Prime Minister

If you agree with the CPRS comments, I think it would be best if I conveyed them – in your name – at once. Otherwise, you can discuss with the Chancellor next week. (Assuming I write, can I say that the Treasury paper was well done, as I think it was?)

c Mr Hoskyns
Mr Walters
Mr Wolfson

We are long on analysis, short on solutions in both papers – but agree we must get to work d' one on demand & the position & the conclusions of paper.

The real answer is that there is no easy solution to nationalised industry problems except to remove the monopolies by denationalisation.

CONFIDENTIAL

Qa 05228 — 22 January 1981

To: MR LANKESTER

From: J R IBBS

NATIONALISED INDUSTRY FINANCING

1. You asked for CPRS comments on the Chancellor's minute, and enclosures, of 16 January. — Flag A

2. Broadly speaking, we agree with the Chancellor's analysis. There is no painless way of financing nationalised industry borrowing. The best hope of optimising the use of resources lies in further competition and privatisation, where this is possible, and increased "internal" pressure for greater efficiency, where it is not. We doubt whether sponsor Departments are well-equipped to keep up the momentum on these fronts.

The Problem

3. The Government is faced with the familiar dilemma. On the one hand it wants the nationalised industries to operate as nearly as possible on a "commercial" basis. On the other hand the financing requirements of the industries must be kept within manageable bounds because of their impact on monetary growth and the PSBR.

4. The Government seeks to reconcile these objectives in setting EFLs. But there is a risk that, within a tight EFL discipline, profitable investment will be unduly restricted. In his paper, the Chancellor examines a number of proposals for dealing with this problem.

(i) Direct Borrowing from the Market

5. By itself, "putting the industries into the market" would do nothing to solve the problem, and would carry certain penalties:

- such borrowing would remain part of the PSBR;

- so long as it continued to carry an implicit or explicit Government guarantee, it would draw on funds which would otherwise go into gilt edged stock;
- any increase in borrowing would thus lead to an increase in the PSBR and either higher interest rates or greater monetary growth;
- borrowing direct from the market would be more expensive than borrowing via Government;
- it would complicate the management of public sector debt.

For all these reasons we should be opposed to "ordinary" direct borrowing in the market. It would not justify any relaxation of borrowing control.

(ii) Downgrading the PSBR

6. There might be more point in "putting the industries into the market" if the Government (and the markets) were concerned not with the PSBR but with, say, the General Government Borrowing Requirement (GGBR) which would exclude nationalised industries' borrowing on their own account.

7. The CPRS, however, sees little attraction in such a change of direction:

- the PSBR has been a main plank of the Government's economic policy: any attempt to downgrade it would be taken as a considerable change in policy;
- Ministers would be accused of "fiddling the books", particularly as they criticised the previous Government for attempting a similar move;
- there is a risk that the GGBR would be ignored, just as the TPI has been ignored: worse still, the Opposition could concentrate attention on the PSBR or the GGBR, whichever was the worse;
- so long as the Government has to treat the PSBR as a constraint, increased demands of the nationalised industries compete with other forms of public expenditure: in principle this

seems to us right, given that it is the Government which is having to reach a judgement on the relative worthwhileness of these various forms of expenditure;

- if the Government treated the GGBR as the constraint, increased demands of the nationalised industries would still, through higher interest rates, tend to "crowd out" the private sector. This seems to us undesirable unless the nationalised industries and private sector are in genuine competition.

For all these reasons we doubt whether it is worth pursuing a change of emphasis from the PSBR to the GGBR.

(iii) New Forms of Borrowing

8. We agree with the Chancellor that new forms of borrowing should be explored. Indeed this is an area the CPRS is also examining in its study on Telecommunications. The aim is to tap savings which are currently available neither to the public nor to the private sectors since this would make it possible to increase investment, without adding to the money supply. But it is a tall order. We do not want to prejudge the outcome of further work on the suggestions in Annex C of the Chancellor's paper but frankly doubt whether their effectiveness in attracting additional savings could be other than marginal. They may, of course, have other merits: for example a performance bond might bring additional pressure to bear on an industry to improve its performance.

9. In addition to the suggestions in Annex C, however, we believe there is a further option which should be examined. Some industries (eg BSC) incur substantial expenditure abroad and we should like to see an analysis of the arguments for and against financing at least part of that expenditure from overseas borrowing which would provide a new source of funds. The economic consequences are complex, but we think there might be advantage from overseas borrowing in terms of the effects on monetary growth.

(iv) Privatisation

10. The Chancellor proposes a major new initiative in which sponsoring Ministers and Departments should examine new and imaginative possibilities for privatisation. In principle we agree.

But it is just worth pausing to consider the underlying objectives, and how best to tackle them. Possible aims are:-

(a) to reduce the size of the public sector;

(b) to subject the industries to the discipline of the market;

(c) to provide immediate easement of the PSBR.

In our view, (a) and (b) above go together. We see doubtful value in privatising if the only effect is to switch (with some disruption) from a state monopoly to a private sector monopoly. The latter would equally need to be subject to Government regulation. It would compete for funds with the private sector (instead of the public sector) without a market mechanism for determining priorities. It would be difficult to write a prospectus when the future of the industry depended on regulation by successive Governments.

11. In our view, therefore, an essential ingredient for privatisation is the introduction of competition. The emphasis of the new initiative should therefore be on greater privatisation and competition.

12. How, then is this initiative to be tackled? The CPRS doubts whether the search for new possibilities should be left solely to sponsor Departments who have become, to a greater or lesser extent, advocates for and protectors of their industries. We believe the Chancellor should be asked to consider alternative approaches. One option might be to set up a task force for the purpose, to include insiders from Departments and outsiders eg with experience of merchant banking and the operation of utilities in other countries.

13. With the best will in the world, however, a new initiative on privatisation/competition will not contribute to the third aim above - to provide immediate easement of the PSBR. On this we think there may be scope for a more rapid disposal of unwanted assets - particularly land and buildings. One possibility worth considering would be to provide industries with a greater incentive to sell eg by allowing them to retain a proportion of the proceeds instead of surrendering them to the Exchequer. This may be thought

objectionable as a form of hypothecation. On the other hand it might be effective, and it offers gain both to the industries and to the Exchequer.

Efficiency

14. Where privatisation and increased competition are not possible, there is a need to step up the pressure for greater efficiency more directly. To this end the CPRS has proposed a system of efficiency audits and, as the Chancellor mentions in paragraph 26 of his paper, we are currently pursuing this proposal with the Treasury. It would be helpful if the Prime Minister could express an interest in this work since we are expecting considerable opposition from sponsor Departments.

Conclusion

15. If the Prime Minister agrees with our comments we suggest that her reply to the Chancellor should include the following points:-

(i) that, broadly speaking, she agrees with the Chancellor's analysis;

(ii) that she endorses the need for a major new initiative on privatisation where activities can be made subject to competitive pressures;

(iii) that the Chancellor should consider whether this initiative is best left to sponsor Departments, or whether some alternative should be adopted eg by a special task force with some outside participation;

(iv) that new forms of borrowing (on the lines of Annex C) should ~~could~~ be examined further, although their effectiveness in attracting additional savings seems likely to be marginal;

(v) that the merits of overseas borrowing should be further examined;

(vi) that downgrading the PSBR and direct borrowing from the market (other than under (iv) and (v) above) should not be pursued;

(vii) that consideration should be given to providing industries with a greater incentive to sell unwanted assets eg by allowing them to retain a proportion of the proceeds.

(viii) that the Prime Minister was pleased to see that the Treasury and the CPRS were working on new methods to secure greater efficiency in the nationalised industries, for example by a system of efficiency audits.

16. I am sending a copy of this minute to Sir Robert Armstrong.

JL