ECONOMIC RECONSTRUCTION GROUP

The next meeting will be held on Friday 8th July 1977 at 11.00 a.m. in the new Westminister Hall Interview Rooms at the House of Commons, Room W.1.

AGENDA

To discuss the Final Report of the Nationalised Industry Policy Group chaired by the Hon. Nicholas Ridley.

Paper enclosed: Nationalised Industries Policy Group Report (PG/10/77/38).

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30th June 1977

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CONFIDENTIAL PG/10/77/38

ECONOMIC RECONSTRUCTION GROUP

8TH JULY, 1977

Final Report of the Nationalised Industries Policy Group

CONTENTS

FINAL REPORT OF THE POLICY GROUP ON THE NATIONALISED INDUSTRIES

PART 1 - Running Nationalised Industries

A. MOTIVATION

1. There are fundamental differences between the private and the public sector. In the private sector there is the fear of bankruptcy and redundancy - "the stick"; there is also the hope of reward in the form of higher dividends, salaries or wages, as the results of success - the "carrot".

2. These "sticks" and "carrots" are weaker in the nationalised industries. The sanction of bankruptcy does not, and cannot apply although that of redundancy can and does. The incentive of working for higher reward applies in relation to piece-work or payment-by-result schemes - in no cases does it apply to management, let alone to the providers of investment capital. People are rarely dismissed for inefficiency.

3. There is a need to provide sticks, and carrots, in the public sector. They are bound to be infinitely less effective than those in the private sector - because of the very nature of the public sector and its immunity from bankruptcy. But some sanction is necessary when there is a serious failure - and some reward is necessary when performance is good.

4. One element of our policy for the public sector should be to provide greater rewards for success and penalties for failure - particularly for managers - but as far as is practical for all concerned.

5. More and more the nationalised industries are run for the benefit of those who work in them. The pressures are for more jobs for the boys, and more money for each boy. The need to satisfy the customer is less and less apparent: mainly because they tend to be monopolistic concerns.

6. Another element of our policy should be to break up the monopolies, and to make each unit of public industry survive, and prosper, by means of providing a better service to the public than its competitor. There are sections later in this paper describing how we should do this.

B. MANAGEMENT INFORMATION

1. Unit costs are vital information in relation to measuring efficiency. Any attempt to improve efficiency must start from considering unit costs. In the nationalised industries the output is measurable and unit costs can be obtained.

2. The strange thing is that this information about unit costs is not made available publicly, although it is probably available to managers in the nationalised industries. This information would be of the greatest value in monitoring efficiency. Parliamentary Questions asking for information about the unit costs of nationalised industries and the comparable costs in other industrialised countries are answered by Ministers by saying that the information is not available. It is clear from answers that the civil service either does not know or will not release such information.

3. The truth is that the Government's attitude to the public sector is not commercially orientated. The cost of producing steel, or electricity, or coal, or air travel is determined by a mixture of the political pressures and the union pressures. The income that may be obtained depends upon what the customers will pay, and the political pressures at work. The resulting return on capital varies between zero in the Steel Industry, to a 120% return on capital in the duty free shops at London Airport, but it is usually much less than the cost to the State of providing the capital.

4. The cost and the income are not related in the bureaucratic mind. It follows that the loss is a residual representing the political price that must be paid. Striving after efficiency has thus tended to be fruitless - because both the financial inputs and the financial outputs are the result of political determination. Publishing unit costs would at least highlight the extent of the inefficiency.

5. The nationalised industries should be required to keep and to publish detailed unit costs, in the interests of public accountability.

C. COMPETITION

1. The public sector is very seldom found in successful direct competition with private producers. There are exceptions - buses, some ports, special steels, Giro, parts of the National Freight Corporation and a few others. Such competition nearly always results

in heavy public sector losses, rather than in an attempt being made by the public sector enterprise to improve its performance. The usual reaction is to seek ways of disguising the loss, and/or of disadvantaging the private sector competitor, or better still obliterating it. For instance the National Bus Company sought to dress up its 1975 loss of £19m as a profit of £1m in its accounts - the Giro behaved similarly. The B.T.D.B.'s answer to Felixstowe's success was to try to buy it out; the BSC's reaction to competition in special steels was to put up the price of crude steel to its competitors discriminatingly. None of them sought to increase efficiency in order to meet the competition.

2. The sanction of competition for the public sector therefore, although in theory desirable, is not really effective so long as no penalty attends upon losing in that competition. Losses have always been made up in the past. Special pleading as to how they arose has always been accepted. No disciplinary action has ever resulted.

3. There is another respect in which such competition is unfair. Private companies have to raise capital in the market at commercial rates, whereas the Nationalised Industries can borrow from the Exchequer easily and relatively cheaply.

4. It follows that competition between private and public sector companies should be avoided until there is designed for the public sector a financial discipline which really works, and there is equality in the cost of capital raising.

D. <u>FINANCIAL CONTROL</u>

1. It is clear that the next Tory Government will have to manage a sizeable public sector, even if in the long run it can be reduced. The proposals later on in this paper might result in a much larger number of units (albeit a smaller total volume) in the public sector. Further proposals are therefore put forward for managing those concerns with which our government will find itself burdened.

2. The principal instrument of control should be to set each concern a financial obligation to achieve. This obligation should be expressed as a required rate of return on capital employed. The amount of capital employed in each undertaking is, of course, arbitrary. Many industries have had capital written off, and none has updated the value of its assets to cope with inflation. Government should therefore set arbitrary capital employed figures for each concern, upon which each would be required to pay the prescribed rate of return. (The "capital employed" could be increased (or

decreased) annually in the light of any changes in the value of its existing assets. The rate of return should be the same for all industries.)

3. New advances of capital for the industries should be made at a price a little above the cost of capital to the Exchequer, at the time they are drawn, in order, as nearly as possible, to lend to the industries at the same interest rate at which the private sector borrows.

4. This control mechanism is analagous to cash limits. It could be used to squeeze public industry a little over the years - but it must not be used to squeeze too hard or it would break down.

5. It would be important to establish that the required rate of return was totally inflexible. It must eventually be taken for granted that in order to meet the obligation plants must be closed and people must be sacked. It would therefore be trebly important for the obligation to be worked out realistically - first in relation to the likely rate of inflation, secondly, in relation to the likely relative movement of wages between different groups, and thirdly in relation to the possibility of improving productivity.

6. If the nationalised industries were eventually to be broken up into smaller units, the return on capital obligation could be applied to each unit, just as a holding company with a number of subsidiaries does.

7. The importance of such a policy should be stressed. If the required rate of return on capital was not achieved, either management must demonstrate that it was taking effective action to rectify the omission, or it must be replaced. Effective action might mean that men would be laid off, or uneconomic plants would be closed down, or whole businesses sold off or liquidated. The National Freight Corporation, B.S.C., the Giro, Govan shipbuilders would be on the list, among many others, for drastic treatment if this policy were followed.

8. It should be asked whether we have the political willpower for such a policy. If there were to be weakness in one case - doubtless a politically embarrassing one - the whole policy would be lost. There is no other way to restore financial responsibility in the public sector of industry. Something like this has to be done if the country's economy is to be brought under control. Nevertheless there is no point in undertaking it if we are not prepared to go through with it.

E. PRICE CONTROL

1. Price control must be avoided at all costs. If there is evidence of exploitation by a State monopoly, either in the form of excessively high margins, or of discriminatory or cross-subsidised pricing, government should refer the matter to the Director General of Fair Trading. (Powers already exist). The general level of prices would in fact be determined by the required rate of return on capital employed. This would result in some pressure for higher productivity and efficiency, as well as transferring some of the odium for price rises from government to the industries. It must, however, be recognised that prices calculated to produce a commercial rate of return to nationalised industries would result in the government incurring a degree of unpopularity.

F. UNECONOMIC ACTIVITIES

1. Whenever an industry considered it was being asked to undertake uneconomic activities (rural telephone kiosks, branch or commuter railway services, uneconomic pits, or steel mills, etc.), it would be open to it to apply for a specific subsidy from government, if government wanted it continued. If Government refused, the activity must either be fully charged for or be discontinued. The industries should be required to keep proper accounts and show the results on each of their activities, including the losses on uneconomic ones. This policy could lead to undesirable bargaining situations, but the advantages of identifying and quantifying the loss-making activities would outweigh this disadvantage. If it could be seen publicly how much we were paying for what, there would be more informed public debate about whether we were getting value for money.

2. The cost of subsidies to continue uneconomic activities should be borne on the vote of the Department which wanted them carried on. It would be necessary for the Department to be precise and specific about those uneconomic activities it wished to buy: e.g. 3 million tons of extra coal; or a commuter service from Reigate to London of a certain frequency; or 1,000 extra rural telephone kiosks, etc. If the requests are specific, to do this is practical, and would not involve a lot of extra paper work.

3. It is by these means that provision can be made for major social problems resulting from making the Nationalised Industries more efficient. There are whole towns dependent on steel works, coal mines and ports, which might be severely deprived if full efficiency policies are carried out. The responsibility for dealing with these

problems is that of Government rather than the Industry. The Government can either refund the industry for the continuation of uneconomic plants for social reasons, or it can use its financial strength to bring in new industries; or it can compensate financially the victims of industrial change.

4. Such direct subsidies for uneconomic activities should be the only additional source of Exchequer money available to an industry to meet its required rate of return.

5. It is worth noting that this policy would make infinitely more difficult such concepts as "energy policy" or "transport policy". Any Minister seeking to promote such policies would have to pay for the uneconomic costs he imposed on any industry with money from his own vote. It would also mean ending social concessions - such as the government contribution to the Redundant Mineworkers Pension, and half fares for students and pensioners on public transport, unless the relevant sponsoring Ministers were prepared to pay the cost of them out of their votes.

G. <u>INVESTMENT CONTROL</u>

1. Investment control by government must alas continue. Admittedly it is this control which gives the Civil Service its opportunity for detailed, fussy supervision of the industries. But it should be possible to insist on overall control only - and prevent the bureaucracy checking each item of investment. The control is necessary both for purposes of public expenditure control as part of macro-economic policy, and also for preventing the industries extending their empires too much, or into undesirable fields. For the latter purpose Ministers must have enough information to say no, if they want to. For both purposes, having to earn the required rate of return will be a steadying influence, but the Chancellor must retain the power to make arbitrary cuts.

2. Investment control should be carried out by means of the preparation and negotiation of five-year rolling corporate plans, agreed between each industry and its sponsoring Department and published. There should be a commitment by government to the investment intentions in such a plan as follows:

Year 1	100%	of total
Year 2	90%	of total
Year 3	75%	of total
Year 4	50%	of total

H. ACCOUNTS

1. Government should insist on an improvement in the industries' accounts. They should be published half-yearly and follow a standard laid down pattern. In addition to the usual information the accounts should show the cost per unit of output, plus the comparable figures for previous years, and those of rival concerns in other similar countries. This might be an added spur to greater efficiency. They should also show audited profit and loss accounts and balance sheets for all subsidiaries.

2. It is for the Public Accounts Committee to consider whether it would like to get the Comptroller and Auditor General to audit the accounts of Nationalised Industries, and to report upon them to it.

I. GENERAL

1. It is recognised that there are defects in this overall system of control. Doubts must arise because there never has been, and never can be, any real financial discipline where the possibility of bankruptcy does not exist. Any system of financial control lacks an ultimate sanction. Nevertheless, this system, which is neither novel nor impractical, would seem to have the greatest authority, and also to have the merit of increasing public knowledge of what each activity really costs. If later some industries are broken down into a larger number of "profit centres", this is probably the only practical control system which could have general application right across the board.

2. Until such times as we can make the financial disciplines real (if we ever can) it is not wise to consider nationalised industries as commercial undertakings, and to give them full freedom to expand into any activity which catches their fancy. They are at present almost certain to undercut, and to make losses, in the belief that they can recoup from the taxpayer. In the process they damage private sector competitors. Investment control should therefore be used to restrict the industries strictly to their main-line activity.

3. Where they are already engaged in such extra-mural activities it is probably not worth a major fight to get them to divest. Electricity and gas showrooms are cases in point - and so is the NCB's landscape gardening and ironmongering activities. If an easy opening to sell off such peripheral activities arose it should certainly be taken. But a major political battle for a very small piece of industrial ground is not to be recommended.