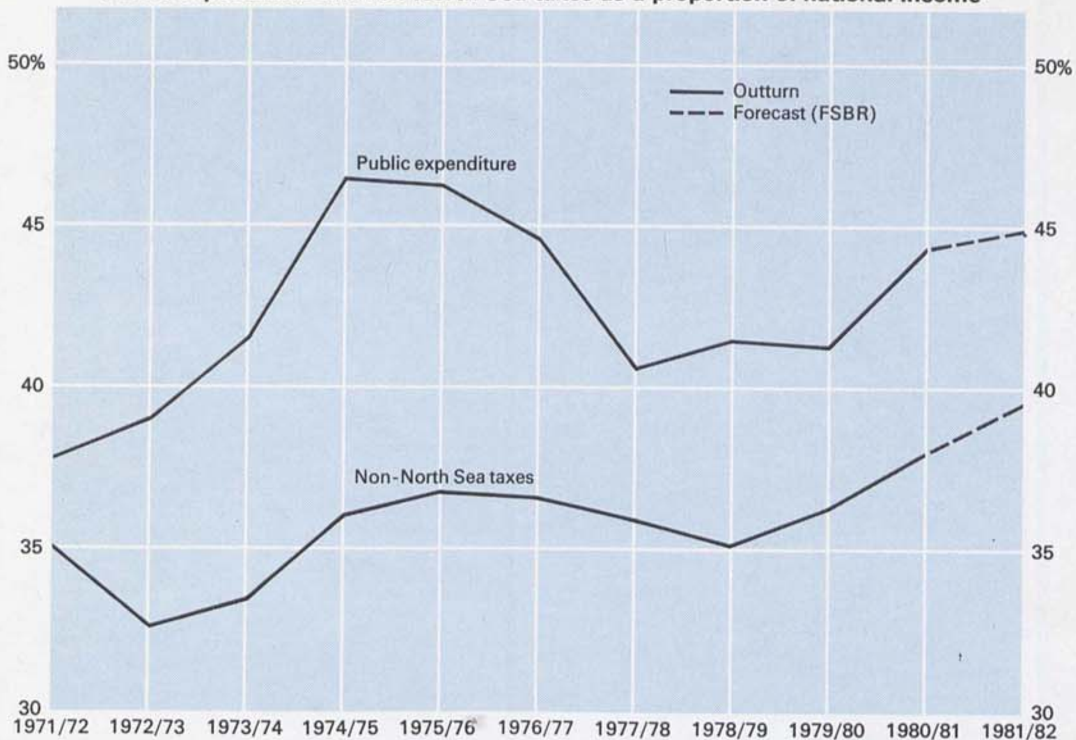
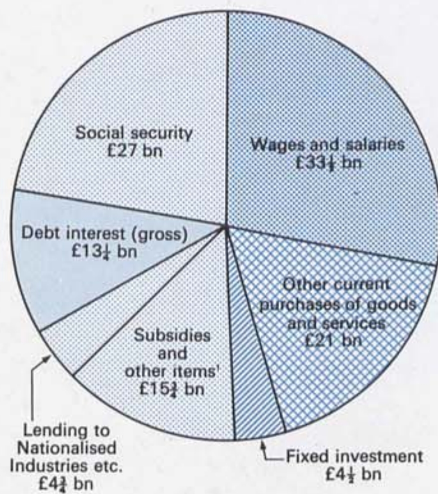


CHART I

Central and Local Government expenditure, 1981/82

Total cash expenditure : £120 billion

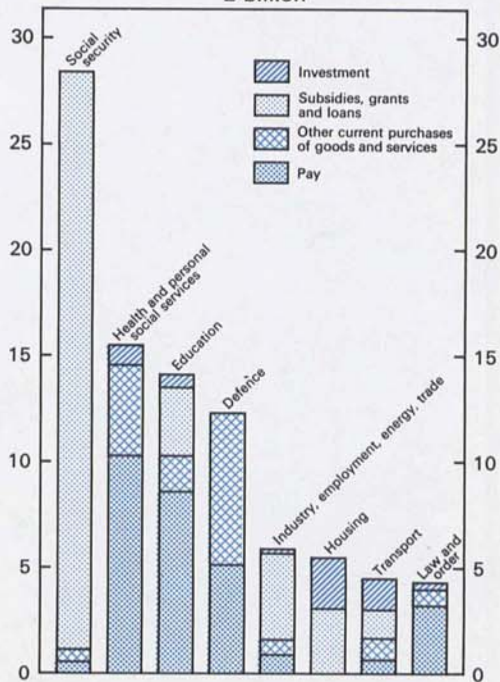


[1]Other items include industrial and regional assistance, current grants abroad, student awards, grants to universities and lending for house purchase.

CHART J

Main public expenditure programmes, 1981/82

£ billion



ANNEX B

CAPITAL AND CURRENT EXPENDITURE

There is a wide-spread feeling at present that capital expenditure in the public sector should be increased. This note examines some of the issues briefly.

2. First, some facts. The plans we published last March show that the dramatic shift between capital and current spending occurred between 1975-76 and 1978-79, when public capital spending (including Government loans to nationalised industries) fell by over one-third - £6 billion in 1980 Survey prices - while current spending rose - by over £3 billion. Between 1978-79 and 1980-81 capital expenditure will have fallen by a further £1½ billion, while current spending increases by a further £3 billion.

3. It should be noted that some of this reduction has reflected a decline in needs. For example, there is now less need for a major road building programme than there was in the late 1960s and 70s, so capital spending on Motorways has fallen from its previous high level. (In fact, the need at present is to maintain the Motorways in good order, and this falls on current expenditure rather than capital.) Similarly, a decline in the numbers of school children has reduced the need for new school buildings.

4. So far as nationalised industries go, where pressure for additional capital spending is greatest, the position is that from 1977-78 to 1980-81 capital expenditure has been broadly maintained in real terms at about £4½ billion per year; and this is already expected to rise to about £5.2 billion for each of the years up to 1983-84. This is a level for investment last attained in 1976-77. This is all in marked contrast to the fall which has taken place, and may continue to take place, in private sector investment.

5. It is widely assumed that capital expenditure is good because it builds up the long term productive capacity for the economy, whereas current expenditure is wasteful and does not do so. This is not

always the case, because the categorisation of expenditure as capital or current is not of course made on that basis.

6. Not all capital expenditure produces a long term economic benefit, and some current expenditure does. Research and development and industrial training, for example, are generally classified as current expenditure but ought to be adding to the nation's productive capacity. Investment in prisons and unemployment benefit offices, on the other hand, however beneficial or necessary they may be on other grounds, can hardly be regarded as adding to the nation's productive capacity. Over simplified application of commercial accounting principles can mislead in the case of public spending.

7. Moreover, even in the case of capital investment which undoubtedly adds to productive capacity, its desirability, compared with alternative uses of the resources involved, must obviously depend on the quality of the investment. Public investment is only worth undertaking if it yields a satisfactory return. At present the test which is applied to nationalised industry investment is whether it will enable the spending programme in question overall to yield 5 per cent in real terms. Worthwhile projects have to be identified. But history shows how difficult this is. There are numerous examples of unprofitable, misguided or wasteful public sector investment projects such as the Isle of Grain power station and British Steel's investment programme of the early 1970's. The return on nationalised industry investment since 1972 in the aggregate has been very poor - never significantly above zero - and well below that of the private sector.

8. The difficulties that arise are, in part at least, a reflection of the fact that the process by which the market appraises a private sector invitation to investors is trusted, but the process by which government appraises a nationalised industries application for funds for capital investment is less clear cut, dependent on administrative discretion, and therefore less acceptable.

9. Indeed, even the 5 per cent test applied in the public sector is not really comparable to the market test faced by investment in the private sector. Some nationalised industries can produce any given

rate of return by the exercise of monopoly powers, regardless of whether the project genuinely increases efficiency. In other cases the rate of return is met by reducing the cost of providing a service which already runs at a loss (this is the meaning of the 11 per cent claim for electrification of rail, for instance - it would show an 11 per cent return as compared with investment in diesels).

10. If investment proposals do pass appropriate tests, the next question is how they should be financed. If our central economic objective is to defeat inflation by controlling the growth of money, at any given time the total level of money expenditure in the economy must be limited. This means that investment proposals can only be financed at the expense of other expenditure.

11. This is true, whether one is speaking of public investment or private. In the case of private investment proposals, the general economic climate within which they are put forward is of course materially influenced by the Government's fiscal and monetary policies, but both the total level of investment and its distribution between projects are determined by the market.

12. In the case of the nationalised industries, if investment can only be financed at the expense of other expenditure, the way in which this can be done outside the governmental rationing system is for the necessary funds to be generated internally. In other words, nationalised industries should primarily finance investment out of their trading surpluses - which may often only be attainable by taking quite radical steps, such as substantial manpower reductions and significant cuts in real earnings levels, but not, of course, unjustifiable price rises brought about through the exercise of monopoly power.

13. But in the case of public sector investment the competition for funds is wholly distorted by the Government's own credit being behind the borrowing, quite apart from the existence in many cases of monopoly power. Investors naturally like the security of lending to public sector bodies, whether there is an explicit Government guarantee or not.

The power to borrow is in effect backed by the power to tax, and this makes it radically different from private borrowing. The more borrowing of this kind there is, within the monetary limits we have set, the more difficult or expensive it must be for the private sector to borrow. Even if private investment is possible interest rates can be forced up and in that sense crowding out can take place. That is why the extent of public borrowing has had to be rationed by the Government, just as it is in other Western countries with both a public and a private sector. The invention of new methods of finance for the public sector does not alter this basic point.

14. The possibility of allowing nationalised industries to raise part or all of this finance for capital projects direct from the market has of course been carefully considered and final conclusions on this question have not yet been reached and will be taken in the light of the findings of the NEDC taskforce set up following the June Council under Treasury Chairmanship. But it would only be worth doing if some genuine link could be made between the performance and efficiency of the industry and the returns on the bond - so that investors are able to put the same sort of pressures on to management as shareholders do in the private sector. The effect of a direct relationship with the markets, including the issue of prospectuses, could have a useful impact on performance in efficiency, if this genuine link could be made. Without the real prospect of savings through greater efficiency the higher cost of private rather than Government finance would not be justifiable. Again the difficulties of the monopoly powers and protected competitive position of many of the industries present themselves; but it may be that a limited move in this area would be possible. This would not affect the main issue, as it would not justify any increase in total expenditure.

15. The difficulties of determining the level, distribution and financing of public investment all underline the conclusion that we have long ago reached that, whenever it is at all attainable, by far the best course is privatisation. But however vigorously that is pursued, the problem of the distribution of capital and current expenditure within a reduce public sector will remain.

16. It may well be true that the present pattern of capital and current expenditure within the public sector is not the best one. When total expenditure has to be cut, it is often easier to cut the capital, both in Government and in nationalised industries. There may well be projects for capital expenditure in both these areas which should be given some degree of preference.

17. The best way to finance profitable public investment is to cut out unprofitable public investment, or make offsetting reductions in current expenditure in the public sector whether within Government or in the nationalised industries. But if additional investments adds to the totals, either or both of two consequences must follow:-

(i) There must be more public sector borrowing and thus higher interest rates and less private investment; or

(ii) taxes must be higher so as to reduce private consumption.

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11 June 1981