Chapter 2
Britain's economic crisis and possible remedies

In this chapter we first characterise Britain's decline over the past twenty years from being one of the richest European countries to being one of the poorest. We argue that adverse trends in trade have been nearing a critical point which would in any event have posed immense new problems in the 1980s in spite of North Sea oil. Next we show how no government before the present one had what can properly be called an economic strategy; rather, each acted in accordance with what was seen as short-term necessity. The present government does have an economic strategy in the sense that it is seeking through the determined use of declared policies to achieve long-term objectives. But the policies are miscalculated; their effect is to accentuate depression of real income and employment with no lessening of inflation. Indeed we foresee that these policies will generate undesired effects on such a scale that they will have to be abandoned well before the end of next year.*

Finally, we discuss the medium-term future of Britain on two different assumptions. First we imagine that after the present debacle the policy stance returns to what it was previously, in the sense that the government attempts to resolve the most urgent political pressures within what has hitherto been regarded as the conventional framework of instruments and institutions. There would have to be a large public sector borrowing requirement (PSBR), an accommodating monetary policy, devaluation and an incomes policy. The best to be hoped for from such a conventional *volte-face* is that Britain will still be left with the old strategic predicament but will be less able, because so much weakened, to deal with it. In the last section we consider Britain's medium-term future under a second assumption: a programme of internal expansion sustained by tariffs. Such a programme now, more clearly than ever, seems the only way of rectifying inflation and recession.

*Detailed projections of this and of the consequences of policy changes are given in tables in the Statistical Appendix, at the end of the Review, which provides a quantitative background to the whole argument. The main historical trends and their projection are also illustrated in charts in an Appendix at the end of this chapter.

What went wrong

From the early postwar period to the end of the 1960s, although Britain was at the bottom of the growth league table, demand and output did generally rise fast enough to maintain full employment. Throughout this period imports of manufactured goods rose about twice as fast as exports, but this was not of crucial importance because imports were initially so small that the disparity in growth rates could continue for twenty years without the absolute balance of trade in manufactures declining.

It was only in the 1970s that imports of manufactured goods reached the critical level where continuation of the trends in trade would result in progressive stagnation of output.

For an open economy such as Britain's, international trade performance affects domestic output and employment in two mutually reinforcing ways.

When exports rise less than 'constant employment' imports, the first consequence is that the current balance of payments deteriorates, and that some destruction of domestic output and employment occurs directly through the operation of the foreign trade multiplier. Higher exports create fewer jobs than are destroyed by the rising import propensity: incomes, home spending and government revenue all fall.

But the tendency for the current account to deteriorate and for tax revenue to fall also results in the government having to raise taxes, cut expenditure and adopt a more restrictive monetary policy, thereby further reducing domestic output. In other words *unless the government takes measures which improve trade performance,* it normally takes, or is forced into, deflationary actions which reinforce the original depressive impulse coming from foreign trade. The final outcome may then be that output and employment become severely depressed by the weak trading performance without there being any balance-of-payments deficit after the event.

This is broadly what happened between 1969 and 1979 despite the balance-of-payments gain from North Sea oil and gas.

Non-oil exports at 1979 prices rose from £32 billion in 1969 to £50 billion in 1979, an increase of

57% over the decade. However, since the import content of exports was rising, the net foreign exchange earned rose by only 40% in real terms. At the same time, there was a fall in net profits and direct investment from abroad; this, together with contributions to the EEC budget, cost over £3 billion. Finally, North Sea oil and gas, measured as if they were entirely exported, afforded a £5 billion gain. Overall, net foreign exchange earnings, including North Sea benefits, rose by 50% in real terms over the ten-year period.

But, simultaneously, import penetration rose. Moreover, having treated the whole of North Sea oil and gas as if they were exported, we must add to imports the cost of purchases for home use from the North Sea. Over the decade, the import and North Sea content of home spending (excluding public service employment which has no direct import content) rose as follows: finished manufactures, 125%; materials and semi-manufactures, 20%; and food, fuels and services, 20%. The total import content of home spending increased by 40% from 18.6% in 1969 to 26% in 1979. This increase in import content would have absorbed four-fifths of the rise in net foreign exchange earnings even if domestic spending has been frozen in real terms for the whole of the 1970s. In the event domestic spending was allowed to rise by nearly 2% per year on average, not enough to maintain full employment, but enough to cause the balance of payments, looked at *ex post,* to deteriorate by £4 billion.

Now consider the consequences of import penetration and slow export growth for business output (ie output excluding public services and the North Sea). Between 1969 and 1979 the volume of output for export rose by 45%, but with slow growth of home spending and rising import penetration output for the home market rose by only 11%. Total manufacturing output increased by a mere 6% over the decade. The volume of production was actually lower in 1979 than it had been ten years earlier in many important industries, including steel, vehicles, metal goods and textiles.

The North Sea mirage

Since the mid 1970s the immediate problem of stagnation has been seen against the backdrop of rising North Sea oil production which many people hoped would eventually bring an economic recovery. It is still widely believed today that within a few years massive North Sea tax revenues will solve many of the government's problems.

Table 2.1 gives estimates of the gains made so far and those likely to materialise in the future. As far as the volume of production is concerned, North Sea oil and gas are already nearing their peak. The effect has been to eliminate Britain's net deficit on trade in fuels, which reached £5 billion (at 1979 values) after OPEC's 1973-74 price increases. But there will only be a small surplus from now on because UK consumption is almost as large as North Sea production. Indeed, if there is a domestic economic recovery during the 1980s, Britain may be a net importer of fuel by 1990. The improvement in the trade balance on fuels since 1975 has been more than cancelled out by the deterioration in trade in manufactures. Since little further improvement can be expected as far as fuels are concerned, the situation will *prima facie* be worse from now on than it has been in the past few years.

Now that the volume of North Sea production is nearing its peak, attention has switched instead to its value as world oil prices rise again – in particular to large tax receipts which will accrue to the government. However, the rise in oil prices does not really yield much gain to Britain as a whole, nor even to the government. The point is that most of the increase will be paid for by British industries and households as they face higher prices for fuel and energy-intensive products. If North Sea prices rise more than we have assumed the government will collect even more revenue. But the effect is still no different from that of a straightforward increase in value-added tax (VAT) or other indirect taxes. From the point of view of the public, high oil and gas prices are one more element in the rising cost of living.

It is small consolation that the North Sea protects

Table 2.1 North Sea benefits

(£ billion, real values in 1979 non-oil export purchasing power)

	Volume of North Sea oil and gas sales	Value of North Sea oil and gas sales	Average real price (1979 = 100)	Net UK exports of fuels	North Sea tax revenue	Producer costs and post-tax profits
1965	0.0	0.0	–	–1.4	0.0	0.0
1970	0.2	0.1	84	–1.5	0.0	0.1
1975	0.7	0.4	63	–5.2	0.0	0.4
1980	7.3	9.5	135	+1.6	3.1	6.4
1985[a]	9.1	14.7	166	+1.8	9.5	5.2
1990[a]	9.1	19.2	217	–1.3	13.7	5.5

[a] Projections assuming resumed economic growth

Britain from problems experienced by other countries who have to pay OPEC for their oil. Those countries will either cut back their own economic growth, depressing trade, or else compete more vigorously in non-oil export markets in order to pay for the oil they need.

Government policies

Any government strategy for managing the economy in the 1970s should have started with policies designed to improve Britain's performance in non-oil trade; nothing else could have averted stagnation. There were only two policies which in principle had some chance of success within a medium-term time-scale: devaluation of sterling (reinforced as far as possible by an incomes policy) and restriction of imports by tariffs or some other form of control.

But these facts were not recognised by either Conservative or Labour governments, nor indeed by the vast majority of economists and or commentators. Instead policy debate, and actual policy measures, focused on how Britain could learn to live through the short term within its increasingly severe constraints. There were several related policy 'cycles'. One, the old stop-go-cycle (see Chart 2.1), consisted of bursts of fiscal and monetary expansion aimed at 'crushing out' of the stagnation induced by the failure in foreign trade – and condemned for this reason to end in massive balance-of-payments deficits – followed by periods of cuts and restriction designed to restore the confidence of financial markets. Another, the incomes-policy cycle (see Chart 2.2), consisted of bouts of wage restraint designed to suppress inflation, followed by 'break-outs' after real wage settlements had been squeezed and differentials had become distorted. Whether by design or by default, there was also an exchange-rate cycle (see Chart 2.3). As far as the government was concerned, devaluation seemed attractive when concern about exports and industrial profits got the upper hand, but once devaluation had pushed up import prices and increased domestic inflation the emphasis switched back and focused on exchange rate stability.

The characteristic of all these cycles was that prevailing opinion, and with it governments, reacted against the failure of each tack of policy by an about-turn to the opposite tack without recognising the imperative need for measures to deal with the fundamental problem of exports and import penetration. This basic miscomprehension was compounded by the fact that the economy has considerable momentum in the short term. It took time for the ill effects of each overreaction to make themselves felt. Each round of ills could be blamed on past mistakes and there was always a delay during which Ministers could claim that current policies would eventually succeed.

Consequences of stagnation throughout the 1970s

The effect of stagnation of demand and production on productivity is illustrated in Chart A5 on page 24. It certainly cannot have assisted British industries to export or to compete against imports. It led to a fall of over one million in business employment at a time when the labour supply was expanding. In spite of a rise of one million in public service employment, unemployment therefore rose to nearly 1.5 million.

The other major consequence of the stagnation of production has been a rise in the burden of taxation and slow growth in real take-home pay. The end of the 1960s affords a distorted starting point for examination of this particular trend because taxation was then at a cyclical peak (under Mr Jenkins' measures designed to eliminate the balance-of-payments deficit) and real wages were being squeezed by a combination of high taxes, the 1967 devaluation, and a statutory incomes policy. Thus the 1970s started with a major wage break-out involving what were at the time unprecedented, double-figure money pay settlements. The long-run trend will stand out most clearly if we take 1964, the end of the 'never-had-it-so-good' era, as our starting point.

Table 2.2 shows changes between 1964 and 1979 in the ratio of public spending and taxation to gross national product (GNP). Public expenditure on goods and services increased little as a share of national income, largely because public investment was heavily cut after the mid 1970s. The long-run reason for the large (6% of GNP) rise in the tax burden which took place was a huge increase in social benefits and other grants relative to national income. This was partly due to the growing number of pensioners and to a rise of nearly 4% per year in average real benefit paid per capita of the aided population. But the increase in grants relative to national income was also very much due to unemployment, slow growth of productivity, and other consequences of recession. Over half of the increase in the tax burden can be directly attributed to unemployment and slower productivity growth in the 1970s.

Table 2.2 Changes in the tax burden, 1964-79

	1964	1979
(Percentage of GNP)		
Public expenditure on goods and services	23.8	26.5
less net interest and borrowing	– 4.9	– 6.5
less North Sea tax revenue	0.0	– 0.7
Resource expenditure chargeable against general taxation	18.9	19.2
plus social benefits	6.1	10.4
plus other grants (including net contribution to EEC budget)	1.4	3.1
Taxes and National Insurance (NI) contributions less subsidies	26.4	32.7
(Percentage of gross money earnings)		
Income tax and NI contributions	15.2	23.8
plus taxes less subsidies on consumption	12.7	12.4
Net tax burden on employees	27.9	36.2

Chart 2.1 Stop-go: domestic spending and the balance of payments

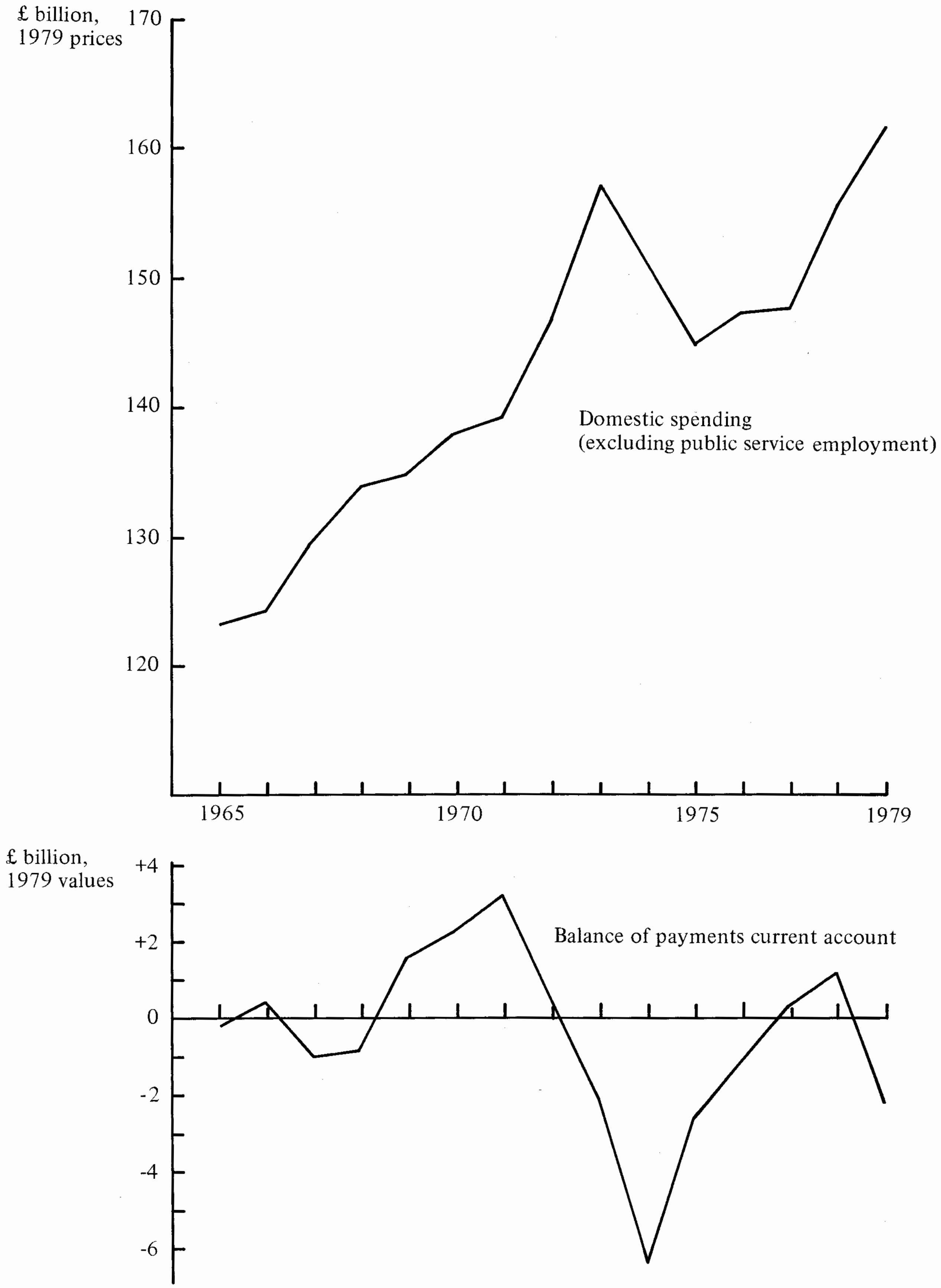


Chart 2.2 Stop-go: incomes policies and wage settlements

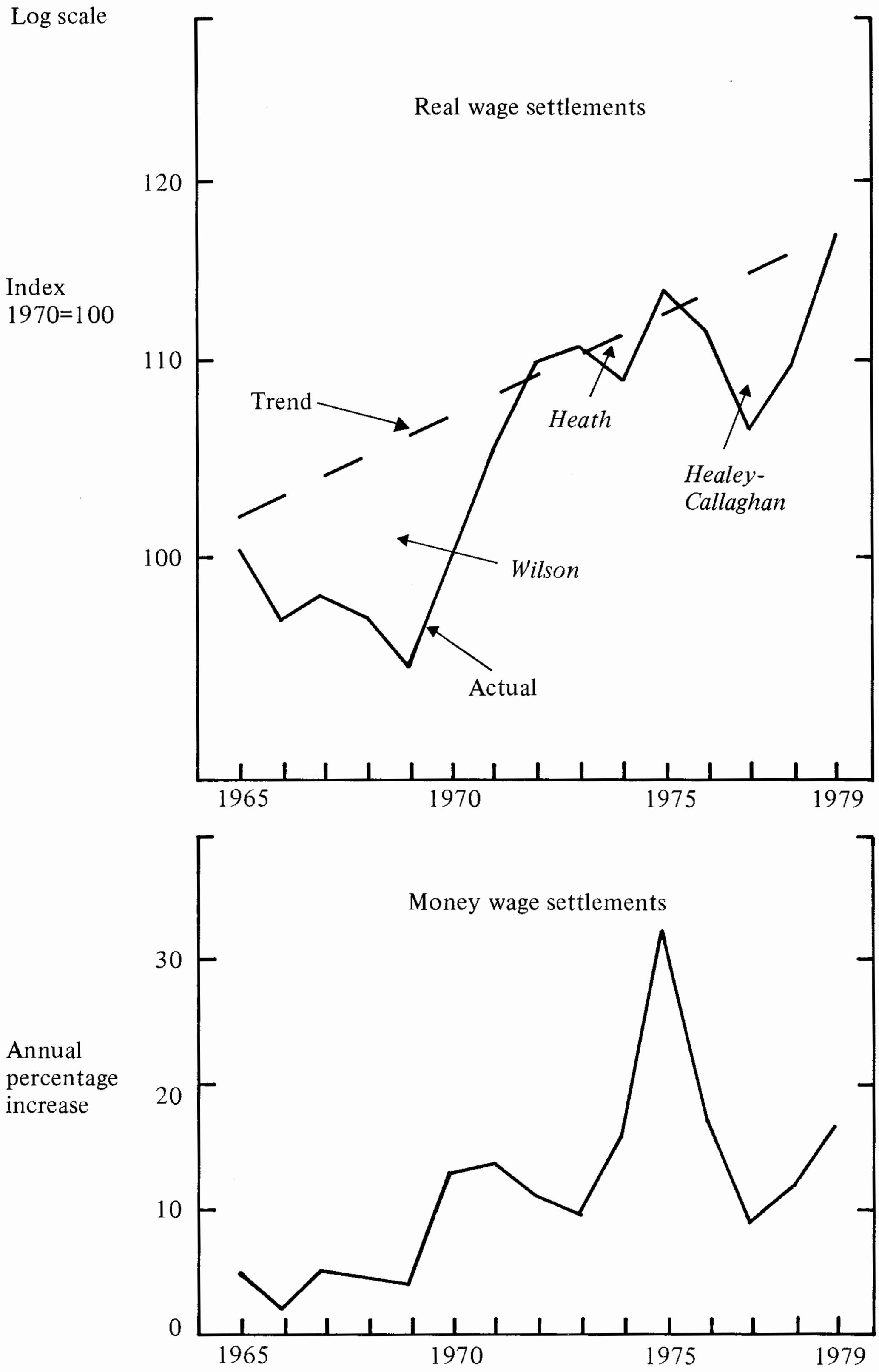
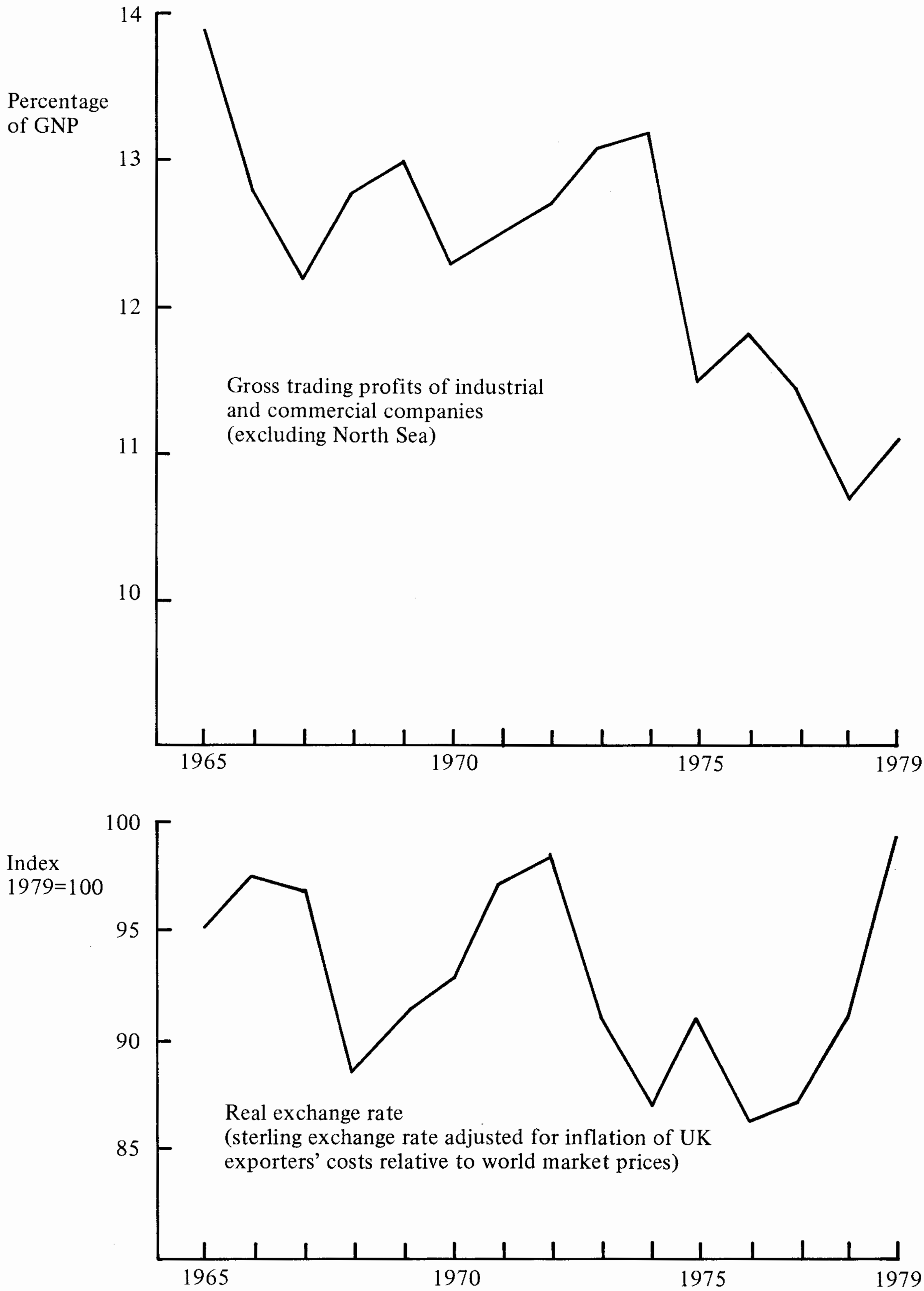


Chart 2.3 Stop-go: company profits and the exchange rate



The tax burden fell disproportionately on employees because, as profits declined, corporate income and investment were increasingly exempted from tax. As a percentage of gross money earnings, the average net tax from employment incomes (National Insurance contributions, income tax and indirect taxes on consumption less subsidies) rose from 28% to 36% between 1964 and 1979, having peaked at 38.5% in 1976. This large rise in taxation, together with higher energy and food prices, held the average growth of real take-home pay (standardised for changes in demographic composition of the labour force) below 2% per year. Given that wage drift alone pushes up earnings by at least this amount relative to nationally negotiated wage rates, it is small wonder that the end of the 1970s saw an incomes policy collapsing with a wage break-out larger than that which had heralded the start of the decade.

The failure to provide sufficient growth of real earnings closed the trap. Growing wage pressure has made devaluation increasingly ineffective and risky. The cost position of UK industries has worsened relative to that of their foreign competitors. Exports have suffered and import penetration has increased.

The present government's strategy

The new Conservative government takes a very distinct view of what is required to improve Britain's economic performance. As the Chancellor put it in a recent letter to the Treasury and Civil Service Committee:

> The poor trend in our trade performance in recent years, which reflects the UK's inadequate industrial performance, is a matter of concern. The way to improve this, however, is not by a depreciation of the exchange rate – since any gains to competitiveness will in turn be eroded – but by higher productivity and lower cost increases. The Government believe, therefore, that overriding priority must be given to reducing inflation, which impairs economic efficiency and discourages investment, and to strengthening the supply side of the economy.

The first of these two overriding priorities is to be met by progressively reducing the growth of the money supply, which is regarded as 'the only way of achieving a permanent reduction' in the rate of inflation. The second priority is to be met by 'restoring incentives so that hard work pays, success is rewarded and genuine new jobs are created in an expanding economy' (Conservative Manifesto, 1979). To this end, the intention is 'to cut income tax at all levels', with the long-term aim of reducing the basic rate 'to no more than 25 per cent' and to encourage market forces 'to work as freely and flexibly as possible' (Sir Geoffrey Howe's letter). According to the Chancellor, therefore, the budgetary measures taken last June 'should not be viewed as traditional Keynesian reflationary or deflationary devices' but rather 'as first steps towards restoring incentives for long-term recovery' (Sir Geoffrey Howe as reported by the *Wall Street Journal* in August 1979).

This economic programme contains very serious flaws, as will now be shown. Whatever the Chancellor says, its short-term effect will be to cause a fall in non-oil exports, a worsening of import penetration and an unprecedented deflation of demand and output. This implies that there will in practice be no scope for general tax cuts. Finally inflation, already aggravated by higher VAT and other measures taken by the new government, rather than being permanently reduced is likely to remain exceptionally high.

The prospect of deflation

The most perverse aspect of the new policies is that restriction of the money supply has caused an *appreciation* of the exchange rate which will make trends in trade even worse than before.

By February 1980 the weighted-average exchange rate for sterling was 17% higher than at the end of the last period of devaluation in 1976. Over the same period costs in Britain had risen by about 14% more than the average of those for our competitors. Thus the cost position is in foreign currency terms some 30% worse for UK exporters relative to foreign competitors than it was in 1976 – a good 10% worse than *ever* before. By next year, if the exchange rate holds up, the deterioration since 1976 will have been over 35%.

Under these circumstances it must be expected that non-oil exports will *fall* over the next two years by a total of 6-8%. This will more or less cancel out the trade gain to be expected as Britain becomes a net exporter of oil and means that non-oil imports would have to remain roughly constant in real terms unless the balance-of-payments deficit were to grow larger.

At the same time the government's policy of fiscal and monetary restriction is designed to hold down both public and private borrowing. If this succeeds the balance-of-payments deficit (which represents net borrowing from abroad) cannot expand. Therefore with rising import penetration, there will have to be a fall in home spending and output. Our estimate is that, as stocks are run down, gross domestic product (GDP) as a whole will fall by about 8% between 1979 and 1981, and business output (ie GDP less North Sea production and public service employment) will fall by about 10%.

The largest previous two-year fall since the war was only 4% for GDP and 5% for business output (between 1973 and 1975), and we cannot be sure whether the collapse will be as rapid as calculations suggest. But if it is slower, this will only be because of higher public or private borrowing (despite restriction of the PSBR and the high cost of bank credit) and the balance of payments will remain in larger deficit. Moreover, given for the first time the prospect of a simultaneous fall in non-oil exports and a domestic fiscal and monetary squeeze, the recession is certainly likely to be sharper and larger than on previous occasions.

The effects on unemployment will probably be dramatic. Again for the first time, there will be *simultaneous* cuts in public service employment (possibly several hundred thousand) and in business employment (of the order of one million). Unemployment could well exceed 2.5 million before the end of next year.

The adverse effects of recession on business efficiency will evidently overwhelm any beneficial consequences of increased competition and lower income tax. Studies carried out in both the UK and the USA have failed to find any significant effect of taxation either on work effort or on labour supply (see, for example, Stern (1976)). In any case the international competitiveness of industries depends less on increased work effort than on the introduction of new products and processes and the installation of new plant and machinery, all of which will be made more difficult by recession and the additional profit squeeze caused by the overvalued exchange rate. The Conservative Manifesto argued last year:

> Lower taxes on earnings and savings would encourage economic growth. But on their own they would not be enough to secure it. Profits are the foundation of a free enterprise economy. In Britain profits are dangerously low.

Yet, as a result of monetary restriction, profits from now on will be much lower than the level considered 'dangerous' a year ago.

The scope for tax cuts

The second serious miscalculation has been the expectation that by cutting public spending the government could significantly reduce the burden of taxation. In the context of redundancies, trade unions have often pointed out that little money will be saved because the government automatically loses tax revenue and has to pay additional unemployment-related benefits. But the full implications of having a welfare state in a high-unemployment, balance-of-payments constrained economy have not been properly understood. The principle of income-maintenance underlying the welfare state clearly implies that, in times of recession, those who remain in work will pay higher taxes to support the unemployed.

At present the average tax burden (National Insurance contributions, direct and indirect taxes less subsidies, public sector rents and trading profits) comes to about 40% of national income. This pays for domestic benefits and grants (12.5% of GNP), government employment and domestic purchases (23% of GNP), and government imports (such as those needed for defence) and grants abroad including payments to the EEC (4.5% of GNP). But the tax burden cannot be attributed *pro rata* to those items because if the government cuts expenditure there will in general be changes in the tax base (GNP) and in the cost of unemployment-related benefits.

The broad features of the system may be demonstrated by a simplified calculation of the effects of removing the various items of public spending step by step.* Starting from the existing average tax burden equal to 40% of GNP, consider first the implications of eliminating government imports and spending abroad. This could provide a substantial gain to taxpayers since there would be no direct loss of domestic employment. Indeed there would be an indirect gain as a result of the government's foreign-exchange saving. If the foreign-exchange content of government spending were entirely eliminated, the average tax rate could fall from 40% to 30% without any reduction in the jobs and services provided by government employment at home.

Now suppose that, in addition, all government employment and spending on domestic value-added were abolished – ie that the government retained only its residual function as caretaker of the national insurance system. Abolishing the government's domestic spending would eliminate a huge range of services and some 5 million jobs without yielding any more foreign exchange to sustain a counterpart expansion of private spending. The cost of unemployment benefits would escalate and this would have to be funded from a smaller tax base in terms of employment and GNP. This time tax rates could only be cut by under 0.5% for every 1% cut in spending. If all domestic spending programmes were abolished, the average tax rate could be reduced by about 12.5%. Thus the *minimum* average tax rate, with no public services and investment at all, would still be as high as 17.5%, or not much less than half the rate we actually pay.

The government's hopes of reducing tax rates therefore run into more serious problems than most people suppose. Being committed to defence and to aid for developing countries, it has little chance of making foreign exchange savings (unless the EEC agrees to a reduced British contribution). If the government cuts spending at home, it increases unemployment and has to make large cuts in public services to achieve small tax savings, so that taxpayers receive worse value for money. The final option, cuts in the level of income-maintenance itself, is particularly sensitive in the present context of recession.

One way out which the government has clearly abjured would be to risk financing tax cuts by increased borrowing, at the expense of a larger balance-of-payments deficit.

It is beginning to look increasingly as though the government, finding itself unable to make real cuts in expenditure of a kind which would lead to genuine tax reductions, is having recourse to 'cuts' which are not themselves distinguishable from tax increases. This happens most clearly when there is a rise in charges for services, such as prescriptions or school meals, which appear by convention in the public accounts as negative expenditure. It also happens when stringent cash limits are imposed on nationalised industries or local authorities, forcing them to raise prices (or rates) well in excess of the general rate of inflation. In reality, increases in charges, rates and nationalised industry prices are tax increases as much

*Assuming a zero balance of payments and that exports and the import content of private spending remain unchanged, the average tax rate under different public spending assumptions is given by

$$t = \frac{m\,(yL + GE + GM)}{X + mGE - (1-m)\,GM} - \frac{y}{p}$$

where GE is government spending on domestic value-added, GM is government imports and payments abroad, X is exports, m is the import content of private expenditure, y is the guaranteed income level of the adult-equivalent population L (employed, unemployed and inactive), and p is GNP per employed person.

as a rise in income tax is. Indeed what has actually been achieved so far is an *increase* in the overall tax burden, but with redistribution to benefit high-income taxpayers.

Monetary policy and inflation

The final element in the government's strategy, its hope that restriction of the money supply would control inflation, although with a time-lag, looks totally unreal in the light of recent experience. Growth of the money supply has been held down to around 11% per year for the past *five* years (although it went up a little more in 1978). The monetarist claim is that control of the money supply after a time lag of up to two years – perhaps a bit more, perhaps a bit less – is a necessary and sufficient condition for reducing inflation. After five years of restraint the effects on inflation are now long overdue, and the clear evidence that inflation of both wages and prices has recently been *accelerating,* to levels far in excess of previous monetary growth, entirely confutes the monetarist claim (see Table 2.3). It is not possible within the monetarist system of beliefs to attribute any part of the acceleration to an exogenous increase in oil or other commodity prices.* Nor can accelerated wage inflation in the private sector be attributed to distortions caused by the incomes policy of the previous government, since it was public sector pay which had been held down in relative terms.

Table 2.3 The money supply and inflation

(percentage increase over previous year)

	Money supply (M3)	Retail prices	Average earnings
1975	6.6	24.2	26.5[a]
1976	9.5	16.5	15.6[a]
1977	10.0	15.8	9.1
1978	14.9	8.3	13.0
1979	10.9	13.4	15.4
January 1980	11.4	18.4	19.9

[a] Old series for production industries and some services

Monetary restriction is in fact contributing to high inflation by intensifying the tax burden and pushing up interest rates. It is true that in the short run the strong exchange rate induced by monetary restriction helps to ease inflation by holding down the sterling price of imports. But in the longer run, as it damages exports and encourages import penetration, the effect is to reduce GNP and thereby raise the tax burden. After three years with a strong exchange rate, the longer run has now arrived. Higher VAT, local rates, public charges and nationalised industry prices are now a major element in the accelerating inflation.

Matters can be expected to worsen. With falling exports and rising import penetration, the public sector's financing problems will become enormous. Without corrective action, the PSBR will be likely to rise to about £20 billion at current prices next year, as increased North Sea revenue is swamped by falling non-oil tax receipts and insurance contributions, reduced nationalised industry profits and the escalating cost of unemployment-related benefits (see Table 2.4). In the short run the problem will be compounded as government employees recoup losses under Labour's incomes policy through comparability awards which are additional to their normal annual pay settlements. Local authorities in particular face an average pay rise of about 25% for the 1980/81 financial year – far in excess of the 14% assumption on the basis of which the government costed the cash limits for this year's rate support grant.

If the public finances do get out of control, and for this or other reasons the overvalued exchange rate starts to fall, a new inflationary risk will appear. The official exchange reserves, in excess of $20 billion, are adequate to cover official foreign currency debt and overseas holdings of government securities. But now that exchange controls have been abolished, there is nothing to stop domestic residents and companies operating in Britain from switching their funds into foreign currencies.

The Weimar hyperinflation, often quoted by monetarists as if it supported their case, was in fact an extreme example of exchange-rate collapse interacting with domestic inflation and government bankruptcy. The study by Bresciani-Turroni (1937) makes it clear that the collapse of the German mark was precipitated by its external depreciation as prices came to be indexed on the dollar and people tried

Table 2.4 Prospects for the public accounts, 1979-81

(percentages of GNP)

	1979	1981[a]
Public expenditure on goods and services	26.5	29.3
Grants (including EEC contribution)	13.5	15.4
Total grants and resource expenditure	40.0	44.7
North Sea tax revenue	0.7	2.0
NI contributions and other tax revenue less subsidies	32.7	33.6
Trading profits and rents less debt interest	1.0	0.2
Net revenue	34.5	35.9
Financial deficit	5.5	8.8

[a] Estimates on pre-Budget policies with taxes indexed for inflation.

*It is the monetarists' standard claim that inflation in 1974 and 1975 was entirely the consequence of monetary expansion in 1972 and 1973, and nothing at all to do with the rise in oil and commodity prices nor even with the ill-fated threshold scheme.

to convert their money into foreign exchange. The point is that, in the absence of exchange control, if the public loses faith in a currency there is little the government can do. Public finances fall into disorder as tax receipts lag behind the fall in the currency and the government is forced to print money.

The situation in Britain now is still far from being as chaotic as that in Germany after World War I. But the government is taking increasing risks in the name of free markets. The inflationary position in Britain is unstable, public finances are unsound, and the risk of exchange-rate collapse is considerable. It is all too likely that a severe inflationary penalty will have to be paid for Britain's 'monetarist experiment'.

Pressures for a policy change

The new government seems to have expected, like many commentators, that North Sea oil would abolish Britain's balance-of-payments problems. Being opposed to incomes policy, it believed it could rely on restriction of the PSBR and money supply, and the strong exchange rate which these encouraged, to hold down inflation. At the same time the government intended to make further cuts in public expenditure and reduce taxes, believing that this would stimulate business expansion.

Already the programme has visibly gone wrong. After the May 1979 election the new Chancellor found that official assessments of the economic situation were far worse than expected. He was obliged to publish forecasts, unprecedented in the postwar period, that output would *fall* in the coming year under the government's own proposals. Inflation accelerated sharply, the balance of payments went into deficit and by the end of the year unemployment was rising once more. Clearly the government had misunderstood the situation it would inherit.

The government's programme contained three basic flaws. The most serious was to ignore the devastating implications of a rising sterling exchange rate, accompanied by domestic inflation in excess of that in competitor countries, for Britain's already weak trading position. The second mistake was to imagine that the government would be able to afford significant tax cuts and thereby stimulate better business performance. The final error was to assume that control of the money supply would necessarily bring down the rate of inflation.

These basic miscalculations at the heart of the government's programme are creating an unprecedented recession which is progressively undermining the public sector's finances. It seems inevitable that as output falls and the financial position becomes uncontrollable, the programme will have to be abandoned.

The immediate consequences will be a fall in the exchange rate (presumably leading to the reintroduction of exchange controls), a less restrictive target for the PSBR and, almost certainly, another incomes policy aimed at preventing an exchange-rate/price/wage spiral. Thus, at minimum, the familiar assortment of 1970s policies would be re-established.

A return to conventional policies

We have made a careful attempt to think out what the medium-term future would look like if the government, whether deliberately or under compulsion, were to abandon its present strategy and resort to what has hitherto been thought of as conventional policy. More precisely we consider what would happen if fiscal and monetary policy were used, once again, to expand domestic demand to the maximum extent consistent with equilibrium in the current balance of payments. Such a policy would certainly result in a substantial fall in the exchange rate and would most likely be accompanied by a new incomes policy.

In carrying out this exercise we are very conscious that the assumptions are even more arbitrary than usual, as we are postulating that the country will have passed through a period of exceptional chaos with unemployment and possibly inflation having reached levels unprecedented in the postwar period.

To bring precision to the simulation (given in detail in the Statistical Appendix) it has been assumed that there will be a large (over 20%) fall in the exchange rate at the end of this year, accompanied by a very tough incomes policy which cuts wage settlements in real terms by 11.5%, ie back to their 1977 level.

We can be reasonably confident that after such a devaluation exports would eventually rise again and therefore that the government could allow a gradual recovery of home demand to take place without generating too large a trade deficit. Import penetration would on past evidence still rise – although not as fast as recently. By 1983 the *fall* in GDP caused by present policies could more or less have been recovered. The PSBR would look very large (£15-20 billion at current prices). However this could be regarded as a virtue since it would be the counterpart, not of uncontrolled slump, but of a deliberately stimulated recovery of activity.

The immediate problems would be that the recovery would come too late to prevent unemployment from rising to a level in excess of 2.5 million, that the severe incomes policy on which the strategy rested would after a time break down, and that sterling might still look unsafe, having fallen so far. If the incomes policy started to break down, 25% pay settlements and 20% consumer price inflation could be expected once again. Worse still, the danger of a resurgence of inflation might, as it always has in the past, tempt the government to support the exchange rate and thereby abandon any hope of preserving the international competitiveness of British industries.

Even supposing that the lesson had been learnt and that the cost advantage were not sacrificed, further effective devaluation so as to increase this advantage would be out of the question, at least for several years. Therefore the old problem of slow growth would soon reassert itself. North Sea oil would have reached its production peak, export competitiveness would still be no better than in the 1970s, industries would have been weakened by the 1980 slump and unemployment would remain far higher than in the 1970s. Worst of all is the prospect of absolute decline as the progressive exhaustion of North Sea reserves begins, in five to ten years, at a time when our industrial base would have become so weak.

The alternative strategy once again

Given the probability that a modest recovery is the best that devaluation could achieve for the early 1980s and that greater difficulties must be expected in the late 1980s, there may be some hope that the case for import restrictions will be more fully considered.

In the remaining part of this chapter we examine the implications of using tariffs, assuming only limited foreign retaliation, to secure a sustained recovery of the economy during the 1980s. Other more sophisticated forms of import control such as marketed licences can be thought of as having a tariff equivalent. The advantage of studying a tariff package is that this enables us to estimate explicitly the degree of protection involved and the impact of import control on costs and prices (including those of exporters) as well as on government revenue. The tariff rates assumed in illustrative calculations here and in the Statistical Appendix are 20% for semi-manufactures, 30% for finished manufactures, 15% for services (foreign travel, shipping, etc.), and zero for food, oil and raw materials, imposed as from the start of 1981.

As a counterpart to the tariff policy we have assumed that the economic aspects, at least, of Britain's membership of the EEC will come to an end (including application of the Common Agricultural Policy), and that the Community's external tariff will be applied against UK exports. This and other consequential losses of preference might cause the equivalent of a 5% reduction in total UK exports of goods and services to all destinations as compared with what would otherwise have happened (given the level of cost-competitiveness).

It is also sensible to suppose that devaluation will happen anyway. Indeed if tariffs were introduced without any fall in the sterling exchange rate, UK exporters would be placed at an extraordinary disadvantage through loss of preferences abroad and the higher cum-tariff cost of imported materials and components, on top of their present appalling relative cost position. Thus a tariff policy would only make sense if it were accompanied by a substantial devaluation of sterling to compensate exporters. The devaluation would, we assume, require a short-term incomes policy to reduce its inflationary aftermath.

The combination of tariffs and devaluation should permit a substantial reflation of home spending without any large trade deficit. It is not possible to estimate from past experience how successful a given level of tariffs would be in deterring import penetration because the UK's postwar history has been one of a steady reduction in tariffs, only briefly (and to a very minor degree) interrupted by the import surcharge imposed in 1964. The response would certainly be greater for finished manufactures than for semi-manufactures or services which are less easily substituted by home production. Our best guess (which is not incompatible with data for the past) is that tariffs of 30% on finished manufactures, 20% on semi-manufactures and 15% on services would be sufficient, in combination with a devaluation, to reduce imports of finished manufactures in the period 1981-85 (expressed as a proportion of total spending) to a little below their 1979 level. The total import and North Sea content of home spending would remain slightly higher than in 1979 because of rising oil prices and the rebuilding of raw material stocks.

This modest degree of restraint on imports, in combination with North Sea earnings, would make it possible at least to restore 1979 levels of spending and output by the end of 1981 and to maintain expansion averaging 3-4% per year for two or three years thereafter. This may not seem much of an achievement, but it would represent a huge improvement compared with what will otherwise happen. Unemployment, instead of rising to 2.5 million next year, could be held at about 2 million. There would be sufficient resources for higher investment and public spending as well as consumption. The tax burden on wage-earners could be reduced to the mid 1960s level and real take-home pay would be a good 10% higher than in 1979. Consumer price inflation would fall below 10% as long as the incomes policy lasted. When incomes policy was abandoned or broke down, money wage settlements could still be lower than has usually been the case in such circumstances.

Assuming the tariff-cum-devaluation policy could be introduced successfully, the most important question is whether and how the benefit to production and employment could be sustained in the longer term. This is a question not only of macroeconomics but also of industrial policy. Moreover, past trends might well be modified in the new situation. However, the problem of sustaining expansion of the economy throughout the 1980s is bound to be a difficult one, not only because of the disastrous position from which we start and the likelihood that international trade and finance will remain in disarray, but also because after 1984 the volume of North Sea oil and gas production will stagnate, making Britain a net importer of oil by 1990 if economic growth is achieved.

There are two macroeconomic strategies which could be pursued to help keep expansion going: additional devaluation, and the tightening of import restraints. The best policy would probably be some combination of the two. In any case it cannot now be foreseen whether an internal recovery in the next few years will leave British industries sufficiently well placed to take advantage of progressive devaluation, nor what the state of world markets is then likely to be. Since it is important to try to check that a tariff policy would not lead into an entirely blind alley, the approach followed here is to make the pessimistic assumptions that world trade will not expand quickly, that little further devaluation will prove worthwhile, and that world oil prices will rise steadily in real terms in the late 1980s. In these circumstances growth of the economy would have to be sustained by rising tariffs.

The results of very tentative calculations (illustrated in the Statistical Appendix) are that by 1990 the highest tariff rate, that on finished manufactures, might have to reach about 70% to sustain growth of business output at 4% per year (sufficient to achieve a slow fall in unemployment). Levels of public and private expenditure would by then have risen about 50% over the decade (starting from the depressed 1980 position). If tariffs were raised this high, they would have become the main source of public revenue, far exceeding revenues from the North Sea, and providing a yield about equal to that of all other direct and indirect taxes (less subsidies) put together. Thus, for example, if income tax and National Insurance contributions were to be maintained at present levels, virtually all other taxes including rates and VAT could have been abolished. Real wages would be about 40% higher than in 1979, an improvement which might have been sufficient to stabilise (if not eliminate) inflation, without a permanent incomes policy.

It may be that an economic recovery of this magnitude could be achieved without such high tariffs if UK industries take advantage of sustained expansion by modernising more rapidly than in the past. It may also be that the world recession will come to an end, providing better opportunities for UK exports. In either of these circumstances, the opportunities provided by a tariff-cum-devaluation strategy are flexible; greater reliance could be placed on depreciation of the exchange rate and tariffs could be cut. The main point is that the tariff element of the strategy would provide some assurance that economic recovery could be sustained, come what may, and that Britain would have a stronger productive base with which to face the 1990s.

International agreements and retaliation

Of the various formal international arrangements concerning trade between countries, by far the most important are the General Agreement on Tariffs and Trade (GATT) and the Treaty of Rome. The latter agreement is discussed in Chapter 3 which is concerned with Britain's membership of the European Community.

As far as the GATT is concerned, Britain's formal commitments are substantially contained in the text of the Agreement as amended in 1969.*

The general objective of the GATT, as stated in its preamble, was that trade relations should be aimed at 'raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, developing the full use of the resources of the world and expanding the production and exchange of goods'. To this end tariffs, once settled under GATT negotiations, were not to be raised (Article II (1)) and quantitative restrictions were, in general, to be eliminated (XI (1)).

It is well known that 'emergency action on imports of particular products' is permitted under Article XIX where serious injury to domestic producers is threatened, and requests for import restrictions under this article have been made from time to time.

Article XII however, although much less frequently invoked, specifically permits import controls by any country that in a general way needs to 'safeguard its external position' (XII (1)). Moreover, although restrictions should be reduced as quickly as possible (XII 2(b)), it is explicitly recognised that these restrictions need not be lifted *as long as domestic policies directed towards the maintenance of full employment cannot be implemented in the absence of those restrictions* (XII 2(d)).

The questions now arise whether Britain can establish that it is a deficit country in the relevant sense and, if so, what conditions would be attached to use of import restrictions under Article XII.

The circumstances under which import restrictions may be instituted (XII 2(a)) are where they are needed by a country 'to forestall the imminent threat of, or to stop, a serious decline in its monetary reserves'. In addition there must be immediate consultation with the GATT, which may sponsor discriminatory retaliation if the statutory conditions are not satisfied (XII (4)); it is up to the International Monetary Fund (IMF) to decide whether or not this is so (XV (2)).

The crucial condition, set out in terms of a threat to the reserves, does not at first sight apply very comfortably to the British predicament, because at the moment sterling is strong and the reserves are relatively high and rising.

Although it is always open to a deficit country to protect its reserves by inducing a domestic recession and mass unemployment, it is entirely inconsistent with the intention of the GATT, as expressed in the preamble and elsewhere, that any country should be forced into recession as the permanent remedy for an external deficit.

It should not therefore be necessary for a deficit country actually to generate a loss of reserves by fiscal expansion before Article XII can be successfully invoked; it should be enough to establish the conditional proposition that there would be a reserve loss *if* effective demand were raised enough to secure full employment. This interpretation is supported by the passage (XII 3(d)) already referred to which conditionally permits import controls* for as long as there is a conflict between full employment and balance-of-payments equilibrium.

Another crucially important condition attached to the use of import restrictions under the GATT is that they shall be non-discriminatory as between countries; indeed the whole purpose of Article XIII† is to establish this principle.

*GATT (1969). In addition, in 1979 the government signed the 'Draft Declaration on Trade Measures taken for Balance of Payments Purposes' which reinforced but did not substantially alter the provisions in the articles of the General Agreement.

* 'The contracting parties recognize that, *as a result of domestic policies directed towards the achievement and maintenance of full and productive employment* or towards the development of economic resources, a contracting party may experience a high level of demand for imports involving a threat to its monetary reserves. . .' (our italics)

† See in particular XIII (1): 'No prohibition or restriction shall be applied by any contracting party on the importation of any product of the territory of any other contracting party or on the exportation of any product destined for the territory of any other contracting party, unless the importation of the like product of all third countries or the exportation of the like product to all third countries is similarly prohibited or restricted'.

The text of the GATT is somewhat obscure about what instruments may be used. Article XIII rather gives the impression that restrictions should take the form of quotas, although it adds (XIII 2 (b)) that 'in cases in which quotas are not practicable the restrictions may be applied by means of import licenses or permits without a quota'. The apparent predilection for quotas is rather surprising, because it would seem that these are in practice much more likely to prove discriminatory than tariffs are. Moreover, the imposition of a quota is more likely than a tariff to conflict with another principle (XII 3(a)) that 'it is desirable, so far as possible, to adopt measures which expand rather than contract international trade'. In practice, when in recent years import restrictions of a general kind have been used on a temporary basis (eg by the USA, Britain and Italy), these have been of the tariff type.

Taken all in all the Articles of the GATT are far less dogmatic about trade restrictions than seems to be generally supposed. The spirit of the Agreement is to sponsor the achievement of full employment in every country; and throughout the text it seems clear that the non-discriminatory principle is of considerably greater importance than that of free trade itself. The importance of this, the so-called 'most favoured nation' principle, is emphasised right at the start, in Article 1:

> With respect to customs duties and charges of any kind (in connection with imports or exports)... any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.

Our conclusion from all this is that if our analysis of Britain's strategic predicament is correct, and the IMF can be persuaded of this, far from the GATT making it impossible for us to impose import controls the provisions of Articles XII and XIII do, specifically, permit their use on a non-discriminatory basis.

It might, of course, turn out to be difficult to persuade the IMF that Britain's condition is such as to meet the criteria set out in XII 2 (a) because our reserves have been rising. It would however seem wholly unreasonable to expect Britain to generate an expansion of home demand on a scale that would lead to a loss of reserves before the criteria are considered to be satisfied. If this course of action were taken, domestic demand would have to be cut back to some extent after the imposition of controls and the pattern of expansion would have been disorderly and wasteful. It would be vastly preferable to adopt a 'twin-instrument' approach to demand management, with the impetus coming in a balanced way simultaneously from external and internal forces.

The fact which the UK needs to convey forcefully to the IMF and to its trading partners is that the boom in imports to Britain, fed by North Sea oil, must in any case come to an end because our foreign exchange earnings will be insufficient to pay for more. The total volume of imports will have to fall a little in the next two years as a result of domestic deflation, if not of tariffs. Even after an effective devaluation of sterling to boost non-oil exports, the total volume of UK imports would only be able to rise slowly. Imports of manufactures, in particular, will be roughly stationary whatever policy is followed (see Table 2.5). Thus if tariffs are introduced, their purpose will be to permit internal recovery, not to cut imports by more than would have happened through internal deflation.

This discussion of the formal position with regard to GATT by no means disposes of the argument that retaliation could be a serious obstacle to a successful policy of expansion based on import control. And it has to be recognised that, in the extreme case, if *every* country exercised the maximum of discriminatory retaliation against us such a policy would be bound to fail.

Table 2.5 Volume of imports, with and without tariffs

(at 1975 market prices, £ billion)

	1979	1981[a]		1983[a]	
	Actual	No tariffs	With tariffs	No tariffs	With tariffs
Finished manufactures	10.9	11.2	10.4	13.2	11.2
Semi-manufactures	8.0	7.2	7.8	9.1	9.7
Total manufactures	18.8	18.4	18.2	22.3	20.9
Food, raw materials, fuel	9.9	8.0	8.5	8.1	9.1
Total goods	28.7	26.4	26.7	30.3	30.0
Services	6.3	5.9	6.1	6.1	6.3
Total goods and services	35.0	32.3	32.7	36.4	36.3

[a] Figures for 1981 and 1983 are derived from the 'base' projection and 'tariffs' projection given in the Statistical Appendix.

However, as we have argued before, provided Britain's policies are such that imports are not lower in total than they otherwise would have been, the rest of the world is not being harmed, on balance. Second, should some countries exercise discriminatory retaliation in response to non-discriminatory protection by Britain it would be those countries, not Britain, who would be acting in contravention of the GATT. And quite apart from this legalistic point, we may note that a breach of the most favoured nation principle (of which Britain would not be guilty) might be seen by other countries as a very dangerous step towards a general trade war of a kind from which everyone would suffer and which everyone should fear.

References

Bresciani-Turroni, C. 1937. *The Economics of Inflation,* London, Allen and Unwin

General Agreement on Tariffs and Trade (GATT) 1969. *Basic Instruments and Selected Documents,* vol. IV, Geneva

Stern, N. 1976. *Taxation and Labour Supply – A Partial Survey,* London, Institute for Fiscal Studies

Appendix

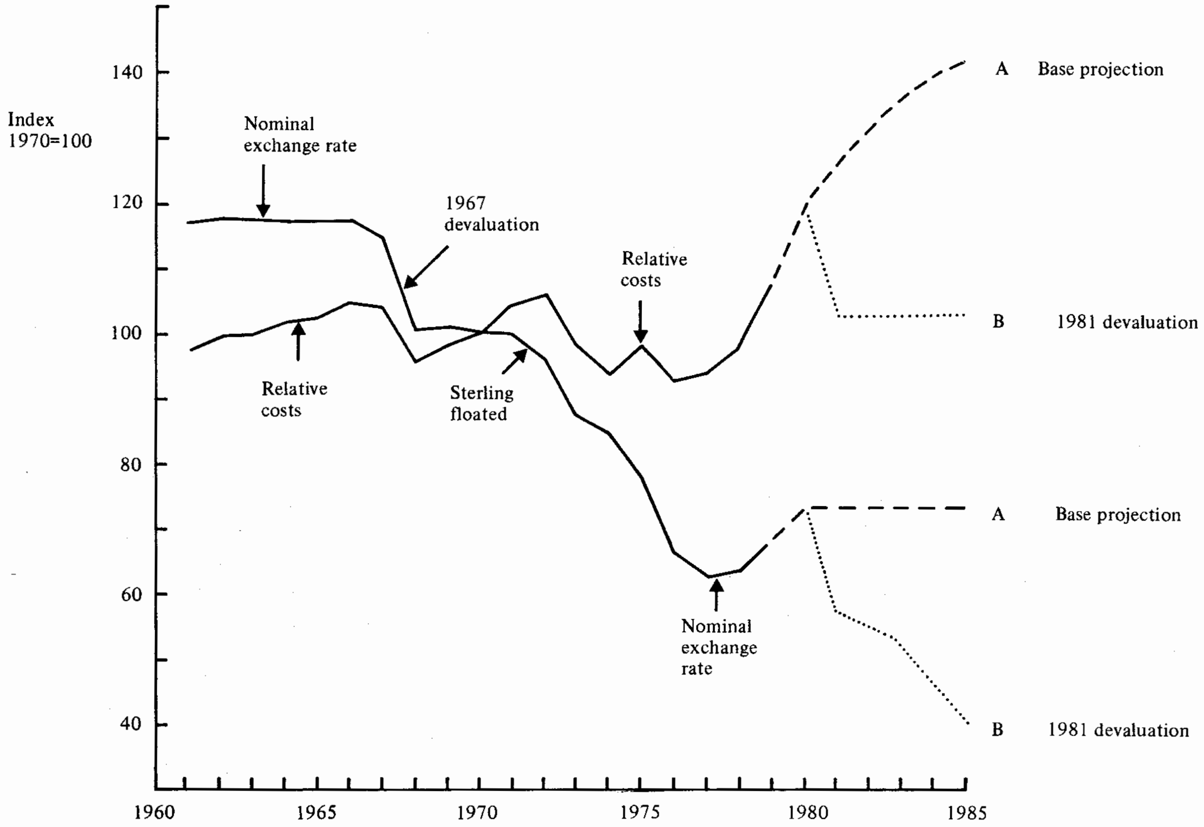
This Appendix presents the main quantitative elements of the historical analysis and projections on which the preceding chapter is based, displayed in the form of seven charts, each accompanied by a brief textual note outlining the main features of past changes and one or more conditional projections (tables of historical data and projections are given in the Statistical Appendix at the end of the *Review*).

Contents:

Key:

—— Historical levels or changes
---- Projection A: base projection assuming a fixed nominal exchange rate
.... Projection B: devaluation in 1981 accompanied by a short-term incomes policy

Chart A1 Relative costs and the exchange rate



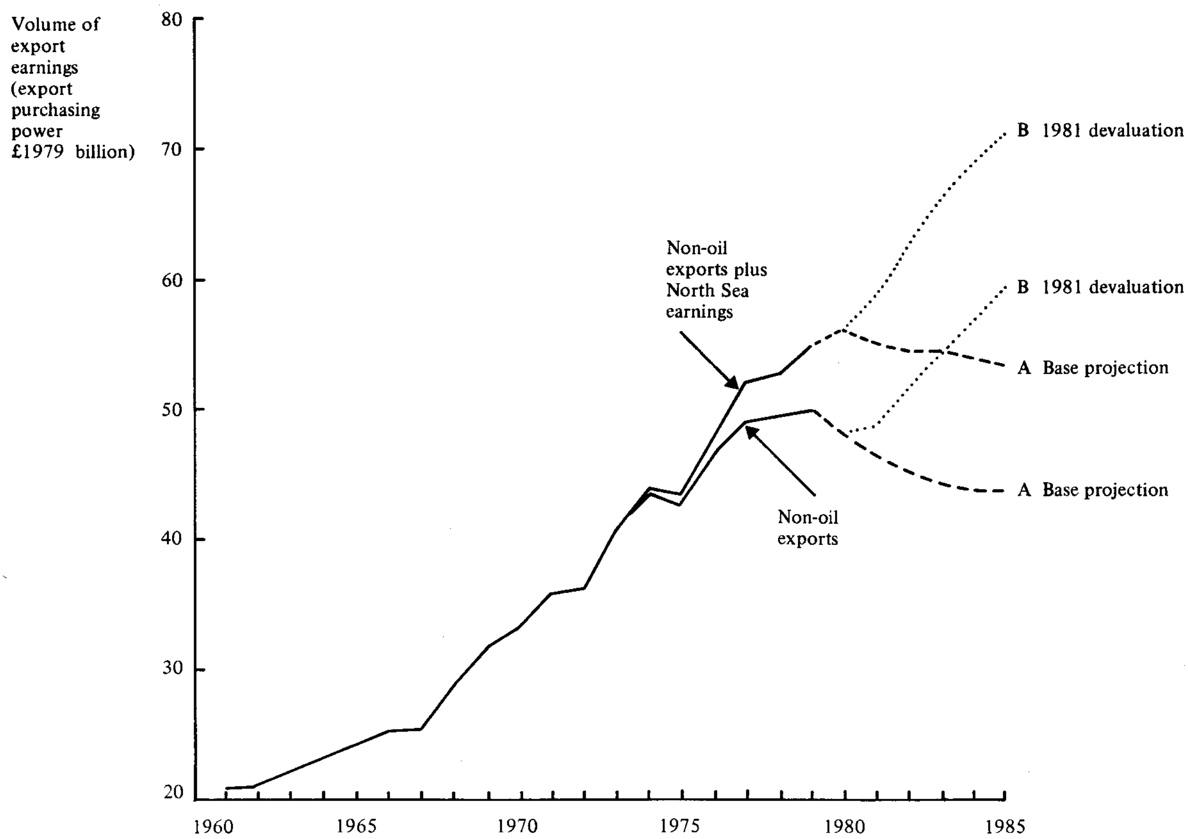
The UK's need for exchange rate devaluation in order to keep its costs in line with those in other countries is demonstrated on the above chart. Between 1961 and 1966, with a fixed exchange rate, relative costs rose steadily, increasing by 7%. The devaluation of sterling in November 1967 restored much of the loss in cost competitiveness, but the consequence of maintaining the new nominal rate until sterling was floated in 1972 was another steady increase in relative costs amounting to a 9% rise by early 1972. The rapid depreciation of sterling between 1972 and 1977 maintained relative costs below their average level for the 1960s. Since 1977 the exchange rate has floated upwards and relative costs have risen quickly.

Policies for the future which maintained the exchange rate at its current level would be associated once again with a rise in relative costs amounting to over 50% by 1985 as compared with 1977. Over half of this rise (28%) has already occurred at the time of writing. In order to restore cost competitiveness to a level more in line with that of the 1960s and 1970s, the nominal exchange rate will in the next few years need to fall by 45% from its current level (even assuming a successful short-run incomes policy).

Exchange rate: *Economic Trends* weighted-average index of sterling relative to other currencies (rebased to 1970 = 100)

Relative costs: an index of normal home costs expressed in foreign currency relative to an index of world prices of exports of manufactured goods (1970 = 100)

Chart A2 The growth of non-oil exports and the contribution of North Sea earnings



With the exception of 1975, when world trade collapsed, non-oil exports have risen each year. In each of the years when relative costs had fallen as a result of exchange rate depreciation, the growth of non-oil export volumes improved. The continuing rise in relative costs if the present exchange rate is held is expected to lead to a substantial decline in non-oil export volumes, with the level in 1985 being 12% lower than in 1979. A devaluation in 1981, followed by continuing depreciation, should restore the growth of non-oil export volumes. However the damage already done by the current high level of the exchange rate means that non-oil export volumes would not regain their 1979 level until 1982.

The balance-of-payments contribution of the North Sea has been increasingly beneficial since 1973. By 1979, it had reached the equivalent of 10% of export earnings.

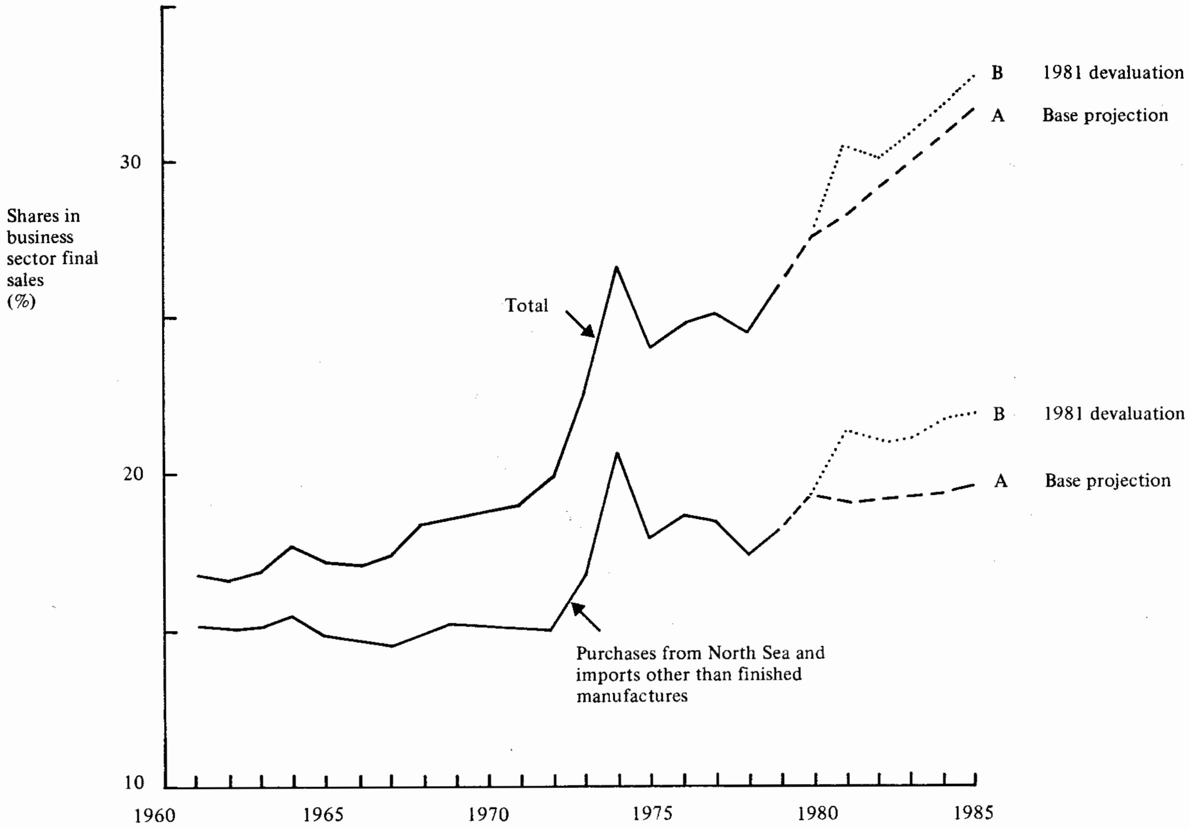
The contribution of North Sea earnings will continue to increase for some years. This would be sufficient to offset most of the decline in non-oil exports expected if the exchange rate were maintained at its current high level. But it would not prevent a deterioration in the balance of payments as a whole because, as is shown in Chart A3, import penetration is expected to rise.

Non-oil exports: total exports of goods and services excluding fuels

North Sea earnings: sales of oil and gas plus associated capital inflows less imports of equipment and services less post-tax profits paid abroad

Export purchasing power, £1979 billion: current values deflated by the price of non-oil exports relative to 1979

Chart A3 The share of imports and purchases from the North Sea in final sales

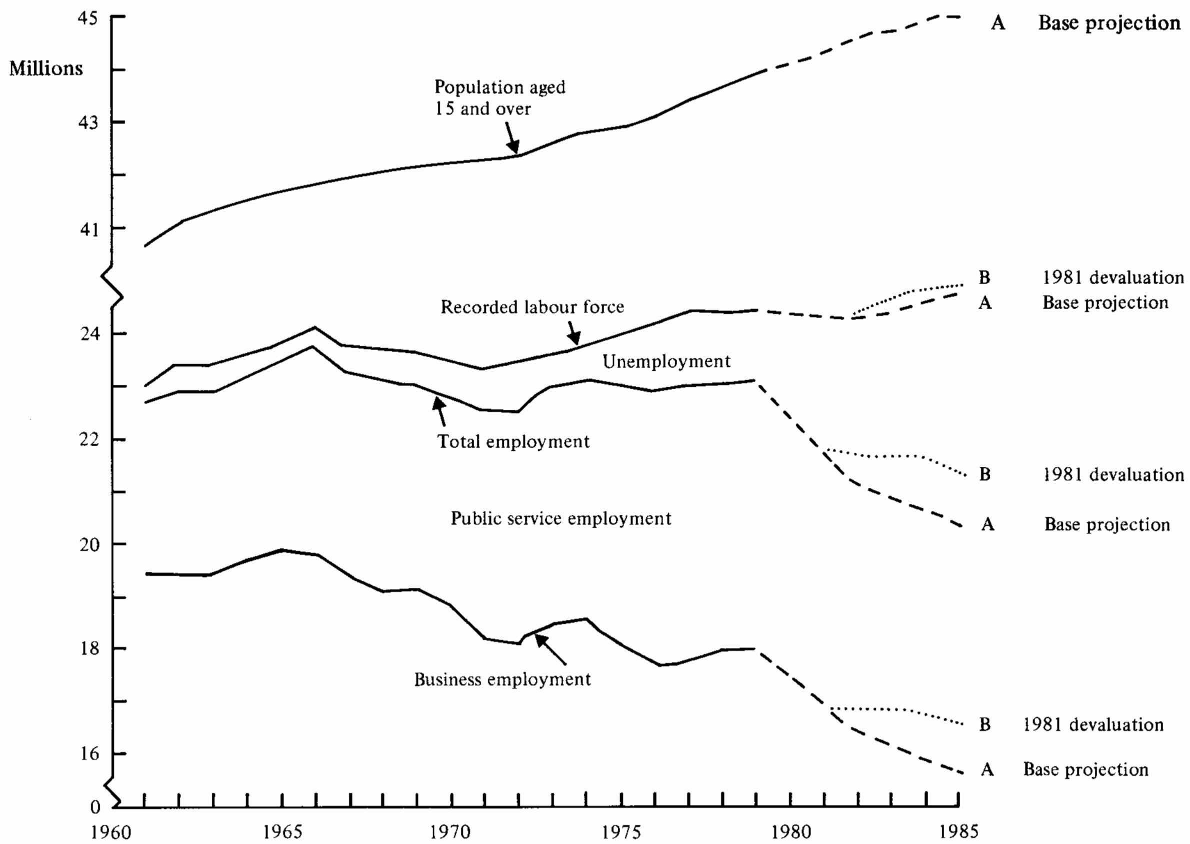


During the 1960s, imports rose in value by 2% more than business sector final sales. During the 1970s they have risen more rapidly. Most of this penetration of imports has been the result of the rapid increase in imports of finished manufactures. The gap between the two series on the chart shows the increasing share of home market sales going to imports of finished manufactures. In the next few years the share of total imports is expected to increase by a further 4 or 5% as this trend continues.

Business sector final sales: domestic expenditure on goods and services excluding expenditure on public sector employment plus non-oil exports

Imports and purchases from North Sea: imports of goods and services excluding equipment and services for North Sea plus purchases from North Sea for home use

Chart A4 Population, employment and unemployment



The population aged 15 and over increased by 3.3 million between 1961 and 1979 but only 1.3 million of this increase was in the working-age group (males 15-64 and females 15-59); the remaining 2 million was in the pensionable-age group. The recorded labour force (employment plus registered unemployment) increased by 1.4 million over the same period. The number of jobs has failed to increase sufficiently to absorb all of this, despite a 2 million increase in public sector employment. Unemployment is now 1 million higher than in 1961.

In the period up to 1985, the population aged 15 and over is expected to grow by 1.1 million, of which 0.9 million will be of working age and the net addition to population over pensionable age only 0.2 million. The base projection with a fixed exchange rate would imply a fall in business sector employment of 3.3 million and a fall in public sector employment of 0.5 million. The conjunction of these job market and demographic changes would cause a rise of 3.7 million in the population of working age without a job, of which 3 million would appear on the unemployment register. Even with devaluation in 1981, unemployment would rise by over 2 million.

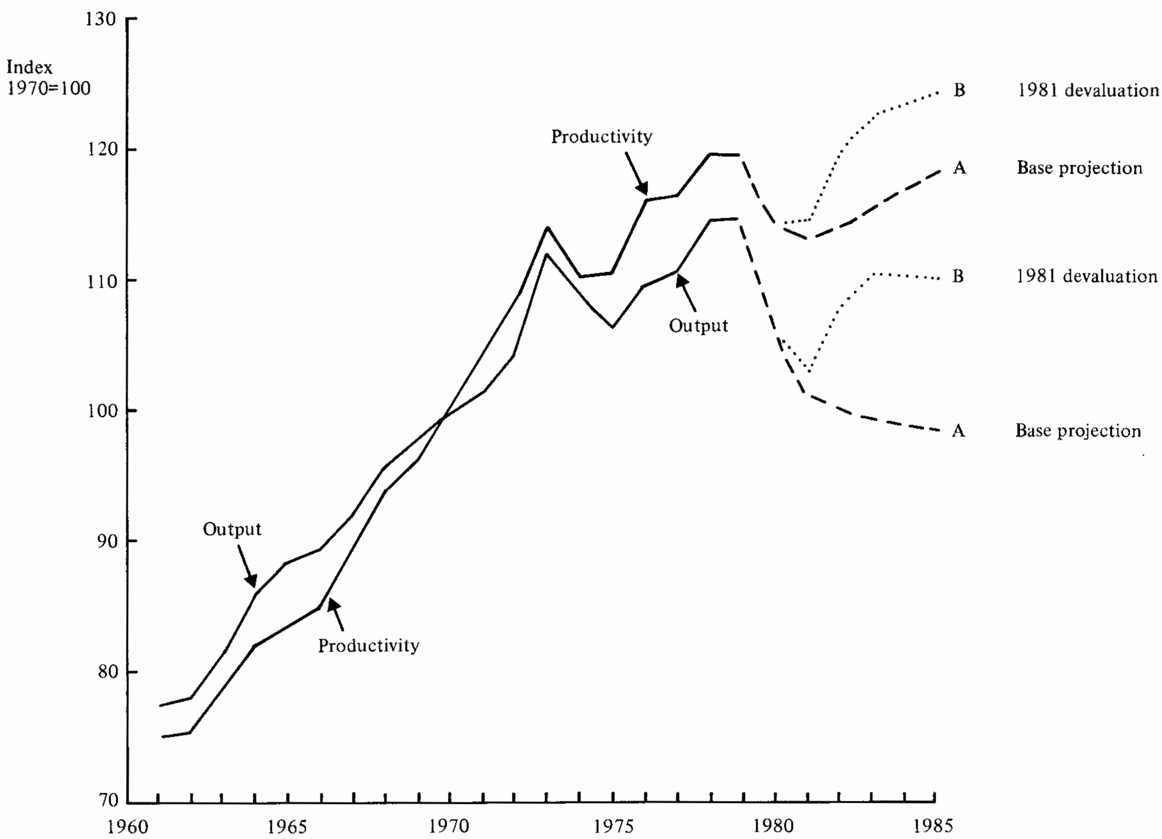
Employment: employees in employment including HM forces

Unemployment: annual average of monthly figures for UK wholly unemployed, excluding school leavers and adult students

Labour force: total of employment plus unemployment (this total excludes the self-employed)

Population: total UK population aged 15 and over

Chart A5 Business sector output and productivity



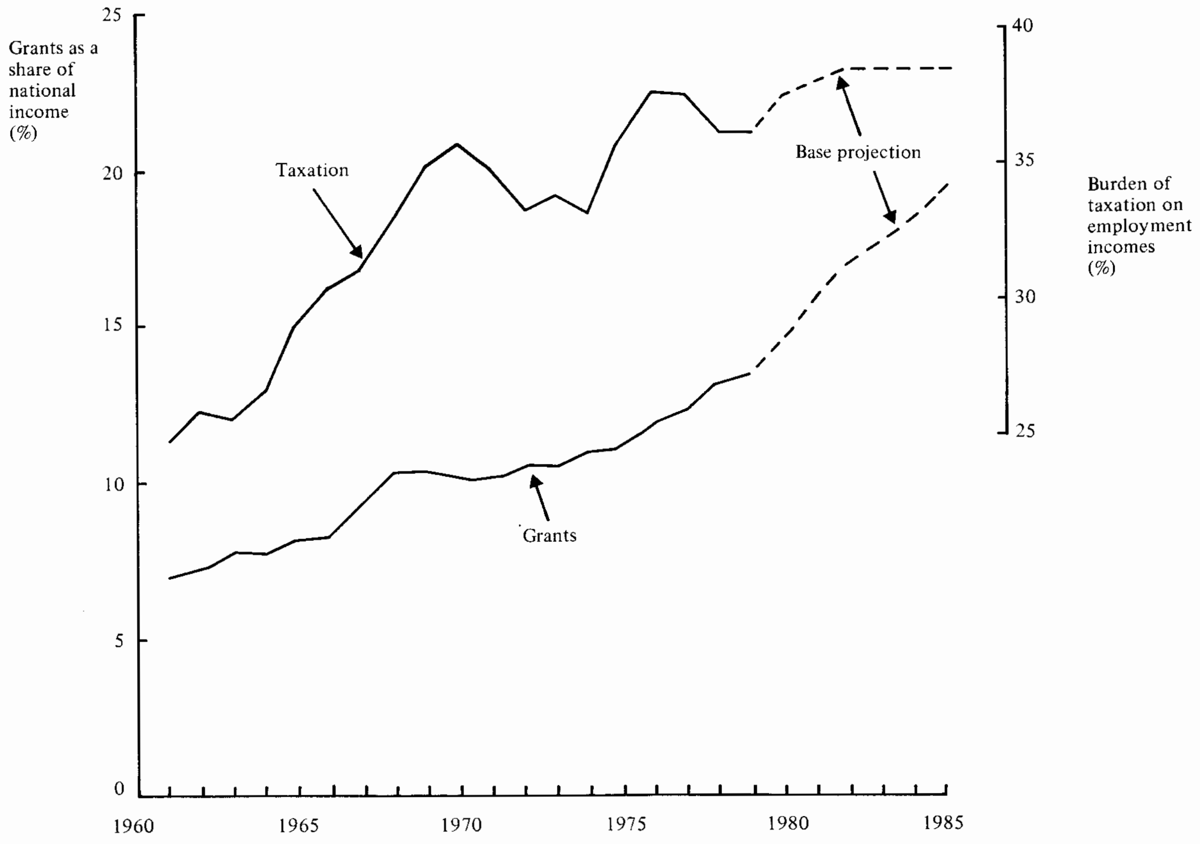
Output and productivity over the period 1961-1979 moved in line with each other, variations in productivity dampening the effects of output variations on employment. Productivity rose faster than output and the provision of jobs was, as shown in Chart A4, inadequate to prevent a rise in unemployment.

The year 1973 stands out as the end of an era. In 1974 and 1975, for the first time, output and productivity both fell substantially. The projections imply that the next few years will show an even more significant break with past trends. Business output will fall about 10% between 1979 and 1981, and without devaluation would not recover thereafter. Even after devaluation, the 1979 output level would not be regained. A large fall in productivity in 1980 should (as was the case in 1974) moderate the impact of the fall in output on unemployment. But subsequently productivity increases, albeit at a historically slow rate, would give rise to an inexorable increase in unemployment.

Business sector output: gross domestic product, excluding public service employment and value added in the North Sea, at constant market prices

Business sector productivity: output per person employed in the business sector

Chart A6 Public sector grants and the burden of taxation



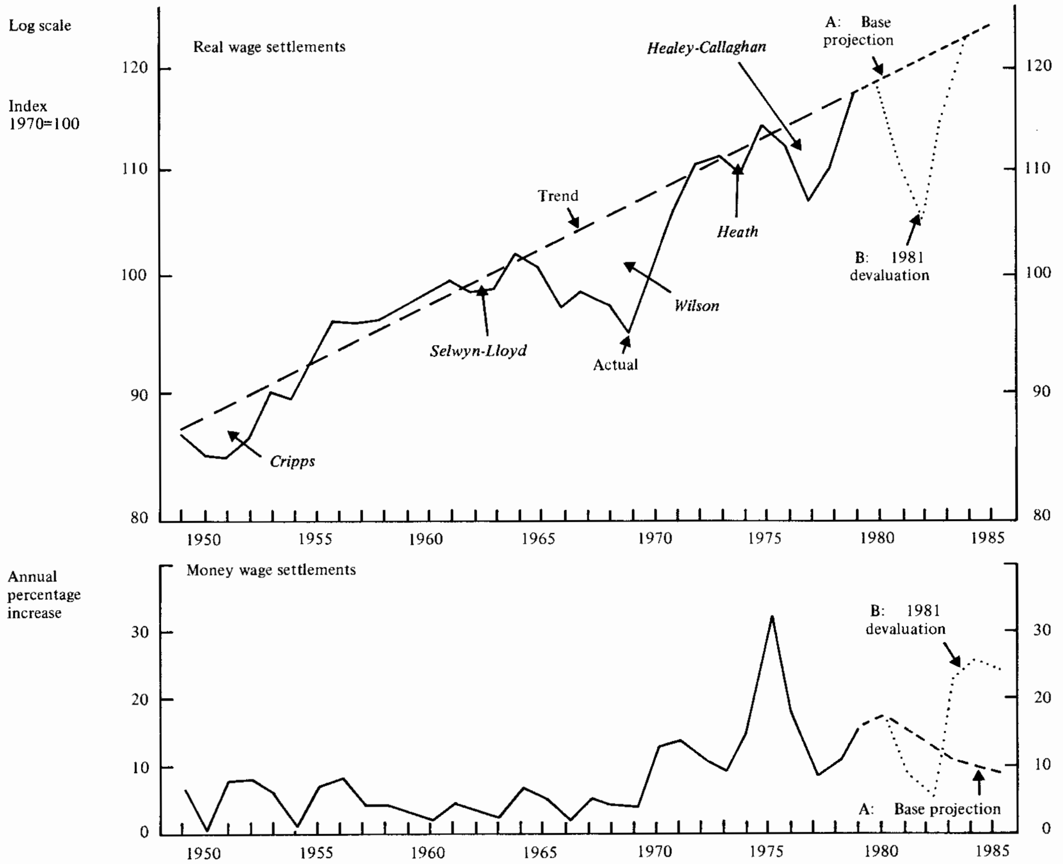
Public expenditure on grants rose from 7% of national income in 1961 to over 13% in 1979. The sharp rise between 1966 and 1968 is explained by the doubling of unemployment and the introduction of earnings-related benefits; the increase after the mid 1970s is explained by the UK's contribution to the EEC budget and a faster increase in pension and other benefit rates relative to earnings than previously, as well as by higher unemployment. The rapid increase in the projection period is due almost exclusively to the projected rise in numbers unemployed.

The burden of taxation as a share of employment incomes is also shown in the chart. In the long run it has increased by about the same amount as grant expenditure. Following a sharp rise during the 1960s, it fell in the early 1970s but increased again between 1973 and 1976. The assumption in projections is that it will not be possible (for political reasons) for the government to push the tax burden on wages and salaries much higher in the early 1980s.

Public sector grants as a share of national income: current and capital grants from the public sector to the private sector plus net current government transfers paid abroad (including contributions to the EEC budget), expressed as a percentage of national income

Burden of taxation on employment incomes: the effective rate of direct taxation (including National Insurance contributions) on income from employment plus the effective rate of indirect taxation less subsidies on consumption

Chart A7 Real wage settlements and money wage increases



Postwar incomes policies have all been associated with a real value of wage settlements below what appears to be the normal negotiating level for national bargaining. This normal level shows an upward trend of just under 1% per year (it excludes the 2% or so annual drift of earnings relative to nationally-negotiated wage rates).

The Stafford Cripps incomes policy following the 1947 devaluation of sterling had an immediate effect in depressing settlements but quickly broke down as import prices rose following the devaluation and the commodity price explosion of the Korean War boom. The recovery of real wage settlements from 1950 to 1955 was achieved with rates of increase of money wages at around 7% per year. Between 1955 and 1961, real wages at settlement increased at the 'trend' rate, while money wage increases halved to between 3 and 4% per year. The Wilson incomes policy from 1965 to 1969 pushed real wage settlements over 10% below trend by 1969. The collapse of the incomes policy was rapid and money wage increases rose from below 5% per year to about 13% per year in 1970 and 1971. The Heath incomes policy had little impact because of its threshold clause. The various stages of the Social Contract between 1975 and 1978 brought the real wage at settlement down to 7% below trend in 1977, and money wage increases fell below 10% per year. After the collapse of the policy, real wages at settlement regained their trend level by 1979 and money wage increases rose to 16% per year.

With a fixed exchange rate in the future and post-tax real wages at settlement rising at their trend rate, the rate of money wage increases would decline gradually to around 10% per year in the mid 1980s. With devaluation of sterling an incomes policy might succeed in holding money wage increases down for a time. But if and when it broke down, money wage increases would again be well over 20% per year.

Real wage settlements: an index of the money wage rates at settlement in the business sector adjusted for prices, direct taxes and National Insurance contributions (1970 = 100)

Money wage settlements: the annual increase in money wage rates in settlements in the business sector