SECRET

15 December 1983
Policy Unit

PRIME MINISTER

24

THE FOLLOW-UP MEETING

INTRODUCTION

The purpose of your original seminar was to identify barriers to employment. We must not lose sight of the fact that many, if not most, of these barriers are erected by government.

Our micro-economic policies are still keeping unemployment high, as are those of most governments in Europe. So long as these policies persist, it seems unlikely that unemployment will fall significantly, however strong and sustained is the recovery. These policies encourage the substitution of capital for labour by:

i. making capital artificially cheap, by 100 per cent first-year tax allowances and investment incentives which are always tied to capital used, whether in manufacturing industry or agriculture;

ii. making labour artificially expensive, and complicated and burdensome to take on, by the imposition of costs on the employer and of social obligations in respect to redundancy, training, pensions and employment protection.

So long as these policies conspire against employment in this way, employers will be driven in the direction of increasing the productivity of their existing work forces, rather than in the direction of expanding these work forces. As the Financial Times editorial (attached) suggests, British governments have chosen, with the connivance of the trades unions, a high-productivity, high-unemployment path for the economy.

Hence the rises in real pay in the last pay round, and so far in this one. Despite the high level of unemployment, real earnings rose by 3 per cent in the last pay round, and will probably do so again in this. Management seem content to allow a substantial degree of wage drift (about 3 per cent) over and above pay settlements, in the expectation that their existing work forces can increase their productivity to pay for this.

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We do not therefore need a futile quest for "where jobs are coming from" of a kind discussed at the last NEDC meeting. If we unwind the distortions, the jobs will reappear.

We also know from our experience of regional policy that the artificial jobs created at such huge public expense tend to be sadly temporary. The Northern Ireland Economic Council reports that two-thirds of the jobs created by government grants since the War had disappeared by last year (see attached cutting). Significantly, they believe the same is true in the Republic. Yet the "grants race" between North and South still continues to grow apace, with more demands for capital allowances etc.

300,000 more Jobs in Manufacturing?

This is not just an academic point: the numbers of jobs involved are very considerable. To illustrate: in 1981, payroll taxes accounted for 24 per cent of labour costs. In 1978, our generous depreciation allowance was equivalent to a subsidy of six and two-thirds per cent, according to an IMF study.* The combination of these two made capital cheaper relative to labour by 30 per cent. Capital grants and regulatory constraints on employers would have added a further twist against employment.

Research we have seen suggests that a 30 per cent cheapening of capital relative to labour could have reduced the numbers required to produce a given output in the cheapest way by 5 per cent. The other effects mentioned could have increased this by half as much again. This is equivalent to one-third of a million people in manufacturing alone.

American business pays similar payroll taxes but, according to the same IMF study, received virtually no capital subsidy through depreciation allowances in 1978. This may explain why the USA has generated more jobs, and rather less growth in productivity, than we have. In other words, if we moved to a set of micro-economic policies which were neutral as between capital and labour, we might expect to boost employment in manufacturing by 300,000. Employment would increase in agriculture and service industries too, though probably not as dramatically.

Of course, capital investment is the engine of progress. Industries need to adopt new technologies. But the bias against labour in Britain's tax-and-subsidy system is now much too severe. Employers are induced to replace men by machinery when the machinery would actually be more expensive if the system were neutral. This ought to be the central thrust of our employment policies: to make it as cheap and

* Comparison of tax depreciation methods in major industrial countries, George K Kopits, IMF, 1980

simple as possible to employ people and to remove the distortions in the tax system. Those distortions are hugely costly, not only in jobs lost and the resulting extra social security expenditure, but in revenue foregone.

It is these costs which frustrate our efforts to reduce the levels of taxation and borrowing, and so prevent the creation of new wealth and new jobs.

This follow-up meeting gives you an opportunity:

- to remind colleagues of the strategy;
- to press for quick action in the areas which have been selected for discussion;
- to set a vigorous timetable for departments, forcing them to produce precise and well-formulated proposals for legislation.

Below are some comments on the priority areas. (The numbering is still as in Michael Scholar's letter.)

AGENDA TOPICS

2. Taxation - Chancellor to lead

(a) Share Option Scheme. By charging to income tax any shares distributed to employees, we discourage employee participation. The Treasury now have a working device to replace this by Capital Gains Tax on disposal. There would be controls on the holding period and on the quantity of shares eligible. They should be encouraged to put this provision in the 1984 Budget.

(c) Taxation of Companies. This is the heart of the matter. The present structure of Corporation Tax is ludicrously complicated. Some £40,000 million of unused tax reliefs are floating around in the system. There are tax reliefs for investing in capital equipment, for stockholding, for being small, or for being a building society.

The Treasury are still discussing a plan for phasing out the allowances for moving to a 30 per cent flat Corporation Tax rate over 4 years, with the 100 per cent first-year capital allowance being reduced to 25 per cent, and the abolition of stock relief.

But the Chancellor is worried about (a) starting in 1984; and (b) revealing his phased programme from the start. He fears that the immediate effect on capital investment might damage the pace of economic growth.

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This is doubtful. If we don't start in 1984, we are unlikely to complete the programme within this Parliament. And a phased programme would encourage firms to speed up their investment plans, since they would know that next year first-year capital allowances would be lower.

We argue strongly for an early public commitment to a phased programme. A Corporation Tax rate of 30 per cent would be a magnet to investors and a real boost to employment.

(d) Reduce the Administrative Burden on Enterprise.

(i) Simpler taxes mean less work and fewer forms for businessmen. You could entrench the commitment to simpler taxes by reporting on your 14 December meeting on simplifying tax legislation.

(ii) Statistical services. You could ask for a review to establish whether the information presently demanded by the Government Statistical Services places unnecessary burdens on firms.

(iii) Employer-employee law. Should be reviewed with a view to simplification, wherever possible.

(iv) Regulations. You could ask all Ministers to have a trawl through the rules and regulations sponsored by their departments, and report back.

4. Trade Policy - S/S Trade and Industry

Our aim must be to switch our trade in the direction of countries which can pay, and of business which does not require subsidy. At present, the truth is that we do not expect to be paid in full for a substantial part of our exports, since we:

(i) provide grants of 25 per cent and upwards to some export projects as part of the aid programme (cost £66 million a year);

(ii) provide fixed rate interest support for capital projects (cost £300 million in 1982-3);

(iii) accept country risks to a degree which is not always commercially justified.

1.1

Aid and Trade Provision

It is doubtful whether these subsidies really help the development of poor countries. The ODA "tests of developmental soundness" tend to be over-ridden by commercial pressures from British manufacturers. The Columbian railway project discussed in July was rated a poor investment, but we persevered. To the extent that recipient countries would proceed anyway, the aid is simply a balance of payments contribution. From our national point of view, it must be doubtful, too, whether a subsidy of up to 50 per cent or more of UK value-added is an effective way of creating jobs and "helping industry". Their financing results in a diversion of resources which could create greater wealth than the project in question is likely to do.

Proposal: Contain ATP in cash terms, and improve control and selectivity by making it clear that any overruns of cash limits will be recovered in the succeeding year.

Interest Support

In the 1970s, interest rates charged to overseas customers fell well below market rates. As a result, interest support costs rose to £590 million in 1981-2. As interest rates moved closer to market rates, the costs of this support fell to £300 million this year. The recent OECD Consensus should maintain this position.

Proposal: Our aim must be to move towards the market rate (a basket of OECD rates) on a multilateral basis, and eventually eliminate the subsidy.

Risk

We are owed an increasing amount by our overseas customers. ECGD's liabilities (ie the amount it is liable to pay to exporters if their customers default) rose from £29 billion in 1979-80 to £47 billion in 1982-3. (Our exposure on Brazil is £2.5 billion.) In the same period, ECGD's cash cover fell from £485 million to £290 million. Increased exposure is not itself disadvantageous: it becomes so if our customers show signs of an increasing inability to pay. Indications last year suggest that they are indeed moving in this direction: debts of £200 million were "rescheduled".

We do not forecast credit-worthiness well. If we are exposed to a 15-20 year risk, we ought at least try to forecast the position in 5 years from now. Several departments are involved, but not in a co-ordinated way. Differences are resolved in an ad hoc, adversarial way, overshadowed by a particular project which might be in prospect.

We do not relate exposure on a particular country to our export performance in that country. We are over-exposed on Brazil, by comparison with other OECD countries, yet obtain only a small share of Brazil's imports from OECD.

Proposal: Invite Treasury/ECGD to initiate reviews of our credit portfolio, our forecasting performance, and our returns in relation to risks incurred.

6. Small Firms Policies - S/S Trade and Industry

(a) David Trippier's initiative* to reduce the number of schemes for small businesses is not yet complete, and needs some encouraging words to provide it with stimulus. The task is Herculean, as there are 88 schemes currently in operation to aid small business, often entailing separate information and separate form-filling by the applicant if he is to succeed. It is vital for the small businessman that the number of schemes be reduced to the bare minimum, and the forms for application are simplified as much as is compatible with retaining some check on the distribution of monies.

There could be a high-technology package of schemes with a single form, a business expansion package of equity support, and a loan guarantee package for debt. Any scheme which has attracted little support or few applications, any scheme which is too complicated or which duplicates another, should be wound up or subsumed by one of the main categories of scheme.

(b) Extending the Enterprise Allowance beyond the unemployed. The purpose of this was to add further stimulus to the development of self-employed small businesses. The follow-up meeting could reaffirm its enthusiasm for such a project, and ask Tom King to make the necessary arrangements, if the Department of Employment report on the scheme's effectiveness is favourable.

* This is separate from David Trippier's other exercise on reducing the legislative and administrative burdens on small firms.

8. Planning Controls - S/S Environment

Patrick Jenkin's paper describes the progress we have made. The average time for deciding planning appeals is down from 29 weeks in 1979 to 19 weeks in 1982 - still too long, but better. We have widened the range of developments that don't need permission. More appeals are now granted.

Annex A describes the "Sainsbury" problem and what the DoE is doing to give a fairer chance to application to build a superstore: building provision for them in local plans, a code of practice, and calling in all applications, say, over 25,000 square feet. These seem sensible provisions, but I think it is inevitable that a superstore will always provoke a furore and Sainsbury's cannot expect instant approval.

We feel that the real problem lies with land for housing and the structure plans, and the way some authorities insert "trivial, onerous and prescriptive controls of a kind which no Government (certainly not this one) would contemplate introducing in general legislation" (paragraph 8).

The worst such restrictions are:

> "Timetabling" of development so that only a certain small number of houses may be built each year, thus keeping land prices horrendously high.
>
> Exclusion of all new industry. Many rural authorities refuse permission if the firm applying has no existing factory or business in the district.
>
> Discouragement of, or general presumption against, all development.
>
> General population restrictions.
>
> Discouragement of housing for old people. This restriction is surprisingly common.
>
> No development in or near villages.

These restrictions combine to make development scarce and pricey. They cannot even be justified on Green Belt grounds - or in most cases, even on environmental grounds. Timetabling, after all, does not prevent ultimate development. It merely ensures perpetual scarcity of land and a continuing depression in the housebuilding industry.

We endorse Patrick's main conclusions, especially paragraph 13, where he proposes exemplary planning appeal decisions and the use of his powers to intervene in the planning process; ie to strike out these restrictions from council plans, and make it ever more clear that, while he will defend the Green Belt and the countryside, he will not tolerate attempts to rule out all development.

It is quite possible for him, steadily and quietly, to change the whole scene by using his existing powers over 2 or 3 years. This is likely to be more effective as well as less controversial than altering the planning legislation once again.

10. Barriers to Employment - S/S Employment

(b) Abolish Wages Councils in 1985/6

(c) Abolish/Limit Agricultural Wages Boards

A case for sweeping away the entire Wages Council system is well understood by most Ministers:

(i) If Councils are effective in pushing up wages, they damage job prospects of the less able and qualified, particularly of the young. They also make life difficult for small firms which might depend on labour of this kind.

(ii) If they are not effective in influencing wages, they simply waste administrative resources and impose considerable compliance costs on thousands of businesses, to no point whatever.

In short, Councils are either actively harmful, or just an encumbrance.

Long-Term Aim

The ILO Convention of 1928 has inhibited the Government from abolishing the Councils; it was felt that to abolish without first denouncing the Convention would have political costs. The opportunity to "denounce" the Convention arises only every 5 years. The window of opportunity for denouncing the Agricultural Wages Boards is now open;

the window for the Wages Councils is open in 1985/6. The long-term aim should be to abolish both the Boards and the Councils by 1986.

Tactics

It is awkward that the window for the AWBs opens before that for the Councils, because the Government has not agreed a view on the AWBs (Mr Jopling favours retention: see his letter to Mr King of 24 November); whereas Ministers are clear about their wish to abolish the Councils.

The first step is to denounce the ILO Convention 99 in respect to AWBs, regardless of arguments which may be advanced in favour of retention. The essential point is that we cannot allow ourselves to be constrained by a Convention of 1928. This step would allow us to consider the AWBs and the Councils together. If the AWBs are retained, it will be difficult to dispose of the Councils.

We suggest that following the Seminar, a No.10 letter should invite Tom King to begin the process of consultation (required by ILO Convention 144) prior to denouncing ILO Convention 99 governing the AWBs. He should also be invited to prepare a strategy paper for consideration at E Committee, dealing with both the AWBs and the Wages Councils.

13. Housing Policy - S/S Environment

(a) Progressive decontrol, particularly in respect of new lettings etc.

Economic revival has highlighted the crying shortage of rented accommodation. All over Southern England and South Wales, jobs are going begging for this reason.

We agreed at the beginning of the year to extend assured tenancies to newly-improved and converted dwellings. This would encourage the letting of attic and basement flats in under-used houses.

We could extend decontrol to new lettings of existing accommodation. There would be a greater risk that Labour would threaten to repeal this and discourage potential landlords. But it would encourage landlords to continue to rent at the end of a letting, instead of selling. There would be an incentive for Rachman-types to winkle tenants out, but then there already is at the moment.

A further possibility would be to encourage householders to take in lodgers by exempting from tax any income received from lettings up to a maximum of, say, £50 a week. As the total tax-take from resident landlords is only about £20 million, the Exchequer cost of this would be very tiny.

You might wish to call for a paper on Reviving the Rented Sector for early in the New Year.

(b) Land for housing, particularly in the South

See Patrick Jenkin's paper on planning. Circulars on Green Belt and Land for Housing were a little too far-reaching. Revised versions will be issued in draft in February.

(c) Legislation to expand activities of building societies

DoE and Treasury still discussing this with building societies. Treasury will produce a Green Paper after the Building Societies Association has issued another version of its consultative paper. So no Government response before the Budget.

(d) Remove private rented property from liability to Capital Gains Tax

CGT relief for resident landlords will be in the next Finance Bill. But that apart, the Chancellor prefers to relax rent controls.

(e) Improve effectiveness of Employment Transfer Scheme

Department of Employment can see no way through at present. Worth an interdepartmental group (DoE, DE, Treasury, Policy Unit?)

(f) Consider level of stamp duty on house purchase

This is being considered, along with stamp duty on securities (in the context of Stock Exchange liberalisation). Action on either would be expensive.

(g) Await paper on conveyancing monopoly

Cabinet has now decided.

(h) Consider possibility of improving pace of land registration

Encouraged by H, not least for simplifying and reducing the costs of conveyancing.

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15. Education - S/S Education

(a) Consider how to encourage parents to take more active interest and role in children's education

You have already seen the DES paper. You might ask Keith Joseph to describe his proposals on school government, so that you and other participants can urge him to proceed quickly with devolving power to parent governors.

(b) Welcome proposals by local education authorities to re-establish grammar or technical schools

You might ask Keith to reinforce Bob Dunn's speeches by saying in public that he does not believe in mixed-ability classes in comprehensives, and that he thinks grammar, technical and secondary modern schools are often splendid.

You may wish to ask about the possibility of Direct-Grant technical colleges, eg David Young's scheme for using the vacant County Hall.

(c) Pursue reform of teacher-training schools and curriculum

Reform is going ahead - no need for lengthy discussion.

(e) Encourage industrial sponsorship of students in universities and polytechnics

This is one of the best ways of getting private money into HE. So why no action yet? You could ask for a meeting in January, and a DES paper by then.

(f) Pursue the possibilities for improving understanding, both in schools and in the country at large, of economic realities. Consider the introduction of pilot schemes.

This subject could run and run; but nobody has any substantive proposals. We suggest that you curtail discussion.

(k) Promote parity of esteem for technical education (as compared with traditional educational qualifications): encourage universities to accept technical qualifications for entrance.

You might ask what progress is being made by Keith's inter-departmental group. You could set a deadline of February or March for a report.

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LUNCHTIME DISCUSSION

1. Review of Strategy and Summary of Main Themes

You might with to point out that experience since the summer has confirmed the rightness of the Chancellor's July measures and the overwhelming need to control public expenditure and public borrowing. This is the essential pre-condition not only for reducing inflation, interest rates and taxation, but also for making room for enterprise to flourish. This is an opportunity to hammer home the lesson that it is only because we have controlled public expenditure that we are experiencing for the first time in years a respectable rate of growth and a respectable rate of inflation.

Our strategy falls into two broadly distinct parts:

(a) Removing the bias in favour of capital:

- Corporation Tax reform, NIS
- reducing the huge subsidies for investment in nationalised industry and agriculture
- reducing the subsidies for capital-intensive projects overseas
- reform of regional policy

(b) Reducing the barriers to employment:

- less regulation and paperwork
- trade union reform
- abolishing Wages Councils
- improving mobility of labour through housing and pensions measures.

Taken together, these measures form a coherent strategy to make it easier, more attractive and more economically efficient for employers to hire people.

But taken individually, some of the measures can and will be caricatured as "hitting industry" (eg reducing capital allowances) or "exploiting workers" (eg abolishing Wages Councils).

It is therefore vital to put our case across and dominate the debate.

Improving Presentation of Government Policy

Most of these measures can also be caricatured as more "savage Tory Cuts". They will be regarded as part of the Public Expenditure Survey - the only major Government document to appear this winter. We do need a major policy document which accentuates the positive.

Would the proposed White Paper on Employment fit the bill?

This could contain:

(a) The sort of information about changing patterns of employment contained in the Chancellor's paper for NEDO.

(b) A much expanded version of Nigel's section on "Making the Labour Market Work" (3.14-3.22), describing what the Government is doing on technical training and mobility of labour.

(c) A section on other relevant parts of our economic policy: competition and deregulation, denationalisation and contracting-out, efficiency in Government, managing the public sector.

In effect, it would be broadened into a White Paper on Employment and Economic Growth. This would have two virtues. It would put employment in the right context of economic growth. And it would enable us to make a broad-ranging presentation of our central economic policies. Such a White Paper could be published at about the time of the Budget (or preferably earlier) as a brisk rejoinder to those who say we have lost our way.

3. Next steps to follow up outstanding remits and for further development of policy

You may need to commission papers for decision-taking meetings under the following headings:

(2) Taxation: a Strategy for Corporation Tax

(4) Trade Policy: a Review of Export Subsidies

(6) Small Firms: the Trippier Report on Repackaging Small Firms Schemes

(10) Barriers to Employment: Wages Councils

(13) Housing: Reviving the Rented Sector

(15) Education: KJ's Paper on Making Schools Better

You may also wish to raise the possibility of another wide-ranging seminar at Chequers in September, preceded by a meeting in June to identify themes and commission papers.

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Thursday December 8 1983

Policies which destroy jobs

THE NATIONAL Economic Development Council failed yesterday to solve the problem of unemployment, to nobody's surprise; for in spite of the worthiest intentions, NEDC is ill constituted to solve problems. Its ground rules get in the way: officials cannot question government policy, nobody is allowed to be rude to the trade unions, and as a result any illumination can only seep in between the lines.

The discussion was based on a Treasury briefing paper. It contains some figures illustrating what everybody knows: jobs are shrinking in manufacturing and growing in services in the UK, in the U.S. and continental Europe. Its analysis, though, is muffled and sometimes muddled.

Faster growth

The paper does point out, for example, that though the structural pattern in the U.S. is quite like that in Britain, the pattern of recovery has been very different. Here there has been a strong rise in labour productivity, a weaker rise in output and a fall in employment; but real earnings have risen strongly. In the U.S., by contrast, labour productivity has performed poorly; the strong rise in output has been achieved by a sharp rise in man-hours, and a corresponding rise in the productivity of *capital*. Result: a strong rise in output, employment and profits, but little rise in real earnings.

The moral of this contrast is not very difficult to draw. If the Americans want faster growth still, and higher earnings they have a problem with labour productivity. Our own problem of low profitability and high expenditure on unemployment benefit seems to lie more in the field of capital productivity. In other words, if the Government wants to achieve some of its central objectives in one stroke, it should be asking itself why employers are so unwilling to hire more labour, and continue to invest in labour-saving, at poor returns, when unemployment is high.

Once the problem is stated clearly, some awkward questions arise both for the unions and for the Government. The fact is that we have high unemployment because we have chosen this course. Thirty years of union lobbying have produced "employment protection" laws which make it forbiddingly expensive to hire any labour which might by any chance have to be shed in future. Such measures inevitably reduce hiring; in the Netherlands, where workers are a still more protected species, they are correspondingly rarer.

Tax concessions

These laws, coupled with union bargaining pressure, have compressed profit margins over the years; successive governments have responded with tax concessions — all of them designed to make capital rather than labour cheaper. So on top of anti-employment laws, we have had a growing labour-substitution subsidy. The result simply illustrates the powers of such incentives. It is in many ways a comfortable result for those in work, with high real wages and some security of tenure; perhaps it is what the unions secretly want. It is up to the Government to change the rules.

Central question

Compared with this crucial issue, which is barely acknowledged, the issues the Treasury paper does raise are marginal; but they are still important enough to merit something more than cliches. It is rightly argued that a bigger private rented sector in housing would help labour mobility; yet the Government continues to strangle this sector with controls and fiscal disadvantages. Flexible work practices and an open attitude to training certainly help, but here progress is already encouraging. But the central question remains: fuller employment comes at a price, in unpopular legislation and surrender of privileges. Are the unions and the Government ready to pay?

FINANCIAL TIMES, WEDNESDAY 14 DECEMBER 1983

Vanishing jobs of Ulster

By Our Belfast Correspondent

TWO-THIRDS OF the jobs created in Northern Ireland by government industrial development grants since the Second World War had disappeared by last year, according to the Northern Ireland Economic Council.

In a report on the effects of government financial assistance, the council says 137,000 jobs were created between 1945 and 1982. Only 45,000 of them still existed in June last year. But they represented 40 per cent of all manufacturing employment in the province.

"Although this survival rate may appear low, it is broadly similar to the experience of the Irish Republic," the report says.

The council, which advises the Northern Ireland Office on economic policy, examined 673 projects assisted under government schemes. The study was restricted to "selective assistance" involving grants and loans linked to employment targets.

Newer and larger projects had created more durable employment, but the grant cost suggested it might be more cost-effective to create employment in small and medium firms and in the expansion of existing companies.

The grants had helped diversify the industrial base by developing new industries—man-made fibres, consumer electronics, car components and rubber products—and by the introduction of new processes and products to existing firms.

The report looks closely at Northern Ireland's synthetic fibre companies, which, at one stage, accounted for a quarter of total UK employment in the industry and about 7 per cent of manufacturing jobs in the province.

The jobs were costly to create and when recession hit the industry in the late 1970s, the impact on the local economy was severe. The report says that underlines the need for Government to maintain a balance between different industrial sectors in the application of policy.

The Duration of Industrial Development Assisted Employment, Northern Ireland Economic Council, 2 Linenhall Street, Belfast.