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MANAGING THE ECONOMY

REPORT OF A POLICY GROUP - AUTUMN 1986

The Group met six times between September and December 1986. A Summary of Recommendations will be found at the back of the report.

Membership of the Group

Rt Hon Nigel Lawson MP
Rt Hon John MacGregor OBE MP
Nigel Forman MP
Rt Hon David Howell MP
Sir Peter Lane JP
Prof. Stephen Littlechild
Peter Lilley MP
John Major MP
Rt Hon Cecil Parkinson MP
John Redwood
Sir Peter Hordern MP
Peter Cropper
Mrs Judith Chaplin (Secretary)

INTRODUCTION

1. This paper is primarily concerned with policy options rather than their presentation. However, the Group was convinced that success in securing both re-election and effective implementation of these policies would depend crucially on proper presentation. Our programme must not be seen as negative, restrictive and depressing. In fact it is, and must be projected as, positive, liberating and optimistic. Our aim is to extend individual freedom, to give greater responsibility to individuals and families, to enlarge choice in crucial areas of people's lives, and to promote prosperity.

2. Far from holding back provision of health care, education, social security and infrastructure we want to open up these areas for additional private provision. In so doing we will be working with the grain of popular choice. Millions of people are already opting for private provision to supplement or replace state health, education, pension and other benefits and more would love to do so.

3. These positive objectives can only be achieved within the overall framework of the government's macroeconomic strategy. The Group agreed that the primary aim of macroeconomic policy must remain the reduction and eventual elimination of inflation.

4. A summary of recommendations is appended at the end of this report. At least as important as the specific policies and objectives listed here was the recommendation that no doors should be closed on options to curb public spending and reform taxation.

PUBLIC SPENDING

5. Strict control of public spending and the consequent enlargement of the private sector remain essential. It is the key to reducing taxes and thereby restoring to people the freedom and responsibility to spend more of their money as they choose. Lower tax rates also mean greater incentives which make for a more efficient and prosperous economy.

6. The incoming government must be prepared to step up efforts to curb public spending immediately it takes office. This means preparatory work must be undertaken in advance. The relevance of each public sector activity must be reviewed and the scope for transfer in whole or part to the private sector reconsidered. And the Government must be ready - very early in the new Parliament - to take difficult decisions whose benefits will only emerge over the course of the Parliament.

7. Social Security is the largest programme of all. The best welfare provision for the overwhelming majority of reasonably self-sufficient citizens is undoubtedly that which they can finance from their own incomes and tailor to their own needs.

8. By contrast, when benefits are financed from taxation and universally available to those meeting the relevant criterion of need, there is an automatic tendency for the number of claimants to rise. As more people receive benefits from existing programmes the demands increase for new programmes catering for those who feel left out. State social security spending can only be prevented from escalating uncontrollably by either curtailing the level of benefits or restricting their availability.

9. There are both social and political limits to the extent to which the level of benefits can be altered. Although we want to minimise the incentive for people to become claimants we must also retain a reasonable level of benefit for those who have no option but to rely on that benefit. Moreover, the government has pledged itself to index certain benefits and the Group accepted that that pledge would have to be reaffirmed. But given a period of low and declining inflation it should be possible to get away from index-linking of unpledged benefits. Important savings could be made by confining any increases in family support to the new Family Credit while allowing the value of child benefit to be eroded.

10. There is much to be learned from experience in the US and elsewhere. The initial uproar over curtailment of certain welfare benefits proved remarkably shortlived in the US and predicted horror stories failed to materialise. We should be looking to see where stricter conditions can be applied to the eligibility for benefits. In particular we should build on the Restart and Availability for Work programmes, in order to confine benefits more rigorously to those who are entitled to and need them. For example, refusal to accept a Community Programme job or training place could render a claimant ineligible for benefit. The Group also felt that housing benefit in particular was still too indiscriminate.

11 The Group recommended consideration of a more flexible retirement period, which would be the same for both sexes. People would be able to choose when to retire within a given age span. If they chose to retire early in this period their state pension would be correspondingly lower

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for a number of years. This would bring pensions into conformity with modern social trends. It would be sensible to fix the common pivotal age for both sexes at a level which reduced the total cost of pensions, eg 65.

12. Education and Health. In both these sectors there is a natural desire for, and willingness to finance, improving standards of provision as incomes rise. If extra resources are funded by the taxpayer this involves an increasing burden of tax with no guarantee that the additional spending will feed through to a perceived improvement in the services of the sort the public most wants.

13. Moreover, as long as the service is provided free to the recipient the demand is potentially unlimited. This is particularly true in the case of health care: 'free' provision combines with the constant advances in medical science to generate ever expanding demand for treatment. In practice a limit must be put somewhere. Under an entirely taxpayer funded system it is always the government which is placed in the position of saying 'No'. If there is a significant element of pricing/charging or genuine insurance it may be the consumer and/or the insurance company who to some extent establish the inevitable limit.

14. Any solution to this problem must involve diminished reliance on tax finance. That means greater reliance on either:

- (i) pricing and charging for services provided by the state and/or,
- (ii) health insurance and/or,
- (iii) private provision.

It is important that none of these options be closed.

15. It is possible to improve the efficiency with which taxpayers' resources are used within the state health and education services by introducing more consumer choice and competition. To give the consumer real power resources must be redeployed in direct response to consumer choices. For example, if the funding of individual state schools and colleges is related to their success in attracting pupils (by some kind of per capita formula) and schools have more control over their own budgets, and the ability to charge some level of fees, there will be more pressure to use resources economically in ways which satisfy parents.

16. Likewise, provided it can be done without undue administration cost, district health authorities might charge each other for treatments carried out on patients from other areas; this way they would have an incentive to reduce their own costs, to make full use of underutilised facilities of neighbouring authorities and to specialise in treatments for which they are most cost effective and for which there is greatest demand. The development of internal markets also makes it easier to evaluate the benefits and cost of buying in provision from private institutions, be they schools or hospitals.

17. The analysis of recent developments in the USA ("Challenge to the NHS", David Green IEA) suggests that competition is generating new solutions to problems of cost control, unnecessary treatment etc. These developments, especially the rise of Health Maintenance Organisations, may have useful lessons for the UK, which need to be studied. Greater involvement of private finance in health care is essential.

18. In introducing reforms in any of these services it is vital to ensure that key people responsible for implementing those reforms have an incentive to do so constructively. In the case of schools the headteachers ought to be enthusiastic about schemes which enhance their role. In the NHS it is vital that those appointed to Authorities are keen on reform rather than on campaigning for more funds and resisting change.

19. Defence. The UK spends a far higher proportion of national income on defence than any of its European NATO partners. The committee recommended a rigorous review of defence spending in the light of this disparity. No commitment should be made to any arbitrary spending target. Development of our own defence systems from scratch, when perfectly good systems are available for purchase from our allies, has cost billions of pounds. Often such duplicate developments were not requested by our Defence Commanders but were initiated by defence contractors to create orders for themselves. In future we must develop any new systems in conjunction with our NATO allies rather than in competition with them.

20. CAP. Irrespective of the wishes of our Community partners it is essential to insist on a firm limit to the EEC budget even if this leads to repatriation of parts of agricultural support. Most CAP expenditures reflect political and social considerations which differ from country to country. The greater our success in curbing domestic public expenditure the more important it becomes to restrain EEC spending.

21. Local Authority Spending. The growing tide of public concern about the excesses of some local authorities and

shortcomings of most others (especially in education) provides an opportunity for radical measures. It would be possible to withdraw education from local authority control and simultaneously abolish the central government rate support grant. Some mechanism to recycle revenues to the most needy areas would remain necessary. But this would leave local authorities with a range of responsibilities which could be financed from their own resources. It would then be possible for Central Government (while retaining control over borrowing) to leave local authorities to determine their own current spending levels. The level of rates/community charge would be seen to be the sole responsibility of local government, thus greatly enhancing local accountability. Financial discipline would be applied by the electorate.

TAXATION

22. Reducing the burden of tax must be a central element of our strategy for three categories of reason: the moral/political, the economic and the electoral.

(i) The moral/political arguments - It is a fundamental Conservative presumption that money belongs to those who earn and own it. Only the minimum necessary to finance the necessary functions of the state should be taken in taxes.

- It is desirable that people have the freedom and responsibility to spend their own money as they choose in providing, where possible, for themselves and their families.

(ii) The economic arguments - given that reductions in the top rates of income tax have been

demonstrably successful* in restoring incentives to the upper income groups it is reasonable to suppose that cuts in the standard rate will have some - albeit far smaller - impact on incentives further down the scale. Although the impact on individuals may be small the numbers affected are so large that the cumulative effect is likely to be substantial.

- income tax is one of the costs of employment: the lower it is, the smaller the wedge between the revenues a company must earn to pay its total payroll bill and employees' take home pay.

- the lower taxes, the more rapidly people can save and accumulate sufficient capital to set up their own business. The inability of British people to accumulate savings has been a major impediment to risk taking enterprise.

- perhaps the greatest effect of tax cuts, however, is their impact on the psychological climate. Nothing can contribute more to creating a climate of enterprise and optimism.

(iii) Electoral arguments - The Conservative Party can never outbid the opposition by offering higher public spending. Were we to attempt to do so, electors would conclude that if more spending is the answer to the nation's problems they should elect those who are clearly more committed to it than us.

*Reductions in the higher rates have led to the upper income groups paying a higher proportion of total income tax. This reflects, in part, the upsurge in business formation and reversal of the brain drain.

- by contrast the electorate recognise us as the Party most sincerely committed to tax cuts. And given that we have taken steps in that direction, promises to proceed further carry electoral credibility.

- although the upper income groups, who are often the most articulate, may not feel a pressing need for further tax cuts, there is considerable pressure further down the scale from lower income groups who find tax deductions at current rates leave them with barely enough to meet their needs. These are the crucial swing voters.

23. The Conservative Party must ensure that it is recognised as the sole party determined to reduce taxes. The manifesto should commit the Government to the target of reducing the basic rate of income tax to 25p. Emphasis on cutting the basic rate makes it clear that everyone will benefit, not just the rich.

24. We should also cut the top rate of tax in the next Parliament, probably to 50p, especially since the recent US tax reform could revive the 'brain drain'. (The new US system has an effective top marginal rate of federal income tax of 33% over the range in which allowances are withdrawn, falling back to 28% on the very highest incomes. State and local income taxes typically raise the top marginal rate to about 40%.) In addition France plans to reduce its top marginal rate of income tax to 50%, and Germany seems likely to follow suit.

25. Further reform and simplification of taxation is desirable and electorally attractive. It might not be appropriate to spell out details in the manifesto. But it is vital that no option for reform be ruled out between now and the Election.

26. This applies in particular to VAT. It is unlikely that we will be able within the bounds of fiscal prudence to reduce income tax sufficiently to encourage the enterprise culture we seek without a further switch from direct to indirect tax.

27. The tax regime for pension funds should be reconsidered especially to narrow the difference between taxes bearing on institutional and individual investment of savings.

28. Mortgage interest relief will have to be retained for political reasons. But it is important not to raise the ceiling nor to rule out changes in the form of the relief (eg limitation of relief at higher tax rates).

29. So far as income tax is concerned, the Manifesto should affirm a commitment to:

- (i) a reduction of the basic rate to 25p;
- (ii) a fair deal for women, probably via transferable allowances and equal treatment of investment income;
- (iii) removal of the existing tax penalties on marriage such as the extra mortgage interest relief available to unmarried cohabiting couples;

PRIVATISATION

30. The Manifesto should contain a commitment to substantial further privatisation but there is no need to include a list of specific industries which will be privatised in the next Parliament.

31. The objective during the election campaign must be to concentrate attention on Labour's threat to the industries which have already been privatised; not to provide specific targets for union scaremongering campaigns against further privatisation.

32. The committee felt it was important to reaffirm the objective of increasing competition as an important part of the privatisation programme.

33. The committee agreed that steel, electricity, coal and water would be natural candidates for privatisation in the next Parliament. Electricity generation and coal are intimately linked and must be considered in tandem. The PSA and Waterways merit further study. British Rail would be the most politically difficult industry to privatise - though parts such as freight might be suitable separately.

34. It is important to encourage genuine private development of infrastructure projects. This would help alleviate public concern about the supposed inadequacy of spending on infrastructure.

WIDER SHARE OWNERSHIP AND PENSIONS

35. A major objective of privatisation is the extension of share ownership, which should feature in the Manifesto and continue to influence the manner of future share issues.

The committee rejected the idea of giving away shares in one or more privatised companies even as a way of extending the taste for share ownership to every family. It would be impossible to explain why some shares should be sold and others given away.

36. The Manifesto should highlight the changes already introduced in the rights of contributors to private pension schemes - transferability and revaluation of 'preserved pensions'.

LABOUR MARKET

37. The committee welcomed the growing trend towards self-employment; small business; part-time working and greater flexibility in employment patterns. These trends reflect both individual preferences and the needs of employers and should not be resisted.

38. Profit related pay was also felt to be desirable since it encouraged improved productivity and discouraged the old 'them and us' divisions as well as providing a degree of flexibility which should diminish the pricing out of work problem.

39. The committee felt that proposals to give taxpayers the right to choose employed or self-employed status were based on a misunderstanding. Self-employed status is made fiscally attractive to reflect the risk and should only be available to people who are genuinely self-employed. Inevitably the boundary between self-employment and employment is not always clear cut and problems of definition grow with the increasing number of self-employed. The criteria for drawing it should be reviewed.

40. The most urgent concrete change which could help the labour market work better would be legislation to revitalise the private rented sector. This should certainly feature in the Manifesto.

EMS

41. Members expressed a range of views on the relative weight to attach to the advantages and disadvantages of joining the Exchange Rate Mechanism of the EMS.

42. Almost all felt the benefits of membership now outweighed the disadvantages for four reasons.

- (i) Since £M3 no longer has a clear and predictable relationship with inflationary conditions another monetary target - like the exchange rate - is needed both as a discipline on government and to influence expectations.
- (ii) The current pattern of exchange rates is in the view of most people more likely to be sustainable than that which prevailed before the Plaza accord.
- (iii) The downside risks to the £ exchange rate of a further slump in either oil prices or the \$ are much less since both have already fallen so far.
- (iv) Uncertainty about the Government's intentions currently means that exporters are reluctant to invest and sell on the assumption that rates will remain favourable. Yet at the same time

the exchange rate does not act as an anti-inflationary discipline since wage negotiators assume it will sink further to offset pay awards.

43. There were two schools of thought about the timing of entry into the ERM. The sooner-the-better school felt that membership would provide a more credible economic policy in the pre-election period. There would be less speculation and therefore less likelihood of having to raise interest rates substantially, because speculators would know the government was not going to let the exchange rate 'take the strain'. It would also take the wind out of the sails of the Liberals and SDP as well as consolidating support among industrialists. The other school favoured entry after the election, either because they felt it was something of a leap in the dark or because the strains of speculation on a Labour victory could face Government with an unpalatable choice between a sharp rise in interest rates or an embarrassingly explicit devaluation. In the latter case there would be advantage in including the commitment to enter the ERM in the Manifesto.

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SUMMARY OF RECOMMENDATIONS

- Overall objective of economic policy is to extend individual freedom, responsibility, and choice and to promote prosperity.
- Objective of macroeconomic policy is to reduce and eventually eradicate inflation.
- Reduce basic rate of income tax to 25p.
- Reduce top rate of income tax, probably to 50p.
- General commitment to continuing reform and simplification of the tax system.
- Propose a fair deal for women and marriage: probably by transferable allowances and separate taxation of investment income; abolition of all tax penalties on marriage (eg double mortgage relief for unmarried people living together).
- Programme of privatising nationalised industries to continue.
- Objective of extending share ownership even more widely.
- Encouragement of profit related pay (if not already enacted).

- Revitalisation of the Private Rented Sector.
- Membership of the ERM (if not already implemented).
- Preparatory work is needed on the privatisation of all remaining nationalised industries but especially on the approach to electricity distribution and generation and the coal industry.
- Reinforce efforts to curb public spending. Undertake preparatory work on all areas of expenditure including:-
 - non-indexation of unpledged welfare benefits.
 - introduction of flexible retirement period about a common age for both sexes, preferably 65.
 - finding ways of tapping non-tax sources to finance rising health spending.
 - development of internal markets in health and education to put the consumer in charge.
 - extension of charging.
 - reducing local authorities' responsibilities to a level which can be financed entirely from local revenues, and then giving them greater freedom from central control.