

PROSPECTS FOR ECONOMIC POLICY

[Paper by Sir Keith Joseph]

1. With the system under threat from so many angles, it might be useful to consider our reaction to possible developments.
2. At a time when we are heavily overspending on consumption - thanks to vast overseas loans - and under-investing in industry, consumption is planned to increase by 3½ per cent between 1974 and 1975, first halves. Wage earners' purchasing power is still increasing while middle incomes are penalised.
3. Exports are losing their competitive edge. The exchange rate is being allowed to fall.
4. The return on capital at replacement cost has fallen from 10.7 per cent in 1963 to 5.2 per cent in 1973 and trading profits arising in the UK as a percentage of total domestic income have fallen over the same period from 12.2 per cent to 6 per cent but during the same period the share of the total domestic income attributable to wages and salaries has risen from 75 per cent in 1963 to 79 per cent in 1973.
5. Any one or any combination of strikes, excessive wage claims, bankruptcies, monthly deficits or world events could force the Government to change policies.
6. The 1975 Budget deficit and borrowing requirement will on present policies be much higher than this year's £6.3 billion because of the extra rate support grant and negative fiscal drag - the gap between the rising cost due to inflation of public services and the lower rate of increase of tax revenue because several important indirect taxes are specific and not buoyant. Negative fiscal drag has been the prelude to hyperinflation several times this century.
7. The money supply trend may perhaps at best, coupled with petrodollar loans, be compatible with a gradualist attack on inflation. But the threat of bankruptcies or emerging unemployment could force the trend rate up again. We face combined recession and inflation: the more we try to reduce the former, the greater the latter.
8. Inflation is in fact far worse than the cost of living index shows. Price controls and subsidies are suppressing much inflation, expanding already excessive purchasing power at the expense of the liquid corporate sector. The effect of suppression is to cause faster inflation later because of catching up; concealed quality changes; shortages; deterioration of service and deliveries; and reduced investment.

9. Uncertainty about commercial rent control is causing a chain reaction throughout the credit structure. Extended clearing banks are already struggling to prop up fringe banks, themselves dependent upon property values, which in turn depend upon rent control prospects. Commercial rent control is no benefit to the consumer but merely a perverse transfer within the corporate sector. Abolition of rent control would be only a modest help but still a help.
10. Against this background no doubt Whitehall has plans for an indexed freeze in the light of the failure of the social contract. Provided the consequences of public sector wage claims are at once passed through to the consumer in prices, and provided the money supply growth continues to decline, then high wage settlements in some sectors will penalise the jobs and earnings of less powerfully organised wage-earners, and could still be compatible with a lagged fall in the rate of inflation.
11. A wage freeze unaccompanied by such policies would be damaging: it would do more harm than good if accompanied by too many controls designed to placate Trade Union opinion.
12. Sooner or later the gap between our output and our spending will have to be reduced sharply in order to reduce negative fiscal drag and our deficit, and our dependence upon foreign loans. In addition we need to free money by way of savings for investment. It would help in many ways if we were to index taxation and savings. Perhaps we could discuss this on another paper on another day.

For discussion I end with a few propositions:

- (a) It is important to close negative fiscal drag by cutting spending or by making buoyant some indirect taxes.
- (b) Suppressed inflation should be released as one step in the process of abating inflation. If combined with a gradualist monetary policy, the ending of price control will mop up purchasing power and help the corporate sector.
- (c) Commercial rents are significant in the credit structure and should be freed.
- (d) Any wage freeze should be accompanied by a firm declaration of a government programme to reduce the growth rate of money supply, with target figures including the borrowing requirement stretching a few years ahead.

K.J.

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Keith Joseph has prepared the attached paper which I am content should be circulated as a basis for discussion.

ROBERT CARR

Conservative Central Office,
32 Smith Square, SW1P 3HH.

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