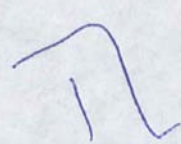


TIM LANKESTER  
cc ALAN WALTERS  
A. DUGUID



I cleared this with John Hoskyns last week. However, I thought I ought to send you an advanced copy so that you knew what was happening.

DOUGLAS HAGUE  
30th March 1981.



PLEASE EMBARGO UNTIL 11-00 HOURS ON THURSDAY 2ND APRIL 1981

Professor D.C. Hague, Deputy Director of Manchester Business School and Adviser to the Prime Minister's Policy Unit at 10 Downing Street, spoke in Birmingham today to the Society of Chief Personnel Officers in Local Government.

He said that the economic situation in Britain today was very much like that faced by Edward Heath 10 years ago. As today, there was severe recession and high unemployment. As today, there was clamour for a complete change of policy. In the face of this clamour, it was only too easy to sympathise with Mr. Heath's decision to change course, silencing the critics. Life became so much quieter. But Mr. Heath's U-turn had been disastrous. So would one be today. This was why the government had to stand firm.

Today, the 'idiots' called for demand reflation. Heath's reflation, with Labour's help, had led to price increases of well over 20% in 1974 and 1975 and to more unemployment. Demand reflation today would lead to even bigger price increases. We understood what was going on better and responded more quickly.

Giving in to the 'idiots' would also throw away one clear benefit from the recent pressures on business. There was now greater potential for increased productivity and greater competitiveness than at any time since 1971 when the position had been similar, after a period of recession. Yet, by 1973, Heath's dash for growth had more than cancelled out the earlier gains. Productivity performance had been torn to shreds. The 'idiots' would have us do the same today. We must not.

More-refined idiots recognised the perils of excessive demand reflation, but recommended increased government investment. They urged us to repeat another error of the 1970s.

In 1970-74 (in 1975 money) British Steel had invested little short of £2 billion, and in 1975-79 a similar amount, in new plants etc. The result was not an efficient steel industry. This year, for example, we should be spending little short of another £1 billion in bailing out British Steel.



We were financing British Steel twice over. Having spent to over-expand it in the 1970s, we were spending again to slim it down, depriving private industry of funds in the process.

Professor Hague continued: 'With nationalised industries, it is all too often a case of: Pay now and pay later. Like electricity in the 1960s, steel in the 1970s provided a bottomless pit for state money - that is, our money. The railways are now being nominated as the bottomless pit of the 1980s.'

This was why the government had to scrutinise proposals for nationalised industry investment with scepticism. There was no general case against increasing public investment in recession. There were public investment projects that would give good returns. The problem was that they were rarely those that the public investment lobby had in mind. Because human beings lacked foresight, lobbies usually backed yesterday's industries, not tomorrow's. The problem with most economists and civil servants when they dealt with issues like this was not that they did not understand economics, but that they did not understand business. Britain did not need more public investment for its own sake. It needed more profitable public investment.

This explained the strategy of the Budget. Rather than giving direct subsidies to business investment, it sought to bring down interest rates and so encourage business to finance its own investment. Private business, backing its own judgment with its own money, was being encouraged, as it must be, to take the main burden in establishing the industries of the future. We must ensure that public investment did not gobble up the seed corn that private business needed.

The final legacy of the Heath era was a permanent, and unfortunate, shift in the traditional pattern of government finance. Until 1970, the central government had traditionally run a big enough surplus to finance its own expenditure and also part of the deficit of local government. During the 1960s, for example, the central government surplus covered more than 80% of the deficit of local government. Only the remaining 20%, plus the deficit of the nationalised industries, had to be borrowed.



Between 1970 and 1974, the Heath government turned a central government surplus of nearly £3 billion into a small deficit. Under Labour, the deficit grew, by 1976, to about £4 billion. Far from helping to finance local authority deficit, central government has, since then, run a huge deficit of its own. Hence today's enormous public sector borrowing. The 'idiots' had their way.

Against this background, it was sad to see a lobby, with The Guardian to the fore, seeking to legitimise huge public sector borrowing. Two points must be made.

First, in the 1960s, the public sector borrowed less than 4% of GDP. Since 1974, it had borrowed more than 8%. Worse, we had increasingly borrowed to meet current, not capital, spending. To argue that the increase in public borrowing was the sole cause of our economic difficulties would be foolish. Yet the fact was that under the traditional arrangement the economy had prospered reasonably well. Since 1974 it had not. The onus of proof was on those who supported higher public sector borrowing. Could they convince us that bigger public borrowing and poorer general economic performance were not linked?

Second, if it was now argued that a PSBR of £15 billion was quite acceptable, why not one of £25 billion? Or of £50 billion? There must be a limit somewhere. Those who were so enthusiastic about public borrowing should explain where that limit was, and why.

Professor Hague concluded: 'We have become accustomed to speak of the British disease. Its symptoms are high government spending and borrowing, high interest rates, high pay rises, high inflation and poor industrial performance. Similar symptoms are now appearing in other European countries. In Sweden the disease is chronic. In truth, this is not a British disease. It is a social democrats' disease.'