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To: MR LANKESTER
From: SIR KENNETH BERRILL

1. I attach two personal notes of mine which the Prime Minister might like to read.
2. The first is on "the UK problem" as I see it which the Prime Minister might find useful as background for the forthcoming Censure Debate. I have deliberately written it in note form to save time and space.
3. The second is on the Chancellor's proposed medium term monetary plan. I have some doubts, which I believe the Prime Minister may share, on the wisdom of the Government hooking itself on a programme for the reduction of M3 over the years ahead, and the note covers my first reactions to reading the Chancellor's paper on Friday.

KS

25 February 1980

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NOTES ON "THE UK PROBLEM"

1. There is general agreement that the UK problem is basically one of fast inflation since the early 1970s and economic growth which, for the last third of a century at least, has been slow in comparison with our competitors.

2. With slow economic growth has come falling competitiveness in every important aspect - quality, design, reliability of delivery, concern for the customer, etc. Some of these failings are due to labour but many of them are at least equally the responsibility of management.

Why has this happened?

3. For the 25 years after 1945 we failed to join in the great period of expansion in world trade - and the expanding years of the EEC. We lived on Beveridge (demands that the State protect us from all adversity) and on myths (that British craftsmanship is the best in the world). At the same time, the balance of power in the labour market was shifting - partly due to the law but mainly due to changes in practice (e.g. picketing and blacking).

4. Governments of both parties concentrated on demand rather than supply. They aimed to keep demand sufficiently high to create near full employment (under half a million unemployed) but not so high as to cause unacceptable inflation. The belief was that strong demand would produce strong responses in terms of investment and improvements on the supply side. Small changes in the level of demand would be sufficient to alter the bargaining strength of the unions and hence the level of wage settlements and inflation.

5. There was a continuous refusal to recognise how fast and how far the UK was slipping and continuous optimism in the sense of planning increases in public expenditure which could only be justified on assumptions of economic growth and balance of payments performance which were seldom achieved.

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6. The balance of payments constraint forced continuous rounds of stop-go economies. But when the brakes were applied they were not allowed to affect the most uncompetitive parts of the economy. Every effort was made to cushion the effects by regional policy and unemployment protection measures.
7. The efficient operation of the market was further inhibited by Government action in many fields - particularly by recurrent bouts of incomes policy.
8. By the 1970s the world was about to shift from 20 years of unprecedented fast growth to what now looks like 20 years of much slower growth, and the UK was badly organised to adjust to this - membership of the EEC at this particular time did not help.
9. The most important event was that the unions discovered just how much power had really had in the three-day week and at the Saltley coke depot. The Labour spending spree of 1974 (which followed a Tory spending spree at the end of the previous Administration) made things worse. The balance of payments and the IMF eventually put the brakes on the spending but only after a great deal of damage had been done (a 20 per cent increase in public expenditure over a period when the GNP had risen hardly at all).
10. In the face of the evident imbalance in the labour market (union power) the Labour Party was constitutionally incapable of trying to move the power balance back. The alternative for them was either a "social contract" under which unions would agree to hold their power in abeyance (temporarily) or mitigating that power by whatever level of unemployment proved necessary.
11. Naturally they chose the "social contract" - incomes policy in exchange for social security spending plus further changes in the law in favour of the unions, including health and safety, redundancy, etc.
12. The combination of an incomes policy (£6 a week) which squeezed differentials and the inability under the social contract to raise indirect taxes adequately meant that with inflation the impact of direct tax spread right down through the income levels creating major and unforeseen problems of the 'in-and-out' of work trap and the poverty trap.

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13. By 1979 the stage was set for a major increase in inflation as soon as incomes policy was removed and, despite cut backs in public expenditure programmes following the IMF, there was still sufficient growth remaining in public expenditure programmes to present major headaches in a period of no economic growth and a long wait ahead for the fiscal benefits of North Sea oil and gas.

14. Given that the UK problem is how to reduce inflation and increase growth against a background of slow growth in the world economy, the main areas of adjustment have to be -

(i) how to get a better balance of power in the labour market - changes in law, changes in practice under the law, move to smaller units. All this accompanied by efforts to change worker attitudes towards the need for their companies to be productive (and profitable) in order that higher real wages may be possible. A major task for management is better communications with the work force (not necessarily along Bullock lines).

(ii) How to improve incentives - level and structure of direct taxation; the in-and-out of work problem; the poverty trap.

(iii) How to 'roll back' the size of the public sector and to achieve more accountability and efficiency within what remains - including local government.

(iv) How to move away from the emphasis on the large firm and the large plant by encouraging demergers, break up of nationalised industries, small firms, etc.

(v) While improving productivity, how to encourage an emphasis on quality as well as quantity - British standards; public sector purchasing, R and D policy.

15. In the short run, as far as inflation is concerned, the present imbalance in the labour market means that the choice is between unions not using their strength (incomes policy) or having their strength sapped by a weak market for labour (unemployment) and stronger employer resistance. This last can be brought about by fiscal measures to

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weaken demand and by monetary constraint which reduce the ability to pay higher wages. Unfortunately, given the present power and attitudes of trades unions in the UK, we do not know how severe the restraint would have to be to weaken that power and hence what damage would need to be done in terms of reduction of investment, bankruptcies, etc. - the incidence of which could be both capricious and unfortunate.

16. Against this background, what are the Government's main achievements so far?

17. They have begun the process of monetary restraint and the process of shifting the balance of power in the labour market through the operation of trades union law and practice. The immediate effects of the monetary squeeze are obviously unfortunate. How long it will need to last it is impossible to say. Only when the balance of power and attitudes in the labour market make free collective bargaining compatible with very modest inflation can the constraints be eased and significant economic growth be resumed.

18. On incentives the first moves have been made on both direct tax and the overlap of tax and social security payments. Public spending programmes have been cut but the inheritance of the Labour Government (including Clegg) was such that, broadly speaking, we will have to wait for the arrival of North Sea oil and gas receipts before going much farther.

19. A start has begun on rolling back the nationalised sector on breaking up into smaller units and on the improvements in efficiency and accountability (Rayner). It will all take time.

20. But what are the alternatives?

21. Back to incomes policy and the social contract under which union power is increased and public spending expanded?

22. Back to continued support for inefficient production in the nationalised sector - steel, shipbuilding, British Rail, postal services - and British Leyland.

23. How would this begin to tackle the twin British problems of inflation and inefficiency?

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