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National Economic Development Council

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POLICY ON THE ECONOMY

Memorandum by the Chancellor of the Exchequer

Introduction

It is not difficult to define the main objectives of economic policy. At the centre is sustainable non-inflationary growth in output to provide more jobs and improved living standards - including better public services as well as higher private consumption. The real problem is in agreeing on the precise means of achieving these objectives. But even here there is probably more agreement than many commentators would suggest.

2. Before turning to the prospects for the coming year or so, and the broad policies that seem inescapable if the foundations for economic recovery are to be soundly laid, it must be recognised that the economic position puts powerful limits on what is feasible in the period ahead. This means that in the short run the scope for influencing underlying trends is necessarily small.

The historical context

3. Undoubtedly the most important general trends in the UK economy in the last 10 or 15 years have been poor productivity growth and continued inflation, reflected in weak industrial and trading performance and erosion of company profits. Some sectors - such as chemicals, instruments and electrical engineering - have grown rapidly since the war. And their productivity record has been good. Other industries for a variety of reasons have performed badly. For example under the impact of low productivity and industrial unrest the output of the UK car industry fell from 1.7m vehicles in 1973 to about 1.2m in 1978, whereas competitor countries increased their output markedly. As a result overseas competitors now have more than half the UK market for cars and employment in the home industry is suffering. The successful industries and companies are however a pointer to

what can be done, even though the dynamic sectors have not so far been a match for those in decline.

4. The rate at which the economy in aggregate has lagged behind has, of course, varied. At times we have done better but recently performance has weakened. For example, output per head in manufacturing rose by only ½ per cent a year between 1973 and 1978 - below previous trends and significantly slower than for most of our competitors. By contrast, money earnings rose fast and our relative labour cost competitiveness accordingly worsened. And, squeezed by cost pressures and competition from abroad, industrial and commercial companies' real rates of return averaged only about 4 per cent in the past 5 years, compared with around 11 per cent in the 1960s. All this has meant that, taken as a whole, our industry has not expanded to meet demand; manufacturing production last year, for example, was below its 1973 level, while the volume of manufactured imports had increased since 1973 by more than 30 per cent. This increasing inability of significant sectors of home industry to compete with overseas suppliers has been the main barrier to growth, not lack of demand.

Immediate prospects

5. Under the provisions of the Industry Act the government recently published forecasts for the period up to the end of 1980 and a number of other forecasts have also been published. Although there are differences of degree and emphasis, and the uncertainties are particularly large at present, three common features perhaps stand out:

(i) Inflation is still too high, with the underlying rate of increase in retail prices, for example, now around 1 per cent a month. All the forecasts predict a slowing of inflation during 1980 although the year on year figure seems unlikely to come down until the second half of the year. The government's forecast suggests that in the year to the 4th quarter of 1980 the RPI increase will be about 14 per cent, provided - and this is a key assumption - there is a progressive reduction in the size of pay settlements.

(ii) Nearly all forecasters predict a fall in GDP in 1980 after the fairly flat trend over the past year, although the precise course of this will depend on success in reducing inflation, the pace of world trade and our trading performance.

(iii) The current account of the balance of payments this year seems likely to be in deficit by up to £3 billion following the sharp increase in imports of manufactured goods, particularly in the first half of 1979, and a continued current account deficit, albeit at a reduced rate, is expected for 1980.

6. This outlook necessarily reflects world developments which increase domestic inflationary pressures and depress the demand for our exports. The effective price of oil, for example, is now 65 per cent higher than it was a year ago and the quickening of world inflation is one reason for the expected slower growth in the world economy. Output growth in the main industrialised countries seems likely to slow down from about 4 per cent in 1978 to little more than 1 per cent next year. And in turn markets for British exports of manufactures may grow by only about 4 per cent in 1980, less than half the rate enjoyed before 1974.

7. These international developments make the task of economic recovery that much more difficult. The shock effect of the oil price increase has worsened world inflation and has made the conduct of national economic policies, including monetary policies, more difficult. Nevertheless they must not be regarded as an excuse for failing to adopt the right measures for our own situation.

Future policies

8. This background and the history of previous attempts to improve our performance underline the fact that there are no quick or easy solutions. (A major test at present may indeed prove to be how far, given the general recession in prospect for the world economy as a whole, we can retain our present standards of prosperity.) But they highlight again two imperatives:

(i) If we are to avoid a long-term absolute decline in overall economic performance we should lose no time in laying foundations that will allow sustained non-inflationary expansion of the economy;

(ii) growth and living standards cannot improve unless resources are used more effectively and efficiently.

9. It is probably helpful to distinguish two main approaches to be followed in setting the right climate for renewed growth. First, it is common ground that government should try to set the right overall economic framework in order to ensure, as far as is within its power, a proper balance of resources between different sectors of the economy, that inflation is controlled and that a satisfactory external position is maintained. Second, within this framework, there must be substantial improvement in, and encouragement to, what has come to be called the "supply side" of the economy. A major lesson of recent years has been the ineffectiveness of overall economic policies that have failed to pay sufficient regard to the problem of supply.

10. The pattern of industrial growth to be built on these foundations is not something that governments can or should dictate from the centre. Opportunities for building new industries - services as well as manufacturing - around new products and markets will spring from trends in consumer demands and technological change at home and overseas. What these trends will be is uncertain but they could, for example, spring

from developments in the energy field and in service oriented industries. Smaller scale enterprises will probably have a big role to play: a recent study showed that in the USA 60 per cent of all jobs are generated by firms employing 20 employees or less and a recent study of the Cleveland area in the UK indicated the importance of small firms in providing new jobs as jobs in old-established industries disappeared. It will be necessary to think in completely new ways about what will in future constitute "employment". Trends for employment under the impact of new technology will be discussed at the January meeting of the Council. The economic framework and industrial atmosphere need to create an environment in which new occupations, industries and jobs can flourish and take up resources freed from industries in decline.

Overall economic framework

11. Successive Governments have set themselves the aim of controlling inflation. Continued high inflation undermines consumer confidence and demand and eats into the social fabric through its perverse redistributive effects. It affects not only today's jobs but, by corroding business confidence and reducing investment, ensures that many potential new jobs will be stillborn. There have been repeated attempts, whether of a statutory or non-statutory kind, to restrain inflation by direct control of incomes. The promulgation of a norm for pay increases - for example a fixed percentage - has not been successful. By introducing distortions and hampering the flexible allocation of resources it can be positively harmful and there is now increasingly general agreement that an institutionalised "incomes policy" is not a realistic answer to the problem of inflation. There has at the same time been a growing recognition on all sides of industry that firm monetary control is essential if inflation is to be tackled at its roots.

12. Precisely how that monetary control should be applied is a matter for legitimate discussion and debate. The government

has continued the practice of setting specific targets for monetary growth, and has demonstrated its determination to see that they are observed. Inflation can only be mastered if the money supply is brought under firm control and its rate of growth progressively reduced over the years.

13. But although an appropriate monetary policy is a vital part of the framework, it is also necessary to ensure a proper balance between the resource needs of the public and private sectors. In particular this means that, though there is room for disagreement over particular priorities, the total volume of public spending must be planned on realistic assumptions about economic growth. The evidence is that to allow public spending plans to run ahead of growth of GDP leads to the need for disruptive cut-backs and, except in the very short term, a stifling of the very economic growth that is the only sound basis for improvements in public services. The aim is to see that over the years public spending as a proportion of GDP should decline.

14. Experience has shown that excessive levels of public spending have led to too much government borrowing and to high taxation, which have impeded growth. High levels of borrowing have also prevented proper monetary control and therefore led to inflation and high interest rates, and hence in turn to further disincentives to investment and economic efficiency. And the consequent lack of growth has made it harder to bear the burden already imposed on the economy by rising public expenditure. It is essential to break out of this vicious circle; and proper restraint on public expenditure is clearly a necessary element in achieving this. In present circumstances indeed, it is not possible to plan for any increase in public expenditure over the next few years.

"Supply Side" policies

15. The setting of the right overall framework is an essential requirement for resumption of sustainable growth. But it is

not enough. The challenge of the energy crisis, of new technology and of newly industrialising countries - all of which the Council have discussed - call for much greater flexibility and willingness to adapt within industry and society generally. The response has to come from industry, but the government can help by doing what it can to create an environment favourable to enterprise and innovation. A major need at present, as recognised in papers before the November meeting of the Council, is for a major programme to raise awareness of new technologies throughout industry and to use all opportunities to persuade people of the paramount need for more effective use of industrial resources.

Incentives

16. There has been little doubt that the public has wanted the burden of direct tax reduced. With current levels of public expenditure this has necessarily involved a substantial switch from tax on income to tax on spending. Income tax reductions in the Budget helped to mitigate the disincentive effects of the poverty trap and bring our personal tax rates more in line with those in other countries. The restoration of incentives is an important part of action to remove the contraints on growth imposed by skilled labour shortages, which have tended to persist even when unemployment generally has risen and have acted as a brake on expansion. The TUC paper discussed at the November Council meeting, for example, stressed the importance of securing a proper supply of trained manpower for the micro-electronics industry. Improvements in manpower and training policies are one part of the solution to this problem but tax policy must help in establishing differentials which make it worthwhile to gain and use improved skills.

17. The Government hopes in the years ahead to be able to make further cuts in income tax and to achieve a further real increase in thresholds; and it is also reviewing the systems of company and capital taxation. But the rate of progress in all these areas will be subject to the constraints imposed by the difficult economic prospect and to the need for fiscal policies consistent with responsible monetary control.

18. Change in the economy inevitably involves upheavals for individuals and their families as jobs disappear in one industry and new employment opportunities arise elsewhere. It is an important responsibility of government to ease the passage of change for those who lose their jobs, through manpower and training services and the social services.

Removal of barriers

19. Apart from changes in tax policy, of the kind now implemented, there have been widespread demands for the removal of unnecessary controls and administrative burdens on industry. The government is ready to do what it can. Price, dividend and exchange controls have already been removed, as have Office Development Permits. Changes have been made in the Industrial Development Certificate system, and other planning controls are being modified. Ways of simplifying planning procedures and building regulations are being reviewed with a view to reducing the time taken to complete investment projects. In addition certain changes were made in July to provisions of the Employment Protection Act and consultations have begun on proposals to amend other provisions which many agree have discouraged the formation of new jobs. The aim of all these changes is not change for change's sake but a genuine wish to let firms and their employees concentrate on flexible deployment of resources and reduce the effort which has too often had to be put into observing rules and regulations of only marginal usefulness.

20. Although none of these measures by itself holds the key to getting the "supply side" of the economy right, cumulatively they should help to improve the general climate for industry. But there are other factors of equal importance. In many situations, for example, competition is the best promoter of both industrial efficiency and the interests of the consumer. This is why the Government have introduced the Competition Bill which will permit the Director General of Fair Trading and the Monopolies and Mergers Commission to investigate restrictive practices more selectively - individual firms and bad practices will be liable to investigation - and more expeditiously. The

Bill also provides for the investigation of alleged abuse of monopoly power by, and of the general efficiency of, public sector trading bodies.

21. Within the freer and potentially more rewarding environment that we should like to create, the prime responsibility for improving industrial performance must rest squarely with management and employees at company and plant level. But, when they operate effectively, the tripartite Sector Working Parties (SWPs) also have a valuable role in helping to identify what needs to be done in particular industries and in stimulating the necessary action at company level. In many sectors the problem is one of poor non-price competitiveness (e.g. outdated product design, poor quality and inadequate delivery and after-sales service); in other cases the SWPs have shown that there is considerable scope for improving performance by strengthening co-operation between potential users (including retailers) and potential suppliers, or by curbing the unnecessary proliferation of purchasing standards and requirements. There are other major cross-sectoral issues such as productivity (in its widest sense), the manpower issues such as skill shortages, and technological developments including microelectronics. These are all issues which the SWPs have been tackling and will need to keep to the fore in future work.

General conclusions

22. In the light of this and the other papers before it the Council will wish to consider the general approach to the difficult problems ahead. While there will naturally be different views on particular aspects, some broad conclusions may be thought to emerge.

23. First, although the difficult prospect ahead limits the room for manoeuvre and a painful period of adjustment seems inevitable, the prime aims of economic policy must be to reduce inflation (and thereby restore confidence) by proper monetary control, to get the balance of the economy right and to take every opportunity to encourage growth through encouragement to the "supply side" of the economy.

24. Second, within the above objectives, the prospects for the company sector and the path of unemployment depend heavily on the individual behaviour of those setting pay and prices in industry. The absence of an institutionalised "incomes policy" does not remove the need for a responsible attitude to pay settlements. Indeed the firm restraint of money supply underlines the imperatives that need to be respected by both sides of industry. Excessive increases in pay or prices are bound to cause a deeper recession, more unemployment and slower reduction of inflation.

25. Prosperity and jobs depend crucially upon achieving an effective use of all resources. The economy can only grow if we are industrially competitive. There is widespread agreement about the need to accept new technology; and about the importance of improving consultations and communications between both sides of industry at all levels. The main focus for action must be at company and plant level, and here the Sector Working Parties have an important part to play. It is vital that throughout industry and in government everything possible should be done to help raise industrial performance and to equip the economy to respond and adapt more quickly to a fast-changing world.

(G.H.)

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