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Qa 05390

12 June 1981

To: MR LANKESTER

From: J R IBBS

Prime Minister
You might discuss
with the Chancellor
on Sunday evening
whether it would be
helpful to
circulate this
note to Cabinet.
My view is that
it would.

Economic Strategy

12

1. I attach a draft note by the CPRS which, if the Prime Minister were content, might be circulated as a contribution towards suggesting answers to some of the questions posed by the Chancellor at the end of his paper.

17/6

2. I am sending a copy of this Minute and the note to Sir Robert Armstrong.

Mr's colleagues
did not like
the "summary"
presentation last
year which is why
we are having an
ordinary Cabinet
meeting this
year. Geoff
will have to
read the following
out

See also
John Hoskyns'
note below

When I told John
Hoskyns you had agreed that he and
Alan Walker should attend this meeting
of Cabinet, I made it clear it would be
a non-speaking capacity sitting at the
table with the rest of us. But his note implies
this and assumes Alan Walker and Terry Burns
will be full participants - full

cc T. Mackay

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ECONOMIC STRATEGY

Note by the Central Policy Review Staff

1. The CPRS agrees with the Chancellor that it would be wrong to risk throwing away the gains made by the Government's economic policies, by a hasty reflation now. Too often in the past, at the trough in the cycle when output has stopped falling but unemployment (given the lags) is continuing to rise, Governments have acted to hasten the upswing, leading straight to overheating and the next "Stop". Though the situation now is in some ways worse than in previous recessions, we firmly believe that a drastic change of fiscal and monetary stance would have bad effects on the pay outlook, the exchange rate and therefore on inflation which would outweigh and outlast any temporary gain in employment.

2. But the "national cash limit" means that it is absolutely imperative to hold back pay settlements. As the Chancellor explains, the higher the share of that overall limit taken by inflation, the less room there is for real growth of output. The uncomfortable conclusion is that if wage inflation is not somehow kept below the overall limit, there can be no sustained recovery in output and no prospect of reducing unemployment.

3. There has been some success in the present wages round; keeping to the present firm stance on fiscal and monetary policy, and on public service pay, will help to maintain this. But there is a limit to what can be done by exhortation. Even while people recognise their interest in lower inflation as consumers, and as a nation, they see that as wage-bargainers they risk falling behind if they accept a low settlement. As result, in areas of the private sector where profits are higher (e.g. the financial sector), or in monopoly industries in the public sector, union negotiators will exploit their bargaining power. This in turn tends to increase what those who recognise the relative weakness of their position nevertheless expect.

4. The CPRS therefore believes that Ministers should ask officials to carry out urgently a wide-ranging study into ways of reforming the wage-bargaining process. This should consider all feasible suggestions for

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limiting pay settlements, by shifting the balance of industrial power or altering the incentives and penalties which face wage bargainers now. We recognise that a great deal of work has been done on these questions in the past. But in our judgement the issue is crucial to the success of the Government's policy, and likely to be highlighted even more starkly over the coming months and years. Hence it is worth the most thorough study, without preconceptions, to present options for Ministers to consider.

5. Even if wages can be held down, output will only rise to the extent that industry is able to produce saleable goods and services. Gains in productivity should give firms a better base for expanding output when they see market opportunities at home or abroad. But firms will only find market opportunities to exploit if they have the right products. And they will only design and develop new products and make the necessary investment if their cash-flow and profitability justify this. Confidence in future improvement is also essential if investment is to occur. Some sign of encouragement is therefore important.

6. The Chancellor's paper asks how important it is to secure significant cuts in the present tax burden. In the CPRS's view, despite the need to reduce the burden of personal taxation, a priority in this crucial phase of recovery should be to help industry obtain some improvement in profitability as a basis for expansion. Among fiscal measures with this aim, one would be to reduce the National Insurance surcharge on employers. But again this will merely boost inflation unless some means can be found of preventing the extra cash flowing through into higher wages; this reinforces our conviction of the need to find a way of curtailing these.

Summary

7. Among the answers to the questions at the end of the Chancellor's paper, the CPRS wishes to emphasise:

- (a) the urgent need to carry out a wide-ranging study of options for reforming the wage bargaining process;
- (b) the need to switch fiscal resources into industry, e.g. by cutting the National Insurance surcharge.