Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

22 September 1980

Michael Latham, Esq., M.P.,
House of Commons

Dear Michael

Many thanks for your long and thoughtful letter of 9 September, and for the trouble you have obviously gone to in setting down your thoughts and anxieties in so considered a way. They clearly call for an equally serious and responsible response from me. As you may know, I will be out of the country more or less continuously from now until 2 October, principally because of the Conference of Commonwealth Finance Ministers and the IMF/World Bank meeting in Washington. I wonder therefore whether in my absence you would be happy to enlarge on your ideas to my Special Adviser, Adam Ridley. It would help me greatly by helping to identify the matters which concern you most and, in passing, would give Adam a chance to fill you in on various points which are relevant to your argument. That done, I would like very much to talk matters over further with you as soon as can conveniently be arranged after the Party Conference. On the assumption that this is agreeable to you, Adam Ridley will be getting in touch with you shortly - or you can call him on 233 5618.

As ever

Geoffrey

GEOFFREY HOWE

FROM MICHAEL LATHAM, M.P.

CONFIDENTIAL

9th September, 1980.

I feel that I must write to ask you whether our medium term economic strategy is still on target. I am becoming concerned that some of the essential aspects of economic policy are getting out of phase, and it may be time to ask ourselves some unwelcome questions.

As I understand it, the basis of our economic policy remains as defined in our Manifesto, namely:-

(1) To improve incentives and to reward hard work by cutting Income Tax.

(2) To bring inflation under control through proper monetary discipline and by a gradual reduction in the size of the Borrowing Requirement.

(3) To reduce the proportion of national income taken by the public sector.

I am worried that the methods of pursuing these objectives are proving mutually contradictory. We must proceed further with our Income Tax cutting policies. Your 1979 Budget was a very useful start in that regard, but I hope it is not the end of the matter, especially as your 1980 Budget involved an <u>increase</u> in real terms, since allowances were not fully indexed. The encouraging feature of the 1980 "Red Book" is its indication that there is room for further extensive direct tax cuts in 1983, provided that the Borrowing Requirement is reduced, and that the targets for money supply and public expenditure are met. But, if the targets were to be missed, according to the reasoning behind the "Red Book," it must follow that the further reductions in Income Tax would be impossible, unless paid for by increases in indirect taxation, or further spending cuts. If the targets were missed badly, it would, presumably, require all-round tax increases in 1983, the political effects of which I do not need to enlarge upon.

Given the cardinal ~~conditional~~ importance which you have attached to the monetary targets and reducing the P.S.B.R., it disturbs me that we are making such little progress in meeting them. Nor is public expenditure yet satisfactorily under control, despite 16 months of reductions. Conservatives reluctantly accepted the 17% M.L.R. last November, once it became clear that the increase to 14% in June 1979 had not achieved its aim. But the recent money supply figures were most dismaying, after all the hardship already caused to business and industry by the high M.L.R. I know it can be argued that the ending of "the Corset" has distorted the figures. But we cannot have it both ways. If the figures are meaningless now, they must also have been wrong three or four months ago, when we were claiming that the targets were being met. Regrettably, the Borrowing Requirement does not appear to be on schedule either, and the likelihood of achieving the necessary reductions in nationalised industry deficits look extremely slim. I do not see how B.S.C., British Leyland, the N.C.B. or the C.E.G.B. can operate profitably in a major recession.

This leads me to wonder whether we know enough about what money supply really is in order to be able to make proper economic judgements based upon it. Can we really control it? Can we even measure it? If the purpose of high interest rates is to use the price mechanism to force down corporate borrowing, how, in practice, are companies supposed to respond? Either they can reduce their work force - which they are doing - or they can put up their prices (which they cannot do at present because of competitive forces), or they can borrow more, simply to pay the interest on past borrowing. This seems to be a wholly circular situation. Surely, it would be better to cut interest rates considerably so as to reduce the totally abortive debt payments which are mounting up for British industry, and which do not even seem to have the desired effect of controlling the money supply. If they had achieved their aim - fine. But they appear to make little useful difference, and have most damaging side effects. The Bank of England itself must have some doubts about this, since it is well known that it has intervened to hold down M.L.R. several times this year when market pressures were calling for further increases, thereby, presumably, adding to the money supply.

So far as the Borrowing Requirement is concerned, I am sure that the greatest single difficulty is the recession in the economy. I appreciate that this is a world-wide phenomenon, but increased unemployment benefit payments and loss of tax receipts make it harder every day to meet our stated targets. I find it difficult to justify a situation whereby manufacturing industry takes the strain of high interest rates, while public sector employment remains largely unaffected, public spending little changed in total, and the Borrowing Requirement and the monetary stock remain obstinately high. Plainly, without growth in the economy and with substantial under-utilisation of capacity, control of the Borrowing Requirement becomes a self-defeating exercise. It is controlled in one place, but it rises in another. There is very little value in reducing the number of teachers or places in old people's homes if the savings are more than counterbalanced by rising social benefits for the unemployed, and a fall-off in Income Tax or V.A.T. receipts because of reduced purchasing power. You yourself have repeatedly stressed that the reduction of Government borrowing is the key to the level of interest rates. But, again, the problem becomes circular. High interest rates lead to reduced manufacturing output, increased unemployment, higher social benefit payments, and a higher (or, at any rate, no lower) P.S.B.R., thus preventing the reduction of interest rates, and so continuing the circle. These penal interest rates also help to keep the value of sterling very high, and attract imports. I am increasingly doubtful it it will be possible to break out of this vicious circle without new initiatives.

I feel that the correct response to this dilemma is to reduce the degree of under-capacity. Either we restore growth to the economy, or we are going to have to accept Enoch Powell's alternative policy, which he rightly described

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last week - the need for a substantial increase in taxation to meet the Borrowing Requirement target. Another choice would be a really draconian - and immediate - attack on public spending. Both Enoch's tax proposals, or a major cuts programme, would deepen the recession. I do not believe they are really the answer.

My alternative would be to cut Income Tax again forthwith, and reduce employers' National Insurance Contributions. This could involve concessions of the order of £2.5 billion. In an economy with so much slack, there is scope for a significant increase in consumer purchasing power, provided it is also accompanied by a realistic attitude towards pay settlements and a tougher stance on import penetration. Indeed, an Income Tac cut now of another 2p. or 3p. on the standard rate (but with the higher rates unchanged) might actually help to achieve a lower pay round this winter. That would be a challenge to the Trade Unions, and one which they could respond to effectively. If they failed to do so, we would manifestly have to consider a more formal incomes policy, beyond that which we effectively already have in the public sector, though I hope such a thing could be avoided. If we also adopted a much more restrictive attitude towards import penetration and a Government-led "Buy British" Campaign, we might do something to revive home industry and reduce unemployment.

A tax cut now would <u>not</u> necessarily worsen the medium-term P.S.B.R. outlook if it produced more growth, and thereby more tax revenue through V.A.T. as a result of enhanced consumer spending. As for import controls, I simply do not believe that we can go on witnessing the weakening of British industry in the face of a rising tide of imports, and take no action to prevent it. Do our competitors do that? Do the Americans do that? I doubt it.

It will be argued that this is a classic reflationary proposal. So it is. What disturbs me is that we may continue with the steady decline of our manufacturing industry in the face of over-valued sterling, high import penetration, high interest rates and domestic recession, while retailers vigourously de-stock, thereby adding to the future problems of home manufacturers. If I felt that monetary control was really achieving our aims, and that we would move out of the recession naturally as the rate of inflation fell and home productivity grew, I would be prepared to accept the present situat on, grim though it is. What worries me is that the lack of demand in the economy will steadily frustrate the Government's overall strategic objectives.

Natually, public spending still needs firmer control. It contributes very little to the productive side of the economy, and has not really been cut back. I do not think we have sufficient weapons to be able to tackle the nationalised industries. Since they are immune from market pressures in the form of bankruptcy, they can use your E.F.L. policy as an excuse to put up prices, thereby frustrating your counter-inflation aims. The recent Post Office Engineers

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settlement was a classic example of a monopoly conceding on an inflationary pay award, and then immediately passing it on to the consumer in the form of higher prices. What a deplorable example to private industry! Surely, we should have powers to direct that there be commensurate staff cuts, or reductions in the corporate investment programme.

I am sorry to write at such length, but I felt it my duty to express to you my considerable concern, and I am only doing so after very great thought.

The Rt. Hon. Sir Geoffrey Howe, Q.C., M.P.,
Treasury Chambers,
Great George Street,
Whitehall,
LONDON, S.W.1.

LATHAM, M.P.

13th November, 1980

Thank you so much for your letter of 10th November, with which you enclosed a copy of your letter to Geoffrey dated 9th September, together with a copy of his reply dated 22nd September.

May we please have a word, after your meeting with Geoffrey later today?

IAN GOW

Michael Latham, Esq. M.P.
House of Commons,
Westminster, London SW1

HOUSE OF COMMONS
LONDON SW1A 0AA

Private

10/11/

Dear Tom,

You asked to see the attached. I hadn't bothered you with it before because I didn't want Geoffrey to feel he was under any other pressure. But since the Finance letter, the matter is now different.

I saw Adam Ridley some three weeks ago, & I am seeing G.H. on Thursday.

Best wishes,

Michael