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Policy Unit Econ Pol

PRIME MINISTER

Back - up

POLICY OPTIONS

Here are our comments on Sir Douglas Wass' paper, with references, in brackets, to his numbered paragraphs.

1. IMPORTANT TO SEE THE WOOD FOR THE TREES

1.1 The box we are now in is totally predictable as regards public spending and PSBR (see Annex A), less so as regards behaviour of the exchange rate. A "crisis of belief" was inevitable once the going got rough.

1.2 The MTFS has never been a real strategy. It was simply a set of numerical objectives. There was no strategy - or at least no adequate strategy - for actually making it happen, in terms of deceleration of public expenditure, public sector pay, de-indexing of social security, trade union reform. As we said in our paper of 19 June, the strategy rests on three legs - money supply, public spending, trade union bargaining balance. Monetarism alone can't do the trick.

1.3 The apparent constraints are: we can't allow further rises in PSBR and MLR; we can't find further cuts in public spending; increases in direct taxation are not politically possible; we can't let British industry go under. Obviously something has to give.

1.4 The behaviour of the exchange rate compounds the problem. If oil prices and thus the exchange rate are set to increase further over the next 5-10 years, then we may simply escape from the present box in order to find ourselves in another one. This will require further thinking, outside the scope of these papers.

2. COMMENTS ON THE DOUGLAS WASS OPTIONS

2.1 Option (i): Inflow controls etc

2.1.1 Although I favoured examination of controls, I am beginning to suspect they are a waste of time. Should we be spending administrative time and brain power on something which didn't really work in Switzerland, is even less likely to work in Britain, in the face of all the evidence that trying to control market behaviour doesn't work? I would waste no more time on this.

2.2 Option (ii): A modest cut in interest rates

2.2.1 MLR should be related to the prospective inflation rate, not the past rate. The past six-month rate is already down to 9% or, seasonally corrected, about 11%.

2.2.2 The scars of 1976 are still deep in the Treasury. The fear of a runaway fall in sterling seems exaggerated. The position was different then: a massive PSBR, a huge balance of payments deficit, public spending totally out of control, inflation rates just past their highest ever peak.

2.2.3 We should bring down MLR by two points. This is likely to produce a rush to buy gilts. We should not worry about political embarrassment if we have to put MLR up again. If we have to, we have to.

2.3 Option (iii): A large reduction in interest rates

Not worth serious consideration.

2.4 Option (iv): An explicit exchange rate target

It is not possible to have an exchange rate target and a money supply target.

Not worth serious consideration.

2.5 Option (v): A significant tax switch to the benefit of companies

2.5.1 On the face of it, this would "pre-empt taxable capacity" (paragraph 32). But this is a circular argument. We have to lay our hands on every penny we can to hold down PSBR (which helps companies in the end) and also to help companies directly and immediately. The question is - could we raise further revenue other than from the personal sector: eg via PRT or a levy on bank profits?

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5.2 It is argued that if we switch benefit to companies, "wage pressures would be strengthened and employer resistance diminished" (paragraph 31). We are all in danger of getting confused here. Anything we do to help industry is going to have that effect. Of course, wage pressures will be stronger in a buoyant and prosperous corporate sector than in a bankrupt one (so will wages, eventually). We are close to arguing that only adverse conditions really suit employers! What has really happened is that, having failed to significantly reduce trade union power, we are driven to bombing both sides of industry with recession, thus giving the employers the courage of desperation and the unions the fear of unemployment (meanwhile ourselves funking the hard decisions on nationalised lame ducks). We don't seriously believe that an upturn should be discouraged because industrial civil war might break out again?

2.5.3 A tax switch is of course likely to help companies that do not need it, like the banks and the oil companies. Hence the need to do more, rather than less, on PRT and bank profits. Are there other ways to channel help more directly to the companies that need it, rather than those who don't? The rationale for action on bank profits and oil revenues is that the structural adjustment of the economy to North Sea oil is being forced, by external events, at a much faster pace than anyone had predicted, and faster than the corporate sector can readily absorb (a point which Douglas Hague has recently been stressing to us). We are therefore in an unprecedented situation in which those parts of the economy which do not have to make this massive oil-driven restructuring (ie the public sector, the oil companies themselves and the financial sector) must contribute to ease the pain of adjustment. We should be actively communicating this in the context of the Budget, PEWP, cash limits, and EFLs, our pay implications for the public services. It is rough justice, but we are not living in normal times.

2.5.4 Sir Douglas makes an important point (paragraph 34) that even though the switch would be neutral as regards the PSBR, it might actually ease pressure on money supply, because the personal sector tends to borrow less than the corporate, when its disposable income falls.

2.5.5 Unless we think that complaints from industry are unwarranted, we must prepare to make a substantial fiscal switch, as well as achieving our new enlarged PSBR, for 1981-2.

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2.6 Option (vi): Pay freeze

2.6.1 As you will remember, we suggested that a pay freeze should be considered immediately after the Election, in order to get control of the economic crisis before it got control of us. The purpose would have been to speed the reduction of inflation without so much damage to the corporate sector and unemployment. It might have allowed us to break out of all our indexing commitments on social security and various parts of public service pay. But it could only have been done as part of a comprehensive emergency package introduced when our post-Election authority and goodwill was at its highest.

2.6.2 A freeze is positively conducive to lower monetary growth (paragraph 39) and we still believe that the exit from a freeze need not be too difficult if the freeze is well designed and trade union bargaining power reduced.

2.6.3 We feel, however, that the time has passed when a freeze is a serious option. We did in any case discuss this with you in the early summer and we agreed that there was no option but to "take the high road". Perhaps we shouldn't reject the possibility out of hand without some discussion, but we don't think it's a serious starter now.

3. CONCLUSION

3.1 Option (ii), a 2% cut in MLR, should be seriously considered. So also should option (v), a fiscal switch to companies. The switch will have to be bigger than we may realise, if it is to hold down PSBR and help companies. Increases in personal taxation should be explicitly linked to nationalised industry over-runs and any excessive public service pay increases. We should perhaps be thinking much bigger than Geoffrey is on PRT. It has been suggested to me that the whole time profile of PRT should be reversed so that we get the front-end benefit when the utility value of the money in our hands may be higher (ie for breaking out of the box rather than fiscal adjustments in the run-up to an Election). We may think this is impossible, but some businessmen would not, in the context of an economic emergency. (The side effects might even be compatible with depletion policy.) But it might raise the exchange rate.

3.2 Consider also a levy on bank profits to supplement PRT.

3.3 We should continue to push hard for significant de-indexing of social security, despite the political difficulties. This is the only place left to find the big numbers (if £25bn of social security were to rise this month by 11.5% instead of 16.5%, it would save £1¼bn in a full year), though it may be too late to win the argument about why these are not "real cuts". I am quite sure that many of the colleagues still do not distinguish between monetary deceleration and PEWP cuts. Until they do, it is going to be very difficult to win the political argument for such changes outside. De-indexing will probably only be possible, however, as part of a bigger package, with explicit "fair distribution of sacrifice" including perhaps a symbolic surcharge on the upper levels of tax. People will accept almost anything if they are persuaded that it is (a) necessary; (b) fair.

3.4 We must not lose sight of the importance of the Green Paper on trade union immunities. Militancy is low now because of the recession. But the underlying structural realities are almost unchanged and the British disease will manifest itself in familiar form as soon as the upturn starts. We must not lose sight of the total strategy, of which reduction of trade union power is a central part. Without it, the corporate sector cannot rebuild its profits, public services pay cannot be curbed, nationalised industries will continue to put their prices up faster than inflation. The UK economy is simply unmanageable until the underlying structure of trade union power, public spending, and public sector indexing commitments, and nationalised industry/union monopoly power, is changed. That is why Governments fail.

3.5 All our experience since the Election shows that we have constantly underestimated the scale of the problem and the speed at which it is getting worse. As a result, we have constantly aimed behind an accelerating target. Our past efforts on Budgets and public expenditure have been like someone pouring buckets of water on a fire, when the realist would have recognised that it was time to dial 999 for the fire engines. The colleagues have never grasped the reality.

3.6 An "over-kill" Budget and PEWP may look like an admission of failure. But it would be better to accept such embarrassment now than real and irreversible failure later. The Whitehall inclination will be to take the minimum and least contentious measures which might just be adequate, in the hope that the true scale of the problem (and thus the inadequacy of our measures to date) can be prevented from becoming visible to the public. We have consistently advocated, since our dinner with David last January, that a "shock package" is needed and you used exactly the same expression when we were talking at Chequers, shortly before the Conference Speech. We have 18 months' leeway to make up and 1981 Budget/PEWP are our last chance to start doing so.

3.7 Tomorrow's discussion can do no more than set the agenda for the most important decisions the Government has yet had to take. Getting those decisions right will take hours and days of reading, writing, thinking and discussion. All the bits of the problem, and the solution, interact with each other. It is a game of chess in which the next move will decide who wins.

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