

Handwritten: *Reading on*

Prime Minister  
Handwritten: *You asked for this earlier today.  
I have sent a copy to*

7 December 1981  
ALAN WALTERS

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NOTES ON THE CLARE GROUP'S RECOMMENDATIONS OF DECEMBER 6, 1981

*The Chancellor, in case it's of use for him tomorrow.*

DEFICIENCY OF DEMAND VERSUS REAL WAGE STICKINESS      *MCS 7/12*

- 1. The Clare Group argues that there are two elements which explain the high level of unemployment in the UK. First they argue that there is deficiency of demand. At one point on page 15, they say that deficiency in general effective demand is of "dominant importance". But they do not suggest how they have reached this conclusion. It remains an assertion rather than the result of an argument.
  
- 2. But aggregate money demand is translated into aggregate real demand by dividing by the price and wage level. For a given increase in money demand, roughly 10-12% in the UK, we can get an increase in real demand by subtracting from it the rate of wage and price inflation.
  
- 3. They argue, consistently with the Government, that real wages per unit of output are too high and should be reduced. But they argue that the normal pressures of monetary policy, and indeed unemployment, are not effective in the highly rigid labour markets of Britain. They are in favour of measures to improve the workings of the labour market, such as trade union reform and the various subsidies, they believe that the only way to bring back growth is by an increase in "demand reflation".
  
- 4. INCOMES POLICY  
 In order to make sure that increases in demand are not dissipated in increases in wage costs, they propose some sort of incomes policy. This policy, however, is not specified. Broadly speaking this takes the form of "conditionality"; that is to say the Government says that only if pay settlements and price increases are reasonable (say the former below 5% and the latter less than say 7%) will the expansionary policy be embarked upon. If pay settlements are excessive then presumably the expansionary policy will be reigned back.
  
- 5. It may have escaped the notice of the Clare Group that this is the sort of policy we have been pursuing, for example on the railways.



6. And in effect through the medium term strategy there is an automatic reduction in aggregate demand if inflation is too high.
7. To do the authors justice, one must recognise that they do admit that there are problems in operating an incomes policy. But it seems a little rash to rest the whole expansion programme on such a fragile basis as the so-called conditionality type of incomes policy. Since the conditionality would apply, presumably, to the whole economy, as distinct from our railway example, then this would in no way constrain any individual union or individual shop steward from breaking ranks. Even though it were possible for the TUC to enter into any such undertaking, I cannot see how one would prevent the individual unions or shop organisations from busting the policy wide open and declaring an open season.

#### INTEREST RATES AND DEVALUATION

8. Their proposal for lower interest rates, although unspecified quantitatively, and a 10% devaluation of sterling seem to me to be not at all inconsistent with our policies. In spite of the various messages which the Chancellor has issued, the Clare Group are clearly concerned that we shall pursue a restrictive policy for interest rates in order to deliver on the MTF5 target for M3. Clearly, however, if we give more weight to the narrow aggregates, there is no reason why interest rates should not fall along with international interest rates. And a trade-weighted average for sterling of 86 (1975 = 100) is well within the bounds of acceptability.

#### TAX CHANGES

9. Their proposal to eliminate the National Insurance Surcharge, since it is a tax on the employment of labour, is one we would put fairly high on our agenda. Since the objective, however, is largely to increase employment and output, it is odd that the Clare Group did not consider the benefits/tax system in working to make unemployment an attractive state. They do mention the poverty trap and the need to index the tax thresholds and allowances, but it is en passant. They do not consider at all the effects of the benefits/tax system on keeping up the level of real wages.
10. They recommend a reduction of VAT by 2½ percentage points. Apparently they believe that the main effect of this would be to help in wage bargaining since it would give a reduction in the final price level. The decrease in VAT will also "raise demand".



THE EFFECT ON PSBR, MONEY SUPPLY, INFLATION AND INTEREST RATES

11. The Clare Group appear to argue that there would be off-setting gains of £5.5 plus billions to the cost of their £6.8 billion package. So the net cost would be less than £1.3 billion in 1983. They do modestly say that these are only "orders of magnitude" so perhaps we should not expect too much from that. But the net reduction on the recorded unemployed is alleged to be only about 320,000; the output of goods is thought to be about 3% higher than it would otherwise be. The lion's share of the reduction in unit labour costs is brought about by the proposed devaluation down to 86. A reduction in the National Insurance Surcharge adds another 3%, giving a total of 7½%. These reductions generate much of the increase in output that the Clare Group anticipate. It is to be noted that the devaluation effect has always the strong, positive, and no negative effects on reducing the PSBR, whereas the reduction of the National Insurance Surcharge does involve a loss of revenue.
12. There is an important lacuna in the Clare Group's arguments. Although they show the PSBR increasing, nevertheless they require interest rates to be lower. How they manage the trick of having an increased demand for credit, both from the private and public sectors, and lower interest rates, is never explained.
13. The Clare Group are also confused in saying that our policy has cut out the "automatic stabilisers in the system to counter the falling tendency of output by raising the PSBR". I should have thought that there was ample evidence that in 1980/81 the PSBR was some 5 billion above target. Much of this was an automatic regulator. Their judgement is valid for the announced policy, but does not apply at all to the realised outcome.

CONCLUSION

14. The Clare Group is not so far from the Government's position as the press appear to think. However, the optimistic results of the Clare Group's policy depends upon heroic assumptions which have been so discredited in the past - such as an incomes policy. Furthermore, there is a basic inconsistency between financing the Clare Group's proposals for an increased PSBR and falling interest rates. We might ask how they solve this central conundrum.