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TOP SECRET

Copy No. 28

CP(76) 111

22 November 1976

CABINET

IMF NEGOTIATIONS

Memorandum by the Chancellor of the Exchequer

BACKGROUND

1. In this paper I put before my colleagues my considered assessment of the prospect before us, and of the measures which that prospect requires us to take.

2. It is clear from the latest short-term forecasts that at the present planned levels of expenditure and taxation we shall face very severe financing problems over the next year or two, both at home and abroad. The latest forecast for the public sector borrowing requirement (PSBR) in 1977-78 is between £10½ billion and £11 billion; and the forecast deficit on the current account of the balance of payments next year is £1.6 billion to which we must add the deficit of £1.4 billion on capital account, making a total of about £3 billion. Unless we take action to deal with this situation, we face a further slide in the sterling parity and an uncontrolled growth of the money supply - and both of these would refuel the engine of inflation. Furthermore, domestically, we should face the continuing prospect of high interest rates, restrictions on bank lending and continuing damage to our industrial policy.

3. At present we are holding our own well in both the foreign exchange and the gilt-edged markets. This owes much to the fact that people know we have the International Monetary Fund (IMF) team here - and to the expectations which that has created. However, we cannot expect confidence to continue unchecked, if we do not act fairly soon to meet those expectations. The reserves at end-November will be just over $5 billion of which $1.6 billion in gold and Special Drawing Rights is not liquid. Of the remaining $3.4 billion, $1.6 billion has to be repaid on 9 December, leaving $1.8 billion. This is why we must reach agreement with the IMF. If we fail or if there is what the markets regard as ominous delay, the exchange rate will slide - perhaps plunge - and we will not have the reserves to stop it.

4. Having considered all the possibilities, I am convinced that we need to make a significant adjustment in fiscal policy, to meet the situation. And it is clear from my discussions with them that the IMF team here share that judgment.

IMF DISCUSSIONS

5. In all discussions so far the Fund have emphasised that their overriding concern is to see a marked improvement in the United Kingdom's export performance and a sustained programme for economic recovery over the next two years. They have been at pains to point out that they see it as no part of their function to dictate policies to the United Kingdom Government. Given the limited scope of our negotiating authority, however, they have, at our request, indicated a number of objectives which they believe we should need to adopt in order to persuade the Board and our main creditors that our policies are viable; and have expressed preferences about the most effective means of achieving those objectives.

6. The Fund team accept that, given the social and political strains involved in a too rapid adjustment, the present imbalance in the economy cannot be eliminated in less than two years. This is to be welcomed. They are convinced, however, that if confidence is to be restored, our aims should be to work towards targets for 1978-79 of £5 billion for domestic credit expansion which leads to £6½ billion for the PSBR. Provided early action was taken to validate a credible path to those figures, and provided the mix of policies was such as to sustain confidence, they would envisage that we then had a good prospect of achieving an output growth rate of about 1½ per cent in 1977-78 and 4 per cent in 1978-79. On these assumptions, and assuming that confidence will allow interest rates to come down, they see the need for a fiscal adjustment for 1978-79 of £3-£4 billion at 1976 Survey prices. Their confidence that we shall achieve a 4 per cent growth rate in 1978-79 after such a substantial fiscal adjustment rests on an expectation that, by allowing the exchange rate to depreciate in line with our present state of competitiveness, we shall achieve a large expansion in our net exports that year, and that industrial investment will be rising strongly. To the extent that these expocations are not realised, the Fund would be prepared to contemplate some demarcation from the PSBR target.

7. In discussion with officials, the Fund team originally argued that, to have maximum effect, this adjustment should be achieved solely through savings on public expenditure. They acknowledge that this is a matter for the Government to decide, but argue that the adjustment would need to be more severe if public expenditure were not the main source of savings.

8. For 1977-78 the Fund team believe strongly that we should not risk losing the chance to restore confidence by doing too little. They argue that there would be disproportionate benefits if we set a target below the level of

£9 billion which I announced in July. They are, therefore, looking for a PSBR of about £8½ billion to be achieved primarily by means of public expenditure savings.

ASSESSMENT

9. The scope of action required must inevitably be a matter of judgment. I have already persuaded the IMF team to reduce its initial demand for public expenditure cuts in the coming year and will continue to negotiate very toughly on the scale of the action required now to affect the outcome in 1978-79.

10. In my judgment, however, the broad scale of the action they now suggest is about right if we accept their view of the pattern of growth in the next two years. In any case we need to take action on this scale to restore confidence and re-establish control of our currency. The bulk of this action should be taken through reductions in public expenditure, but these might need to be supplemented by some further increases in taxation, particularly for 1978-79, if the forecasts the IMF have accepted as a basis for their suggestions prove to be correct. If on the other hand the PSBR predictions which have been taken as a base prove to be too pessimistic, it may be possible to make some reductions in direct taxation without missing the new PSBR targets. Moreover, the IMF staff have agreed that if the growth of national output in 1978-79 were to prove lower than they assume, a larger PSBR target for that year could be envisaged.

PUBLIC EXPENDITURE

11. In considering how big the public expenditure component of a package should be, my colleagues will naturally wish to know what would be involved. As agreed earlier on, work has been carried out by officials of the Treasury and the Departments concerned on reductions which might be technically possible, starting in the period immediately ahead. This can be completed and circulated in the light of our discussion. Meanwhile I will indicate briefly the kind of options involved.

12. The full list of possibilities which has been drawn up, from which a specific set of measures could be constructed, could produce savings of about £3 billion in a full year if all of them were adopted. This would involve a moratorium for a full year of all public sector construction projects not already committed, excluding the nationalised industries but including housing. This would account for about one-third of the £3 billion. It would also require the total cancellation of upratings of social security benefits and public sector pensions next year, and in addition it would require further specific savings in a wide range of programmes including health, education, aid, defence and industrial support. Such measures would be technically feasible but politically very difficult to accept.

13. We cannot be sure in advance of a detailed negotiation how far we may have to go on public expenditure to meet the Fund's objectives, but I think we must in any case be prepared to make savings of £1½ billion in 1977-78, rising by a further £½ billion to £2 billion in 1978-79 at 1976 Survey prices. In my judgment savings of this size are the minimum necessary to give us a reasonable prospect of carrying through the Fund negotiations to a successful conclusion, and to re-establish confidence in the markets. My officials have already done some work on illustrative packages of different magnitudes, the largest of which would meet this requirement. Any of these illustrative packages would involve some action, but less drastic, on all the items which I have already mentioned, eg some pause in new construction commitments, but falling short of a 12 months moratorium across the board, and some saving on benefits and public service pensions, but not a total cancellation of the next upratings. The higher level of savings in the second year would largely be secured by the carry-through of the first-year measures, some of which would have an increasing effect; but some of the other first-year measures would not carry through in full, so that some additional action would be required to achieve the larger total in 1978-79.

14. Thus, among other options, we should have to consider substantial further economies in the housing programme for that year, probably by a reduction in the level of new council house construction and/or legislation to allow for a marked real increase in local authority rents. Another possible source of savings would be a further substantial reduction in defence expenditure beyond that in the illustrative packages; this would require another Defence Review and reconsideration of our defence commitments. But the need for such additional savings in these programmes in 1978-79 will be significantly reduced if my colleagues accept my proposals, which I intend shortly to bring to Cabinet, for encouraging a shift to foreign currency financing of export credit by arrangements which would include a raising of interest rates for sterling-financed export credit.

15. Changes in the planned level of benefits and public sector pensions would require legislation. In the former case the required provisions could be added to the Social Security (Miscellaneous Provisions) Bill which is due to be introduced this week. The basic idea put forward for our consideration is that the statutory requirement for mandatory upratings should be repealed or suspended, and replaced by a discretionary power. The same approach would be adopted to public service pensions and would affect not only the Civil Service but also local authorities, the Health Service, the police, the armed forces, Members of Parliament and the judges. The implications for the nationalised industries would also have to be examined.

16. A decision on this legislation will be crucial to the package as a whole. We need to consider action on these lines not merely for the sake of the expenditure reductions involved but also in order to deal with the

situation in which real living standards of those on benefit or pensions are being maintained or even increased while the real wages of those at work are being squeezed.

NEXT STEPS

17. We must take decisions on the main issues without further delay. Drawings under the June $5.3 billion standby have to be repaid by 9 December. It is not necessary for us to draw money from the Fund by that date, but it is of vital importance that we should be able to indicate by then at least that we have reached a firm understanding with the Fund. There are further stages of consultation to be carried out, mainly with the Group of Ten countries who will be asked to put up the money for the Fund drawing, after the talks in London are completed. Progress in the talks has been slow largely because of our own inability until now to make concrete proposals. If we are to meet the timetable it is now essential that we should come to an understanding with the Fund this week on the main elements of a programme.

18. Details of the agreement with the Fund can be filled out later, but this week's decisions will have to cover the size of the PSBR and the growth of the money supply in both 1977-78 and 1978-79 (although both would be contingent on economic circumstances in those years and subject to review) and the size of the public expenditure element in the adjustment.

CONCLUSION

19. I recognise that I am facing my colleagues with extremely difficult decisions, but I believe we also have an opportunity to establish a viable path to recovery over a two-year period. Moreover, if negotiations with the IMF are successfully concluded, we shall have obtained international endorsement of the validity of our policies and of the recovery at which they aim. This endorsement in itself should provide an invaluable boost to confidence both at home and abroad.

20. It is in this belief that I make the following recommendations:

> i. I should be authorised forthwith to discuss with the Fund, without commitment, packages designed to meet their PSBR requirements, with a public expenditure component of £1½ billion in 1977-78, rising by a further £½ billion to £2 billion in 1978-79; and an appropriate tax component. At the same time work should be carried forward on the preparation of documents for an agreement with the Fund.

ii. The Lord Privy Seal should be invited to bring before us as a matter of urgency a paper dealing with the question of an amendment to the Pensions (Increase) Act.

iii. I should be invited to arrange, in consultation with the Secretary of State for Social Services, for a more detailed paper to be prepared on the implications of amending the existing social security legislation. This paper would also indicate the problems involved in taxing short-term benefits.

iv. The Secretary of State for the Environment, in consultation with the Chief Secretary, Treasury, should be invited to bring forward a paper on policy options arising from the Housing Policy Review.

The papers under ii., iii. and iv. should be available for our next meeting.

D W H

Treasury Chambers

22 November 1976

CP(76) 112

COPY NO 81

22 November 1976

CABINET

A STRATEGY FOR THE COMMON AGRICULTURAL POLICY

Note by the Secretary of State for Foreign and Commonwealth Affairs

1. The Cabinet on 11 June endorsed proposals by the then Minister of Agriculture Fisheries and Food (CP(76) 31) on procedures for agricultural price fixing in the European Economic Community. The Prime Minister in summing up the discussion said that Cabinet would wish to consider before the end of the year a further memorandum on our strategy towards the Common Agricultural Policy. This subject has accordingly engaged the attention of the Ministerial Committee on European Questions, who have invited me, as their Chairman, to bring their conclusions before Cabinet. They are set out in the attached report.

2. Briefly we recommend as our main long-term aim the reduction in real terms of the support prices of those commodities where present policies produce structural surpluses. At the same time we want to secure continuing subsidies for our consumers from the Community's financial arrangements. In present circumstances these benefits derive largely from the effects of the Green Pound and this leads us to the conclusion that in the application of our strategy at the present time we should not provoke a confrontation on the Common Agricultural Policy but should concentrate primarily on the short-term effects on British food prices of any Common Agricultural Policy decisions, in the interests of our immediate economic policy. We should be prepared, if necessary, to trade off a modest change in the Green Pound in order to obtain a satisfactory settlement on common prices. But the recent increases in the Monetary Compensation Amounts from 17 per cent to over 40 per cent has so altered the balance in our favour that our prime objective should be to hold the Green Pound, rather than to go for longer-term changes in the Common Agricultural Policy at the expense of the Green Pound.

A C

Foreign and Commonwealth Office

22 November 1976

CONFIDENTIAL

A STRATEGY FOR THE COMMON AGRICULTRUAL POLICY

Report by the Ministerial Committee on European Questions

Our Aims

1. Our basic aims on the CAP remain what they have always been: to minimise its cost ot our balance of payments; to try to hold agricultural commodity prices in this country at the lowest levels consistent with the satisfactory expension of our own agriculture in accordance with the objectives set out in the Government's White Paper "Food From Our Own Resources", and to reduce Exchequer cost to acceptable levels; we must also continue to make satisfactory, provision for New Zealand and the Commonwealth sugar producers and to obtain a more liberal policy of food imports from outside the Community.

2. Against this background, the detailed changes required by the UK can be narrowed down to four essential points:

(a) Support prices. Our aim should be to reduce the level of prices in real terms, thus not only providing that "supplies reach consumers at reasonable prices" (as envisaged by Article 39(1)(e) of the Treaty of Rome) but also eliminating the structural surpluses of food created by the present policy.

(b) Consumer subsidies. Our aim should be to secure continuing FEOGA subsidies to UK consumers, whether as monetary compensatory amounts or in other forms, to the maximum extent consistent consistent with the long-term continuation of such subsidies and with our own plans for agricultural expansion in the UK. This could be the most effective means of securing a satisfactory balance of advantage between ourselves and member countries whose economies are stronger than ours or who gain from the CAP as net exporters.

(c) World trade. Our aim should be to achieve a better management of export subsidies under the CAP, although the achievement of a lowering of support prices would inevitably help in this. But the sub-committee felt that the present system was both inept and inequitable: inept in that it creates absurdities such as cut-price sale of butter to Russia, and inequitable in that by subsidised dumping in third country markets it is restrictive of world trade. On imports, we should continue to press for more liberalisation of trade with third countries

(d) Different financing of rehabilitation of poor farmers. Our aim should be to make this wholly desirable social change a charge upon social policy, rather than a charge upon consumer prices. It should be the duty of national exchequers to take a bigger share of the social costs of farm support.

3. Objectives (a) and (b) arise directly in the price-fixing and would contribute to all the basic aims set out in paragraph 2, provided always that we leave room to expand our own agriculture. The objectives set out in (c) and (d) however do not arise directly in the price fixing and could not by their nature be finally secured as part of it. Their main significance is financial and more work is needed to establish more precisely what changes would be to our advantage. Our first priority should therefore be to secure the best balance between objectives (a) and (b).

4. Of the points detailed above, each has its difficulties from the political point of view, since rightly or wrongly the other eight member governments are convinced that they require the farmers' votes to preserve them in office. But the greatest difficulty arises in considering the support prices, since the eight member states would look at the commodities item by item. The situation can be summarised as follows:

Milk A large, daunting and very costly surplus - much the worst and most difficult problem.

Cereals The EEC normally has a costly surplus of milling wheat, but a net import requirement of feed grains.

Beef The recent surplus will be followed, according to the normal beef production cycle, by a requirement for imports over the next two years.

Sugar The EEC is in surplus after taking account of its annual imports of ACP sugar, but the sugar price is regarded as too low by Commonwealth sugar producers.

Olive Oil A costly and inefficient system, which isoperated for Italy's benefit. Greek accession will mean a big surplus.

Wine There is a surplus, and a big one in years of high yield, but the problem is mainly limited to France and Italy.

Attitude of other member states

5. Clearly the major question of support prices concerns milk products, and this in turn is confirmed by our own experience in the UK. We stated in "Food From Our Own Resources" that "most benefit is likely to come from higher output of milk" in relation to the long-term prospects for British agriculture (and, we might have added, for the British consumer). But the aims of France, Belguim, Luxembourg and Ireland are to protect their milk producers by high prices, while whittling down the amount of milk produced in the Community by paying for a decrease in the number of cows. This will, therefore, be a sticking point for them. On the other hand, Germany opposes milk price increases but is prepared to accept them if she can get bigger increases in cereal prices.

6. The continuance of consumer subsidies implies the indefinite retention also of something akin to the MCA system at whatever level both accords with our position as the biggest importer of foodstuffs and our need to expand our own agriculture to cut down on imports. All the other member states would oppose a formally permanent system, but some would be prepared to agree that we should determine the pace of change.

7. The countries most interested in maintaining export subsidies as a regular mechanism are France, Denmark and the Netherlands, all of whom have a traditional export trade with third countries. But since export restitutions are a more cost-effective instrument than intervention, most of the eight would doubtless fight for them, though they might be prepared to look at the question. On liberalisation of imports we hope to make some progress on agriculture in the multilateral trade negotiations (MTN) which should start moving again next year. The strongest opposition to concessions on agriculture has come from France and Ireland, who argue that the principles and mechanisms of the CAP cannot be altered to suit non-Community countries. But Germany, Italy and the Netherlands all have a big interest in getting a success on the industrial side and will not let the MTN fail because of a too rigid stance on agriculture. Apart from the MTN, we can pursue various ad hoc improvements particularly for the developing countries (through the Generalised Preference Scheme or the ACP agreement) which can be accepted by the other members for general foreign policy reasons.

8. Different financing of rehabilitation of poor farmers would mean reducing the percentage contribution by FEOGA to various existing schemes and to future schemes. The Italisans and Irish would be against any re-opening of decisions that have already been taken in this field. The French might be willing to accept it, provided they got greater freedom in the manner of paying such aids at the national level, but this latter concession would be opposed by the Danes and Dutch.

9. It would seem that we could get allies in each of the four changes we seek, especially if we were to have bilateral discussions with the other member states - a tactic made easier by our Chairmanship of the Council of Ministers from January to June next year, since bilaterals are part of the normal price-fixing process. The difficulty is, however, to arrive at a package which all the other eight could accept. It will take time to achieve our aims and we should not therefore provoke a confrontation at the next price fixing.

The Green Pound

10. We had intended to consider CAP strategy separately from matters that arise on the green pound. But as the points in paragraphs 3(b) and 6 above show, it is not possible to disentangle the two questions; and it is widely believed that the green pound itself could be used as a negotiating factor in obtaining changes in the CAP.

11. In the short term, it is clearly the green pound that has the biggest impact in keeping food prices in Britain at a reasonable level; the gap between the green pound and the market rate has widened so greatly (the MCA increased from 17.4 per cent to 40.6 per cent in the six months between 1 May and 1 November this year) that it has far more influence on our food prices than any annual change in the common support prices. On the other hand, any increase in the common prices does directly affect the level of price support in Britain both now and at the end of the transitional period; it affects us indirectly through its influence on the level of European surpluses and therefore our contribution to expenditure from the farm budget; and if in the long term we eventually do align the green pound with the market rate, then only the common prices will matter anyway.

12. Therefore, whether it would be in the national interest for us to trade a short term disadvantage on food prices (fixing the green pound at a lower level than we want) for a long term benefit (keeping the common prices below what they would otherwise have been) would depend on the orders of magnitude involved and on the priorities of our own economic management. A devaluation of the green pound of x per cent, in return for avoiding an increase of y per cent in the common prices, could in the long term be worthwhile; alternatively an increase in the common prices could be a price worth paying for the short term maintenance of the green pound at near its present rate. In the absence of detailed analysis, we were not in a position to put figures on such a trade-off.

13. There has been strong pressure on us from the Commission and the other member states to accept a devaluation of the green pound, if only by a token amount. The Commission has launched a proposal for an automatic mechanism for changes in green currencies and reductions in the size of MCAs; both we and the Germans opposed this suggestion at the joint meeting of Agriculture and Finance Ministers in Luxembourg on 26 October, and the Minister of Agriculture, Fisheries and Food will be submitting a separate paper on it to CQM shortly. The view has been expressed - for example, by the Member of the Commission responsible for agriculture, Mr Lardinois - that if the UK refuses to devalue the green pound in any circumstances, or blocks any attempt to have an automatic system for reducing MCAs, this means the end of the CAP. We thought that this view was greatly exaggerated, and that it was not currently shared by other member governments. If such a view did become generally accepted by other members, Cabinet would clearly have to decide whether to accept this possibility and its consequences.

Conclusions on Strategy

14. We should not provoke a confrontation on the CAP but should concentrate primarily on the short-term effects on British food prices of any CAP decisi[on] in the interest of our immediate economic policy. We should be prepared, if necessary, to trade-off a modest change in the green pound in order to obtain a satisfactory settlement on common prices*. But the recent increase in the MCA from 17 per cent to over 40 per cent has so altered the balance in our favour that our prime objective should be to hold the green pound, rather th[an] to go for longer-term changes in the CAP at the expense of the green pound.

*Note: For the purposes of assessing a settlement on common prices, Annex A to this paper shows what the effect of price increases would be on the Com[munity] budget and on the UK's contribution to it. Annex B shows the effect of ch[anges] in the Green Pound on the Retail Price Index and the Food Price Index

Annex A

A STRATEGY FOR THE COMMON AGRICULTURAL POLICY

BUDGET COST OF CAP PRICE INCREASES

The attached table illustrates the possible consequences for the Community Budget and UK contribution of various levels of price increases for the main CAP products. It is based on the best assumptions which can be made about market prospects for individual products and it assumes no change from current exchange rates and green currency levels and no change in CAP support mechanisms. The estimates are based on an average EEC rate of inflation of 8%.

For the purpose of the table it has also been assumed that the effect on the budget represents the situation once the full consumption and production response to a price increase has worked through. It would be meaningless to assume otherwise, but this introduces a high degree of artificiality into the calculations. For those commodities with a long production cycle it could take 18 months or longer for the production response to be felt; and over such a time scale it is difficult to foresee clearly what would be the effect of normal market trends. The time scale also affects directly the cost of surpluses to the Community budget; for example in the short-term, as assumed here, milk products can be stored relatively cheaply, but once they have to be disposed of the cost is higher.

In order to estimate effects on the Community budget it has also been necessary to make assumptions about the size of budgetary expenditure and of the UK contribution. The table is needed in the context of price increases in the next CAP price-fixing and the effects of those increases would apply partly in 1977 but also in 1978 and succeeding years. The table takes as the best working basis the Commission forecasts for the 1977 budget and assumes that the UK contribution will be subject to the 1977 key of 19.24% - though of course this is unrealistic to the extent that the effect we are discussing will be felt in 1978 and later when we shall be paying a bigger contribution. The first column in the table gives expenditure from the 1976 budget; the second corresponds to the 1977 budget but is deflated to take account of the effect of the assumed 8% fall in

real prices. The budget key is not applied to each individual commodity, but it is fairly simple to do this by taking roughly one-fifth of the figure given.

Finally, this table only purports to show a budgetary effect. It does not deal with consumer price effects, or with costs across the exchanges which would give some indication of resource costs.

Ministry of Agriculture, Fisheries & Food
16 November 1976

CONFIDENTIAL

EFFECTS OF PERCENTAGE CHANGES IN MAIN CAP PRODUCT PRICES

millions of units of account

PERCENT CHANGE IN SUPPORT PRICES IN MONEY TERMS PERCENT CHANGE IN SUPPORT PRICES IN REAL TERMS	Community Budget for 1976	0 -8	2 -6	4 -4	6 -2	8 0	10 +2
Cereals	722	710	811	923	1044	1157	1264
Milk	1930	1930	1940	2000	2200	2400	2750
Beef	750	150	275	400	525	655	780
Oils and Fats	441	415	420	425	435	446	455
Sugar	270	263	292	315	340	370	400
Wine	151	124	126	129	131	134	136
Tobacco	208	186	198	209	219	230	240
Other Commodities	753*	430	425	420	415	413	410
MCA	610	1090	1090	1090	1110	1130	1150
Double exchange rate (Budget/Agricultural ua's)	**	412	443	480	538	588	657
Total million budget units of account	5835	5710	6020	6390	6997	7521	8242
UK share at 1977 budget key of 19.24 and budget rate of £1 = 2.4 ua £'s		458	483	512	561	602	661

* includes ACA worth 392 mua

** included in individual commodity

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Annex B

A devaluation of the Representative Rate (Green Pound) would automatically increase in sterling terms the various institutional CAP prices applicable in the UK; reduce the level of MCAs paid on imports; and raise the maximum guaranteed price for milk permitted by EEC Regulations. If market prices already exceed intervention prices, the increase in wholesale and so retail prices might be less. In addition, the price of liquid milk is set by the Government, and does not automatically rise on a devaluation. Assuming an increase in the liquid milk retail price sufficient to fund the maximum permitted rise in the price guaranteed to farmers, devaluations of the representative rate by 5, 10 or 15 per cent might have the following effects on the RPI and Food Index

	5%	10%	15%
Retail Price Index	¼	½	1
Food Index	1¼	2½	4

These effects assume that the reduction of MCAs is generally reflected in market prices. The figures for the Food Index would be smaller by up to one-third if the price of milk were not increased.

It is not realistic to attempt estimates of the effect of greater devaluations because they would require alternative assumptions on the milk guarantee and because it is impossible to predict how markets might react in the face of such large changes in institutional support prices and MCA levels.

CP(76) 113 COPY NO 81

26 November 1976

CABINET

EXPORT CREDIT POLICY

Note by the Secretary of the Cabinet

I attach a joint memorandum by the Secretary of State for Trade and the Secretary of State for Industry. This has not been considered by the Ministerial Committee on Economic Strategy and is now for discussion at Cabinet.

Signed JOHN HUNT

Cabinet Office

26 November 1976

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EY(76)63
15 November 1976

CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

EXPORT CREDIT POLICY

Joint Memorandum by the Secretary of State for Trade and the Secretary of State for Industry

INTRODUCTION

1 The Chancellor of the Exchequer is rightly concerned about the financial and economic burden arising from the present arrangements for subsidising and financing medium and long term export credit. Whilst sharing his anxieties however, we have serious misgivings about the nature and timing of the proposed remedy of raising the fixed interest rate for sterling credit by 2 percentage points. These misgivings focus primarily on the total incompatibility of such a step with the main thrust of the Government's publicly stated economic and industrial policies. Linked with these doubts are the uncertainties surrounding the viability of the cheaper interest rate option for business transacted and financed in hard currencies. Some of our misgivings are referred to in the Chancellor's paper, but they are sufficiently important to justify further elaboration.

ECONOMIC AND INDUSTRIAL STRATEGY

2 Apart from the control of inflation, the oft-repeated objectives of current Government strategy are to secure stable export-led growth, through a switch of resources into exports and investment. Closely associated with this is the industrial strategy, designed to raise industrial efficiency and competitive power, with priority being given to the re-generation of manufacturing industry.

3 It has long been established UK policy to give our exporters broadly similar export credit facilities to those enjoyed by their major competitors. Although, overall, the fixed rate export finance scheme covers only about 8% of exports, the amount is high in absolute terms (up to £2,000m this year) and it is particularly important to the heavier end of industry and to a number of key industries which are heavily dependent on overseas orders to maintain output and employment - shipbuilding, process plant, electricity generating machinery, and aerospace.

These industries face depressed demand at home, surplus world capacity and fierce competition for overseas sales - some of it from countries who also have weak domestic currencies and yet who still offer internationally competitive fixed export rates of interest (eg France and Italy).

TIMING

4 Against this background, a sharp and unilateral increase in UK interest rates for sterling export credit must inevitably damage the export prospects of those industries directly affected. It will also be interpreted more widely as a further blow to manufacturing industry at a time when confidence in the Government's industrial strategy has already been shaken, notably by the National Insurance Surcharge and the increase in Minimum Lending Rate. In this context a recurring theme in the Sectoral Studies in the first phase of the industrial strategy work was a plea for various improvements in aid to exports, and one of the most important themes in the last NEDC meeting was the need for a positive manifestation of the Government's declared intention

to give priority to manufacturing industry. Thus, unilateral tightening of UK export credit terms would, to say the least, appear inconsistent with our economic and industrial strategy, especially at a time when we are experiencing a pause in the growth of exports and the prospects are uncertain.

PUBLIC SECTOR BORROWING REQUIREMENTS

5 We accept that present arrangements for the provision of finance for sterling export credits of two years or more do involve, via ECGD's refinancing arrangements with the Clearing Banks, a substantial burden on PSBR. But the Chancellor has recently secured the banks' agreement to carrying themselves approximately an extra £200m of this burden in 1977/78. This will provide a once for all, though substantial and valuable, reduction in the PSBR; moreover the refinancing arrangements come up for fundamental review prior to next October, and there is no reason why the Government should not take that opportunity to press the banks to bear from 1978/9 onwards an even larger share of the burden of financing export credits, at least for medium-term maturities.

FOREIGN CURRENCY OPTION

6 Against this background we accept that a switch to contracting and financing of exports in foreign currencies would be a desirable step, but the prospects of achieving such an early switch on any substantial scale should not be exaggerated. It is estimated that about 20% of UK exports are at present invoiced in currencies other than sterling but

this practice is almost entirely confined to short term business. In the fixed rate finance field (ie credit of 2 years or more), which is the field affected by the Chancellor's proposals, contracting and financing in foreign currency represents a step into the unknown. There will inevitably be resistance amongst overseas buyers most of whom will prefer to incur long term liabilities in sterling. The extent of the resistance cannot be assessed at this stage. Time will be needed for our exporters and financial institutions to cope with the new and sometimes difficult techniques which are involved.

7 Thus, an immediate 2% differential between sterling and foreign currency interest rates could be excessively damaging for our most vulnerable industries. On balance, therefore, we should recommend a trial period during which sterling interest rates should be left unchanged, but more would be done to assist and stimulate exporters to move into dollar or deutschmark financing. Action on this front is already in hand in that a special unit is being set up in ECGD to act as a "marriage bureau" between exporters who may be interested in exploring such possibilities, and those banks who are interested in promoting such business. In this connection, some of the UK subsidiaries of foreign, (particularly American banks), have shown interest in mobilising external finance for UK exports under the ECGD guarantee and interest support mechanism. This potential encroachment by the foreign banks into a profitable and

risk free area of business hitherto dominated by the UK banking system could in itself act as a stimulus to our own clearing banks to take a more active role in organising foreign currency financing. It would therefore be a mistake to run the danger of an increase in the sterling rate certainly before seeing what the effect of pressures on the banks could achieve in the next 6-12 months. In addition, ECGD could avoid levying an extra premium specifically upon exporters in foreign currency (to pay for the extra cover now given against exchange fluctuations) by spreading this cost over all exporters in the same general classes of business. Again, in respect of all markets where prudential limits have to be set to the total amount of medium and long term export credit which we can extend (some 60 or so countries at present), it would be possible to announce a policy, which would convey a very clear message to many classes of exporters, of setting lower limits for sterling business than for exports in foreign currency.

8 It it were thought that even further stimulus were needed, the future of the cost escalation insurance scheme for export contracts of £2m and more, (which runs until next March in its present form and can only be extended thereafter by Affirmative Resolution), could be reviewed in the present context. We would be agreeable to the case being urgently studied without commitment for its extension to be on the basis of significantly less favourable terms for sterling exports than for foreign currency exports. Against present fears in industry of a resurgency of cost inflation, such a change, whilst undoubtedly provoking an outcry from those who would not believe they could induce their overseas customers

to accept invoicing in foreign currency, should be a powerful inducement to swtich to foreign currency exporting wherever this seemed feasible.

CONCLUSIONS

9 To sum up, we consider that the Chancellor's proposal is ill-timed against the background of the present pause in export growth, while confidence on both sides of industry is in a very delicate state, and when doubts are being express-ed about the Government's real commitment to the Industrial Strategy. Recent Government measures - especially the National Insurance Surcharge and the MLR increase - have added to these doubts. A tightening of export credit facilities would be difficult to justify, and the rationale of the move would be incomprehensible to many, both at home and abroad. Even if the underlying motive were appreciated, there is a danger that cuts in this of all areas would be interpreted as a measure of desperation.

10 In addition, any adverse effect on external confidence would be added to an appreciation that there would be new and additional public expenditure costs arising from the unemployment which an increase in the sterling export rate would create through loss of orders. This follows from the inescapable logic that a rise in interest rates would lead to a loss of exports by firms who are not faced with long order books and whose resources simply cannot be switched easily or quickly to other uses.

11 We therefore see very substantial objections to an increase of 2% in the sterling interest rate at the present time. These would extend from serious damage in basic industries, many in areas of high unemployment, to

wider damage to confidence at home and abroad. That is why we favour continued urgent concentration on assisting and encouraging exporters to contract in foreign currency linked with the stimulation of competition between financing institutions to mobilise foreign currency financing, without making the immediate leap in the dark which an increase in the sterling interest rate would represent.

Department of Trade E.D.

Department of Industry E.G.V.

15 November, 1976

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26 November 1976

CABINET

EXPORT CREDIT POLICY

Note by the Secretary of the Cabinet

I attach a memorandum by the Chancellor of the Exchequer. This has not been considered by the Ministerial Committee on Economic Strategy and is now for discussion at Cabinet.

Signed JOHN HUNT

Cabinet Office

26 November 1976

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11 November 1976

CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

EXPORT CREDIT POLICY

Note by the Chancellor of the Exchequer

Medium and long-term export credit is now presenting acute problems over a range of policy fronts. The issues are examined in detail in the annex to this paper. In brief, we are effectively lending very large amounts overseas, at heavily subsidised rates of interest, while having ourselves to borrow to finance our balance of payments deficits - and to repay the amounts so borrowed. On present policies we are likely to be lending the overseas buyers of the exports concerned some £2 billion in 1977-78 and increasing amounts thereafter. Because the Government refinances a major part of the increases in net export credit advanced by the banks, the result is a very large, uncontrolled and unpredictable claim on public expenditure, and consequently on the PSBR. Problems are also created for monetary policy given the existence of specific targets for both the PSBR and money supply.

2. I have secured some alleviation of the latter problems, for 1977-78, by persuading the clearing banks to revise the refinancing formula. This will mean that the refinancing which the Government has to do will be about £200 million less than it otherwise would be, in that year only. Nevertheless, the latest forecasts suggest that expenditure on refinancing will still amount to almost £500 million in 1977-78/ and nearly £670m in 1978-79. This implies additional bids of nearly £150 million in each of these years, an unacceptable situation when significant reductions are being made in other areas of public expenditure. It is unrealistic to suppose that the banks would agree to shoulder all this additional burden. Even if they would, shifts in the internal financing of export credit do not get to the root of the problem. The basic problem is that because almost all our export credit is at present financed in sterling, we are lending abroad on a massive scale, often to customers in countries whose currencies and balance of payments are much stronger than our own; and especially in circumstances of sterling depreciation, the consequence is a free gift of part of the value of our exports to overseas buyers.

3. Whether or not export credit is refinanced, all of this is subsidised by HMG. Currently the fixed rates charged on these credits range from 7¾% to 8% or so according to the length of credit and market involved, implying a subsidy at present of anything up to 8% per annum. The cost of this subsidy depends on levels of UK interest rates but is expected to cost around £200 million this year. This cost could rise to £400 million or more in 1978-79, if the subsidy continues to be in the region of 8% per annum. These costs represent additional burdens on the PSBR. Thus by 1978-79 the total impact on the PSBR of both expenditure on refinancing and the cost of the interest rate subsidy could well exceed £1,000 million.

4. We need to take urgent steps to change this situation. My proposal is that we should provide substantial incentives for exporters to make use of foreign currency financing rather than sterling credit. For this purpose the key requirement is to increase the rates of interest charged for guaranteed sterling finance. My proposal is that the rates should be increased by a minimum of 2% across the board to give a new minimum of 9¾% This increase in nominal interest rates will still maintain sterling export credit interest rates at their real level of two years ago: in this sense the increase would only be a partial reversal of the unintended increqse in the subsidy that has recently taken place.

5. In order to encourage the use of foreign currency finance, I would propose that those exporters who do so should be allowed to quote interest rates at the minimum level compatible with international agreements: in some cases this would mean in practice a lower rate of interest than under present arrangements. Officials are also urgently examining other ways of making the use of foreign currency financing more attractive to exporters, eg ways of enabling them to increase their sterling profits by selling forward prospective foreign currency receipts. A switch to foreign currency financing would inevitably create the need to re-examine practices currently geared to the use of sterling financing and sterling invoicing.

6. A switch to foreign currency financing will have substantial

national advantages. To the extent that exports are financed in foreign currency rather than in sterling, the balance of payments cost of export credit is eliminated. There is similarly a direct benefit to public expenditure since there would be no question of having to refinance export credit financed in foreign currency. The public expenditure benefit, and the reduction in the subsidy flowing from lower nominal interest rates on foreign currency finance would flow through to the PSBR.

7. I should however stress that the export credit problem cannot be solved simply by action to facilitate foreign currency financing, or to put it on an equal footing with sterling financing. We must create an incentive to foreign currency financing, and take steps to reduce the amount and burden of the sterling finance we provide, by increasing the rate charged for the latter.

8. I have discussed these problems and proposals with the Secretaries of State for Trade and Industry. They accept that the current arrangements are unsatisfactory, but have suggested that before making an increase in the rates of interest on sterling credit, we should have a trial period during which the possibility of securing a switch to foreign currency financing should be tested without such an increase. I appreciate their concern over the possible impact of such an increase on the prospects for exports by certain industries; but the urgency and severity of the problem require in my view a positive push towards foreign currency financing, and do not permit half-measures.

9. An increase in the minimum fixed rates for sterling credit will require careful presentation since it will be bound to provoke protests from those sections of industry most dependent on this form of credit and more generally could appear to run counter to our efforts to encourage exports. We must get across the message that our overriding need is to increase those exports which bring an immediate or early benefit to the balance of payments. In present circumstances the present open ended arrangements for refinancing abd subsidising sterling export credit impose too great a burden on the PSBR.

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10. I therefore recommend the following measures:-

a. An increase in the minimum fixed rate of interest on sterling export credit of at least 2% for all classes of business on these terms, with the possible but only exception of shipbuilding because of its long recognised special treatment for these purposes.

b. A more rigorous approach in considering those cases where ECGD are unable to support a transaction on a commercial basis but do so "in the national interest", and also the adoption of tougher limits on the amount of credit we are prepared to extend to individual markets - in several cases there is already mounting anxiety about the ability of the countries in question to repay the accumulating debts.

c. No increase to be made in the present minimum fixed rates of interest when the credit is financed in foreign currency - ie the dollar or possibly the Deutschmark - with the lowest possible rates being charged in these cases and ECGD to make no extra charge when insuring such contracts.

D W H

HM Treasury

11 November 1976

ANNEX

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EXPORT CREDIT

Introduction

Medium and long term export credit is now presenting acute problems over a range of policy fronts. The amount of overseas lending involved creates a very large charge on the balance of payments capital account. Because the Government refinances a major part of export credit advanced by the banks there is an uncontrolled and unpredictable claim on public expenditure, and consequently on the PSBR. Current problems also arise for monetary policy. And finally the allocation of national resources is being distorted by selling goods abroad to foreigners at prices below the value we put on the use of the same resources at home. This note sets out these problems in more detail and makes specific recommendations designed to curb the extension of fixed rate sterling credit and to promote the financing of such credit in foreign currency.

Background

2. The UK, in common with most other industrialised countries, provides credit at fixed rates of interest for those exports which are sold on repayment terms of two years or longer. The credit terms vary from contract to contract, subject since July 1976 to internationally agreed guidelines on minimum interest rates and maximum credit lengths for different categories of markets. In 1975-76 the rate of interest of most contracts fell within the range of 7% to 8½%. The length of credit varies between 2 and 10 years or even longer on occasions. Exports sold on these terms are mainly the larger capital goods and they represent about 8% or less of the total value of UK exports.

3. For this class of exports we are therefore providing a big effective subsidy since the cost of obtaining such credit on commercial terms in the domestic market would be in the region of 15% or more. The implicit subsidy on these credits rises with the length of credit, but on a credit length of eight years (a not unusual period in a buyer credit case) the effective subsidy is of the order of 25-30%. For all business on fixed interest terms, the average subsidy amounts to some 15% to 20%. The subsidy element is even higher if a Test Discount Rate in real terms is used instead of the monetary cost of government borrowing. This subsidy

is far greater than was envisaged four years ago, when the present fixed rate scheme was introduced, as a result of UK domestic interest rates rising to and remaining at higher levels than those in other major exporting countries. (Most other countries provide a subsidy in some form - except Germany - but the effective subsidy is much less than the UK because of our higher domestic interest rates).

The Balance of Payments problem

4. Export credit represents an outflow of capital abroad. These outflows, in addition to our continuing current account deficits, are a major factor in our external borrowing requirements. It is now clear that even on the most optimistic assumptions about our borrowing prospects there is going to be a critical problem in raising external finance over the period ahead.

5. We are lending very large sums overseas the repayment of which is deferred over long periods whereas our overriding need is for foreign exchange now and in the immediate future. It is particularly inappropriate for the UK to be offering such large sums - involving gross advances which are likely to reach some £2 billion next year - over a period when we are seeking to borrow and repay comparable sums abroad. Repayments due on the longer term credits will be making no contribution to meeting the repayments due on our own, shorter term borrowings. Moreover, our borrowings will have to be repaid in "hard" currencies, whereas the repayments of these export credits are at the moment in depreciating sterling. Figures for the forecast increases in both gross and net fixed rate credit outstanding are given below.

	£ million at current prices				
	1976-77	1977-78	1978-79	1979-80	1980-81
1. Gross Advances	1566	2015	2321	2477	2838
2. Net Advances*	811	1064	1109	982	1018
3. Export Credit outstanding at year end	3832	4896	6005	6987	8005

*Line 2 = changes in annual totals outstanding as in line 3.

These numbers are subject to a considerable margin of error and may prove to be significantly underestimated. They assume that the share of exports covered by this type of credit will decline from the present historically high levels. In practice, if foreign importers respond to the increased real level of subsidies involved, the share of exports covered might be expected to rise.

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The Public Expenditure problem and the PSBR

6. Under present arrangements, the clearing banks lend on demand to exporters if the business is insured by ECGD. Because the scale of such lending is so large, the banks will not provide all the finance from their own resources. Under an agreement between HMG and the banks, the latter carry on their own books an amount of export credit lending equal to 18% of their non-interest bearing sterling sight deposits (roughly speaking, their current account deposits). The balance is refinanced by ECGD. This refinancing represents public expenditure and an addition to the Public Sector borrowing requirement. This expenditure is impossible to forecast with any precision since it depends on both the forecast for export values and a forecast of bank deposits and a small error in either of these has a major impact on the estimate of refinancing.

7. Subject to these forecasting uncertainties, refinancing could give rise to a substantial "additional bid" this year and a similar claim on the Contingency Reserve was in prospect for 1977-78. For this reason the Chancellor of the Exchequer saw Lord Armstrong and other representatives of the clearing banks in July with the result that the banks have agreed to raise the refinancing "threshold" in 1977 from 18% to 20%. Provided the banks agree to maintain the threshold at this level, this increase will avoid much of the prospective increase in public expenditure in 1977-78. Nevertheless, the latest forecasts suggest that there will be substantial additional bids for expenditure on refinancing in every year of the survey period - at a time when the room for manoeuvre in holding public expenditure limits is virtually zero.

EXPENDITURE ON REFINANCING EXPORT CREDIT
£m at 1976 Survey Prices

	1976-77	1977-78	1978-79	1979-80	1980-81
1. Estimated Refinancing Requirement	547	497.4	669.6	551.8	557.0
2. "Additional bids" implied by 1.	160	149.2	148.4	29.7	42.0

7a. These figures represent expenditure on refinancing only. They do not include the cost of subsidising the interest rates charged on these loans. This cost (broadly speaking, the difference between the fixed rate charged on these export credits and the government borrowing rate as a percentage of the net amounts of credit outstanding) imposes an additional burden on the PSBR. Although this cannot be forecast, since it depends on interest rate levels, it is likely to amount to some £200 million this year. If the subsidy continues at around 8%pa, by 1978-79 this subsidy will be adding some £400 million to the PSBR.

7b. Thus the total effect of the subsidy cost plus expenditure on refinancing will be to add some £1,000 million or more to the PSBR in 1978-79 and similar increases thereafter.

8. If the problem were only one of reducing public expenditure on refinancing one obvious solution would be to try and induce the clearing banks to carry a still larger proportion of export credit without refinancing and to introduce other private sector lenders into the scheme - eg banks other than clearing banks, such as the Coop, some foreign banks and insurance companies. However, there is unlikely to be much scope for securing yet a further increase in the threshold by the clearers, because there is a limit on prudential grounds to the proportion of their funds they are prepared to tie up in this form of medium and long term lending. Thus any significant rise in the proportion of funds allocated to export credit is likely to be at the expense of other medium term lending. More importantly, such shifts in source of financing from the public sector to the private sector do not help with the other problems and the monetary impact is not relieved.

Monetary Policy aspects

9. The extension of export credit whether by the banks or by the Government adds to money supply and DCE. When the banks extend the credit, bank lending is increased; when the Government extends the credit (through refinancing) it adds to

the PSBR. Both the PSBR and the money supply have been subject, since July, to specific targets and it will continue to be necessary to maintain stringent targets in this area to preserve the UK's credit worthiness. The monetary consequences of the present growth of sterling export credit must therefore give cause for serious concern. If export credit on the scale at present projected is to be provided within the constraint of a tight monetary target other demands for bank credit will have to be cut back. In present circumstances, with relatively low demand for advances from ' non-essential' borrowers a substantial part of any cut-back on lending would be likely to fall on other areas of UK industry.

Resource allocation

10. Medium and long term sterling export credit is currently being provided at rates of anything up to 8% below the cost of market borrowing. A subsidy of the present order must, over time, seriously distort the allocation of national resources. We are selling goods to the foreigner at prices far below the value we put on the use of the same resources at home. On domestic grounds such a policy could be justified only if the resources could be used in no other way except to produce these particular exports. On anything but an extremely short-term view, it is difficult to believe that there are many cases that could satisfy this condition. Moreover, both in theory and in practice the PSBR places severe restrictions on subsidies to employ "unusable" resources. An approximate measure of the real resource cost is 15% to 20% of the gross outflows (paragraph 3 and 5 above) amounting to £230-£310 million this year, rising to £250m to £460m in 1978-79.

11. In terms of objectives related to the overall balance of payments position, public expenditure control and monetary policy, and to the optimum use of resources, there are therefore strong arguments for reducing the rapidly growing amount of sterling credit being advanced.

General Economic Strategy

12. However, the real costs of fixed rate export credit are not readily apparent to industry and the general public. The Government's strategy places great reliance on export led growth. Popular attention is focussed on the current account of the balance of payments. This reflects the value of exports as they leave the country, irrespective of when they are paid for. The message to be got across is that our strategy must be to increase those exports which bring a full and early benefit to the balance of payments. (Well over 90% of our exports by value are sold on cash or short-term credit.) We cannot afford to subsidise without limit those

exports for which payment is delayed so far in to the future, payments which are liable to be in depreciated sterling.

Industrial Considerations

13. Fixed rate export credit is particularly important for specific areas of engineering industry - shipbuilding, process plant, electrical generating machinery, ordnance and small arms, "miscellaneous machinery" and aerospace, all of which have more than 10% of their output covered by the current scheme. These industries, leaving aside ordnance and small arms and possibly aerospace as special cases, are generally working far below capacity at present with relatively poor prospects for recovery.

14. The Government is closely concerned with the future of all these industries, either directly (shipbuilding and aerospace), through planning agreements (process plant/ which is now the subject of a CPRS Report) or through sector working parties who would regard a substantial increase in the interest rate on export credits as contrary to the industrial strategy.

15. The theme of increasing export volume is central (along with import substitution) to the second round of the strategy, and it is also a main element in the Government response to industries such as process plant which are facing a drop in UK (mainly public sector) orders.

16. Given the market conditions facing them, these sectors - many of whose firms are in development areas - may not be able to shorten the credit terms they offer with ECGD help or to charge higher interest rates without losses of a substantial number of orders.

Time Lag

17. A further complication is that any action to restrain the extension of credit will take some considerable time to affect the balance of payments and public expenditure figures. This is because there is a variable lag between the banks undertaking commitments to make advances and those advances actually being drawn down by exporters: On very large contracts, when shipment is made in instalments and the credit drawn down correspondingly, it can take several years for the credit to be drawn down completely. In general, ECGD estimate that of commitments

undertaken now some will begin to be called within the first year and the bulk will be drawn by the end of the second year. This does not fully represent the timescale for the effects of policy changes, however, because there will also be a period preceding the commitment by a bank to provide finance during which the contract is being negotiated on the basis of current credit terms. Because the problem related to our balance of payments, public expenditure and monetary policy objectives are going to remain acute for the next three to four years, this means we have to take action urgently to achieve results within this timescale.

Policy Options

18. As matters stand, priority is being given to the open-ended expansion of export credit with the result that we are faced with serious problems over the whole range of policy fronts as discussed above. The scale of these problems means that we cannot afford to go on as we are and that some restraint must be imposed on the prospective growth of subsidised export credit. It is not realistic to suppose that we could get significant help from an early new international agreement on credit terms which would significantly tighten the recently agreed guidelines. (see paragraph 2). This is partly because so little progress has been made over the past two years with each country being jealous of its national independence in this area (especially the French) and partly because such an agreement would only affect officially supported credit and not bear on exporters who could raise finance commercially in those countries with much lower interest rate structures than the UK. We clearly could not expect other countries to agree to higher fixed rates on export credit if this would mean their charging rates higher than those prevailing on their domestic market.

19. In the absence of significant relief from international action we need to consider domestic measures to restrain the growth of subsidised export credit. The most drastic course of action would be to eliminate the interest subsidy completely by raising fixed rates of interest up to the region of market levels. This, however, would involve so large an increase (of [illegible]% or so) as to involve a considerable risk to a wide range of capital goods so long as other exporting countries either continue to subsidise their rates or to enjoy much lower domestic interest rates.

20. We could impose a ceiling on the amount of sterling credit we were prepared to approve or refinance ie fix a limit to the amount of new business which ECGD could guarantee in a particular period. The danger is that in practice this would involve first come first served treatment till the limit was reached, with arbitrary consequences for particular industries. For example, if a tough annual limit were imposed, this could be reached within a matter of months and we would then face the choice of either turning away applications for the rest of the year (which may represent business on better terms than some of that already accepted) or immediately breaching the ceiling. This course of action may have to be taken if no other can be found, but it is not recommended at this stage.

21. A third possibility is to change the basis of a refinancing scheme with the banks so as to relieve them of the collective obligation to finance all the suitable business which presents itself. This by itself would do nothing to reduce the demand for sterling credit in the short run since the volume of business financed by the banks depends upon the number and type of projects which ECGD is prepared to guarantee. Changes in bank/ECGD relationships depend essentially upon a renegotiation of the fixed rate arrangements for the period after October 1977.

22. Various steps could and should be taken to tighten up the terms on which fixed rate export credit is provided. There is always room for discretion about the criteria adopted for giving credit guarantees. In present circumstances it would be sensible to do such things as have stricter limits for those markets where the prospects of the countries concerned meeting their repayment obligations are weaker than others. The percentage of cover offered for individual projects could in some cases be cut back. And the encouragement to look for business could be reduced by cutting back the number of countries where active export promotion takes place.

23. This policy would amount to setting clear limits to the amount of business which can be accepted in particular markets, and in some cases would mean not accepting any further business beyond the present allocation. The advantage of this approach is that it can be explained in clear terms to exporters and overseas customers and it is sensible because there are already anxieties about the risk standing of a number of markets. In order to be effective, however, this approach

would need to be accepted by all the Departments concerned, in order to avoid the present tendency to undermine market limits by pleading special cases whenever these limits are reached.

24. By themselves, however, these changes cannot be relied upon to achieve a sufficient impact on the growth of credit nor will they provide any inducement to exporters and their overseas buyers to arrange sources of finance other than sterling (see para 28-31 below). Some increase in the minimum interest rates on sterling export credit is now needed. The unavoidable problem is that we cannot quantify with any precision the size of interest rate increase which could be secured without unacceptable damage to certain industries because of the loss of orders which might result and the limited scope for the firms concerned to diversify into exporting on cash or non-subsidised terms and into import substitution. However some increase in interest rates is now necessary to curb the demand for sterling credit.

Foreign Currency Financing

25. Many of the problems associated with fixed rate export credit would be reduced if such credit were financed in foreign currency. This would bring an early benefit to the balance of payments as exporters drew down foreign currency loans. The size of subsidy needed to enable fixed rates to be charged to overseas buyers would be substantially reduced since Eurocurrency borrowing rates are so far below UK domestic interest rates. Public expenditure on refinancing would be reduced since foreign currency loans would not be automatically refinanced - though a contingent refinancing liability would arise if ever the foreign currency loans could not be renewed. Moreover, exporters would be able to sell forward their loan drawings (or progress payments) and thus obtain additional sterling, for so long as sterling stands at a discount in the forward market, which can either be taken as profit or used to make their prices more competitive.

26. Although only rough estimates can be made of the amount of funds which might be available from the Euro markets, market conditions for such borrowing to finance export credit at the moment and in the near future seem favourable. A proportion of this borrowing could be expected to be additional to the existing programme of UK borrowing since although it would be UK guaranteed the repayments

would be made by the overseas buyer in foreign currency, to the UK. It is true that current market conditions will probably deteriorate as UK domestic loan demand picks up and more generally the availability of funds is bound to vary over time, depending in particular on market conditions and UK creditworthiness. But with due reservation for the large uncertainties involved, and assuming that sufficient inducement can be found, it would seem reasonable to envisage total borrowing through this channel of perhaps $1 billion in a full year. The extent to which such borrowing would be additional to the ongoing programme of foreign currency borrowing by public sector bodies is still more difficult to estimate, but it seems reasonable to expect that a quarter or perhaps as much as a half might be additional. And both the amount potentially available and the degree of additionality might be expected to improve over time as the form of finance became firmly established and recognised.

27. It is also impossible to estimate the demand for such foreign currency finance. Until now, there have been no cases of such financing of fixed rate credit transactions of which we are aware. In part this has been due to the absence of any arrangements for enabling a fixed rate of interest to be charged on such credit and because ECGD's guarantee against default by the buyer did not afford full protection in the event of exchange rate changes after the guarantee was issued since claims were valued on the basis of the exchange rate ruling at the time the guarantee was signed. ECGD are now introducing new arrangements to make foreign currency financing a much more realistic option - these include protecting the exporter of his bank against exchange rate changes in the event of a buyer defaulting and also the provision of such interest rate adjustments as may be necessary to enable the exporter to quote an interest rate on a foreign currency contract comparable to that on a sterling contract (at the present subsidised rates). This means the basic framework to support foreign currency financing now exists. But this will not of itself secure a significant switch away from sterling finance whilst the existing arrangements, providing easy access to heavily subsidised sterling finance, continue unchanged. Moreover, so long as there is an assumption (reflected in the discount on the £ in forward markets) of continued depreciation of sterling, a strong incentive in favour of sterling financing is created by the present degree of subsidisation of interest rates on the latter.

28. There are bound to be practical problems, only some of which can be identified in the absence of any experience with foreign currency financing, that will have to be dealt with as they arise and because some buyers may be reluctant to accept arrangements entailing quotations in currencies harder than sterling. The changes we have already made, if coupled with an increase in the fixed rates on sterling credit, should produce a reasonably strong incentive to foreign currency financing.

New steps to assist exporters with foreign currency financing.

29. However in order to provide further positive assistance to exporters - many of whom will be unfamiliar with foreign currency financing - the following measures could be considered when credits are financed in foreign currency:

a. ECGD to stipulate the lowest interest rates possible under international guidelines. This would mean that in a number of cases exporters could charge rates lower than the present rates which ECGD would require for certain markets.
b. If an exporter who is using a buyer credit facility financed by a foreign currency loan wishes to sell forward his loan drawings over a longer period than the market can accommodate, the authorities could if necessary make such forward purchases at market related rates.
c. If exporters face additional costs or risks because of the need to know such forward prices at the time they are tendering - whereas the prices may have changed by the time they win the contract - ECGD could consider whether ways could be found to alleviate this risk.
d. The cost of insuring foreign currency financed contracts would have carried an extra premium in addition to ECGD's basic insurance charge. Arrangements could be made so that this extra cost was absorbed in ECGD's overall premium structure.

Consequences of an increase in sterling interest rates

30. In principle, an increase in the rate of interest charged on export credit is equivalent to an increase in the overall prices of those exports sold on such credit.

The amount of business which might be lost as a result of any given increase therefore depends on how sensitive the demand for these exports is to price - the price elasticity of demand. In order to justify a subsidy of the present size, the elasticity would need to be much higher than that of $2\frac{1}{2}$ which is normally taken to characterise the demand for exported manufactured goods generally. The Department of Industry believe that because of intense international competition among exporting countries, most of whom subsidise their export credit interest rates to some degree, the elasticity in respect of these particular exports may be much higher than $2\frac{1}{2}$. If it were twice as high - 5 - and if there were no possibility of foreign currency financing, then DOI tentatively estimate that an increase of 2% in interest rates might result in an overall loss of about 1/5 in value terms of the exports sold on medium and long term export credit. Since these goods account for 8% or less of the total value of UK exports this would imply a loss equal to about $1\frac{3}{4}$% or less of the total of UK exports.

31. However, there are obvious grounds for concluding that this calculation, based on pessimistic assumptions, may considerably overstate the loss of orders. If the elasticity were this high, or even higher, then we would have expected to see a surge in demand for these UK exports, as a result of the recent sustained depreciation of sterling, of an order which does not seem to have materialised so far. Moreover, these calculations may overstate the risk to eports for two further reasons. First, non-price factors such as technology and reliability, etc can be equally important in determining whether an exporter wins a contract. Secondly, and most important in the present context, we are proposing an increase in sterling interest rates but not for rates charged on credit financed in foreign currency. Thus, the risk to business will depend less on the strict question of price sensitivity but more on the extent to which exporters can arrange foreign currency loans and the extent to which buyers are prepared to accept such loans which involve their repaying in a currency harder than sterling. There is some evidence that buyers, particularly in COMECON had OPEC markets, are more concerned with nominal interest rates than with the currency of the loan. In these cases, therefore, the UK exporter would be no less competitive than he is now if he could arrange foreign currency financing. Thirdly, this increase in nominal interest rates will still not restore sterling export credit interest rates to their real level of two years ago - in this sense the increase is only the partial reversal of the unintended increase in the subsidy that has recently taken place.

Conclusions and Recommendations

32. The problems posed by export credit are now so acute that we cannot afford to go on as we are in subsidising the open-ended growth of export credit. Action is therefore required to curb the growth of sterling credit and to secure a substantial shift into foreign currency financing. Because of the time lags involved (para 17 above) such action needs to be decided as soon as possible.

33. The following measures are recommended to achieve these objectives:-

a. a substantial increase in the minimum fixed rates of interest on all sterling credit over 2 years to apply to all export business with the possible exception of ships which have always been treated separately both domestically and internationally. Any further exemptions would seriously undermine the effect of the increase. There is a strong case for increasing interest rates by around 3-4%, which would reflect the discount on sterling in the forward currency market. At the very least, an increase of not less than 2% is required.

b. no increase in fixed rates on credit financed in foreign currency and such rates to be set at the minimum possible internationally so that the nominal rates would be lower than those now charged in some cases.

c. further positive steps to assist foreign currency financing as outlined in paragraph 29 above.

d. agreement on firm limits in the amount of credit we are prepared to extend to particular markets.

H M Treasury
11 November 1976

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26 November 1976

CABINET

BRITISH PETROLEUM SHARES

Memorandum by the Secretary of State for the Home Department

BACKGROUND

1. As part of the support operation for Burmah Oil, the Bank of England at the beginning of 1975 bought for £179 million the 20 per cent of British Petroleum (BP) shares which were previously held by Burmah. The Bank undertook not to use the voting rights which these shares gave them and the Government undertook that there would be no change in their existing relationship with BP.

2. In February Ministers agreed that 2.8 per cent of the BP shares should be transferred from the Bank to the Government to increase the Government's existing shareholding of 48.2 per cent to 51 per cent, and that the remaining 17.2 per cent of BP shares held by the Bank should be sold. At current market prices, 17 per cent of BP shares are worth over £500 million.

3. There is, however, a major snag. Burmah have started legal proceedings against the Bank for restitution of the BP shares sold at the beginning of 1975. Their claim is being resisted and legal advisers to both the Government and the Bank are confident that it will fail and that it has only a nuisance value; but the mere existence of the claim creates a sufficient shade of doubt about the legal title to the shares to make it impossible to mount a successful marketing operation. An attempt will be made by the Bank to persuade the Burmah Oil Company to substitute a purely financial claim for their claim for restitution, if only for BP's sake; but the odds are against this succeeding. The restitution claim will take 18 months to 2 years to go through the Courts.

4. If the Government want to secure £450 - £500 million from the sale of BP shares in order to reduce the public sector borrowing requirement (PSBR) in 1977-78, the alternative to selling the former Burmah shareholding in BP would be to sell an equivalent number of the shares now owned by the Government - the legal title to which is not in doubt - and to replace them in the Government's portfolio by a transfer of shares from the Bank. Burmah's claim for restitution would then lie against the Government. The danger - and the legal advice is that it is very slight indeed - is that if Burmah's claim succeeded, the Government's shareholding in BP would be reduced to 31 per cent.

ISSUES

5. The Ministerial Committee on Energy (ENM) under my chairmanship considered the sale of BP shares on 24 November. They were agreed that, if it proved possible to sell the former Burmah shareholding in BP, there would be no objection to doing so. They also reached agreement on a number of subsidiary questions arising from a possible sale. But they were unable to reach agreement on two questions:-

a. whether in the last resort the Government should be prepared to sell shares from their own portfolio on the basis described in paragraph 4 above;

b. whether BP shares from either the Bank or Government portfolios could be sold to a foreign government, or to an organisation controlled by a foreign government (eg Deminex in Germany) if *this* seemed likely to yield the best price.

6. These are the two questions on which a Cabinet decision is now sought.

SALE OF GOVERNMENT'S SHARES

7. The arguments relevant to selling 17 per cent from the *Government's* holding are:-

i. The over-riding need to get the reduction of c. £500 million in the PSBR in 1977-78, and the fact that alternative measures to achieve it - eg public expenditure cuts - would certainly be more painful and probably also more difficult politically.

ii. Until the Burmah claim is determined there must be some possibility, however slight, that, having sold 17 per cent from their own shares, the Government will subsequently have to return the *former* Burmah shares to Burmah, leaving Her Majesty's Government with only a 31 per cent holding. But -

a. all the legal advice is that Burmah's claim will fail;

b. under the arrangement Her Majesty's Government have with BP, our relations with the firm would be unchanged whether the Government holding was 31 per cent, 48 per cent, 51 per cent, or more. (Anything over 25 per cent would still enable the two Government directors to retain their right to a veto, which the Government have undertaken to exercise only where the national interest is at stake)

iii. Nevertheless, a 51 per cent shareholding does have a symbolic significance; and the latest version of the Social Contract, "The Next Three Years", attaches great importance (in paragraph 20) to "a clear expression of the Government's majority stake in British Petroleum Ltd ...".

(iv) The shares have been in the Government's ownership since 1914, and were not sold even at the height of the Second World War, when many assets were liquidated. Such an asset should not be sold now - particularly when a possible rise in the price of oil and the prospect of BP's Alaska operation becoming active is likely to increase the value of the shares.

(v) It would be politically unattractive in Scotland for the Westminster Government to be seen to be selling off a "Scottish" asset - BP has an interest in the Forties field.

SALE TO FOREIGN GOVERNMENT

8. This question arises whether it is Bank or Government owned shares which are to be sold. The relevant arguments are:-

a. If sold overseas, the proceeds benefit not only the PSBR but also the overseas balance - an important consideration in 1977-78.

b. It might be possible to obtain a better price from a private placing with, eg Deminex, than from mounting a market operation to disseminate the shares among a large number of smaller buyers.

c. While the Government directors would still be in the position indicated in paragraph 7 (ii)b. above, the relationship between a foreign Government (Germany, Iran, another OPEC country?) and BP would seem bound to have some effect on the relationship between Her Majesty's Government and BP, and some conflict of interest could arise.

CONCLUSION

9. There is no agreed recommendation on these two issues to put to Cabinet from ENM. In the context of the measures to reach an agreement with the International Monetary Fund, the Government will need to know whether they can count on the receipt of up to £500 million from this source to reduce the PSBR in 1977-78. It is therefore necessary to decide now in principle whether if it proves impossible to make arrangements which will permit early sale of the Bank-held shares the Government would be ready to sell 17 per cent of the total of BP shares from its own holding and replace them by a corresponding number of shares from the Bank holding.

10. A decision is also needed on the further question: should the sale of BP shares (whether from the portfolio of the Government or the Bank) to a foreign government or government-controlled body, be contemplated if that would maximise the price and benefit to the balance of payments?

M R

Home Office

26 November 1976

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30 November 1976

CABINET

THE CASE FOR AND AGAINST IMPORT CONTROLS

Note by the Central Policy Review Staff

1. In response to a remit from the Ministerial Committee on Economic Strategy, the Central Policy Review Staff (CPRS) circulated to that Committee on 14 October 1976, two papers: the first of these provided the case for general protection and the second the case against it. The two papers were put forward as "lawyer's briefs" and no attempt was made to draw conclusions as to which was the most persuasive. These papers are now circulated to Cabinet as background to the discussions on the International Monetary Fund loan.

2. No changes have been made to the papers as they were originally circulated but, if revisions were to be made, the CPRS would wish to emphasise in the second paper, The Case Against, the necessity for legislation.

Cabinet Office

30 November 1976

THE ALTERNATIVE STRATEGY

THE CASE FOR IMPORT CONTROLS

INTRODUCTION

The Problem - Britain's Secular Economic Decline

1. There is no dispute as to the basic long term problem. It is the need to reverse Britain's secular economic decline. In comparison with that of its main competitors, Britain's economic performance since the war has been, in almost every sense, poor: a low rate of growth of Gross Domestic Product (GDP); a low rate of growth of investment; a low share of investment in GDP, and a low level of investment per worker; slow export growth; increasing import penetration and a falling share of world trade; falling employment; a deteriorating trade balance and low productivity growth in manufacturing. A story of relative decline.

2. If Britain is to have a future as a high wage, high output economy, the relative decline of the past 30 years must be reversed. Yet since the 1960s this relative decline appears to have accelerated. Over recent cycles unemployment and inflation have risen to progressively higher levels, the balance of payments has gone deeper and deeper in deficit. It will be argued in this note that under present policies the prospects for reversing this decline during the remainder of the 1970s are equally poor. In 1980-81 North Sea oil and gas will ease our balance of payments problems; but for the next four years any attempt to reduce the current unprecedentedly high rate of unemployment by reflating the home market is ruled out for balance of payments reasons. Even if exports did expand as planned, the weakness of the home market would inhibit the major turn-round we need.

THE GOVERNMENT'S CURRENT STRATEGY

Industrial Regeneration

3. Without a substantial improvement in the performance of manufacturing there is little prospect of breaking out of the vicious cycle of low growth, low investment, falling employment and high inflation. The Government is rightly committed to securing a major improvement in the industry's performance.

4. The industrial strategy was launched with this aim in mind. By identifying high priority growth sectors and by finding ways of improving their performance - through planning agreements, restructuring, financial aid under the Industry Act and through the National Enterprise Board and so on - it is hoped to bring about a significant change in industrial performance.

5. But this initiative will not be sufficient on its own. The Government has recognised that it will need to be reinforced by macro-economic policies designed to create conditions that will encourage investment, growth and the rebuilding of the industrial base. Continuity of Government policy on taxation, investment incentives, etc, the expectation of a high and sustained rate of growth of output, little or no growth in public expenditure over the next five years, a competitive exchange rate and an increased share of profits in national income are all essential for creating the sort of climate within which industry can invest with confidence.

6. The basic doubts about this policy over the long term are whether the Government can and will set the necessary macro-policy framework for the industrial strategy to work. In the 1980s our balance of payments problems will have been eased by North Sea oil and gas and the old "stop-go" fears of changes in Government policy for balance of payments reasons may, in time, fade from

manufacturers' minds. But the worries on import penetration will still remain. Indeed, to the extent that North Sea oil and gas lead to a strengthening of the exchange rate they could become stronger.

The Immediate Problems facing the strategy - the balance of payments and inflation

7. The regeneration of industry is a long term objective. The fruits of the Government's initiative in industrial policy will not be achieved overnight. But while waiting for an underlying improvement in Britain's economic performance, improving the balance of payments and reducing the rate of inflation still have to be achieved. The Government's strategy in these fields involves -

i. relying on the social contract with the Trades Union Congress (TUC) to reduce still further the rate of inflation both during and beyond the current pay round;

ii. establishing a level for the exchange rate that will both enable the current account to reach balance by 1979 (given the prospects for inflation in the United Kingdom relative to that of our competitors) and will allow the maximum feasible growth of manufacturing output in the process;

iii. covering the current account deficits and any outflows on the capital account between now and 1979 by further borrowing from abroad - the IMF, the Eurodollar markets, the Group of 10;

iv. controlling the domestic economy through tight fiscal policy and through control on public expenditure to enable resources to be switched into the balance of payments as world trade grows over the next three years;

v. reinforcing the whole strategy by tight monetary policy and a steady reduction in the PSBR.

8. By sticking to these policies the economy should be in a position by the end of the decade to take the fullest possible benefit from North Sea oil. Debts accumulated since the oil crisis of 1973-74 can then be repaid and the remaining benefits of North Sea oil used to reinforce the industrial strategy.

9. There are several doubts about this policy. First, the exchange rate depreciation necessary to achieve balance and a fast rate of growth of manufacturing output may be so large (or unobtainable in an orderly way) that it puts at risk the social contract and the prospect of a falling rate of inflation. Secondly, the social contract may not hold anyway in the face of continued unemployment. Thirdly, with a weak home market and very high interest rates, investment in manufacturing may not increase adequately. And lastly workers may be unwilling to accept revised manning standards and raise productivity when unemployment is high.

AN ALTERNATIVE STRATEGY

10. Britain's relative economic decline since the war must be seen in the context of a worldwide trend towards trade liberalisation. First, there was the dismantling of physical controls during the ten years after 1945. That was followed in the 1950s and 1960s by successive rounds of reductions in tariffs. And the European Economic Community (EEC) and the European Free Trade Association (EFTA) hastened the process towards total free trade in Europe. With hindsight, Britain did not benefit as much from this movement towards free trade as did other countries. Some of them - Germany in particular - benefited greatly from the rebuilding of their industries

with modern equipment after extensive devastation during the war. Others - Japan is a good example - were able to develop new industries, in particular, and their economies, in general, behind trade barriers which were only removed when they were in a position to compete effectively in world markets. Britain, on the other hand, was left with her capital stock run-down, an economy completely open to foreign competition and with debt repayment, exports and rearmament taking priority over industrial re-equipment.

11. With this competitive advantage and increasingly liberal world trade, Britain's main competitors were able to increase their shares of world trade in the 1950s. For these other countries, the balance of payments, far from being a constraint on domestic expansion, was a cause of relatively fast output growth. They built up a momentum of fast output growth, fast investment growth, fast productivity growth and so on.

12. The reverse occurred in Britain. Without the benefit of a modern capital stock, without the ability to compete in an increasingly competitive world, the balance of payments, especially with a fixed exchange rate, became the major constraint on growth. "Stop-go" cycles, induced by domestic demand management policies to protect the balance of payments, created uncertainty and had adverse effects on the rate of investment. Output grew slowly and was expected to grow slowly, there was little incentive to invest, capacity constraints appeared in each successive boom and import penetration increased. The process became one of cumulative decline - a process that seems to have accelerated in the 1970s.

13. On this analysis the solution lies basically in raising the rate of growth of industrial capacity, modernising plants and products, and improving the utilisation of labour with a higher level of capital per

worker. This will involve major reorganisation (including changes in shopfloor attitudes and practice) and investment across manufacturing industries. But attempting to do this with an open economy in the context of increasing world competition and a slow-growing home market suffering severe import penetration, would be extremely difficult. The weakness of much of British industry, in the face of competition both from more advanced high productivity industries (especially in Japan and some of the countries of the EEC) and from cheap labour countries elsewhere, is now so great that free trade is ceasing to be of benefit to the United Kingdom. It is essential to have a period during which industry can expand and invest without the fears (i) that balance of payments constraints will require the Government to deflate; and (ii) that increasing foreign competition will lead to the continued loss of export markets and higher levels of import penetration will steal the home market. The historical record shows that no country has ever made a major industrial leap forward while, at the same time, leaving its economic frontiers continually open to penetration by its more advanced competitors.

<u>The Form of Protection</u>

14. There are, broadly, four main ways of "protecting" our home industry. They are -

i. subsidies;

ii. dropping the exchange rate;

iii. tariffs;

iv. quotas.

Subsidies are in principle flexible in that one can adapt the subsidy to the needs of the industry, but the public expenditure/taxation implications rule them out as a major general instrument across all manufacturing industry. Dropping the exchange rate is inflexible in that it affects all industries equally but, above all, is uncertain. The Government cannot be at all sure how far the exchange rate would have to fall to achieve the desired effect and industry has no way of knowing how far the Government would allow or want it to fall. Tariffs are flexible in that they can be tailored to the industry but uncertain in their effect in that their degree of protection depends on movements in the exchange rate. Only quotas are both flexible and certain. The degree of protection is independent of the exchange rate and of the price mechanism.

15. Quotas to limit the total value of imports would therefore give the most certain and effective protection to industry. They would need -

a. wide coverage

b. to be kept on for long enough for the necessary industrial reorganisation and investment to go ahead with confidence;

c. to be operated as flexibly as possible in order to minimise the risk of shortages of components, etc: provision for allowing at least part of the quotas to be bought and sold on an open market could help here.

The International Implications

16. Unilateral action to introduce general import restrictions would be regarded by our EEC partners, our NATO allies, and the IMF, as a gross breach of our international undertakings. Their immediate reaction would be to try and dissuade us from going ahead with any such scheme.

This discussion would initially take the form of extreme diplomatic pressure, and refusal to lend.

17. Whether we could effectively stand up to such pressures is a matter of political judgement. We would have to persuade our allies that Britain's problem is a structural one which short term measures will not solve - it may be possible to insist to our allies that a long period of protection is the only answer. Past experience shows no convincing reason why if present policies are continued Britain would not otherwise find herself with the same fundamental disequilibrium on the balance of payments in ten years' time as she does now. Also the traditional method of closing balance of payments deficits - devaluation and deflation - would damage their exporting industries just as protection would. If quotas lead to a prosperous Britain, a good market and a good ally, they are better for the trading world than a continuing sickly free trade partner. If we cannot persuade them of this, we shall have to go it alone.

18. In trying to convince our allies of the seriousness of our position, we should seek to demonstrate that Britain's situation is so adverse that international economic law justifies the use of import controls -

a. Article XII of the General Agreement on Tariffs and Trade (GATT) allows the use of general import restrictions to protect the balance of payments if they are necessary (the IMF determines whether they are necessary) to protect a country's foreign exchange reserves. This exactly meets the current problem;

b. Article 108 of the EEC Treaty of Accession allows a country (with the authorisation of the EEC Commission) to take measures to protect its balance of payments where, in the absence of such measures, the operation of the Common Market or the gradual achievement of the common commercial policy would be jeopardised

19. The risks of actual retaliation are difficult to assess. Some major trading countries, at least, would probably be reluctant to take any significant retaliatory action until other means of dissuading us had failed, because they would not want to start a trade war which might spread, and because they would not want other deficit countries to follow our example. (It has to be remembered that UK import quotas would affect only some 3 per cent of world trade.) The longer we maintained the restrictions, the more likely we are to provoke retaliation. On the other hand, if the alternative strategy were seen to be working, our competitors might be induced to hold their hands.

The Alternative Strategy in the Short Term: 1977-79

20. A policy of protection by quotas is mainly aimed at reversing over the decade ahead the long term decline in British manufacturing. But it would also have advantages in the short term. These advantages are considered under four heads: balance of payments; employment; inflation; living standards.

Balance of Payments

21. An interdepartmental group has studied the effects of a scheme of import controls, introduced at the beginning of 1977 to last for three years.* The scheme would involve quotas on just over 90 per cent of imports of consumer goods, 72 per cent of capital goods, 26 per cent of semi-manufactures, 5 per cent of basic materials and 19 per cent of food, beverages and tobacco - overall on about 25 per cent of all imports. Cuts of either 20 per cent or 50 per cent below 1975 volumes would be imposed on those imports covered.

*EY(76)48

22. The objective of this scheme is to close the gap on the current balance as soon as possible and thus reduce to a minimum the need for further borrowing abroad. They would have little effect in the first year but would, by about the second half of 1978, have built up sufficiently to turn the current account into surplus. A certain amount of borrowing to cover the intervening current account deficit and any shortfall on capital account would still be required. The size of this external borrowing requirement would depend greatly on how foreign official and market opinion reacted to our change of strategy. With a favourable reaction (i.e. they accepted it as a necessary and wise change) then we could borrow adequately from the IMF and the Group of 10, and the sterling balances would probably not be withdrawn. If they reacted unfavourably, then we would have to consider measures additional to quotas to protect our balance of payments. These could include import deposits (which would have to remain until quotas had restored our balance of payments and would probably not provide adequate foreign exchange); stricter exchange controls on current and capital transactions; guaranteeing (or freezing) the sterling balances. But by 1979 the annual current balance would have improved (assuming no retaliation and no change in fiscal poli y) by some £5 billion compared to present policies. And if the controls lasted for longer and we achieved a surplus they would obviously contribute greatly to the repayment of the external debt accumulated since the oil crisis of 1973-74.

23. Under present policies, unless we achieve major medium term loans from both the IMF and the Group of 10, the exchange rate is bound to remain vulnerable for the next three years. If it slides unpredictably, import prices will rise very sharply again and the

social contract could break down. In the short term the fall in sterling would make the balance of payments worse and the external borrowing requirement still larger and more difficult to meet. Under the *alternative strategy* the period before sterling becomes a strong currency again (with a balance of payments surplus) is halved. This prospect alone should make it easier to get through the next 18 months. But if need be the alternative strategy on imports will have to be accompanied by a companion alternative strategy on exchange control.

Employment

24. The forecast used by the Inter-departmental Group for their analysis of an import restriction scheme (EY(76)48) shows that on the basis of the Government's current strategy (relying on the growth of world trade to increase exports and output) there is little prospect of reducing unemployment significantly below its current level by the end of the 1970s if, at the same time, balance on the current account is to be achieved by 1979. In other words, the current strategy will not generate the demand to allow manugacturing output to expand fast enough to take up all the existing spare capacity in industry either because the exchange rate is still not sufficiently competitive or because of the need to maintain overtight monetary or fiscal demand management policies for external reasons.

25. The interdepartmental exercise on a possible quota scheme (described above) shows how beneficial protection could be (always assuming that there is no retaliation by other countries). By raising the rate of growth of manufacturing output over the next 3 years to its feasible maximum, unemployment would be some 300,000 lower at the end of 1979 than it would otherwise be. Given the impossiblity of reflating with our present balance of payments prospects, it is clear that import controls are the only way to reduce unemployment by any significant amount within the lifetime of this Parliament.

Inflation

26. Forecasting the rate of inflation, especially that of wages, under the alternative strategy, is a particularly hazardous procedure. There is no way of knowing how wages and prices would behave whether or not protection is introduced. But the achievement of a satisfactory agreement with the TUC on wages would be made that much easier if unemployment had some prospect of being significantly reduced in the short term (and import controls would provide that opportunity).

27. As for the non-wage pressures on prices, there is little reason to believe that import prices would rise under a system of import quotas. And the Cambridge Economic Planning Group believe that there would be virtually no effect on the price of domestically-produced import substitutes, despite the fact that they would no longer be subject to foreign competition. Price control would, in any case, prevent a major increase in domestic prices.

Living Standards

28. The difficulties of estimating the relative inflation rates under the two strategies carry over into, and form part of, the difficulty of estimating the effect on living standards. It is clear that under the alternative strategy output would be higher but more would need to go into the balance of payments (because the gap is closing faster). What is not clear is how much more. This is because we have to allow for any effect of the alternative strategy on the UK terms of trade. A plunge in sterling would mean worse terms of trade, a slightly lower real national income and a redistribution of income in favour of profits (mainly in the exporting industries). If the alternative strategy reduced the deterioration in the terms of trade and the shift to profit,

living standards would be that much higher than under present policies. Possibly the best assumption is that the effect on average living standards in the United Kingdom over the three years is likely to be positive but small. But 300,000 people will be at work rather than unemployed and the prospects for higher living standards in the years ahead after that much more secure because the manufacturing base will be expanding faster.

Implications for Fiscal Policy (Public Expenditure and Taxation)

29. It is sometimes assumed that one unpleasant aspect of the "alternative strategy" would be the need for a still tighter fiscal policy. That is to say for yet more public expenditure cuts or increased taxation. In March 1976 the Cambridge Group argued that in order to limit the rise in total demand under protection there "may" have to be an increase in the tax burden. This rise in the tax burden - if it proved necessary - could either come from explicit tax increases, or from failure to increase tax allowances in line with inflation. (An alternative, of course, would be public expenditure reductions.)

30. The issue is a complicated one - as is the question of the alternative strategy and living standards. The conclusion, as with living standards, is that there is unlikely to be much effect but if anything the fiscal problem would probably be a little easier under the alternative strategy rather than more difficult.

31. This is because the alternative strategy means an automatic reduction in the public sector deficit. Higher output and lower unemployment (both absolutely and in relation to present policies) mean less payments for social security and industrial assistance,

more receipts from taxation (PAYE, and taxes on expenditure), possibly more receipts from sales of import licences. Against this there is the need to ensure adequate resources for the higher industrial investment which the strategy will stimulate and for the faster closing of the balance of payments gap. Both these requirements mean that consumption must not increase too fast. On balance, the automatic reduction of the PSBR should be enough, probably more than enough, to provide the necessary restraint. Whether this would be so depends crucially on the behaviour of the current balance of payments under the alternative strategy. If it failed to improve as fast as was needed because exports were being diverted to the home market (quotas will prevent increased imports), then the Government would have to consider deflating. But they would be more likely to consider increasing the tax on exportable goods rather than cutting public expenditure. But if the production of exportable goods is expanded at the rate set out in the inter-departmental study, the alternative strategy would require neither public expenditure cuts nor increased taxation to achieve its objectives.

CONCLUSIONS

32. The first and crucial argument for the adoption of an alternative strategy is that the present strategy is clearly not working now, that it will not work over the crucial years 1977-80, nor yet again over the longer term.

33. At present balance of payments pressures (both current account deficits and capital outflows) are requiring monetary and fiscal policies which inhibit investment and the essential industrial regeneration. Even the present tough measures to protect sterling are no guarantee that over the next two years sterling will not fall sharply and far.

We do not have in sight sufficient medium term loans to support the currency if current and capital account pressures come heavily on the rate. The danger then is that over the next two years failure on industrial regeneration will be accompanied by failure on inflation as the falling pound, rising import prices, higher mortgage rates, high unemployment lead to a non-renewal of the social contract and a return to wage settlements of 20 per cent or more.

34. Protection by quotas is thus the only viable way of attacking the cause of Britain's long run economic decline and of laying the foundations for fast economic growth in the future. It would help close the balance of payments gap faster, help (possibly buttressed by capital controls) avoid the potentially destabilising effects of further runs on sterling. It is the only way of reducing unemployment to any significant extent within the lifetime of this Parliament.

THE ALTERNATIVE STRATEGY

THE CASE AGAINST

1. The case for a strategy based on import restrictions (QRs) set out in EY(76) 49 looks strong. But, in fact, it is a theoretical case, which will not stand up in practice. It does not offer a real alternative because:-

a. it ignores the practical implications of the immediate situation;

b. it disguises, or assumes away, a number of fundamental industrial and economic difficulties, which will in practice prevent it from achieving the results claimed for it.

I - THE EXTERNAL SCENE

The Immediate Situation

2. The events of the past few weeks have shown that we cannot afford to allow sterling to find its own level in the foreign exchange markets. With confidence so weak, no-one knows at what rate we might end up. A freely floating rate could have damaging effects on import prices - and hence the social contract and domestic inflation.

3. To control the rate, we need more reserves. Hence we have no alternative but to proceed with our application to the IMF and get all the support we can. We could not introduce QRs now. To do so would make it impossible to continue with the applications for the further tranches of IMF borrowing. Without the knowledge that IMF support is in prospect, and that our policies would be agreed with the IMF, confidence would collapse and we should be faced with an uncontrollable slide in sterling. We have therefore no alternative but to continue with present policies for some months.

Could we introduce QRs later on?

4. Whenever they are introduced, QRs take time to bite. They will n produce very significant effects for the first six months or so, and would ta another six to nine months to achieve their full effects. In the meantime, who would lend us money to finance the deficit? Certainly not our EEC partners, or the United States, who would regard the imposition of QRs as a gross infringement of our international obligations. Certainly not the IM who may very well only release our remaining credits by instalments. Again, we should be unable to support the rate while QRs take time to bite.

5. Holders of sterling (on both official and private account) would expect (probably rightly) that any QR regime would have to be reinforced by much tighter exchange control on both official and private transactions. They would take the first opportunity to try and get out of sterling, hence exacerbating the pressures on the rate.

6. The protectionist strategy can only work behind a tight ring fence of controls on imports of goods and foreign exchange transactions - both capit and current. In the likely circumstances of 1976 or 1977, are we sure that can get all the fences up fast enough to prevent a collapse of sterling? If n the QR option, whether implemented now or later on, would never get off th ground.

The EEC

7. The legal position is that introduction of QRs is contrary to Community Law: and, under the Treaties, Community Law overrides United Kingdom Law. It is doubtful whether we could repeal the relevant sections of the Treaty of Accession, in order to legalise our position, and the same time remain a member of the EEC.

8. More important is the political impact. QRs are so contrary to the basic principles of the Community that we should be under every kind of political and economic pressure to change our minds, including, most immediately, refusal to help with our foreign exchange difficulties.

Retaliation and Emulation

9. Whatever the precise form of EEC reaction, we would certainly be exposed to retaliation by other countries, under the provisions of the GATT. It seems inconceivable that, under pressure from their industrialists, the USA and Japan would not use the threat of legal retaliation under GATT to try to force us to change our minds. If they did not succeed other countries in weak balance of payments situations - Ireland and Denmark, for instance - would tend to follow our example and impose QRs themselves. This would be bad for our exports and it is by no means certain that we would be better off at the end of the day with QRs than without them. And we would earn the international odium of having started a trade war.

Our place in the Atlantic Community

10. The whole philosophy behind our international policies - both political and economic - has been based on the assumption that our future lies in membership of the Atlantic Community. This takes the form of membership of the EEC and the free trade and political co-operation which that implies; co-operation in trade and payments policies in OECD; and a major commitment to NATO. A decision to introduce QRs implies going back on this whole philosophy. It would be damaging to the EEC, damaging to international co-operation in trade and payments policy, and damaging to NATO. Once this damage had been done, it would be extremely difficult to re-establish ourselves in the Atlantic Community. Our former partners would be reluctant to trust so unreliable an ally again, and we would be liable to find ourselves left economically protectionist, and politically isolated.

II - THE INDUSTRIAL AND ECONOMIC CASE

11. The protectionist strategy assumes that QRs can be imposed without interfering very much with the smooth flow of industrial components and that manufacturing output could rise rapidly and without dislocation. In practice, this assumption is most unlikely to be fulfilled in practice.

12. International trade in manufactures is now so complicated and specialised that any quota scheme will be seriously disruptive. Multinationals make components in one country and assemble in another. Within a single commodity group - eg bearings - we are ourselves an exporter of some kind of bearings and an importer of others. Any quota scheme is bound to run counter to this pattern of specialisation and will lead to shortages of individual components and spare parts, bottlenecks and hold-ups in production. At least in the short run, the interruptions to production could in practice largely cancel out the theoretical gains. And the reversal of the process of international specialisation is likely to damage an important source of increasing productivity in the longer term.

Industrial Regeneration or Industrial Ossification

13. British industry has failed to compete effectively in export markets, and failed to maintain its shares of domestic markets in the face of foreign competition. This failure to compete is not simply due to lack of investment. It has a whole variety of causes: price, poor marketing, inferior or obsolete design, poor after-sales service, etc. British industry can only reverse these weaknesses by facing up to the competition. Protection would only succeed if industry organised itself to develop new and internationally competitive products and to launch new and major marketing campaigns to sell them. There is no reason to think that protection - even in the absence of retaliation - would produce anything of the kind. It is far more likely that under protection, management and labour would be able to avoid the changes which are necessary to face up to their competitors. Behind a wall of quotas they would become still more home-market oriented, and the home market would have no choice but to accept whatever quality and service they offered. When the QRs were eventually relaxed we would find ourselves still as uncompetitive as ever.

14. Moreover, it is worth noting the views of industry itself. Various groups have asked for selective import restrictions, to protect particular industries or products which were suffering special difficulties from foreign competition. But industry is heavily against any measures of general import restriction, and they are against them for the arguments set out above. The view that general import restrictions would be more likely to produce industrial ossification than regeneration is reinforced by the views of industry itself.

Taxes and Public Expenditure

15. The case for the alternative strategy argues (EY(76) 49, paragraphs 29-31) that, while tax increases or public expenditure cuts may be necessary with QRs, the probability is that fiscal policy will be somewhat less difficult with QRs than under the present strategy.

16. This view rests on the major assumption that there would be a rapid increase in output under protection, which would result in higher tax receipts, and reductions in expenditure or unemployment and other social security benefits, and less assistance to industry in difficulties. Given the short-run dislocation which QRs are likely to cause to industrial production, and the doubts about the incentive to modernise and expand in the longer term, this assumption will almost certainly prove optimistic. If output does not rise as fast as the alternative strategy assumes, then there will be excess domestic demand, which will suck back potential exports on to the home market, and tax increases or public expenditure cuts on a substantial scale will prove unavoidable.

Will the consumer accept the implications?

17. The restrictions would fall most heavily on imports of consumer durables and would have to last for several years. Unless and until British manufacturers set up new production lines, there would be at least only very restricted supplies of a wide range of consumer goods including

refrigerators, washing machines, motorcycles, colour television. Radio and hi-fi equipment would be limited to the more expensive and inferior British products. If motorcar exports are not to be frustrated by high domestic demand, restrictions on the supply of cars to the home market w almost certainly be necessary. The forced changes in consumption, and t physical shortages resulting from QRs, would be unacceptable to consumer

18. There is, moreover, a prospect of widespread price inflation - whi would be difficult to control - black markets, profiteering, hoarding, bribe and evasion.

<u>QRs cannot provide a basis for confidence</u>

19. Finally, and perhaps most important, there is a political factor to b taken into account.

20. If a scheme of QRs is to provide a basis for the regeneration of industry, it would have to be kept on for about five years in order to give industry time to carry out the necessary reorganisation and new investmen They will need to have an assurance of five years' protection if they are to plan ahead with any confidence. Even if we used QRs to get the balance of payments back into balance, we would need to be prepared to keep them on for three years.

21. In fact, the Government can give no such assurance. In practice, a everyone knows, the most it can do is to guarantee to keep them on for the lifetime of the present Parliament - and that is not long enough to create th confidence required. Indeed a statement by the Opposition that it intended t dismantle the scheme as soon as it took office would be sufficient to nullify any confidence effects. Given the uncertainties, firms will sit tight, and ta no risks.

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TOP SECRET

Copy No. 28

CP(76) 117

29 November 1976

CABINET

THE REAL CHOICES FACING THE CABINET

Memorandum by the Secretary of State for Energy

INTRODUCTION

1. In his paper to the Cabinet of 22 November (CP(76) 111) the Chancellor advised us of the grave economic dangers facing the country due to the run down of our reserves and the need to fund them by an International Monetary Fund (IMF) loan, later to be supplemented by a more general funding of the sterling balances which we were told cannot be achieved without accepting the loan.

2. The Chancellor also advised us that the conditions the IMF would be likely to impose would involve a cut in the public sector borrowing requirement (PSBR) of at least £1½ billion, including £1 billion in straight cuts in public expenditure in 1977-78 with differing arrangements to be phased in for 1978-79 so as to provide a two year cover for our external position.

3. During the Cabinet discussion an alternative proposal was discussed comprising a £1 billion reduction in the PSBR of which nearly a half would derive from the sale of public holdings in British Petroleum (BP), leaving the other £½ billion to be covered by a mixture of tax increases and cuts.

4. It was agreed that further discussions should be held with the IMF at the highest level to sound them out on this approach and on a general relaxation of their original terms.

THE DANGERS DERIVING FROM IMF CONDITIONS

5. It became clear at the Cabinet that certain dangers to the Government's economic, industrial and political strategy might flow from the Chancellor's proposals.

6. These can be summarised as follows:

i. They would be very deflationary when unemployment is high and rising, investment is slow and sluggish, interest rates are high already, and living standards are falling and due to fall more sharply.

ii. They would involve cuts into public services so deep as to endanger their basic function and cuts in social benefits that would put at risk the Social Contract.

iii. They would put at risk our Parliamentary majority by creating circumstances that might make it difficult for Labour Members to carry through the necessary legislation.

7. There are other dangers that we did not discuss, but which the Cabinet must consider while awaiting the outcome of the further discussions with the Fund.

a. Any agreement with the Fund which controls the Domestic Credit Expansion (DCE) if accepted might carry policy implications not immediately apparent.

The Letters of Intent already sent to the IMF in association with our earlier drawings and borrowing under the oil facility did commit us to DCE targets which, since they have not been met, have precipitated much of the lack of confidence which has led to the present sterling crisis and driven us back to the Fund with the expiry of the standby credit.

b. DCE targets at or below our present expectation might not immediately impact upon the PSBR, but if exceeded could commit us now to future cuts in the PSBR of an unpredictable magnitude at an unspecified date which could be quite soon.

c. Further cuts or tax increases designed to bring the DCE back into line with targets we had agreed would then follow on a scale and in a form that might commit us to further deflation, higher unemployment and lower benefits or public expenditure from which the Cabinet cannot escape within the terms of a new Letter of Intent.

d. The Chancellor has told us repeatedly in the past that a loan from the IMF would not be available to us unless we were prepared to give a categorical assurance that we would forgo completely our right to impose import controls or exchange controls during the two year period which the IMF loan will cover.

e. Some references were made by colleagues to the possibility of a wage/price freeze as an alternative or addition to our present policies which it seemed to be suggested we might offer in return for easier conditions. The Cabinet has not discussed this, but with inflation now forecast to rise to 16 per cent in the coming year, a wage freeze - whether sought voluntarily or imposed statutorily, would terminate the Social Contract and should therefore not be mentioned in any talks with the Fund.

THE REAL CHOICE

8. i. The IMF Road

The Cabinet is therefore faced with a real choice. We might accept that a loan is inescapable and unavoidable in which case we are bound in the end to accept the very best conditions that we can negotiate, even if they fall far short of what we think right and involve us in all the dangers set out above, including a commitment to abandon an option to introduce the alternative strategy during the duration of the loan.

Indeed if we allow ourselves to be persuaded that there is no alternative to the loan we surrender from that moment to any demands that may be made upon us whatever their consequences for the British people and whether or not we were able to carry them through as a Government.

ii. The Alternative Strategy

The case for the alternative strategy has been argued in the Cabinet before. It is based on a plain recognition that the strategy we have followed since March 1974 has failed, and in recommending that we accept the IMF conditions the Chancellor too has now recognised that the existing policy as failed.

The alternative strategy is based upon the belief that the price we must pay for borrowing to finance a free trade policy is too high because it involves unacceptable levels of unemployment, unacceptably low levels of investment and a progressive deterioration of our manufacturing capacity. All these tendencies can be observed to be at work now and our forecasts imply that they will be accelerated by the conditions the IMF might require us to accept.

9. Since we are starting afresh the Cabinet should now look at a five point plan for national recovery, which if adopted will be the basis for a vigorous public campaign for support and would extend up to, during and beyond the next General Election.

10. A national recovery plan of this kind should be based on the following:

a. A decision now to introduce overall import quotas for manufactured goods to be set at levels that permitted us to survive without the loan if we had to do so.

b. The immediate introduction of import deposits to cover the interim period between the enforcement of the import quotas and their full implementation.

c. The immediate enforcement of exchange controls to check speculative outflows, to be buttressed by special arrangements negotiated for the official holders of sterling to guarantee them against loss.

d. The reintroduction of a Capital Issues Committee together with arrangements for the control of bank advances to guarantee that investment did not take place in areas that did not rate as a national priority, thus helping to channel funds into projects that would have become attractive because import controls would provide a secure home market.

e. A lower interest rate for all but the official holders of sterling, to give a secondary incentive to investment and employment which would cut the PSBR by lowering debt interest payments, reduce unemployment and underpin our industrial strategy.

f. Strengthen our industrial legislation by taking reserve powers to introduce planning agreements and by providing more funds for the National Enterprise Board and the Scottish and Welsh Development Agencies.

THE PROBLEMS OF IMPLEMENTATION

11. Given the abandonment of our existing economic strategy the change to a new one would be difficult whichever of the two roads above we adopted. To that extent the alternative strategy could be presented as having been adopted only after all other policies had been tried.

12. Given the degree of international interdependence that exists our clear objective should be to persuade the IMF, the General Agreement on Tariffs and Trade (GATT) and the European Economic Community (EEC) that this is the right course for Britain and one that they should support for the four or five year period necessary to allow us to re-industrialise so that we can emerge strong again at the end.

13. We should therefore boldly tell them that this is the policy we intend to adopt and seek a loan to assist its success and reduce the severity of the measures which would otherwise be necessary which would reflect themselves in internal sacrifice and an even tougher import restriction. We could explain that our level of import penetration would depend upon their readiness to give such assistance, and that such assistance would benefit them to the extent that it allows us higher levels of imports from their countries than would otherwise be possible.

14. Similarly at home we should present the strategy boldly as a strategy for national recovery upon the basis of which we would feel entitled to seek co-operation and to invite the acceptance of the consequences that would flow from it.

15. I would not suggest that we hammered the term "sacrifice" nor urge people to "face the harsh truth", because there are many of our people for whom the sacrifices are already real and the "harsh truths" have become commonplace in the leading articles of Conservative newspapers.

16. Our approach should be based upon the belief that the interests of this country, short term, mid term and long term, require us to find through economic, industrial and political reforms, a way of using our enormous skill and ability more constructively and productively than our present inadequate political industrial and economic structures allow. It is a reform programme too and unless that element is introduced into it it would appear that it involves another hackneyed appeal for people to buckle down in order to prop up an unfair and undemocratic economic system from which they did not benefit fully when it worked, which has caused suffering for them when it failed, and which even if it could be made to work again would involve further sacrifices without any guarantee at the end that these sacrifices would pay off in a fairly shared distribution of benefit or power.

17. Such an appeal to the British people would have certain clear merits. First it would be based upon an industrial strategy that we left to ourselves believe is right, and would only be abandoning under pressure from the international financial community. Secondly it is a strategy for which there is already great support in the Labour and trade union movement which we ourselves created before, during and after the 1974 General Election. Thirdly it would be built upon values and ideas that the Labour movement has developed and cherished over a much longer period than that. Fourthly it would appeal to all those who are not of our political persuasion, but who already sense that Britain's basic interests are being sacrificed under international pressure which also is being used to humiliate us by lending money in return for the surrender of basic rights of national self-determination.

18. It is a programme that does not require us to adopt a posture or stance of confrontation against anybody, since it invites all to work together - managers as well as unions, industrialists as well as professional people. It is an invitation for a new consensus without which no modern industrial society can work.

CONCLUSION

19. I do not wish to underestimate the difficulties of making the choice set out in paragraphs 8-10 above, but colleagues who dissent from this view should not underestimate either the difficulties of adopting a line enforced upon us by the Fund.

20. Either way we shall have to confront obstacles and face some erosion of support until it is seen that the policy choice we have made is working, and as a Government so finely balanced in Parliamentary terms we cannot be certain how we will fare.

21. At least the alternative strategy can be seen to be firmly based on a belief in our own people's capacity to use their skill if the structures permit them to do so. At least the long road might be seen to be ending. At least we would be counting those who create the wealth as assets, not as human units to be dispensed with as a by-product of imposed cuts on social services or necessary sacrifices as a flood of imports engulf us.

22. The alternative strategy is already accepted by many in our movement and can touch and stir those who have never thought of us before as defenders of the British people.

23. But if we are not seen to be defending our interests we cannot aspire to the national leadership which two General Elections have placed in our hands to exercise for the benefit of all.

24. Since the choice we are being asked to make is of such magnitude I recommend to my colleagues that no decision be made until we have had the opportunity of discussing the alternatives, in conditions of confidentiality, including the ones set out in this paper, with the responsible leaders of the Trades Union Congress and the Labour Party.

A W B

Department of Energy

29 November 1976

CP(76) 118

COPY NO 81

29 November 1976

CABINET

ECONOMIC STRATEGY - THE IMF

Memorandum by the Secretary of State for Foreign and Commonwealth Affairs

1. It is now widely agreed that there is no economic case for further deflationary cuts in public expenditure:

a. Resources. No one seriously suggests that, given the prospective level of unemployment and spare capacity under existing policies, we need still more deflation to make room for exports and investment.

b. Inflation. Far from improving matters, further cuts would, by their probable effect on rents and other prices and on relations with the Trades Union Congress (TUC) seriously threaten the Social Contract and the prospects for wage stability next year.

c. Investment. Further cuts, involving another increase in unemployment and a rate of growth in 1977-78 of, say, $1\frac{1}{2}$ per cent, would still further depress the profit expectations of industry. Whatever the rate of interest, industrialists will invest only if they can see the future demand for their products; and a yet greater degree of deflation would kill our industrial strategy stone-dead.

d. Balance of Payments. This, the traditional argument for public spending cuts, is not being advanced in the present controversy; in any event we are likely to move into a healthy surplus in 1978 (Treasury) or mid-1977 (National Institute).

e. Financing the Deficit. It is sometimes argued that we cannot easily finance a public sector borrowing requirement (PSBR) of £$10\frac{1}{2}$ billion. There is much scepticism about this argument; moreover other estimates of the likely PSBR are much lower (eg National Institute £8.2 billion). The uncertainty here is far too great to justify cuts which could torpedo the Social Contract and threaten the future of the Government.

2. The argument therefore boils down to the confidence factor. On this, I would make the following points:-

a. We have to consider the likely effects on confidence of a possible breakdown in the Social Contract caused by further cuts.

b. Informed opinion, both nationally and internationally, is turning strongly against the policy of further deflation (eg statements by leading economists, the recent statement of the Confederation of British Industry (CBI), editorials in the *Washington Post* and the Herald Tribune, the sympathetic response of President Ford and Chancellor Schmidt to the Prime Minister's message, etc.).

c. Provided we secure the IMF loan, we shall get the safety net for the sterling balances. The market will then see that we have the means to regain control of our currency. For the first time in years we shall be seen to have the money to finance our deficit until it is turned into surplus and to remove the sterling balances' threat to the stability of sterling. Our new ability to defend the sterling rate will be a crucially important factor which has hitherto been absent.

d. The fact that our partners have agreed to the IMF loan and safety net will show the market that international opinion wants us to have a stable currency on the basis of which we can pursue our economic policies and are willing to organise important co-operation in support.

e. The market will see the £1 billion PSBR cut which I am proposing for 1977-78 as the precursor of further cuts going with higher economic activity.

3. Our bargaining position with the IMF is in my view stronger than people realise. For if they push us to the point of a siege economy and the full panoply of import controls, this would gravely threaten the cohesion of the EEC, dangerously stimulate a move towards world protectionism, and bring into question the British contribution to the military defence of the West. Our very weakness brings us strength. If we keep our nerve, we shall find that the IMF cannot afford not to give us the loan.

4. I make one final point. It is still sometimes said that the British people are not living within their means and need to be taught a sharp lesson about the reality of our condition. But on present policies we shall be living within our means by late 1977 or early 1978. Meanwhile the British people are enduring $1\frac{1}{2}$ million unemployed, a loss of potential production on an enormous scale, and an actual fall in their real standard of living. There is no canon of morality or economics of social democracy which demands from them a further and needless sacrifice.

A C

Foreign and Commonwealth Office

29 November 1976

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29 November 1976

CABINET

ACTION TO COUNTER UNEMPLOYMENT IN 1977

Memorandum by the Secretary of State for Employment

1. I was invited to consider, in consultation with others concerned, what action might be taken to deal with the forecast level of unemployment.

2. On the forecast we face an increase of 350,000 next year in the numbers unemployed, taking the present level of 1.34 million, to nearly 1.7 million in December 1977. This reflects a decline in employment and a growth in the labour supply. The labour supply figures are particularly tentative and the National Institute of Economic and Social Research do not forecast any increase in unemployment over the next year. Nevertheless I must assume that the Treasury forecast is the best view we are able to take of the course of unemployment and what follows is based on that assumption. Any further public expenditure cuts are likely to add to forecast unemployment.

3. We have never abandoned our publicly declared objective of getting unemployment down to 700,000 by the end of 1979. It is clearly an impossible objective if unemployment is 1.7 million in December 1977. Even if unemployment was 1.34 million in that month, it would not be easy to achieve. At the very least, we must think in terms of ensuring that unemployment is not above its present level, ie 1.34 million at the end of next year. This is not an objective incompatible with the hard facts of the situation. A reduction of 400,000 in the number of unemployed takes £1 billion off the Public Sector Borrowing Requirement (PSBR).

4. An important factor in the forecast rise in unemployment is the declining impact of our present selective employment and training measures. In the first few months of 1977 as they reach their peak impact they take about 20,000 a month off the increase in the unemployment register and so keep the forecast monthly rise, which would otherwise be 30,000, down to about 10,000. But all these measures come to an end during the first half of 1977 and their impact progressively and rapidly declines after the first quarter. As they lose their force the forecast rate of increase in unemployment rises to about 35,000 a month.

THE POSSIBILITIES FOR ACTION

5. The simplest and quickest action would be to extend the life of all present measures to the end of 1977 at the same level of support as at present. This would raise their impact on the unemployment register from 200,000 to about 225,000 in March and keep it at that level until the end of 1977 instead of falling over that period to about 35,000. This would reduce the forecast level of unemployment from about 1.7 million to about $1\frac{1}{2}$ million in December 1977 and would halve the average monthly rate of increase in unemployment through 1977 to 15,000 a month. The gross cost would be of the order of £380 million, but the net cost should not be more than a quarter of this and could be a lot less.

6. To bring registered unemployment by the end of 1977 to the present level - 1.34 million - would mean taking another 160,000 off the register and would necessitate increasing the impact of existing measures to the maximum extent possible (as well as continuing them throughout the year). It might also involve the introduction of new measures.

7. Some expansion of training and job creation could take another 26,000 off the unemployment register at a gross cost of £46 million (net cost £18 million). The further possibilities include extending the period of payment for the Temporary Employment Subsidy from 12 to 18 months and/or increasing it from £20 to £25 or £30; the introduction of educational maintenance allowances; a new employment subsidy for additional labour recruited (a Layard scheme); and, if the present job release scheme proves effective, an expansion of the scheme by extending it to the whole country and/or reducing the eligible ages to 63 for men and 58 for women. Not all these options need to be adopted to remove another 160,000 from the register. The possible choices between them could be considered when we have decided on our overall strategy. With the exception of training and job creation none of the possibilities mentioned is free from difficulty, whether because it is less cost-effective than existing measures or more uncertain in its effects. The best judgment I can make is that we might get the further 160,000 off the unemployment register by spending another £400 million gross. The net cost is likely to be higher in relation to the gross cost than an extension of the present measures, but would certainly be very much less than the gross cost.

8. Another group of measures which could reduce unemployment are those designed to share available work such as reducing overtime, reducing standard hours, extending holidays and encouraging short-time working rather than redundancies. The major difficulty in the way of all such developments is that existing employees will not easily be persuaded to give up work if this means a fall in their earnings; yet the maintenance of earnings would be quite unacceptable because it would push up industrial costs and would be incompatible with incomes policy. The most promising areas may be the reduction of excessive overtime and the

encouragement of short-time as an alternative to redundancy. Legislation would not be appropriate and progress could only be made through negotiations between employers and unions supported by the Government.

9. If we decided to pursue this line of thought the next step would be for the Government to discuss the possibilities with the Trades Union Congress (TUC) and the Confederation of British Industry (CBI). I would see considerable advantage in involving both sides of industry with the Government in tackling the present high level of unemployment, though we could not expect significant results in 1977.

CONCLUSIONS

10. I invite my colleagues to agree that sufficient resources should be made available to expand the present measures and to introduce any new measures in order to prevent unemployment from increasing in 1977. It would cost around £380 million gross (below a quarter of this figure in PSBR terms) to extend the present measures on their present basis which should ensure that unemployment is no higher at the end of 1977 than 1.5 million. It could cost another £400 million gross (about a quarter to a half of this in PSBR terms) and in part the introduction of untried schemes not yet worked out in detail, to attempt to reach a figure of 1.34 million at the end of the year, ie no higher than at present. In my opinion it is necessary to prevent unemployment rising beyond its present point and I recommend to my colleagues that room should be found for the necessary expenditure. I recognise that expenditure reductions in other areas will cause some increase in unemployment but this would be trifling compared with the beneficial effects of the highly labour intensive special measures.

11. If my recommendations are accepted officials should be asked to identify the most appropriate set of measures. In addition, I recommend that we should have discussions with the CBI and TUC on the possible work sharing approaches which do not involve additions to the wage bill, especially the elimination of regular overtime.

12. If this general approach is agreed, I recommend that at an appropriate time (possibly in the statement on the International Monetary Fund discussions or when the economic forecasts are published) we should announce the Government's intention to take further action through selective measures to hold unemployment down through 1977 and to consult industry on the work sharing suggestions. The amount of detail we put into such an announcement can be settled later. It would be necessary to say that we intended to consult the Manpower Services Commission because the suggestions I have made in their field have been made without reference to them.

AB

Department of Employment
29 November 1976

HIS DOCUMENT IS THE PROPERTY OF HER BRITANNIC MAJESTY'S GOVERNMENT

CP(76) 120 COPY NO 81

29 November 1976

CABINET

DEVOLUTION: THE ENGLISH DIMENSION

Memorandum by the Lord President of the Council

1. I attach, for the consideration of colleagues, the draft of a consultative document on devolution and England. We are committed to publish this document before the Second Reading of the Scotland and Wales Bill.

2. In accordance with instructions of the Ministerial Committee on Devolution Strategy (DVY) the draft document follows an analytical, non-committal approach. It aims at avoiding unnecessary offence to any of the various groups of English opinion on whose support we shall have to rely in order to secure the passage of the Scotland and Wales Bill. For the present this must be our primary objective. Whatever view we may take at a later stage about the need for changes in the structure of government in England, the present document is not the occasion for expressing opinions or attempting to steer opinion in one direction rather than another.

3. The structure of the present draft was approved by DVY on 26 November. Beyond ruling out an English Assembly and regional assemblies with legislative powers - to both of which there are clear and persuasive objections - the draft expresses no preference between a number of forms of change which are described (Section IV). These are presented as illustrations of the very wide range of possibilities which exists, depending on the particular combinations of powers and functions which new bodies would exercise. And in setting out factors which have to be weighed when the practicability and acceptability of particular possibilities of change is considered, the draft (Section V) deliberately avoids balancing the factors in relation to any particular possibility.

4. This form of presentation seems to me preferable in this particular document at this particular time to the possible alternative of taking three or four specific formulations of change and setting out the factors referable to each. Such an approach can no doubt produce a more clear cut

impression, but that is what, on this occasion, it is better to avoid. Moreover, it lends to the particular formulations selected for discussion an immediacy and a plausibility which is not produced if the discussion of the factors to be weighed is kept on a general basis.

5. I believe that the approach in the draft will allow us the maximum freedom of manoeuvre in the light of developments on the Scotland and Wales Bill and in the course of the consultative process itself, including the possibility of a further more specific document should that become expedient.

6. I invite my colleagues to approve the attached draft, subject only to any minor drafting amendments or corrections of errors which may be found desirable. The intention is to publish it next week, probably on 9 December.

M F

Privy Council Office

29 November 1976

DEVOLUTION: THE ENGLISH DIMENSION - A CONSULTATIVE DOCUMENT

I THE DEVOLUTION BACKGROUND

1.1 The Government have just published a Bill[1] to give effect to their devolution proposals for Scotland and Wales. The Bill provides for the creation of new bodies which will be directly elected by and answerable to people in Scotland and Wales.

1.2 The proposals for Scotland and Wales are complex. The Government have already been working on them for over two years. They will now be closely scrutinised by Parliament over a period of several months.

1.3 The Government have always intended that their review of government arrangements in Great Britain should cover England also. But consultations undertaken in the summer of 1974 showed not only much greater desire for change in Scotland and Wales than in England but also a clearer view as to what form such change should take.

1.4 The Government announced their preliminary conclusions for Scotland and Wales in September 1974[2] but made it clear that it would be premature to reach any conclusions about change in England until further consultations had been carried out. They decided subsequently to defer these further consultations until they could be conducted against a background of firm proposals for Scotland and Wales.

1.5 The purpose of the present document is to describe the main features of the proposals for Scotland and Wales, to discuss the main implications of these proposals for England and to set out the factors to be taken into account in assessing the case for and against various possible changes in England.

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(1) The Scotland and Wales Bill, published on 30 November 1976

(2) Democracy and Devolution: Proposals for Scotland and Wales: Cmnd 5732

1.6 Constitutional arrangements in the UK have developed over the years in a flexible way. Northern Ireland had a separate Parliament from 1920 to 1973. Scotland has had its own Minister in the Government for many years with an increasing range of functions administered under his direction by officials operating from Edinburgh and working in close contact with representative Scottish bodies. Wales has had a similar though newer and less extensive system. English arrangements have been different again, with a series of specialist Ministers directing functional departments, some of which have regional offices maintaining contact with the interests concerned with a particular function in different parts of the country. The Scotland and Wales Bill does not relate in any way to the arrangements for administration in England and leaves the existing arrangements completely untouched.

1.7 This variety of constitutional arrangements has contributed to the flexibility and responsiveness of government since it has been possible to devise machinery suited to the requirements of a particular function in a particular part of the United Kingdom at a particular time, without having to apply identical arrangements everywhere. Requirements will continue to vary after devolution. The Government see great advantage in avoiding the harmful effects of unnecessary standardisation.

1.8 At this stage the Government do not themselves advocate any specific course of action in England. The factors affecting England are singularly complex. It is important that they should be generally understood so that public discussion can be informed and illuminating. In the light of such discussion and any consensus which may result as to desirable change the Government will decide what proposals, if any, they ought to promote.

1.9 Subsequent sections of this paper deal with the constitutional implications for England of the proposals for Scotland and Wales; their industrial and economic implications for England; the possibilities for change in England; and the factors which have to be weighed in assessing such possibilities. The final section deals with the consultative process and contains a list of questions on which views are invited.

II - ENGLAND AFTER DEVOLUTION - CONSTITUTIONAL IMPLICATIONS

2.1 The English dimension of devolution has to be judged against the background not only of the continuing supreme authority of Parliament, but also of the form of the Government's proposals for Scotland and Wales. It is clear, however, from comments made on the Government's devolution policy that widespread misunderstanding still exist about its purposes and effects. Before considering the constitutional implications for England, therefore, this section briefly recapitulates the main features of the devolution policy.

2.2 The Government see devolution to Scotland and Wales as a means of enabling the domestic affairs of these two parts of the United Kingdom, with their distinctive national traditions, to be administered in closer accordance with the wishes of the people living there. Many of these matters are already administered by the Secretaries of State for Scotland and Wales. Devolution will complement this administrative decentralisation with separate political accountability direct to the Scottish and Welsh electorates, and will also reduce the present pressures on parliamentary time. The Government believe that the unified structure of the United Kingdom can accommodate these new institutions.

2.3 In devising their devolution schemes the Government have sought to identify the areas of activity where decisions affect primarily people living in Scotland or Wales. They consider it important not to devolve to either Assembly powers over activities which substantially affect people living elsewhere or the well-being of the United Kingdom generally.

2.4 In relation to the matters to be devolved the new administrations will inherit the executive powers that Ministers now exercise. In addition, having regard to the separate system of law in Scotland and the existence of separate institutions and policies in many of the activity areas concerned, the Scottish Assembly will have powers to legislate on most of the devolved matters.

2.5 Devolution will not, however, affect the supreme authority of Parliament and its ability to make laws on any subject for the whole of the United Kingdom or any part of it. Apart from this the Government and Parliament will continue

to be directly concerned with a wide range of important matters in Scotland and Wales - for example, general industrial and economic policies (discussed in section III), social security, the major nationalised industries, the regulation of commerce, the preservation of law and order. The Government will also have a general power to intervene, subject to parliamentary approval, where action by a devolved administration or a failure to act, threatens to prejudice an interest for which the Government and Parliament have retained responsibility.

2.6 It might be argued that in the interests of equal treatment between England and Scotland there should be an English Assembly, separate from Parliament, for business (including legislation) corresponding with that to be devolved in Scotland. The Government firmly believe, however, that establishing such an assembly for England could damage the structure of the United Kingdom in ways which the creation of a Scottish Assembly would not.

2.7 It would not be appropriate for Parliament to act both as the legislature for the United Kingdom as a whole and also as the domestic legislature for Wales and Northern Ireland but not for England or Scotland. In practice, if an English Assembly was established, Parliament's role would have to be restricted to a limited range of matters. Four separate Assemblies would be required in the four countries of the United Kingdom, each with its own Executive.

2.8 This would amount in practice to a form of federation - a system which was rejected by the Kilbrandon Commission(3). The Government believe that a federal system would not fit the essential character of the United Kingdom as a union of four distinctive national components of very different sizes; and that it would not be compatible, in the particular circumstances of the United Kingdom, with the close economic unity required to meet national needs and public expectations of social parity. England contains almost 85 per cent of the population with a correspondingly overwhelming proportion of resources. No existing federation contains a partner of anything like this preponderance. An English Assembly representing such a large population could hardly avoid becoming a rival to Parliament, particularly if the two bodies were

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(3) Report of the Royal Commission on the Constitution (1969-73) Cmnd 5460

under the control of opposing parties. And because the expenditure needs of the English Assembly would represent such a large part of total programmes, particularly awkward relationships would exist in relation to taxation, resource allocation, regional planning and comparable issues. These difficulties would affect the relationships between Parliament and the three other Assemblies also.

2.9 The setting up of an English Assembly on the lines proposed for Scotland would, compared with the consequences of a Scottish Assembly, involve an enormous diminution of the role of Parliament and its Members. This might be reduced to industrial, economic and financial matters, defence and foreign affairs. The role of central government would be similarly truncated, although reserve powers in the devolved fields would be needed to carry out our international obligations and to deal with EEC matters generally.

2.10 For these reasons, the establishment of an English Assembly would carry grave risks to the continuing political and economic unity of the United Kingdom, the preservation of which the Government have regarded as a firm principle which should govern the proposals for Scotland and Wales.
Some people have proposed a series of regional assemblies instead. But regional assemblies with legislative powers would mean that the legislative framework for such matters as education, health, housing, local government and land use would be largely determined at regional level leading to possibly marked differences over short distances within England. The Government therefore rule out from further consideration not only the creation of an English Assembly but also a series of regional assemblies with legislative powers.

2.11 Other possible regional arrangements are considered in Sections IV and V.

III. ENGLAND AFTER DEVOLUTION TO SCOTLAND AND WALES - INDUSTRIAL AND ECONOMIC IMPLICATIONS

3.1 Much public comment in England has been concerned with the industrial and economic implications of the Government's proposals for Scotland and Wales. Fears have been expressed that devolution will lead to an accretion of powers and influence to the devolved administrations of a kind likely to prejudice the interests of England and, more particularly, the less prosperous regions of England. These fears are, in fact, groundless.

3.2 The devolution which is being proposed for Scotland and Wales relates to matters which primarily affect people living in Scotland and Wales and which can be administered separately in either country without side-effects for those living in the rest of the United Kingdom. The Government have made clear[4] that their proposals are designed not to infringe the economic unity of the United Kingdom. This economic unity has many important aspects. They include not only external economic relations, the management of demand in the United Kingdom as a whole and the framework of trade, but also the task of devising national policies to benefit particular parts of the United Kingdom and of distributing resources among them according to relative need.

<u>Regional policies</u>

3.3 The main purpose of regional policies is to promote investment and employment in those parts of the country which experience persistently above-average levels of unemployment. Such policies cannot be dealt with in

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(4) Part II of our Changing Democracy: Devolution to Scotland and Wales (Cmnd 6348)

isolation from other national economic policies. They must be formulated and implemented for Britain as a whole so that priorities can be judged fairly and the resources of the whole country deployed to help solve problems as they arise anywhere within it. Accordingly the Government will continue after devolution to Scotland and Wales to determine in which parts of Great Britain economic conditions and prospects justify assisted area status and what forms of relief or incentive are to be available to established or incoming employers. And the Government will remain responsible for industrial development certificate policy which assists the steering of new industrial development to the assisted areas.

3.4 Regional policies are concerned both with the provision of regional financial aids to employers and with public investment designed to eliminate deficiencies in the infrastructure and the amenities of the less prosperous areas.

3.5 At present the three main regional incentives to industry are Regional Development Grants and Regional Selective Assistance (both of which are incentives to capital investment) and Regional Employment Premium (which assists with labour costs and is a continuing aid available to established firms). In addition, much of the selective assistance provided under Section 8 of the Industry Act, for example under the Accelerated Projects Scheme and Special Industry Schemes, on a national basis is in fact given to investment projects in the assisted areas. All these systems of aid are administered by departments of central government; and responsibility for their administration will remain with central government after devolution to Scotland and Wales.

3.6 Infrastructure development is for the main part in the hands not of the central government itself but of local authorities and public corporations. However, the Government influences priorities, firstly in the settling of the public expenditure programmes for the various services and secondly in the granting of capital expenditure authorisations or approvals to borrow.

3.7 The Government will retain responsibility after devolution to Scotland and Wales for a number of important forms of infrastructure which form part of a national network - such as railways and ports. Other forms which are more closely related to local needs - for example, housing, roads, water supply and sewerage - will come under the aegis of the devolved administrations but will normally be provided by local authorities or public corporations, in some cases with financial assistance from the block funds paid to the devolved administrations. Certain types of environmental improvement - notably redevelopment and clearance of derelict land - may be carried out by the recently created Scottish and Welsh Development Agencies using resources put at their disposal by the devolved administrations from the wider resources provided for all devolved purposes.

Finance

3.8 The arrangements for financing devolved services were explained in the White Paper of November 1975[5]. (They have since been modified by withdrawal of the proposal for an optional surcharge on local rates[6].)

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(5) Our Changing Democracy: Devolution to Scotland and Wales (Cmnd 6348)
(6) Devolution to Scotland and Wales: Supplementary Statement (Cmnd 6585)

The essential feature is that there will be a block fund for each administration which will take account both of local needs and of the desirability of some uniformity of standards in all parts of the United Kingdom. These funds will be voted by Parliament. At the same time a limit will be laid down for the total amounts to be authorised by the devolved administrations for developments financed by long term borrowing (eg most capital investment by local authorities). Once these two totals have been settled it will be for the devolved administrations to determine the detailed distribution between the services for which they are responsible. The Government will continue to determine expenditure on the services which remain their own responsibility - whether throughout the United Kingdom, for the whole of Great Britain, for England and Wales or in England alone.

3.9 The settlement of the block funds and the borrowing limits will be closely linked with the annual public expenditure review carried out by the Government. This settles spending programmes for the coming year and outline programmes for three further years ahead. The devolved administrations will be involved in this process. The block funds will be settled by the Government subject to the approval of Parliament, and normally, it is expected with the agreement of the devolved administrations.

3.10 No neat formula is capable of producing fair shares of public expenditure for England, Scotland, Wales and Northern Ireland in varying circumstances from year to year; this requires both sensitive political judgment and information about relative needs and standards.

The Government have already begun work on the scope for improving the base of objective information relevant to the devolved services; and they intend to discuss with the devolved administrations, once they are established, ways and means of achieving this. The objective is to ensure justice to the claims of all parts of the United Kingdom and to make it easier to demonstrate that justice has been done.

3.11 Once fixed, the block funds will not necessarily remain unchanged. If national economic factors make it desirable in any year to supplement agreed public expenditure programmes, the block funds will be supplemented in the same way as the votes of the central government departments responsible for the services concerned. Similarly, if forecast public expenditure has to be reduced for national economic reasons the block funds will bear their fair share of the cuts. The limits on capital expenditure to be financed by borrowing will also be subject to adjustment as necessary.

Development Agencies

3.12 As well as engaging in environmental improvements the Scottish and Welsh Development Agencies provide factories and industrial estates and have powers of industrial investment similar to those which are exercisable by the National Enterprise Board throughout the United Kingdom. The Agencies are not responsible for regional selective assistance unless the Secretary of State specifically directs them to handle a particular application, in which case he lays down in detail the basis on which assistance is to be offered and provides the necessary funds.

3.13 After devolution both Agencies will be financed from the resources available for the devolved administrations and will operate subject to direction by them. As far as industrial investment functions are concerned, however, the administrations will be required to ensure compliance with guidelines laid down by the territorial Secretary of State concerned. These guidelines will be incorporated in statutory instruments which can be annulled by Parliament. As a result of the guidelines the Agencies will continue to operate on a commercial basis and their powers will not be used to provide "soft" loans or other forms of subsidy (except for the schemes for small grants to rural industries previously administered by the Small Industries Council for Rural Areas of Scotland or, in Wales, by the Council for Small Industries in Rural Areas). Similarly the Agencies will not be empowered to dispose of factories or industrial sites on terms more favourable than those which the English Industrial Estates Corporation has to operate. Consultation and collaboration between the Agencies and the National Enterprise Board will continue.

3.14 The Agencies will continue to have no powers to deal with applications for regional selective assistance unless directed to do so by the Secretary of State in a particular case. When a direction is given the Secretary of State will lay down the basis for any offer of assistance and will provide the necessary funds.

3.15 The Agencies will have to present annual reports to Parliament, covering the functions which are subject to guidelines and any cases where they have been directed to handle applications for regional selective assistance. No doubt these reports will be carefully scrutinised by Members representing other parts of the United Kingdom.

3.16 Some people believe that English interests would benefit if there were an English Development Agency with a remit similar to that of the Scottish and Welsh Agencies or, alternatively, that there should be a series of regional Development Agencies in England with similar powers. Some of the main factors, for and against, are set out below to assist the discussion.

3.17 The case which is made for development agencies is that they bring together in a single cohesive organisation various forms of developmental support which would otherwise be channelled through a number of separate organisations. A comprehensive approach to industrial development and promotion is therefore greatly facilitated and, when necessary, action can be taken speedily and flexibly.

3.18 On the other hand, the functions of the Scottish and Welsh Development Agencies are already carried out in England, by different means. For example, factories and industrial estates are made available on a similar basis in the English assisted areas by the English Industrial Estates Corporation, while the Development Commission helps rural areas whether within or without the assisted areas. The industrial development functions of the Agencies are carried out in England by the National Enterprise Board; to develop its awareness of regional needs the Board has established offices in Liverpool and Newcastle. And the environmental improvement powers of the Agencies are exerciseable by local authorities. There is no clear evidence that these various functions would be more effectively carried out if merged together, or that local authorities would welcome a change in the present arrangements in relation to such matters as derelict land clearance.

3.19 Furthermore, it is doubtful whether a single English Agency, having to co-ordinate a range of environmental and industrial functions in the differing circumstances of assisted areas which are spread from Cornwall to Northumbria, would be accepted as having the close familiarity with the problems of particular areas which is looked for from the Scottish and Welsh Agencies. On the other hand, if a number of regional development agencies were established it would be necessary to avoid the risk of wasteful competition between them in order to attract industrial investment and employment.

3.20 These factors have so far been judged to tip the balance of advantage against an English Agency or Agencies. But the Government do not rule out these suggestions and, indeed, would welcome further views on them.

Summing up

3.21 In brief, the position concerning industrial and economic powers, after devolution to Scotland and Wales, will be that:-

a. the Government will retain direct control over economic management and over regional policy, industrial policy and commercial policy;

b. the Government and Parliament will retain direct control over the allocation of block funds to the devolved administrations and over the total of capital expenditure financed by borrowing which they may authorise;

c. the Government will lay down statutory guidelines to control the industrial investment operations of the Scottish and Welsh Development Agencies.

3.22 These powers will be exercised by the Government with a view to ensuring that industrial investment is "steered" to the assisted areas and that resources continue to be allocated to the different countries of the United Kingdom in accordance with needs. Both England and Northern Ireland will continue to receive their fair shares of resources after devolution; and, in exercising their responsibilities within England, the Government intend to secure fairness for all the different parts. There is, in their view, no reason to suppose that the devolution proposed for Scotland and Wales will in any way prejudice the economic prospects of any part of England.

3.23 The Government will keep their regional policies under review, having regard to the changing circumstances of the national economy. They will continue to give a high priority to stimulating industrial investment and employment in the assisted areas, whether in England, Scotland, Wales or Northern Ireland. They are prepared to consider an English Development Agency or Agencies, or any other innovation if it can be shown to offer good prospects of success in achieving these objectives.

IV POSSIBILITIES FOR CHANGE IN ENGLAND

4.1 Change in England could take various forms, not all of which amount to "devolution". As used in the Scottish and Welsh context devolution means the transfer of powers from a central authority. Changes in the structure of government in England would constitute "devolution" only if they involved some transfer of powers from central government to a lower level.

4.2 Discussion of the scope for change in the structure of English Government has, however, extended more widely than this. It has embraced also the whole question of the relationship between Whitehall and the local authorities; the structure and financing of local government; the allocation of functions between different levels of local government; the role of nominated bodies; and the arguments for and against an enhanced role for government at the regional level.

4.3 In considering the implications for England of the proposals for Scotland and Wales it is useful to have these issues in mind, but not all of them have direct relevance to devolution. For example, the case for change in the structure and functions of local government in England - essentially the present counties and districts - has no necessary connection with devolution. It is an issue in its own right.

4.4 Possible changes that have been suggested in the structure of government in England can be considered in two groups, described below as "radical" change and "limited" change. The factors to be weighed in any assessment of these proposals are discussed in Section V.

Radical change

4.5 Into this group fall various forms of new regional elected authorities with executive powers. Their nature, and their relationship to existing authorities, could vary very widely, depending on, among other things, the source of their powers; their system of finance; their range of functions; and their number, size and boundaries. The particular forms described in the following paragraphs are no more than illustrations drawn from a spectrum of possibilities.

4.6 The overriding constitutional and parliamentary objections to a series of elected regional assemblies with powers to legislate on the Scottish pattern have already been considered in paragraph 2.10.

4.7 There remains however the possibility of creating a series of elected regional assemblies, with the ability to exercise functions in specified fields at present carried out by the central government. If these bodies followed the pattern proposed for the Welsh Assembly, the administrative policy in such matters as education, health, housing, highways, water supply, local government and land use would be largely determined at regional level. Appropriate financial provision would have to be made, possibly by way of some form of block fund; and a substantial number of staff would be needed to enable the assemblies to carry out their decisions. Devolution to bodies of this kind would enable domestic affairs and priorities to be decided and administered at regional level.

4.8 A second major possibility would involve not so much the devolution of central government powers, but rather the creation of elected regional bodies drawing their powers from local government and nominated bodies such as the water authorities and health service authorities. It has been argued, that there should be about a dozen directly elected regional

authorities which might be responsible for planning, infrastructure development, and community land, water and sewerage, health and economic planning functions; these might be accompanied by 'multi-purpose' district authorities whose responsibilities might include housing, education, social services and other major functions below the regional tier.

4.9 The establishment of elected regional authorities would thus amount in practice to a comprehensive reorganisation of local government. The present two-tier structure could not sensibly be combined with a third elected "local" tier. Many functions of the counties would therefore need to be raised to the new regional authorities and others would be transferred to the districts. This would require a substantial reorganisation of the district authorities most of which would have to be enlarged in order to handle their new responsibilities. The regional authorities would require major sources of finance and staff.

Limited change

4.10 Limited changes in governmental arrangements in the regions could involve alterations to existing regional bodies or some adjustments to local government, or both.

4.11 At the regional level, proposals have been advanced for more effective regional advisory bodies. The present non-elected Regional Economic Planning Councils already bring together a wide range of interests within each region, including local government and industry. But it is argued that the regions should somehow be given a clearer voice, without involving substantial changes in the structure of government in England.

4.12 Strengthened regional advisory bodies would exist primarily to represent regional interests to central government and advise on regional needs. They might be based on the Economic Planning Councils, whose role could be enlarged to encompass a wider range of central and local government interests. Members might continue all to be appointed; or some might be appointed and others elected indirectly by members of local authorities in the region. Bodies of this kind, without executive powers, would not be large spenders and could operate with small staffs.

4.13 The development of advisory machinery on these lines might be accompanied by increasing the representation of central departments in the regions and by improving interdepartmental liaison machinery there so that the regional advisory body could work in close co-operation with the officials carrying out executive duties. In this way central departments would be more accessible to regional interests and better informed about local circumstances. This could result in better decision making without altering the responsibilities of Ministers or their accountability to Parliament.

4.14 There are also options for limited change at the local government level. Wholesale reorganisation of the present structure may not be the only approach.

An alternative might be to examine the present framework to identify its strengths and weaknesses, and to see what improvements could be made without tearing up local government by its roots. To embark, in short, on a process of local government reform.

4.15 The elements which could be considered under this approach include the following:

a. Functions. There has been a good deal of criticism of the distribution of functions within the present two-tier system, including for example the functional relationship between districts and counties in the metropolitan areas, the division of planning powers between counties and districts generally and the extent of the various powers held concurrently by both tiers. The problems which have arisen under the 1974 structure do not affect all areas in the same way. A reform approach could start with a review of the tiers at which local authority functions are performed; desirable changes could take place selectively and if necessary with different patterns in different parts of the country.

b. Boundaries. Changes in functions may call for changes in boundaries. In addition, there will be a case in some areas for adjusting boundaries either because they were unsatisfactorily set by the 1974 reorganisation, or because developments since then have made change desirable.

c. Ad hoc combinations of local authorities to tackle particular problems, where there is a clear need; wide-ranging powers for joint working already exist under the Local Government Act 1972.

d. The scope for democratising nominated bodies, such as water authorities, could also be examined.

4.16 It would first be necessary to identify and evaluate the deficiencies in the 1974 structure. This consultative process may form the starting point for such an evaluation; leading to consideration of the scope for making improvements and the proper timescale for change of this kind.

V THE FACTORS TO BE WEIGHED

5.1 Many factors, both of general public acceptability and of administrative feasibility, are involved in consideration of the various forms of change outlined in Section IV.

5.2 Before coming to their own conclusions the Government consider it essential to obtain as broadly based as possible an impression of the views of the public on these matters. They wish to establish whether existing institutions are regarded as deficient, and if so, how far and in what ways. To assist public consideration of possible changes this Section sets out the case for change and draws attention to some of the main factors which have to be taken into account in assessing what changes may be practicable.

The Case for Change

5.3 The case for change in the structure of government in England has been argued on a number of different grounds, the main features of which can be summarised as follows:-

a. That the central machinery of government - Parliament, Ministers and Whitehall Departments - would be more efficient if it could concentrate on matters of genuinely national importance. Ministers and Departments are at present overloaded by concern with too much administrative detail and with matters which could with more efficiency and sensitivity be handled locally. The establishment of assemblies in Scotland and Wales should accordingly be followed up by some corresponding lightening of the pressures on the central government machine in relation to England.

b. That the decisions and processes of central government are too remote from the ordinary citizen. Taking more decisions at a level nearer to the individual would ensure that local knowledge and interests were more fully taken into account and would stimulate participation in local affairs.

c. That important nominated bodies, such as water and health authorities whose operations affect daily living conditions and bear closely on services provided by elected local authorities, should be subject to local democratic control. Either the functions of such bodies should be transferred to elected authorities or, if the bodies are to be retained, their members should be elected locally and not appointed by Ministers.

d. That there is a need for a layer of government to handle functions which would be better dealt with in a context smaller than the whole country but larger than the existing local authorities. Even after the 1974 reorganisation of local government the new local authorities cover too small an area for the exercise of strategic planning responsibilities and their boundaries are too tightly drawn to facilitate the rehousing and redevelopment programmes needed in some of the larger cities. The present division of responsibilities between the county and district levels is not seen as the best available.

The Framework for Change

5.4 All these arguments for change place varying degrees of emphasis on the extent to which the over-riding criterion should be that of more efficient administration or more locally responsive government - two desiderata which may not always be reconcilable. In considering what changes may be practicable, and in balancing the benefits gained by each with additional problems which might be created at the same time, it is necessary to take account of the constitutional, financial and other constraints that form the framework within which any restructuring of government in England must take place. These are considered in the following paragraphs.

Constitutional implications

5.5 The framework in which any re-structuring of government in England has to be considered must clearly take account of the limits imposed both by the need to preserve the political and economic unity of the United Kingdom, which the overwhelming majority of people plainly desire, and by the impracticability of federalism in the circumstances of the United Kingdom.

5.6 But even while remaining within these constraints, some institutional changes would still create major problems. In particular, a system of regional assemblies with executive powers derived from central government would have far-reaching effects on the present structure of ministerial and parliamentary responsibilities, under which Ministers have responsibility for the development of policies and determination of priorities but are accountable to Parliament for their decisions and actions.

5.7 The transfer to elected English regional bodies of powers at present exercised by Ministers (whether at a departmental headquarters or in a regional office) would have far-reaching constitutional implications. In particular it could directly reduce their ability to maintain national policies on devolved subjects and the role of Parliament and the scope of its Members. If regional authorities were able to determine the allocation of resources to particular programmes within their regions (and without this ability the exercise of their powers would in practice be severely restricted) this would fundamentally affect the ability of Ministers to account separately and collectively to Parliament for the policies, standards and priorities of the services they administer.

5.8 Major organisational change, whether involving devolution of central government functions or the reorganisation of local government would produce serious administrative problems. It would involve the creation of major new units of administration and an inevitable need for substantial numbers of extra staff. While it is not practicable to put specific costs to the changes the creation of, say, a dozen regional authorities with powers similar to those of the Welsh Assembly would involve thousands of additional staff and additional costs, probably running into hundreds of millions of pounds.

5.9 The more limited forms of change would not carry the major constitutional implications associated with regional assemblies or authorities, and they would not involve the disruption and cost associated with major comprehensive reorganisation. Limited reform of local government might therefore be the most practicable approach to the short-comings of local government structure.

5.10 However, such an approach carries its own dangers. It would be desirable to define as clearly as possible in advance the extent of the changes to be aimed at and the circumstances in which particular changes would be contemplated. Without this, a great deal of the existing organisation below the level of central government could be affected by uncertainties, and this might hinder forward planning and efficient administration.

Financial Implications

5.11 Regional assemblies would call for entirely new financial relationships. These bodies would be free, subject to statutory obligations, to allocate resources amongst the services for which they were responsible and develop distinctive policies based on their own view of regional priorities. Some would argue that this power to allocate resources should also extend to all services provided by the local authorities within the region.

5.12 It would in theory be possible to pay each regional assembly a block fund as is proposed for Scotland and Wales. It is inherent in such a system that the Government's influence over priorities between services and the ability of Ministers to determine national policies and expenditure programmes would be reduced. Indeed some would argue that this would be desirable. In relation to their own directly administered services the regions themselves would settle programmes for large populations and wide areas; and in relation to services administered by local authorities they would ensure that regional priorities were followed (as distinct from national ones, where these differed).

5.13 Such block funds would make the Government's task of economic management more difficult. The composition of expenditure is important because different types of expenditure have different effects on important economic aggregates such as the balance of payments, the public sector borrowing requirement and unemployment as well as different effects on the various sectors of the economy. It is true that the Government will not control the composition of expenditure on devolved services in Scotland and Wales. But to extend this relaxation of control to every region in England would have much larger effects, and would make it vastly more difficult for the Government to exercise its essential functions in managing the economy of the United Kingdom as a whole.

Boundaries

5.14 Any study of possible regional institutions of government in England must take account of the problem of defining the areas over which they would operate. The number of the regions, and their boundaries, would need to reflect a balance between administrative efficiency, in terms of the functions for which they would be responsible; the facts of geography; and historical loyalties and traditions. In some places - at Newcastle or Manchester, for example - there is clearly a sense of regional awareness, but in other places not far away this may be difficult to trace.

5.15 If regional bodies were established with a wide range of executive powers the demarcation lines of regional boundaries would be of increasing practical importance to individuals because the nature and level of government services, and the spending priorities, might differ significantly between neighbouring regions. An important issue for consideration, therefore, is how far - against a historical tradition of common standards - new regional authorities in England could be expected to command, especially in boundary areas, the public support necessary for the acceptance of potentially differing policies and standards, going far beyond the differences encountered in adjoining local authority areas today.

5.16 Moreover, boundaries suitable for one function are not necessarily suitable for another. This may not be an insuperable problem but nobody can doubt that there are substantial difficulties involved. A clear example is water supply, since the areas covered by the regional water authorities have to be drawn up on the basis of undivided river basins: regions suitable for water supply would make little sense for most other purposes. In the consultative document on the review of the water industry[7], the Government made it clear that they remained committed to the principle of unified river basin management, as the basis of the industry's regional structure; although they were well aware of the problems of reconciling the adequate democratic control of water authorities with the large size of some of the river basins

[7] Review of the Water Industry in England and Wales (Department of the Environment, Welsh Office and Ministry of Agriculture, Fisheries and Food - 1976).

5.17 Another example is health, where the boundaries of the regional health authorities must have regard to established pattern of delivery of health care, which are themselves largely determined by the location of major facilities such as the large hospitals associated with universities and their medical schools.

5.18 Yet another is transport, where the natural basis for control tends either to be national (motorways, trunk roads and railways), or local, as with bus operation, though the boundaries do not in some cases accord with those of any one local authority.

5.19 Again, regional areas suitable for strategic land use planning purposes might prove too large for other services often proposed for a regional level, such as police and the fire service. If county authorities were to disappear most existing districts outside the main conurbations would probably be too small in terms of population either for education and personal social services, or as equivalents of (or replacements for) area health authorities (now based on non-metropolitan counties, metropolitan districts and London boroughs).

5.20 It would be desirable to achieve a reasonable balance between regions in terms of size and economic potential, but London and the South East present a special problem from this point of view. The population of the area covered by the South East Economic Planning Region is 17 million people - over $\frac{1}{3}$ that of England, three times that of Scotland and almost six times that of Wales. This problem could not be solved by breaking up the area into artificial sub-units. Any proposals for a regional structure would have to take account of the dominance of the South East in relation to the rest of England, and of London over the rest of the South East.

Other implications

5.21 The present structures of local government, the National Health Service, the regional water authorities, and the police service, have been in existence for less than three years. These new structures are still in the process of settling down. The Government are fully aware of the widespread criticism of certain aspects but any further major redistribution of local government functions would be bound to take a good many years to plan and carry out. And to attempt radical change affecting London and the rest of the country simultaneously would be unprecedented; previous reorganisations affecting London separately were major tasks in their own right. The expected long term benefits of any change have to be measured against the disruptive effects in the meantime. And if one set of changes follows another, the point may come at which the penalties of the recurrent process of change outweigh the advantages which it is hoped ultimately to achieve.

5.22 There is also the effect on the individual citizen. A further reorganisation so soon after the last one would be bound to create confusion in the mind of the average elector. It is also probable that he would feel more remote from the affairs of a local government body administering services over a much wider area - as would certainly be the case with regional authorities.

5.23 There is at present a direct relationship between local authority boundaries and the boundaries of health regions and areas. Unless the benefits of this relationship were to be set aside any major reorganisation of local government would have to be accompanied by changes in the National Health Service.

5.24 A reorganisation of local government which involved the assumption of responsibilities for the health service would require a fundamental reorganisation of the National Health Service. This is an Exchequer financed service with two levels of management accountable to the Secretary of State for Social Services. Virtually all the statutory functions are vested in him and he in turn makes them exerciseable by the 14 regional and 90 area health authorities. The service is a national one in which the Secretary of State, with his Ministerial colleagues, sets national policies and objectives and has, in the last resort, power to issue formal directions to the regional and area authorities as to how they should exercise the functions delegated to them. Control of the health service by elected authorities would require a complete redefinition of the central government's role in relation to it and would inevitably diminish its national character.

5.25 Radical reorganisation of this kind would raise major questions as to how the Service should be financed and what the lines of accountability should be. Major changes of organization would be expensive both in the administrative costs of planning and carrying them through and also in the effects which organisational upheaval would have on morale and in the conflicts and uncertainty that would accompany it.

5.26 The Government have appointed the Royal Commission on the National Health Service to consider the best use and management of the financial and manpower resources of the Service. The memorandum that the Commission has issued on its task makes clear that it will be examining the structure of the Service and its relationship to central and local government. It will need to take into account the development of thinking on devolution in England and its own conclusions will make an important contribution to that thinking. A final decision on the structure of the National Health Service must await receipt and consideration of the Commission's Report.

Summing Up

5.27 To sum up, the case for change is seen to lie in -

a. lightening the burden on central government, enabling it to concentrate on matters of genuinely national importance;

b. bringing government closer to the people;

c. rendering the work of major nominated bodies subject to local democratic control; and

d. providing a layer of government to deal with such matters as may be better dealt with at a level intermediate between central and local government as they now exist.

5.28 But the case for any particular form of change has to be examined within a framework of practical constraints and implications. On this basis, the viability of possible new forms of government in England depends on the view taken of -

a. the constitutional implications, including the effect on the powers of Ministers to maintain national policies and on the role of Parliament;

b. the financial implications, including the arrangements for funding any new institutions;

c. the problems of drawing new boundaries; and

d. other implications, including the effects on existing institutions, both during the transitional period and in the longer term and the extent to which the problems that are seen can be tackled without radical change.

VI THE CONSULTATIVE PROCESS

6.1 As explained in Section I, this consultative document does not put forward proposals for changes in the structure of government in England. The Government wish to hear and consider views and to carry out their own further studies before deciding what, if any, changes to recommend.

6.2 The main purpose of this consultative document has accordingly been to set out in general terms the broad issues which the Government consider should be before members of the public when they form their own conclusions on whether or not there is a need for change and, if so, what forms such change might take.

6.3 There can clearly be a variety of replies to the central question which this paper poses: are there any specific ways in which the structure of government in England might be altered so as to make it more democratically accountable, responsive and efficient, reduce the burdens on Whitehall and Westminster, and develop its full potential for improving the quality of life?

6.4 There are, on the one hand, those who feel that the predominant requirement at present is for a period of stability and that efforts should be concentrated on making the present system work better. On the other hand there are people who feel that what is needed is the establishment of directly-elected regional assemblies taking functions from central government, local government and nominated bodies. Between these two positions lies a whole series of intermediate options which shade into each other.

6.5 These are manifestly difficult matters and need thorough consideration and debate. Behind them lie two questions of great importance to the efficiency of government and to all citizens and taxpayers, namely:-

a. whether government would be more acceptable, accessible and accountable if there were a new regional layer of democratically elected government exercising functions at present exercised centrally or locally?

b. whether, if ways could be found of bringing this about, government would be more efficient?

6.6 What the Government now want is to find out in which ways people in England would like to see our institutions develop. To preserve its vitality a Parliamentary democracy must be capable of adapting to changing needs and pressures, external and internal - hence the proposals for Scottish and Welsh devolution; and the need for thought and debate about English institutions. It is the purpose of this consultative paper to encourage that thought and stimulate that debate.

6.7 Government Departments will be writing direct to bodies with whom they are regularly in contact seeking their views on the matters raised in this consultation document. Among the issues on which views are invited are:-

i. In what fields of government responsibility in England, if any, is it considered that the present level at which decisions are taken (Whitehall/ nominated bodies/counties/districts) is wrong?

ii. Is there a case for an English Development Agency or for English regional development agencies (see Section III)?

iii. What are the advantages and disadvantages (see Section IV) of -

a. no change

b. some form of radical change

c. some form of limited change?

iv. Do people in England have a sense of regional identity strong enough to support regional units of government?

v. What principles should determine the size of regional areas? How should the boundaries be drawn? How many regions should there be? What should be done about London and the South East?

vi. If regional units were set up, should their functions be only advisory and co-ordinating or should they have executive powers?

vii. How should any such units be financed?

viii. Would the development of regional institutions solve or reduce any national problems? If so, which?

ix. Would substantial variations between regions in the standard of public services, and the choice of spending priorities, be acceptable?

x. What are the deficiencies in the present structure, boundaries and distribution of functions within local government? How might they be remedied, broadly within the present structure?

xi. What is the degree of urgency of any changes in English arrangements which may be desired?

6.8 Members of the public wishing to express their views on these issues or any other aspect of the matters discussed in this consultative document are invited to write to the Constitution Unit, Cabinet Office, Great George Street, London SW1P 3AQ.

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30 November 1976

CABINET

SOCIAL SECURITY BENEFITS, PUBLIC SERVICE PENSIONS AND TAXATION

Memorandum by the Chancellor of the Exchequer

1. I should like to indicate briefly why, quite apart from the International Monetary Fund (IMF), there are powerful reasons why we should now review the existing arrangements for uprating social security benefits and public service pensions.

2. At present we are committed by the existing legislation to uprate social security benefits at least once a year and to raise pensions and other long-term benefits in line with earnings (or with prices if they rise faster) and the main short-term benefits in line with prices. As a result, at the time of the last Budget, we had to decide on an uprating which, because of the administrative time-lags involved, has come into effect only this month, and adds approximately £1½ billion to this expenditure, raising it to a total level of over £11 billion a year. As matters stand, at around the time of the next Budget we will be compelled by law to take a similar decision entailing an even greater injection of purchasing power into the economy. Unless we secure some discretion about these upratings, a number of existing problems will remain with us and are likely to become progressively more acute.

CONTROL OF PUBLIC EXPENDITURE

3. Social security accounts for over one-fifth (in fact about 22 per cent) of all public expenditure. Most of this is at present removed from the scope of our decisions on public expenditure so that any reductions must fall all the more heavily on the remaining programmes.

HIGH LEVELS OF INCOME TAX

4. The large sums required for uprating benefits under the present legislation will have to be found out of taxable capacity and reduce the scope for reductions in the income tax burden. Yet there is growing evidence that the level of income tax has become a real obstacle to improved industrial performance at all levels, particularly at the top and bottom of the earnings ladder.

AN INCREASE IN OVERLAP BETWEEN THE INCOME OF THOSE ON BENEFIT AND THOSE AT WORK

5. The standard of living of those on benefit has been improved, in some cases very substantially, at a time when the real wages of those in work has been squeezed and are likely to fall severely in the period ahead. For example, in the period since the last Tory uprating in 1973 when average real take-home pay per employee rose only 1 per cent (and fell for anyone on average gross earnings), both married and single pensions increased by 15 per cent in real terms; and pensions and short term benefits, including unemployment benefit, have improved substantially as a percentage of net average earnings. (46 per cent compared with $37\frac{1}{2}$ per cent for a married pensioner couple; and 50 per cent compared with 46 per cent for a couple with two children on flat rate unemployment benefit). There has been a compelling case for improving the relative position of those on benefit compared with what it was in 1973. But to continue that relative improvement indefinitely will worsen the problem of incentives which is already severe. Many on benefit are better off than they would be at work and to earn substantially more in work than in benefit requires a relatively high gross income. (See paragraph 8 below).

PUBLIC SERVICE PENSIONS

6. So long as social security pensions and other benefits are inflation proofed, it is difficult to make a case against inflation-proofing public service pensions.

7. This does not mean that we should go to the opposite extreme and freeze benefits or cancel the next uprating. But there is clearly a case for amending the existing provisions, or legislating to put them in suspense for a stated period, in such a way as to give us a degree of discretion to uprate with regard to the economic situation and what we can afford. The adjustments to be made need not be the same for both short-term benefits and for pensions, but it is only if we secure some room for manoeuvre on pensions (which, with other long-term benefits account for over half of the social security bill) that we could in equity amend or suspend the Pensions (Increase) Act also so as to have a similar discretion about public service pensions, including but by no means confined to those of retired civil servants.

8. The case is particularly strong for tackling the problem of the overlap between wages and benefits. For example, to get £5 more in work than out of work a married man needs to earn more than £65 gross a week if he has two children, and more than £70 a week if he has four children. Even £5, of course, is hardly a strong work incentive. Thus family men need to get very nearly average earnings to give them a worthwhile advantage over what they would get when out of work. Some 45 per cent of married men with two children in 1975 were on average earnings or less. If present uprating policy continues in 1977, this situation can only get worse. Besides the disincentive effect of this overlap, it is fuelling a backlash among the low paid against the whole concept of the welfare state and creates the impression that people on benefit are in some sense "scroungers". The social and political implications of this backlash are a real cause for concern - not least as it affects the immigrant population.

9. In principle this problem can be tackled by raising tax thresholds or introducing tax on short term benefits or a combination of the two. I would certainly wish to include the raising of tax thresholds in my preferred solution to this complex of issues. But this will be possible only if we succeed in reducing total public expenditure and the total requirement from direct taxation. As regards taxing short term benefits, there are arguments in principle in favour of this course and it could potentially produce considerable tax revenue. For instance, there would be a yield of up to £150 million a year from taxing sickness benefit if that proved possible. But, whether or not these arguments on the merits of the case were accepted, there are first immense practical problems to be overcome. We have already said that we are looking again at this, but that it has been examined more than once under previous Governments when the administrative difficulties were found to be very great. Officials are now looking at the problem again but, even if the administrative difficulties could be overcome, there could not be any yield from this source before 1979-80. Taxation of short term benefits could therefore be no substitute for early action on the levels of benefits.

CONCLUSION

10. For these reasons there would in any case be strong grounds for seeking powers to give us an element of discretion over the next upratings of social security benefits and public service pensions. The need to consider this would arise irrespective of the negotiations with the International Monetary Fund, but because of these negotiations this is an option which we must now bring into the reckoning as a matter of urgency. I understand very well the difficulties involved in tackling this problem but we will also be in considerable difficulty, political and social as well as financial, if we fail to tackle it.

D W H

Treasury Chambers

30 November 1976

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CP(76) 122

30 November 1976

CABINET

IMF NEGOTIATIONS: ALTERNATIVE PACKAGES

Note by the Chancellor of the Exchequer

1. The Treasury were authorised last week to explore with the team from the International Monetary Fund (IMF) the financial and economic effects of three illustrative packages of economic measures. It was made very clear that the discussions were strictly without commitment.

2. The discussions focussed on a two-year prospect, up to the end of the financial year 1978-79. The uncertainties beyond that are such that neither the Fund nor we would wish to commit ourselves to any kind of quantitative targets for the Public Sector Borrowing Requirement (PSBR) or Domestic Credit Expansion (DCE) for 1979-80 or any later period. That did not in any way override our wish - with which the Fund would not quarrel - to present the measures we are now contemplating in the context of a three-year stabilisation programme.

3. The context of these discussions was provided by economic "simulations", using the Treasury's forecasting model. But before I summarise the outcome of these simulations - some more detailed figures are given in the Annex - I should emphasise five points which do not just reflect official caution, but are genuinely important for our policy decisions.

4. First, all the simulations assume that confidence is successfully restored and the internal and external deficits are successfully financed. That is a necessary assumption for forecasting purposes: the simulations are designed to illustrate the problems likely to arise for decision by Ministers - not to prejudge the policy decisions. However, to the extent that those assumptions are unreal, the estimates suffer from an internal contradiction, and would in practice be falsified. The smaller the package, the greater this risk must be.

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5. Second, it follows that the four simulations are not strictly comparable. For example, the financing prospects in the National Income Forecast (NIF) and "package one" are such that, if other policies remained unchanged, the markets would in practice compel a sharp adjustment in interest rates - above the present level which is (conventionally) assumed for the purpose of the simulations. In consequence, growth would be less, and unemployment, prices and the PSBR would all be higher than the simulations indicate. By contrast, it is thought that packages "two" and "three" would make it possible to reduce interest rates below their present levels; and the simulations suggest that the beneficial effects of this would go a long way to offset the ex ante deflationary effects of the packages themselves.

6. Third, the simulations have been worked out on the basis of assumptions about the detailed composition of the packages which, at this stage, can only be arbitrary. A different mix of measures could produce a significantly different effect both on the real economy and on the monetary aggregates.

7. More generally, for illustrative purposes, and for the sake of simplicity, the three packages have been calculated very largely in terms of reduction in public expenditure. A similar reduction in the PSBR could, of course, be achieved by increases in taxation; and it is clear from the discussions which the Treasury have had with the IMF team, that they accept the possibility that tax increases could form some part of the total package.

8. Fourth, the simulations take no account of any effects the packages might have on the rate of increase of earnings, or on the movement of the exchange rate.

9. Finally, the estimates, while they are the best that can be provided in the time available, are still subject to a very wide margin of error; and the margins of error are especially great when they look forward two years to 1978-79. Above all, projections of the monetary aggregates depend on assumptions on interest rates, capital flows, sales of gilt-edged, bank lending, and so forth which, for a period of two years ahead, can only be speculative.

10. All the estimates take credit for receipts from the sale at home of a £½ billion parcel of British Petroleum (BP) shares in addition to public expenditure cuts.

PACKAGE ONE

11. This assumes public expenditure cuts of:-

1977-78 £½ billion

1978-79 £½ billion

(In both years £$\frac{1}{4}$ billion of these cuts are assumed to have little or no effect on demand or activity).

As one would expect, this suggests very much the same economic prospect as the basic NIF (which takes the same conventional financing assumptions referred to in paragraph 4.)

a. The economy grows rather slowly next financial year, but picks up to an annual rate of between $3\frac{1}{4}$ per cent and $3\frac{1}{4}$ per cent in 1978-79.

b. Unemployment increases to a level in the region of $1\frac{3}{4}$ million.

c. The current balance of payments remains in substantial deficit during 1977, but moves into substantial surplus in the course of 1978.

d. The PSBR is about £$9\frac{1}{2}$ billion in 1977-78, but increases again in 1978-79; and this is paralleled by the movement in DCE.

12. The IMF team showed no interest in this package. They were quick to make the point that the monetary and financing problems implicit in the simulation of this package would frustrate the "simulated" improvement in the current balance, and thence the prospect of economic recovery. They clearly believe that a package of this kind would represent a failure of policy to respond to the prospect before us.

PACKAGE TWO

13. This assumed public expenditure cuts of:-

1977-78	£0.8 billion
1978-79	£1.4 billion

(In this simulation and package three a mixture of measures have been assumed, none of them being particularly "demand light").

14. The simulations suggest that under this package:-

a. The economy would grow a little more slowly during 1977-78, but again pick up to an annual rate of between $3\frac{1}{4}$ per cent and $3\frac{1}{2}$ per cent in 1978-79.

b. Unemployment is little changed by the end of 1977 but increases to a level about 100,000 higher by the end of 1978 than the national level under package one.

c. The current balance is in slightly smaller deficit in 1977 and slightly larger surplus in 1978.

d. The PSBR is reduced to £9 billion in 1977-78 but rises a little again in 1978-79. DCE is brought steadily down.

15. It was not possible last week to interest the IMF team in this package. One point which they made was that there was a strong risk that a package of this order might not be sufficient to restore confidence in the markets, and we could therefore face further pressure in a few months' time to go through once again all the agony of a yet further policy review.

PACKAGE THREE

16. This package assumes:-

Public expenditure cuts: 1977-78 £1.2 billion

1978-79 £1.7 billion

Tax increases worth about £½ billion in 1978-79 (as compared with the NIF assumptions).

16. The simulations suggest that on this package:-

a. The economy would grow a little more slowly than under package two, both in 1977-78 and in 1978-79.

b. Unemployment would develop in much the same way as in package two.

c. The current balance would be marginally better than under "Two".

d. The PSBR would be reduced to £8½ billion in 1977-78 and would fall further in 1978-79. This would be reflected in a firm downward trend in DCE.

17. This is the largest package which the Treasury explored with the IMF team. The IMF regarded it as a basis for negotiation. However, it still fell considerably short of what they thought was required. Focussing (as I have said) on the two-year prospect to 1978-79, they believed that we should be aiming for a PSBR in that year of around £6½ billion. They argued that a "step change" in policy, of the kind implied by such a PSBR, would create a wholly new climate in the country, leading to higher investment, higher exports and a better all-round economic performance. However, it was clear that this figure of £6½ billion (and almost certainly the figure of £7 billion which was also mentioned in discussions) turned on a rate of economic growth which we think improbably

high and therefore did not represent their last word. There would be reasonable prospects of securing their agreement to a somewhat higher PSBR than £7 billion; or alternatively the figure would be revised upwards if we did not achieve this higher rate of growth.

18. I have set out in a separate note (CP(76) 123) the conclusions which I draw from the discussions, and the measures which I propose we should now take.

D W H

Treasury Chambers

30 November 1976

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ANNEX

ADJUSTED PACKAGES: CONSTRAINED PSBR

Package		NIF (Revised)	Package one	Package two	Package three
Public expenditure at 1976 Survey prices £ billion	1977/78	-	0.5*	0.8	1.2
	1978/79	-	0.5*	1.4	1.7
Sale of B.P. shares Tax. Net effect on PSBR £ billion	1977/78	-	0.5	0.5	0.5
	1978/79	-	-	-	0.5
PSBR £ billion	1977/78	10.4	9.4	9.0	8.5
	1978/79	11.3	10.8	9.5	8.2
GDP per cent change on year before	77 2nd ½	2.2	2.1	1.8	1.7
	78 2nd ½	3.5	3.3	3.3	3.1
Unemployment millions	77 Q4	1.7	1.7	1.7	1.7
	78 Q4	1.8	1.8	1.9	1.9
Current balance £ billion	1977/78	- 1.2	- 1.1	- 1.0	- 1.0
	1978/79	2.3	2.4	2.8	2.9
Retail price index per cent change on year before	77 Q4	13.8	13.9	14.1	14.2
	78 Q4	8.2	8.3	8.4	9.0
DCE £ billion	1977/78	9.7	8.9	8.2	7.6
	1978/79	9.8	9.4	6.9	6.0
Money Supply (M3) per cent change on year before	1977/78	15.4	14.3	12.8	11.2
	1978/79	19.1	18.7	14.9	13.3
Interest rates					
Long-term per cent	1977/78	16	16	15½	14¾
	1978/79	14¼	14¼	14	12¾
Short-term per cent	1977/78	14½	14½	14	13½
	1978/79	11½	11½	10	8½
Mortgage Rate per cent	1977/78	13½	13½	13	12½
	1978/79	12½	12½	11	10½

Note: the line drawn between packages one and two reflects the fact that for reasons explained in paragraphs 4 and 5 of the paper the estimates shown under "NIF" and "Package One" are internally contradictory and would in practice be falsified.

* of which £¼ billion is "demand light".

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30 November 1976

CABINET

ECONOMIC POLICY AND THE IMF CREDIT

Memorandum by the Chancellor of the Exchequer

1. During our discussions last week some of our colleagues doubted the wisdom of making any substantial measure of fiscal adjustment in 1977-78 - and still more in 1978-79 - on the lines which I have advocated in general terms. The decisions which we have to take are among the most important, and most difficult, which a British Government has had to face in many years. I am anxious that those of my colleagues who are disposed not to accept my advice should fully understand the case for the adjustment and the consequences, in terms of alternative policies to the one I put forward, of not making it. In this memorandum I set out the arguments for an adjustment, my recommendation on its quantum and my judgment of the options open to us - and their implications - if my advice is not accepted.

2. The case for a fiscal adjustment (or, to put it more bluntly, a cut in the prospective Public Sector Borrowing Requirement (PSBR) in the two financial years 1977-78 and 1978-79 is not simply that this is what the International Monetary Fund (IMF) require as a condition of a standby credit, important as that is as an argument; there is a more fundamental reason, which would apply even if we did not require the Fund's money both to repay the $1.6 billion swap facility due to our Central Bank creditors on 9 December and to finance our external deficit over the next few months. The argument is partly about finance, and particularly external finance, and partly about the general direction of the economy and the pace at which it is progressing to our declared goals.

3. The external finance argument is this. We have, certainly on the basis of our economic forecast and to a more limited but still significant extent on the basis of independent forecasts, a continuing substantial deficit on current account. After an encouraging recovery in the first half of 1976, we have had several months of deficits each over £200 million, giving an annual rate of about £2½ billion. To the finance required to cover this we have to add a requirement of about £1 billion per annum to cover the structual element of our capital account - particularly export credit. Finally we have to be prepared at present to finance any continuing tendency for sterling holders to want to convert their assets into foreign currencies.

4. Whether on present policies we eliminate our current deficit in the course of 1977 as the National Institute predict, or whether we do not do so until 1978 as the Treasury expect, we shall have to borrow abroad on a substantial scale for at least a year and probably more. Unless we can do this, we shall not be able to cover the deficit at anything like the present exchange rate. Our only course then would be to hope to achieve equilibrium by allowing the rate to fall to levels at which there might be some chance of foreigners stepping in to buy sterling so as to acquire a lot of United Kingdom assets - British firms and property, as well as financial assets - very cheaply. This, despite the effect that the fall in the exchange rate would have on our own cost of living, is still an optimistic scenario. The pessimistic scenario is one of continuous and probably accelerating depreciation, leading to South American-style inflation, with higher import prices feeding through to wages and vice versa.

5. Our future turns critically therefore on our ability to mobilise external credit on a scale which will enable us to fill the gap - presently of about £3 billion per annum - until we are in the black. Over the three years since the onset of the oil crisis, in addition to earlier IMF borrowings, we have managed to raise something like £6 billion of external credit, whether by receiving a sterling inflow from the Organisation of Petroleum Exporting Countries (OPEC) or by direct market borrowing by public sector bodies and by private institutions. Why do we now suppose that our credit has run out? The answer is that the market remains a potentially large source of further credit, but our creditworthiness has become dangerously undermined. The market and OPEC who together have sustained us since 1973 have both become very sceptical about the viability of our policies, in particular about our determination to move into surplus and about our ability to manage our domestic finance in such a way that we will not see a dangerous monetary expansion undermining, if not destroying, the success of our counter-inflation programme. The experience of this year, when our progress on inflation has been visibly checked, when our balance of payments has deteriorated, when the money supply has begun to expand at an alarming rate, and when PSBR seems to remain obstinately high has not been reassuring. There is no doubt that unless we take decisive action to improve the balance of payments and to get the monetary expansion under firm control, we shall not raise the funds we need to maintain stability at home and abroad.

6. We need in this context to keep the role of the IMF in perspective. Quantitatively it is not as important as the market itself. But it is seen by the market as the bellwether. If the Fund accepts that our policies are credible, the market is virtually certain to follow suit, and the amounts potentially available to us are large. Per contra, if we fail to reach agreement with the Fund, we are unlikely to be able to raise funds on any significant scale in the market.

7. In domestic financial terms, the prospective PSBR - now estimated to be £$10\frac{1}{2}$ billion in 1977-78 - presents a huge internal financing problem. To contain monetary expansion to a level which would not have adverse repercussions on the exchange rate, we should both have to continue to sell gilts on a massive scale and have to contain the growth of bank credit to the private sector: we cannot be certain of achieving the first, even with high interest rates.

8. If we succeeded in containing monetary expansion by action on these two fronts we would in both ways be depriving industry of some of the external funds it needs if we are to regenerate the industrial base on which the future of the economy depends. The continuing high interest rates would also put at risk other policies, notably housing. If we failed in controlling the growth of the money supply, we should forfeit the prospect of recovery in domestic growth, inflation and the balance of payments.

9. Even on the basis of the present prospect we cannot be certain that the predicted improvement in the external balance will come about. There is a risk that, instead of achieving equilibrium in 1978, we shall continue in deficit for some considerable time. In my view this is a risk which we simply cannot afford to take. Too often in the past we have taken risks with the external balance and this has been our undoing.

10. My judgment therefore, which I have reached independently of the Fund - is that there is a powerful case for a fiscal adjustment, and moreover one which would extend over the two years 1977-78 and 1978-79. On present policies both of these years are likely to show substantial fiscal deficits and it is necessary to contemplate measures which run through and indeed have greater effect in the second year than the first. This is mainly because it is in the second year that the growth of the economy is likely to be stronger as the expansion of exports and investment gets under way.

11. The size of the adjustment required involves a difficult exercise of judgment. My own view is that it should be such as to reduce the PSBR to something like £$8\frac{1}{2}$ billion in 1977-78 and perhaps to a similar figure the following year, though the latter figure should be thought of more tentatively because of the many uncertainties which surround estimates for a period so far ahead. I believe that, if we make the necessary moves now, we should safeguard our future, secure agreement with the Fund and decisively re-establish our market creditworthiness. We should establish firm conditions for the exchange rate to stabilise and enable us to plan for a secure industrial revival untroubled by the destabilising and unsettling effects on our economy which have thrown us so badly off course this year.

12. As to the nature of the adjustment, I consider that this should be largely, if not predominantly, through reductions in public expenditure. There are two reasons for this. First, I believe that tax increases would

be regarded by the Trades Union Congress (TUC) as a breach of the understanding we reached with them in May under which, in return for a pay agreement based on £2.50/5 per cent/£4 we agreed certain income tax reductions. I have already been warned by the National Economic Development Countil (NEDC) Six that an increase in tax, whether direct or indirect, would be very badly received by the union rank and file. In practice the only tax increases I could propose would be in the indirect field, and those would impinge immediately on the Retail Price Index. To the extent that, through Government action, we add significantly to prices in the next few months, we shall jeopardise the current pay round and make agreement less likely on a third round pay policy on any basis which offers some prospect of the rate of inflation being brought down in 1977-78. We also give concern to those abroad who judge us primarily by our rate of inflation. The second reason is that, for good or ill, the market undoubtedly places greater weight on expenditure cuts than on tax increases as a measure of reducing the fiscal deficit; and if the package contains tax increases, will look for a greater total reduction in the PSBR for any given impact on confidence. We may as a Party deplore this and write it off as political prejudice. But we cannot ignore it. And we would be unwise to suppose that what the market expects is irrational. It is far from clear that the mass of the public, including our own supporters, would not prefer to see its take-home pay protected than see the social wage kept inviolate. In terms of incentive to effort I am sure that it is the pay packet which counts, not the size of our public programmes, important as these are to the society we want to create.

13. In my paper (CP(76) 111) last week I said that I believed that the size of the fiscal adjustment required was £1½ billion in 1977-78 rising to £2 billion in 1978-79. Since then, further calculations carried out by the Treasury, in which credit is taken for the lower interest rates which a package could achieve, suggest that the PSBR targets at which I was aiming could be secured by adjustments of £1 billion rising to about £2 billion in the second year. These adjustments would be supplemented by the sale of the equivalent of the ex-Burmah holding of British Petroleum (BP) shares. I believe that we could secure agreement with the Fund with such a programme. Although for the reasons I have given the programme should consist mainly of expenditure cuts I would not rule out a small tax component, preferably for the second year, given the great difficulties we should have with the TUC in indirect tax increases now before the negotiation of a third pay round.

14. To the extent that in the next few months the economy develops more favourably than we presently expect and the actual PSBR looks like being lower, I would hope to make some income tax reductions in the 1977 Budget to restore at leadt part of the demand lost by the cuts. If there is scope for this within the programme we shall be committing ourselves to, it would provide us with a valuable inducement for the unions to agree a third year of pay restraint. It is not impossible that if President Carter leads the major countries in a more expansionary policy, this too would create scope for cuts in income tax in Britain.

15. It is important that the package of measures we announce should not be wholly negative but should have a component which deliberately supports the industrial strategy, which is at the centre of our economic policy. There are a number of instruments which have been suggested for this purpose, but the most fruitful is the new Selective Investment Scheme which builds on the success of the Accelerated Project Scheme which we have now brought to an end. Advance indication that we were about to introduce a Selective Investment Scheme was given at last month's meeting of NEDC but we have deliberately held back its formal announcement for inclusion in a package. We earlier had it in mind that the Scheme should have a limit of £100 million. By no means all of this will be spent in 1977-78 and 1978-79; it is not therefore the overall financial limit of the Scheme, so much as the annual rate of spend, which will determine its impact in the next two crucial years. I therefore suggest that, when we announce this Scheme, we should make it clear that, so long as good cost-effective projects are coming forward in support, they will not be allowed to fail for lack of resources on our part; and that, when the £100 million limit is reached, we shall be prepared to look favourably at its extension. We should also indicate that selective assistance to industry under the Industry Acts will also have a high claim on resources, although the limitation here is as much one of administration as of money. We cannot, however, be so forthcoming about schemes of assistance for employment. Indeed, if we were to adopt schemes of the size advocated by the Secretary of State for Employment - which would cost over £750 million gross - we could do so only at the expense of seeking comparable cuts elsewhere.

16. A programme on the lines set out would I think be all we would need for a stable and financially sound economy. It is right that we should consider whether any valuable role could be played by a temporary (12 months) scheme of import deposits, designed to induce a significant financial inflow to the United Kingdom during the critical period when the balance of payments was still in deficit and to reduce marginally the volume of imports. In considering this possibility, we must of course remember that the initial helpful effects of an import deposit scheme are inevitably reversed when the scheme ends, and that there would be very strong international pressure for such a scheme to end after 12 months at the most.

17. If our position were that we could foresee ways of making really dramatic reductions of public expenditure and/or increases in taxation in 1978-79, but not before, there could be great advantage in an import deposit scheme to bring forward some of the effects and create a smoother path of financial improvement. But in fact, I believe we should take fiscal action to reduce the prospective PSBR in both years, although this will require rather larger cuts in 1978-79 than next year. So the profile of the effects of an import deposit scheme would not suit us. To add an import deposit scheme to measures on the lines I have described would have its main impact on the PSBR in the current year; would have a relatively marginal impact on 1977-78, taken as a whole; and would have a strongly adverse impact in

1978-79, when the deposits would have to be repaid. They would therefore generally distort the pattern of change we should be seeking. On the other hand if we used an import deposit scheme as a substitute for expenditure cuts affecting 1977-78, this would be ill-received by our international partners (who might well in some cases be induced to retaliate) and would leave us with an even more difficult problem in 1978-79. In either case an import deposit scheme would greatly reduce company liquidity and might stop the investment recovery in its tracks. It has therefore been strongly opposed in a public statement by the Confederation of British Industry (CBI). For these reasons I doubt the economic value of an import deposit scheme at the present time, although it might have political value in helping to sell the package at home if that package were acceptable abroad without import deposits.

18. I realise that the programme I have outlined would mean that unemployment and, to some extent, prices would rise above their forecast levels in the year or so ahead. Unemployment might be 30,000 higher than in the National Income Forecast (NIF) by the fourth quarter of 1977, but the prospects beyond then would depend very much on the way other elements in the economy were moving. We might well be able to relax the rigour of the programme in late 1977 or early 1978 if the economy was then set fair. We would have overcome the worst of our financial problems and the constraints on our freedom would be greatly reduced.

19. However, it would be misleading to compare the prospect after this fiscal action with the figures suggested by the basic NIF. The NIF forecast of output, employment, balance of payments, etc, was (like the National Institute forecasts) entirely predicated on the assumption of internal financial stability and on a sufficiency of external credit. In practice and on present policies neither of these conditions is likely to be fulfilled. And, if they are not fulfilled, the whole basis of the forecast disintegrates. A failure to adjust present policies could well produce a collapse of the sterling rate, an accelerating rate of inflation and a sharply worsening balance of trade. These developments would produce an employment and price prospect far worse than the one envisaged under the proposed programme.

20. I realise that the proposals I am putting to my colleagues are not agreeable and will be difficult to sell to the Party and the TUC. If there were a better or more viable set of policies I should propose them. But I do not believe that any of the alternatives, all of which would mean abandoning negotiations with the Fund, is preferable to my proposals, or indeed is viable in practice. Three broad alternatives have been suggested, although some elements in each might be combined with others:

i. A programme involving drastic import controls and supporting exchange control measures.

ii. A programme involving little or no fiscal change. It has been suggested that this could be coupled with an attempt to finance our deficit by large-scale credits and the sale abroad of financial assets which would have no effect on the level of activity.

iii. A programme involving minimal cuts in expenditure, a wage/price freeze and a scheme of import deposits designed to raise the external finance.

21. In giving the proper consideration to these policy alternatives we must recognise that the present - still very fragile - state of confidence could be disturbed once again, if there were to be an ominous delay in reaching agreement with the Fund or, worse still, if the discussions were broken off without our having reached agreement. In that event the markets would almost certainly take the timing of decisions out of our hands.

22. I will not go into i. in any detail, for the arguments against it are well set out in the paper by the Central Policy Review Staff (CP(76) 116). This programme would involve a complete reversal of everything we have sought to achieve as a government. We should have to withdraw from the European Community (although whether we would secure the legislation required to permit this seems to me uncertain). We should invite retaliation which would damage those parts of British industry which have been most successful in world markets and we should foster and protect those very industries which are least competitive. It would be a complete reversal of our industrial strategy. At the end of the day we could well be weaker and less able to compete than we are now. The expansion of investment which it would be a main purpose of the programme to promote, would be forthcoming, only if businessmen thought it was likely to endure. But against the likelihood that the Opposition would promise to abandon it as soon as it won office, businessmen would not take the decisions essential to the programme's success. Our manufacturing base would therefore tend to contract, rather than to expand.

23. The programme at ii. appears to be much more attractive and to have fewer long term disadvantages. But is it realistic? To be effective it would require external credit on a vast scale, sufficient in fact not only to finance the deficit but also to allow for the withdrawal of the sterling balances, which would not be underwritten by the safety net arrangements which only agreement with the Fund can secure. I can see no grounds whatever for supposing that this credit would be forthcoming. The market would certainly not supply it, and the Prime Minister's recent exchanges with President Ford and Chancellor Schmidt make it clear that bilateral official borrowing from the strong countries, notably the United States and Germany, is not an option if we fail to agree a programme with the Fund (and we must not forget that these countries have their own domestic political constraints). Nor do I consider that we could obtain sufficient funds by the sale abroad of some of our national assets. We could in theory dispose of the whole of the 70 per cent of the official holdings of BP (valued at £1½ billion), but it would be a difficult operation to mount because of its size and would take a good deal of time. There may be a few other assets which we hold and might hope to sell. But the proceeds would still be well short of our requirements; and, even if they were not, I cannot think that the Government's reputation and credibility would be enhanced by the wholesale disposal of our patrimony at knock-down prices. Is it really in our interests to sell off our industrial base when the equity index is (even now) at 300 - or to sell off the whole of BP, just before the company begins to accumulate massive profits from the North Sea?

24. There remains the theoretical option iii. of seeking to establish our credit and viability by some smaller fiscal adjustment than I have proposed, supported by a wage/price freeze and/or by a scheme of import deposits. I regard this as less impracticable than the other two options but it is nevertheless open to a number of powerful objections.

25. First, as CP(76) 125 points out, a "freeze" can be interpreted in more than one way. In its simplest form, it presumably means no increase in wages and no increase in prices for a stated period. Thus, industry (in both the public and private sectors) would have to absorb the full impact of increases in import costs and any other increases in domestic non-wage costs. As a consequence, it would (by comparison with our present strategy) imply a massive switch of resources from industry to personal consumption - comparable in some ways with the indexing of real take-home pay. It would spell catastrophe for industry, whose cash flow would be gravely interrupted within a matter of months.

26. In a less extreme from, the "freeze" could mean no increase in wages and an increase in prices limited to the effects of import and other domestic non-wage costs. But this would in practice involve much of the hardship of my recommended course, without the benefits of the Fund's money and the Fund's certificate of approval. It might have the presentational advantage of being "our" programme since it would not have been agreed with the Fund. But the wage freeze would require much greater sacrifices from the trade union movement, whose acquiescence would be highly doubtful. Unless postponed until August next year, the freeze would wreck existing horizontal relativities and run the risk of making certain groups, eg the miners, openly defiant. In those circumstances, we certainly could not count on the continued co-operation of the TUC and the CBI on which the success of our economic and industrial policies depends. At the same time, we should still have the problem of external finance (because of the break with the Fund) and the exchange rate would remain vulnerable. Its vulnerability would be intensified by each statement by union leaders questioning or rejecting the pay freeze.

27. I am driven by these considerations to the conclusion that, of all the courses open to us, the one I have put forward is the least damaging and, indeed, more positively, is the only one which is likely to put is in a reasonably strong position when, as a Government, we have to face the electorate. I believe that we must use the remaining international credit available to us, to remove the structural imbalance in our economy, once and for all and so re-establish control of our own affairs. I do not believe the Government would survive yet another policy review under the pressure of the markets and the glare of hostile publicity.

28. I realise that many of our supporters will not like what I propose; but I believe that both in Parliament and outside they can be brought to recognise the realities of our situation. I do not believe they would risk our survival as a Government, when they know what is the only alternative.

D W H

Treasury Chambers

30 November 1976

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TOP SECRET

Copy No. 31

CP(76) 124

30 November 1976

CABINET

A STRATEGY FOR PLANNED EXPANSION

Memorandum by the Secretary of State for the Environment

1. Throughout the lifetime of this Government our central objective has been to avoid massive deflation while at the same time to close our appalling trade deficit, to stimulate growth, and to reduce the rate of inflation. They remain our objectives, but it is now clear that the existing strategy designed to achieve these objectives as near collapse, as all our expectations about the success of that strategy have been falsified.

2. This unpalatable fact has become irrefutably clear from events following the July measures. The objective of those measures was to secure a package "which will re-establish confidence in our economic policies to a degree which enables us to build our reserves and avoid being forced to the International Monetary Fund (IMF) to repay our drawings on $5.3 billion standby". (CP(76)52, paragraph 4). But as we now know, the package which was agreed has not satisfied the market. Confidence, far from reviving, has further collapsed and we are now in the hands of the IMF. At the same time, the hoped for revival of manufacturing output is no longer expected. On the present strategy the October National Income Forecast (NIF) suggests that unemployment will not fall, but rise to $1\frac{3}{4}$ million by the end of next year, and remain there throughout 1978; that inflation will not fall to single digits but rise to 16 per cent up to mid-1977; gross domestic product (GDP) will grow at only just over half the rate forecast in July; the public sector borrowing requirement (PSBR) will increase from an expected £9 billion in 1977-78 to £10.5 - £11 billion.

3. The difficulties of entering an election period on such a scenario do not need spelling out: the disillusion of our own supporters, already strong, will grow apace. Worst of all, still more than in 1969, the ability of union leaders to restrain the growth of wages in the wider interests of economic growth and social justice could disappear. Without a new departure in policy what prospect is there that the present pattern of the social contract can be maintained?

4. We are now faced with the need to change our policy. There are in effect two alternative strategies.

TOP SECRET

A. DEFLATION

5. This is the course being urged upon us by the IMF, the Opposition and a substantial majority of City, industrial and media opinion. Our present negotiations with the Fund are simply about the quantum of deflation and its loading as between 1977-78 and 1978-79. The effect and consequences of the most severe package of cuts which has been considered were discussed in CP(76) 111 and in Cabinet on 23 November (CM(76) 33rd Conclusions, Minute 2 refers) and do not need repeating here. But even if we achieved the much more modest figure of £1 billion off the PSBR (50 per cent of which would come from sales of Burmah Oil) three major objections would remain:

i. £½ billion extra deflation could on a broad approximation be assumed to lead to 25,000 to 40,000 unemployed at the beginning of 1978 in addition to the 1.75 million predicted in the current NIF;

ii. the associated non-PSBR conditions would entail a. tighter Domestic Credit Expansion (DCE) targets that would force us into additional deflation if net exports go less well than foreseen, for instance, because of a large OPEC price increase; b. a formal and explicit renunciation of any resort to import controls;

iii. there is a serious risk that a modest package, even if acceptable to the IMF and the principal governments concerned would not satisfy the market and would lead us to the same conditions of currency instability as followed last summer's £5 billion standby and £2 billion package to reduce the PSBR. If this were to happen it would not then be open to us to adopt the import control alternative. The only option would be further and more savage deflation.

Further the timescale involved gives little prospect of reducing unemployment in the lifetime of this Parliament.

B. PLANNED EXPANSION

6. The crux of a more successful alternative must be a rapid and assured achievement of surplus in our balance of payments. This will necessitate a resort to direct control over imports. This is the only way of escaping the necessity of further borrowing in order to finance our balance of payments deficit in the 18 months or so before North Sea oil and an export revival close the gap.

7. Officials estimated in October that a scheme of general quotas would, on the assumptions of no retaliation and no tax increases, be likely to lead to a current surplus next year of £0.8 billion (compared with the new NIF forecast of a deficit of £1.5 billion), and of £4.2 billion in 1978 (compared with new NIF forecast of £1 billion) unemployment reducing by 80,000 in 1977 and 190,000 in 1978: faster growth of GDP and manufacturing output. (These figures may require some downward revision in the light of more recent developments; but their scale remains broadly correct.)

8. Four serious arguments have been advanced against such controls:-

i. that they would be inflationary;

ii. that they would provoke retaliation;

iii. that they would not overcome short term difficulties in financing our trade;

iv. that, if introduced, we should lose the $3.9 billion IMF loan and the possible Sterling safety net.

9. When we last discussed this matter in depth a majority of colleagues felt that the disadvantages of import controls outweighed their possible benefits. I believe that recent events and the new NIF significantly alter the balance of this argument.

i. Demand and Inflation. It was suggested that a quota scheme would generate substantial excess demand for manufacturing output which could not be met by extra production; and one of the arguments advanced against their introduction was that drastic import controls would be of no help to the employment situation if the economy was already growing at the maximum rate compatible with capacity restraint, and that a reduction in domestic demand would be essential. But the new NIF now suggests a rate of growth 2 per cent less than the assumptions on which the figures in paragraph 7 above were based. The risks of a quota scheme generating excess demand can therefore be discounted.

ii. Retaliation. We are now in a situation which, under international economic law, justifies the use of import restraint - without the legal right of other countries to retaliate against us. The General Agreement on Tariffs and Trade (GATT) Article XII exactly meets our present problem of an unmanageable deficit on the balance of payments with inadequate and falling reserves. Of course, we should need the acquiescence of the European Economic Community (EEC) but, quite apart from recent Italian precedents, the provisions of Articles 108, 109 and 104 are directly relevant. We would of course have to promise to get rid of controls as soon as there was a significant turn-round in the balance of payments and in our reserves - a promise that would make extensive retaliation seem even more pointless.

iii. Short Term Financing of Trade. The point is correctly made that it would be some nine months before import quotas made a serious impact on the trade balance. To cover the intervening period I would propose the introduction of a severe scheme of import deposits of the kind already discussed in the Ministerial Committee on Economic Strategy, for a 9-12 month period, as an interim measure before the benefits of a quota scheme flow through.

iv. IMF Loan. We clearly have to face the fact that such a strategy would involve a serious risk that we would not be able successfully to negotiate the current IMF loan. But this is a high risk situation in any event; and the IMF and its major contributors will understand the options which would present themselves to us if no help is forthcoming. Whatever therefore may be the negotiating posture which the IMF is presently adopting we should certainly not rule out the possibility of concluding arrangements for financial support including an extension of the $5.3 billion credit and the establishment of a sterling safety net. Nevertheless we must be ready and be known to be ready to take other direct measures including bilateral negotiations with major official holders of sterling on the lines of the guarantees agreed in 1968, and the reintroduction of tight exchange controls.

10. We are agreed that there is no economic case for cutting the PSBR in terms of resources but we have of course to bear in mind the need to mitigate the effect on confidence, and to improve the international acceptability, of import controls. We have also to consider the effect of reducing the PSBR on the present high level of interest rates which are themselves damaging to employment. Providing that such measures were linked with import controls with their beneficial effect upon employment I would support increases in excise duty on tobacco, liquor, oil and in car tax. We should also consider whether to increase VAT generally. Apart from the increases in revenue which would flow from these measures they would help in the reduction of imports.

CONCLUSION

11. The outcome of the final negotiations with the IMF will critically affect the fortunes of this Government during its life, and perhaps of the Labour Party over the next decade. I believe that we should go to the IMF to seek their general agreement for an approach to GATT under Article XII, and to the European Economic Community for their support under Article 108. Such a strategy as I have outlined, incorporating import controls with their beneficial effects on unemployment and manufacturing output should be used as the basis for seeking early agreement of the TUC for a policy of income restraint up to July 1978, and I would propose that negotiations on this should be set in hand immediately. What is also essential is that the measures which we decide to take should be i. taken together and ii. should be implemented without delay.

P S

Department of the Environment

30 November 1976

TREATY OF ROME

CHAPTER 2—BALANCE OF PAYMENTS

ARTICLE 104

Each Member State shall pursue the economic policy needed to ensure the equilibrium of its overall balance of payments and to maintain confidence in its currency, while taking care to ensure a high level of employment and a stable level of prices.

ARTICLE 105

1. In order to facilitate attainment of the objectives set out in Article 104, Member States shall coordinate their economic policies. They shall for this purpose provide for cooperation between their appropriate administrative departments and between their central banks.

The Commission shall submit to the Council recommendations on how to achieve such cooperation.

2. In order to promote coordination of the policies of Member States in the monetary field to the full extent needed for the functioning of the common market, a Monetary Committee with advisory status is hereby set up. It shall have the following tasks:

—to keep under review the monetary and financial situation of the Member States and of the Community and the general payments system of the Member States and to report regularly thereon to the Council and to the Commission;

—to deliver opinions at the request of the Council or of the Commission or on its own initiative, for submission to these institutions.

The Member States and the Commission shall each appoint two members of the Monetary Committee.

ARTICLE 106

1. Each Member State undertakes to authorise, in the currency of the Member State in which the creditor or the beneficiary resides, any payments connected with the movement of goods, services or capital, and any transfers of capital and earnings, to the extent that the movement of goods, services, capital and persons between Member States has been liberalised pursuant to this Treaty.

The Member States declare their readiness to undertake the liberalisation of payments beyond the extent provided in the preceding subparagraph, in so far as their economic situation in general and the state of their balance of payments in particular so permit.

2. In so far as movements of goods, services, and capital are limited only by restrictions on payments connected therewith, these restrictions shall be progressively abolished by applying, *mutatis mutandis*, the provisions of the Chapters relating to the abolition of quantitative restrictions, to the liberalisation of services and to the free movement of capital.

3. Member States undertake not to introduce between themselves any new restrictions on transfers connected with the invisible transactions listed in Annex III to this Treaty.

The progressive abolition of existing restrictions shall be effected in accordance with the provisions of Articles 63 to 65, in so far as such abolition is not governed by the provisions contained in paragraphs 1 and 2 or by the Chapter relating to the free movement of capital.

4. If need be, Member States shall consult each other on the measures to be taken to enable the payments and transfers mentioned in this Article to be effected; such measures shall not prejudice the attainment of the objectives set out in this Chapter.

Article 107

1. Each Member State shall treat its policy with regard to rates of exchange as a matter of common concern.

2. If a Member State makes an alteration in its rate of exchange which is inconsistent with the objectives set out in Article 104 and which seriously distorts conditions of competition, the Commission may, after consulting the Monetary Committee, authorise other Member States to take for a strictly limited period the necessary measures, the conditions and details of which it shall determine, in order to counter the consequences of such alteration.

Article 108

1. Where a Member State is in difficulties or is seriously threatened with difficulties as regards its balance of payments either as a result of an overall disequilibrium in its balance of payments, or as a result of the type of currency at its disposal, and where such difficulties are liable in particular to jeopardise the functioning of the common market or the progressive implementation of the common commercial policy, the Commission shall immediately investigate the position of the State in question and the action which, making use of all the means at its disposal, that State has taken or may take in accordance with the provisions of Article 104. The Commission shall state what measures it recommends the State concerned to take.

If the action taken by a Member State and the measures suggested by the Commission do not prove sufficient to overcome the difficulties which have arisen or which threaten, the Commission shall, after consulting the Monetary Committee, recommend to the Council the granting of mutual assistance and appropriate methods therefor.

The Commission shall keep the Council regularly informed of the situation and of how it is developing.

2. The Council, acting by a qualified majority, shall grant such mutual assistance; it shall adopt directives or decisions laying down the conditions and details of such assistance, which may take such forms as:

(a) a concerted approach to or within any other international organisations to which Member States may have recourse;

(b) measures needed to avoid deflection of trade where the State which is in difficulties maintains or reintroduces quantitative restrictionsagainst third countries;

(c) the granting of limited credits by other Member States, subject to their agreement.

During the transitional period, mutual assistance may also take the form of special reductions in customs duties or enlargements of quotas in order to facilitate an increase in imports from the State which is in difficulties, subject to the agreement of the States by which such measures would have to be taken.

3. If the mutual assistance recommended by the Commission is not granted by the Council or if the mutual assistance granted and the measures taken are insufficient, the Commission shall authorise the State which is in difficulties to take protective measures, the conditions and details of which the Commission shall determine.

Such authorisation may be revoked and such conditions and details may be changed by the Council acting by a qualified majority.

Article 109

1. Where a sudden crisis in the balance of payments occurs and a decision within the meaning of Article 108 (2) is not immediately taken, the Member State concerned may, as a precaution, take the necessary protective measures. Such measures must cause the least possible disturbance in the functioning of the common market and must not be wider in scope than is strictly necessary to remedy the sudden difficulties which have arisen.

2. The Commission and the other Member States shall be informed of such protective measures not later than when they enter into force. The Commission may recommend to the Council the granting of mutual assistance under Article 108.

3. After the Commission has delivered an opinion and the Monetary Committee has been consulted, the Council may, acting by a qualified majority, decide that the State concerned shall amend, suspend or abolish the protective measures referred to above.

CHAPTER 3—COMMERCIAL POLICY

Article 110

By establishing a customs union between themselves Member States aim to contribute, in the common interest, to the harmonious development of world trade, the progressive abolition of restrictions on international trade and the lowering of customs barriers.

The common commercial policy shall take into account the favourable effect which the abolition of customs duties between Member States may have on the increase in the competitive strength of undertakings in those States.

Article 111

The following provisions shall, without prejudice to Articles 115 and 116, apply during the transitional period:

1. Member States shall coordinate their trade relations with third countries so as to bring about, by the end of the transitional period, the conditions needed for implementing a common policy in the field of external trade.

to certain groups of domestic consumers free of charge or at prices below the current market level; or

(iii) to restrict the quantities permitted to be produced of any animal product the production of which is directly dependent, wholly or mainly, on the imported commodity, if the domestic production of that commodity is relatively negligible.

Any contracting party applying restrictions on the importation of any product pursuant to sub-paragraph (c) of this paragraph shall give public notice of the total quantity or value of the product permitted to be imported during a specified future period and of any change in such quantity or value. Moreover, any restrictions applied under (i) above shall not be such as will reduce the total of imports relative to the total of domestic production, as compared with the proportion which might reasonably be expected to rule between the two in the absence of restrictions. In determining this proportion, the contracting party shall pay due regard to the proportion prevailing during a previous representative period and to any special factors* which may have affected or may be affecting the trade in the product concerned.

Article XII *

Restrictions to Safeguard the Balance of Payments

1. Notwithstanding the provisions of paragraph 1 of Article XI, any contracting party, in order to safeguard its external financial position and its balance of payments, may restrict the quantity or value of merchandise permitted to be imported, subject to the provisions of the following paragraphs of this Article.

2. (*a*) Import restrictions instituted, maintained or intensified by a contracting party under this Article shall not exceed those necessary:

(i) to forestall the imminent threat of, or to stop, a serious decline in its monetary reserves, or

(ii) in the case of a contracting party with very low monetary reserves, to achieve a reasonable rate of increase in its reserves.

Due regard shall be paid in either case to any special factors which may be affecting the reserves of such contracting party or its need for reserves, including, where special external credits or other resources are available to it, the need to provide for the appropriate use of such credits or resources.

(*b*) Contracting parties applying restrictions under sub-paragraph (*a*) of this paragraph shall progressively relax them as such condi-

tions improve, maintaining them only to the extent that the conditions specified in that sub-paragraph still justify their application. They shall eliminate the restrictions when conditions would no longer justify their institution or maintenance under that sub-paragraph.

3. (*a*) Contracting parties undertake, in carrying out their domestic policies, to pay due regard to the need for maintaining or restoring equilibrium in their balance of payments on a sound and lasting basis and to the desirability of avoiding an uneconomic employment of productive resources. They recognize that, in order to achieve these ends, it is desirable so far as possible to adopt measures which expand rather than contract international trade.

(*b*) Contracting parties applying restrictions under this Article may determine the incidence of the restrictions on imports of different products or classes of products in such a way as to give priority to the importation of those products which are more essential.

(*c*) Contracting parties applying restrictions under this Article undertake:

(i) to avoid unnecessary damage to the commercial or economic interests of any other contracting party;*

(ii) not to apply restrictions so as to prevent unreasonably the importation of any description of goods in minimum commercial quantities the exclusion of which would impair regular channels of trade; and

(iii) not to apply restrictions which would prevent the importation of commercial samples or prevent compliance with patent, trade mark, copyright, or similar procedures.

(*d*) 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 of the sort referred to in paragraph 2 (*a*) of this Article. Accordingly, a contracting party otherwise complying with the provisions of this Article shall not be required to withdraw or modify restrictions on the ground that a change in those policies would render unnecessary restrictions which it is applying under this Article.

4. (*a*) Any contracting party applying new restrictions or raising the general level of its existing restrictions by a substantial intensification of the measures applied under this Article shall immediately after instituting or intensifying such restrictions (or, in circumstances in which prior consultation is practicable, before doing so) consult with the CONTRACTING

PARTIES as to the nature of its balance of payments difficulties, alternative corrective measures which may be available, and the possible effect of the restrictions on the economies of other contracting parties.

(*b*) On a date to be determined by them,* the CONTRACTING PARTIES shall review all restrictions still applied under this Article on that date. Beginning one year after that date, contracting parties applying import restrictions under this Article shall enter into consultations of the type provided for in sub-paragraph (*a*) of this paragraph with the CONTRACTING PARTIES annually.

(*c*) (i) If, in the course of consultations with a contracting party under sub-paragraph (*a*) or (*b*) above, the CONTRACTING PARTIES find that the restrictions are not consistent with the provisions of this Article or with those of Article XIII (subject to the provisions of Article XIV), they shall indicate the nature of the inconsistency and may advise that the restrictions be suitably modified.

(ii) If, however, as a result of the consultations, the CONTRACTING PARTIES determine that the restrictions are being applied in a manner involving an inconsistency of a serious nature with the provisions of this Article or with those of Article XIII (subject to the provisions of Article XIV) and that damage to the trade of any contracting party is caused or threatened thereby, they shall so inform the contracting party applying the restrictions and shall make appropriate recommendations for securing conformity with such provisions within a specified period of time. If such contracting party does not comply with these recommendations within the specified period, the CONTRACTING PARTIES may release any contracting party the trade of which is adversely affected by the restrictions from such obligations under this Agreement towards the contracting party applying the restrictions as they determine to be appropriate in the circumstances.

(*d*) The CONTRACTING PARTIES shall invite any contracting party which is applying restrictions under this Article to enter into consultations with them at the request of any contracting party which can establish a *prima facie* case that the restrictions are inconsistent with the provisions of this Article or with those of Article XIII (subject to the provisions of Article XIV) and that its trade is adversely affected thereby. However, no such invitation shall be issued unless the CONTRACTING PARTIES have ascertained that direct discussions between the contracting parties concerned have not been successful. If, as a result of the consultations with the CONTRACTING PARTIES, no agreement is reached and they determine that the restrictions are being applied inconsistently with such provisions, and that damage to the trade of the contracting party initiating the procedure is caused or threatened thereby, they shall recommend the withdrawal or modification of the restrictions. If the restrictions are not withdrawn or modified

within such time as the CONTRACTING PARTIES may prescribe, they may release the contracting party initiating the procedure from such obligations under this Agreement towards the contracting party applying the restrictions as they determine to be appropriate in the circumstances.

(*e*) In proceeding under this paragraph, the CONTRACTING PARTIES shall have due regard to any special external factors adversely affecting the export trade of the contracting party applying restrictions.*

(*f*) Determinations under this paragraph shall be rendered expeditiously and, if possible, within sixty days of the initiation of the consultations.

5. If there is a persistent and widespread application of import restrictions under this Article, indicating the existence of a general disequilibrium which is restricting international trade, the CONTRACTING PARTIES shall initiate discussions to consider whether other measures might be taken either by those contracting parties the balances of payments of which are under pressure or by those the balances of payments of which are tending to be exceptionally favourable, or by any appropriate intergovernmental organization, to remove the underlying causes of the disequilibrium. On the invitation of the CONTRACTING PARTIES, contracting parties shall participate in such discussions.

Article XIII *

Non-discriminatory Administration of Quantitative Restrictions

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.

2. In applying import restrictions to any product, contracting parties shall aim at a distribution of trade in such product approaching as closely as possible the shares which the various contracting parties might be expected to obtain in the absence of such restrictions, and to this end shall observe the following provisions:

(*a*) Wherever practicable, quotas representing the total amount of permitted imports (whether allocated among supplying countries or not) shall be fixed, and notice given of their amount in accordance with paragraph 3 (*b*) of this Article;

(*b*) In cases in which quotas are not practicable, the restrictions may be applied by means of import licences or permits without a quota;

CP(76) 125

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30 November 1976

CABINET

INCOMES POLICY, LIVING STANDARDS AND PUBLIC EXPENDITURE

Memorandum by the Chancellor of the Exchequer

1. In our discussions on 25 November it was suggested that we might go for a complete freeze on pay and prices as our main initiative to restore external confidence on the economy. With such a freeze, it would be possible to avoid any uprating of social security benefits during 1977 and that would itself produce substantial public expenditure savings. It was envisaged that the effect on confidence of this stop on incomes and prices would be sufficient with little or no further cuts in public expenditure. Given the price and incomes freeze there could be no increases in taxation.

PRACTICABILITY OF A PRICE/INCOMES FREEZE

2. Pay. The first question is whether such a price/incomes freeze would be practicable. We have to start by considering how long the freeze would have to last. In 1965-66 the Labour Government successfully operated a statutory pay policy with a nil norm but at a much lower level of inflation and at a time when there was no build-up of price increases in the pipeline from a major depreciation of sterling. The Heath Government ran a statutory pay and price freeze from November 1972 until March 1973. The experience of successive incomes policies over the last 15 years strongly suggests however that it is dangerous to apply different limits to pay increases within a single pay round. There is acute resentment if the same treatment is not applied to everybody. For that reason the Heath freeze was no more than a deferment of increases for those affected by it.

3. I conclude that if we went for a pay freeze it would have to apply at least to the whole pay round up to August 1977 and very possibly until December 1977, so as to ensure that each group was hit once by it. The freeze would be in substitution for the present 4½ per cent agreement with the Trades Union Congress (TUC) (although over 2 million workers have already settled uner that agreement).

4. Prices. A price freeze to match the pay freeze might take one of several forms:-

i. A freeze for the period 1 January to 31 July on the ground that that would correspond to the period of the pay freeze. The delayed price increases would then come through in the following months, as they did following the Heath price freeze of November 1972 to March 1973. But the counterpart of that would be that pay also should "catch up" after July 1977, or there is no real "match".

ii. A 12 months price freeze, but excluding import cost increases. But of the 16 per cent year on year rate of inflation we now expect by mid-1977 over 8 per cent will be attributable to increased import costs (mainly from the depreciation of sterling). In many cases it would be very difficult to trace the effect of import costs through to consumer prices. It would be still more difficult to convince people that it was right to ask them to bear these costs in a pay freeze and that price increases were genuinely being limited to this factor.

iii. A straight 12 months price freeze: though even then exceptions would have to be made for seasonal foods.

5. Different forms of price freeze would have different effects on the distribution of resources, as well as on unemployment and inflation. Our strategy requires a switch of resources from consumption to the balance of payments and investment. Assuming continuance of the present $4\frac{1}{2}$ per cent pay policy, the latest inflation forecasts and the best assessment we have been able to make of the increase in earnings during the pay round point to a fall in the real take home pay of the average worker by the late summer of 1977 of between 6 per cent and 7 per cent. If the policy holds, this will mean a transfer of resources to the balance of payments and to investment as well as a better inflation outlook from the last months of 1977 onwards.

6. Of course it would be better still if this transfer could be made at a lower level of pay and price increases. That would however require a rate of price increase of something like 6 per cent or 7 per cent during a pay freeze. If it were necessary to have a 12 months price freeze consumers would be substantially better off than under the present policy and there would be extra burdens on the balance of payments and on industry. Industry would benefit from the pay freeze but they would have to carry the inflationary cost increases now in the pipeline (and any subsequent import cost increases) for up to an extra year before recouping them in prices. In practice there would have to be many exceptions to present firms going out of business, and that would reduce the credibility of the price freeze. But there would also be a major squeeze again on liquidity and profits, at a time when private sector bank lending has had to be limited. There would be extra unemployment, a contraction of industrial activity and a serious loss of industrial confidence. Notwithstanding the pay freeze it seems likely that as the effects of the price freeze become apparent relations with industry would be damaged to the point where the industrial strategy would be impaired if not destroyed. These damaging effects on confidence would offset the confidence gain from a pay freeze.

7. A price freeze would have to be applied at least as strictly to public sector prices as to those of the private sector. The total effect on the public sector borrowing requirement (PSBR) would depend on the nature and duration of the price freeze and on the balance between gains from lower public sector pay, lower social security benefits and lower private sector prices for goods and services purchased by the public sector; and losses from lower tax revenues, lower insurance contributions, lower public sector prices and, presumably, a stop on rate increases.

8. In fact the obstacles to a lengthy and convincing price freeze, of a kind which we would be expected to impose to match a complete pay freeze, seem to me insuperable with the degree of inflation now in the pipeline.

A STATUTORY PAY POLICY?

9. I think we must assume that a pay freeze would have to be statutory, especially if it were not possible to accompany it by a fully effective price freeze. It does not seem credible that the TUC would be in a position to negotiate with us a pay freeze lasting 8 or 9 months in substitution for the existing second round pay agreement, and sell the proposition to a special Trade Union Conference. But could we really contemplate enacting a statutory pay freeze to which the TUC were in no way committed and which many individual unions might at once refuse to accept? Given its likely impact on living standards, we shall I think do very well if with TUC help we hold the present $4\frac{1}{2}$ per cent pay round and succeed in negotiating a satisfactory successor agreement.

THE THIRD PAY ROUND AND THE STANDARD OF LIVING

10. The Prime Minister said during the Debate on the Address that we needed an agreement to limit pay in the year after July 1977. Following discussion in EY Committee we have agreed the broad basis on which we should open negotiations with the TUC with a view to an agreement before the spring Budget, if possible. I expect to begin the main negotiation with the TUC National Economic Development Council (NEDC) Six in January. Before we can expect to make much progress on the third pay round however we have to deal with the IMF loan, and see our way to finance the balance of payments deficit and establish external confidence. We shall have to explain fully to the TUC whatever measures are necessary to achieve that and to secure their understanding, if not their agreement. When we get to negotiations for the third pay round we shall need to aim for a rate of pay increase not very different from the increase in the present $4\frac{1}{2}$ per cent round if we are to resume the deceleration of inflation and help restore confidence in the economy. That will leave no room for any increase in the standard of living during the third pay round.

11. My conclusions would be:-

i. that a pay and price freeze is not at present a practicable method of establishing confidence in the economy,

ii. that the prospect for real take home pay described above and our support for a voluntary pay policy point firmly against any attempt at a pay freeze; and that both this prospect and the requirements of confidence point to achieving the necessary PSBR reductions so far as possible through cuts in public expenditure rather than increases in tax.

D W H

Treasury Chambers

30 November 1976

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CP(76) 126

COPY NO 81

30 November 1976

CABINET

PUBLIC EXPENDITURE - CONTINGENCY MEASURES

Memorandum by the Chancellor of the Exchequer

1. In my paper on the International Monetary Fund (IMF) negotiations (CP(76) 111) I said that, as agreed earlier on, work has been carried out by officials of the Treasury and Departments concerned on public expenditure reductions which might be technically possible; and that my officials had also done some work on illustrative packages of different magnitudes. I now enclose the paper by Treasury officials; Appendix A to the paper summarises the illustrative packages. Appendix B gives a full list of the technically possible reductions from which these packages have been constructed, and is accompanied by Annexes on the individual items listed.

2. This paper is not circulated as a basis for specific decisions at our meeting on 1 December, but so that Cabinet can form a preliminary impression of the kind of measures which might be involved in packages of the order of magnitude which I indicated in CP(76) 111. For this purpose, my colleagues need initially to look at no more than Appendix A.

3. I also referred in CP(76) 111 to my proposals to encourage a shift to foreign currency financing of export credit. Further consideration will have to be given to the amount of expenditure savings which can be claimed as a result of action in this area. The present fixed rate scheme is open-ended and as matters stand we are faced with a potentially large addition to the previous forecasts of this expenditure. But if the proposals I have made are approved, or if we can find alternative ways of achieving savings in the export credit field, this would help to counter the prospective higher demand for fixed rate credit, and make some contribution to the required savings for 1978-79. Meanwhile, no allowance for these potential savings has been made in the illustrative packages.

4. I should also point out that, if it is proposed to allocate additional funds in the year ahead to schemes of support for employment or industry - other than the Selective Investment Scheme about which the Chief Secretary

is in touch with the Secretary of State for Industry on the basis already agreed in Cabinet - allowance for these would have to be made from the outset. The total expenditure reductions would thus have to be large enough to cover any such extra funds and still achieve the required objectives.

D W H

Treasury Chambers

30 November 1976

Public Expenditure - Contingency Planning

Note by the Treasury

1. The Cabinet agreed on 26 October that officials should undertake an exercise to identify areas in which reductions in public expenditure in 1977-78 might technically be possible, on the basis that Ministers would be in no way committed by the exercise. The appreciation of technically possible reductions set out below and in the enclosures to this paper has now been prepared in the light of urgent discussions between the Treasury and the Departments concerned, but the text has not been agreed interdepartmentally and some of the estimates are still provisional.

General Approach

2. Two broad approaches can be adopted in seeking expenditure reductions. One is to impose across-the-board percentage cuts on general categories of expenditure, as was done, for example, in the 1975 Budget. The other is to take a number of specific policy decisions which would reduce expenditure on particular programmes.

3. The first approach is a way of distributing the burden of the cuts but does not itself identify the action required to achieve the savings. This method may have to be considered if "equality of misery" is considered necessary; but it has no regard to relative priorities and cannot take account of the relative damage to objectives and the practical difficulties involved in achieving the cuts. Also there are large areas of public expenditure, especially social security, where the across-the-board technique is particularly difficult to apply. Even over the remainder of the field, while across-the-board cuts have been used in the past, they can rarely be imposed without at least some exemptions, and without encountering unforeseen snags which erode the planned savings. The recent exercise to identify the staff savings for which credit was taken in Cmnd 6393 shows the risks of announcing cuts before it has been clearly established how they would be achieved. Given the extent to which expenditure has been

squeezed already, there is a real risk that such cuts, if announced now, would not be fully realised in practice, or carry conviction with outside observers.

4. The moratorium technique represents in a sense an in-between approach. It involves a policy decision to postpone for a given period all capital projects not already committed over a wide range of programmes. This is in itself a method of securing the savings; the incidence on each programme depends not on any pre-determined percentage but on the capital projects in the programme and the extent to which they are committed. The Annexes to this paper which deal with individual areas of expenditure include, in appropriate cases, an estimate of the effect of a moratorium on new capital projects and some other capital expenditure.

5. Apart from this, the exercise has concentrated on specific possible measures affecting particular programmes. The approach has been to identify measures which would start to produce savings in 1977-78 and between them have a substantial effect on expenditure in that year, but not to exclude measures which, while contributing to savings in 1977-78, would produce their full-year effect in 1978-79. All the options which have been identified are summarised in the table at Appendix B to this paper, which is supported by more detailed annexes on the individual items. Annex 16 discusses briefly the question of economy in expenditure on the civil service.

<u>General appraisal</u>

6. It will be seen that if all of these possible measures were adopted (taking the higher options where there are alternatives) they could between them produce gross expenditure savings of the order of £3 billion in 1977-78, at 1976 Survey prices. This does not however make allowance for any additional expenditure on employment-creating measures of a kind which have been suggested for possible inclusion in any package of savings (see Annex 17). Any such measures would need to be decided at the same time, so that they could be brought into account in settling the total amount of savings that were required.

7. A package of this magnitude would involve substantial further action in the fields of housing, health and education, a significant contribution from the aid programme; additional defence cuts which could raise the question of a further defence review; and savings in general schemes of regional support to industry without re-allocating any of the savings to the National Enterprise Board and selective assistance to industry. It would mean no uprating of social security benefits or public service pensions in 1977-78; and a complete stoppage of all new public sector construction, including housing, for at least twelve months. This last measure would account for about a third of a £3 billion package, as the following rough estimates show.

	£ million (1976 Survey Prices)	
	1977-78	1978-79
Savings from moratorium of:-		
6 months	700	500
12 months	1,200	1,250

(These amounts are already included in the appropriate sections of the Table at Appendix B and are not additional to the figures shown in it.) A note on the effect of these savings on the construction industry is at Annex 15.

Illustrative packages

8. Any substantial additional savings in public expenditure must involve both further action on programmes which have already been reduced from their previously planned levels, and also on other programmes which have hitherto been much less affected. It is also difficult to frame such a package without employing both policy changes and the moratorium method. However, to enable Ministers to consider possible decisions which wo_ld involve somewhat less drastic recourse to either, but with correspondingly

less relief to the borrowing requirement, Treasury officials have been asked to present different illustrative packages of possible measures. Those which are discussed below, and which are summarised in Appendix A, are not advanced as proposals by the Treasury at either Ministerial or official level, but as illustrations of how, if Ministers decided on levels of savings falling short of the £3 billion discussed above, these levels could be secured.

9. In this presentation, options have been set out in three categories, ie. measures not involving legislation; measures involving subordinate legislation or a Finance Bill clause; and measures involving main legislation - ie. in increasing order of difficulty from the legislative point of view. Within each category alternative amounts are listed as components of either a smaller or a larger package, ie. in increasing order of difficulty from the point of view of the amount involved.

10. The first category, not involving legislation, assumes roughly a six months moratorium (not applicable to housing) on programmes other than roads; the road programme would not be affected by a moratorium of limited duration, and is therefore assumed to make an ad hoc contribution to the smaller package and a larger contribution, arising from a twelve months moratorium on roads only, to the larger package. The housing programme is assumed to find offsets to the increases which will otherwise arise in this programme in 1977-78, but to make a net contribution only to the larger package.

11. While the first category is a mixture of measures directly affecting employment and others consisting of transfer payments, the second category - still not involving main legislation - consists almost wholly of subsidies and transfer charges. But the option which consists of a new policy for limiting the subsidy to school meals could also indirectly lead to a reduction in the very large staff numbers engaged in the school meals service;

it would thus be the one measure which could supplement the rate support grant settlement in influencing the numbers working for local authorities.

12. The only main legislation for consideration arises in the fields of social security and public service pensions. Thus there are two salient questions for consideration here - are the Government prepared to legislate at all in this field? And if so, are they prepared to repeal, modify or suspend the commitment to mandatory upratings in line with prices for certain benefits, or for others in line with prices or earnings (hitherto interpreted as gross earnings) whichever of these is the more favourable?

13. If the answer to both these questions were yes, a wide range of options would become open and, up to a point, the decision as between the options would depend on the size of the savings which the Government were prepared to secure in this field. The provisional figures which have been shown assume, for the sake of illustration, that in either package earnings-related supplement would be discontinued and that, in addition, in the smaller package benefits would be uprated in line with net earnings, while in the larger package the uprating would fall short of net earnings. An important feature of a change in upratings is that it could give bigger full-year savings in 1978-79 than in 1977-78, which could be of great help in dealing with the continuing problem of the borrowing requirement in the later year. (The implications of the revised national income forecasts for the unemployment provision in the social security programme are discussed in Annex 11).

Northern Ireland

14. None of the figures cover Northern Ireland programmes. When savings have been determined in Great Britain programmes, it would be necessary to consider additional savings in the corresponding Northern Ireland programmes equivalent to 2½% of the amount saved in Great Britain. Some programmes, such as defence, are on a UK basis and there is no separate Northern Ireland programme.

The base-line for expenditure reductions

15. The UK's performance in controlling public expenditure is now monitored by reference to the last White Paper figures, updated to take account of price changes and announced policy changes, including the measures announced in July affecting 1977-78. The position disclosed in July left a much reduced contingency reserve for that year, and since then there are increased estimates for the cost in 1977-78 of a number of open-ended programmes. These include an additional requirement for EEC contributions of about £40 million; an increase of £75 million in the estimated cost of the temporary employment subsidy and job creation programme under the schemes already announced; and, in spite of the new terms negotiated for refinance of fixed rate credit for exports and shipbuilding, an extra £55 million for that scheme. Thus, in relation to the White Paper plan, these extra requirements will have to be set against any savings now secured. Moreover, though the higher interest charges which affect the housing programme have already been the subject of decisions for 1978-79 and later years, the corresponding excess in 1977-78 has not been tackled pending the present round of discussions. For that reason the need to find savings of about £220 million on this programme before any net savings in it can be scored has been noted in Appendix A.

16. As regards 1978-79, Ministers have more recently taken decisions designed to get back to the White Paper levels, but even here there are problems arising from the open-ended programmes. Apart from the special case of provision for the unemployed, which is explained in Annex 11, these programmes include, once again, contributions to the EEC and a further large potential requirement of about £160 million for fixed rate refinance. Proposals are being put separately to Cabinet for policy changes on export credit which would reduce the Government refinancing requirement, but the forecast excess would represent a first charge on any such savings. A very provisional estimate of the net public expenditure saving on export credit if these proposals are implemented is £30 million in 1977-78 and £50 million in 1978-79, compared with the White Paper projections.

HM Treasury
30 November 1976

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APPENDIX A

	£ million at 1976 Survey prices			
	1977-78		1978-79	
	Smaller	Larger	Smaller	Larger
Measures not involving legislation				
Defence	50	100	20	70
Aid	50	100	50	100
Food subsidies	100	150	60	60
Construction etc (other than housing)*	300	350	205	235
Housing:				
Offset additional bid for 1977-78	[220]	[220]	-	-
Net saving	-	100	200**	400**
Community land	50	50	50	50
National Health Service current expenditure and drugs	40	40	50	50
Civil Service staff savings	30	30	8	8
	620	920	643	973
Measures involving subordinate legislation or Finance Bill measures				
School meals	50	50	50	80
Social security:				
remove entitlement to flat-rate benefits for first 6 days of temporary suspension	10	10	10	10
withdraw child tax allowances for non-resident children	20	20	15	15
Prescription charges	35	35	35	35
Regional employment premium:				
withdraw from development areas	20		65	
suspend		150		170
	135	265	175	310
Measures involving main legislation				
Social security and public service pensions:				
remove entitlement to flat-rate benefits for first 6 days of complete interruption of employment	70	70	70	70
Savings on uprating of benefits and on earnings-related supplement	250	400	450	650
Corresponding savings on uprating of public service pensions	10✗	30✗	70✗	100✗
Total	1085	1685	1408	2103

* See Appendix A1 attached

** If there were to be a substantial contribution from increased rents, main legislation would be required

✗ Approximate saving to PSBR

Detailed composition of item "Construction other than housing" in Appendix A

£ million at 1976 Survey prices

	1977-78 Smaller	1977-78 Larger	1978-79 Smaller	1978-79 Larger
1. Other environmental services				
- Water authorities	75	75	130	130
- environmental and local services	125	125	-	-
2. Education	85	85	50	50
3. Health and personal social services	5	5	10	10
4. PSA (civil)	10	10	15	15
5. Roads	-	50	-	30
	300	350	205	235

Notes: Both packages include a 6-month moratorium on the programmes affected. In the case of environmental and local services, the estimate relates to a reduction of 50% in the capital allocation for locally-determined schemes in England and Wales; and in equivalent projects in Scotland. For roads, because of earlier cuts, a 6-month moratorium would yield no further savings: in their case a 12-month moratorium has been included in the larger package.

Defence construction expenditure is not included in these figures but is included in the illustrative savings on defence.

APPENDIX B

ANNEX NUMBER	ITEM	£m (1976 Survey prices) 1977-78	1978-79
1.	Defence		
	Further review of commitments	100	200
2.	Overseas Aid		
	Limit to uncommitted expenditure	50-100	50-100
3.	Food Subsidies		
	Abolish from 1.4.77	200	60
4.	Industry		
	(i) Withdraw REP from Development Areas	20	65
	(ii) Withdraw REP from Special Development Areas	100	105
	(iii) Reduce RDG rate in Development Areas by a quarter	25	50
	(iv) Reduce RDG rates in Special Development Areas by a quarter	20	40
5.	Employment		
	Reduce capital programme and postpone MSC dispersal	12	10
6.	Roads and Transport		
	Moratorium on capital starts		
	6 months	-	-
	or 12 months	50-80	30-60
7.	Housing		
	(a) Moratorium on new building		
	6 months	400	285
	or 12 months	570	790
	(b) Improvement investment	115	240
	(c) Municipalisation	50	100
	(d) Mortgage lending	118	112
	(e) Subsidies	74	112

ANNEX NUMBER	ITEM		£m (1976 Survey prices) 1977-78	1978-79
8.	Other Environmental Services			
	Moratorium on capital			
	6 months	Water	74	132
		Other	125	-
	or 12 months	Water	150	270
		Other	250	-
	Stop community land purchases		55	50+
9.	Education			
	(a) School meals		65	80
	(b) Moratorium on capital starts			
	6 months		85	50
	or 12 months		105	70
10.	Health			
	(a) Charges		40-45	60-65
	(b) Moratorium on capital starts			
	6 months		5	10-20
	or 12 months		10-15	35-40
	(c) NHS current		45-55	65-70
11.	Social Security			
	(a) Uprating		100-350	300-1,000
	(b) Child Benefit (net saving)		20	15
	(c) Abolish earnings related supplement		150	150
	(d) Revise conditions for sickness, unemployment and supplementary benefits		105	105
	(e) Abolish maternity and death grants		25	25

ANNEX NUMBER	ITEM	£m (1976 Survey prices) 1977-78	1978-79
12.	Public Service Pensions*		
	Substitute discretionary upratings on same basis as for social security	10-40*	70-130*
13.	Common Services, etc		
	Moratorium on PSA expenditure (civil)		
	6 months	10	15
	or 12 months	30	45
14.	Nationalised Industries		
	For each 1% on gas, electricity and telecommunications prices	90	90
16.	Civil Service Staff		
	Savings as in Annex 16	31	8

* Approximate saving to PSBR

ANNEX 1

Defence

As a result of the 1974 Defence Review the Defence Budget was sharply reduced in line with the decision to concentrate on our contribution to NATO and to end other commitments wherever possible. Further cuts were announced in Cmnd 6393 and in July 1976. The ceiling for 1977/78 is now more than £300m below the Defence Review level. These further savings have been presented as not directly affecting the front line, as they will be achieved by a severe squeeze in the support area and deferments of equipment and works expenditure. The Americans and Germans in particular have doubts about the effect on the front line and have noted the cuts with concern. Finally Cabinet have now decided that defence should contribute savings of £30m a year from 1978/79 to help offset the additional housing bids.

2. Substantial further savings cannot be achieved by paring at the margin. MOD say that not more than £50m could be saved in this way in 1977/78; a cut of even this amount which would be impossible if we failed to get German offset would add to the political and military damage, flowing from the latest cuts. They consider that there is no scope for paring in subsequent years. The Treasury believe that paring of rather more than £50m a year might be achieved in 1977/78 and rather less in subsequent years.

3. Anything more than this would require major changes in defence policy. An urgent study would be needed:

- (i) to relate our commitments to what we could afford;
- (ii) to identify feasible means of reducing our capabilities; and
- (iii) to assess the implications of particular measures for the defence of the West, for our political and military standing, and for industry and employment.

4. To limit the political and military damage consultation with NATO would be essential on the form of the cuts. The study and consultation would have to be completed quickly to enable the cuts to take effect in 1977/78; and account would have to be taken of redundancy and cancellation charges. Further major defence cuts would seriously damage our credibility with Allies and the morale of our own forces. Moreover our chances of obtaining offset payments from Germany in respect of the foreign exchange costs of our forces

/there

there would be much reduced. At home there would be opposition to the prospect of reduced employment, both directly in the armed forces and indirectly in supplying industries.

5. It is difficult in advance of a study to be precise about what measures would have to be taken to secure a given saving and what the consequences might be. Provided the study was undertaken quickly and our Allies were persuaded both of the inevitability of further defence cuts and the acceptability of the measures proposed some savings should in the Treasury's view be possible in 1977/78, of the order of £100m below the baseline figure. We should aim to secure savings of some £200m a year in 1978/79 and subsequent years.

6. Purely for illustration, to achieve savings of this size might involve:-

(i) A choice between maintaining the Navy with its present fleet and role and keeping substantial forces in Germany, in line with Treaty obligations, to defend our sector of the Central Front. Withdrawal of forces from Germany could save up to £500m a year in foreign exchange at current prices although public expenditure would be substantially increased in the short-term to meet redeployment costs. Even disbandment of these forces would not save money in the short term, because of redundancy payments.

(ii) A quicker withdrawal from Cyprus and Gibraltar despite the political difficulties. Complete withdrawal would yield savings rising to £50m a year by 1979/80.

(iii) Scrapping our nuclear deterrent or letting its effectiveness deteriorate. This could ultimately save £40m-140m a year.

SECRET

ANNEX 2

OVERSEAS AID PROGRAMME

£ million at 1976 Survey prices

	1976-77	1977-78	1978-79
Cmnd 6393 programme	516	544	579

The size of the Aid Programme is not determined, as some other programmes are, by the need to maintain a given level of service, or to meet statutory commitments. The constraints upon reducing the programme are - political considerations apart - (i) the extent to which it is already contractually committed (ii) foreign policy considerations.

CONTRACTUAL COMMITMENTS

2. For 1977-78 we estimate that some £350 million is firmly and contractually committed. Another £100 million or so is, although not signed sealed and delivered, pretty firmly morally committed: in this category, for example, come projects and programmes which ODM have discussed with recipient governments or international organisations, avowedly with a view to signing agreements, but where the agreements are not yet signed. This leaves about £100 million which is not morally or contractually committed for 1977-78 and about the same figure for 1978-79. Provision will need to be made out of these sums for such contingencies as an ODM contribution to a Rhodesian Trust Fund and to a Common Fund, or to other new commitments which may arise from the North/South Dialogue. But the Treasury think that a reduction of £50-100 million in both years would be feasible (after taking account of the reduction of £5 million for 1978-79 agreed in Cabinet on 11 November).

FOREIGN POLICY CONSIDERATIONS

3. These cut both ways. On the one hand cuts in the aid programme might be well received by our creditors as a sign of realism and of the government's wholehearted commitment to the control of public expenditure. Against this cuts would put at risk the policy of increasing the proportion of the aid programme which goes to the poorest (although this is already high by international standards); they would also mean no improvement and, depending on their size, perhaps a decline in our performance against the 0.7% target. We have taken credit internationally for not cutting aid so far. Lastly, it may be argued that cuts will make still more difficult the attainment of our damage-limitation objective in the North/South dialogue, particularly in the Conference on International Economic Co-operation (CIEC), whose final Ministerial session will be in December.

SECRET

Annex 3

Food Subsidies

The removal of all provision for food subsidies in 1977/78 (currently £200m at 1976 prices) would raise the food index, over the year as a whole, by about 1.3% and the all-items index by about 0.3%. It would mean bringing forward the abolition of the bread and flour subsidies by 3-4 weeks and that of the butter and cheese subsidies by 8 months (from November to March 1977 - which is roughly when butter and cheese prices will in any case go up as a result of the next move towards EEC prices). It would also take away the possibility of a reduction in the milk price for next summer; instead an increase might be needed, perhaps as early as May.

2. Details of possible effects of total removal of subsidies and of less extreme courses are annexed.

	1977/78 expenditure at 1976 prices				
	£200 million (present policy)	£150 million	£100 million	£50 million	Nil
March	-	-	-	Bread +1p Flour +1p	Bread +1p Flour +1p Butter +5p Cheese +7p
April	Bread +1p Flour +1p Milk -1p	Bread +1p Flour +1p Milk -½p	Bread +1p Flour +1p	-	-
May	-	-	-	-	Milk +1p
June	-	-	-	Butter +3p Cheese +3p	-
July	-	-	Milk +½p	Milk +1p	-
August	Butter +3p Cheese +3p	Butter +3p Cheese +3p	Butter +3p Cheese +3p	-	-
September	-	-	-	Butter +2p Cheese +4p	-
October	Milk +1p	Milk +1p	-	-	-
November	Butter +2p Cheese +4p	Butter +2p Cheese +4p	Butter +2p Cheese +4p	-	-
December	-	-	-	-	-

INDUSTRY AND REGIONAL SUPPORT

The Cabinet decided on 4 November that expenditure figures for the National Enterprise Board and other selective assistance should be left in the next White Paper at their present level pending the outcome of a further review of the scope for savings in other areas of industrial support. Provision for a successor to the Accelerated Capital Projects (ACP) scheme was to be treated as a potential charge to the Contingency Reserve.

Abolition of REP taking effect from the next financial year would be possible by statutory order: withdrawal from Development Areas alone would require a clause in the Finance Bill. The investment effects are not thought likely to be significant. Withdrawal of REP from Development Areas might involve the loss of 4,000 jobs in the first full year: withdrawal from Special Development Areas could involve the loss of a further 6,000 jobs in the same period.

In broad terms, withdrawal of REP from Development Areas in the second half of next year would save some £20m in 1977-78: savings of some £150m would be secured by total abolition. Savings in later years from total abolition would amount to £170m. Such savings would correspondingly reduce the room for manoeuvre in the wider review of industrial support.

A 25% cut in regional development grants to Development Areas would save £50m in a full year. A similar cut applied to grants in Special Development Areas would yield a further £40m. But even if applied forthwith to new applications, savings in 1977-78 would be much less. Such a measure, without notice and in present conditions, would be damaging to confidence although the effects would be lagged and national investment levels would probably be little reduced in the short term.

ANNEX 5

EMPLOYMENT

(a) Reduce loan sanction for capital spending at colleges of Further Education for industrial training purposes.

Little has been used this year and the allocation of £13.2 million could well be reduced by at least £10 million this year and half that for following years.

(b) Postpone MSC's dispersal move to Sheffield by a year.

This will cost £2 million in 1977-78 and £20m in total.

SECRET

EFFECT OF MORATORIUM ON ROAD PROGRAMME

	Savings £ million, 1976 SP	
	1977-78	1978-79
ENGLAND		
Six month moratorium	Nil	Nil
Twelve month moratorium:		
Trunk roads	15-40	5-30
Local roads and car parks	30	20
TOTAL	45-70	25-50
WALES AND SCOTLAND (Estimated pro rata)		
Twelve month moratorium	5-10	5-10
GREAT BRITAIN		
TOTAL	50-80	30-60

Notes:

1. A six-month moratorium would have no effect because D/Tp have already suspended all new construction for that period to achieve the savings on their programmes that were announced on 22 July.

2. On the twelve-month moratorium, D/Tp consider that the feasible savings on trunk roads in 1977-78 would be only £15 million. That is the saving that would be achieved by letting no new contracts after 15 November other than those that have already been put out to tender. To obtain the further £25 million it would be necessary to withdraw invitations to tender that have already been issued.

3. The scope for further savings on local authority roads is limited by the facts, first, that substantial savings on capital will be required to offset the prospective excess on current expenditure and, secondly, that about £20 million a year for new roads is linked to projects for new housing and new industry.

ANNEX 7

HOUSING

A - ENGLAND

MORATORIUM ON NEW BUILDING

£ million

(i) 6 MONTHS

	1977-78	1978-79
Local authorities	300	175
New towns	35	15
Housing associations*	30	35
	365	225

(ii) 12 MONTHS

	1977-78	1978-79
Local authorities	400	525
New towns	50	50
Housing associations*	55	65
	505	640

*The figures assume a moratorium operating at the stage of loan approval (ie when the outline of an expenditure scheme is approved). Larger immediate savings would be achieved by operating at the stage of tender approval; but this would ultimately involve higher costs.

	1977-78	1978-79
IMPROVEMENT INVESTMENT	75	200

The figures shown are equal to estimates of allocations not yet committed. DOE would strongly resist cuts here: the emphasis of housing policy is away from new building and towards improvement and rehabilitation; and improvement work is very labour-intensive.

	1977-78	1978-79
MUNICIPALISATION	50	100

DOE argue that these savings would lead to additional premature decay in the housing stock: much of the municipalisation programme

involves acquisition from private landlords who have no incentive to maintain their property.

	1977-78	1978-79
MORTGAGE LENDING	100	100

These savings would entail the complete cessation of lending by local authorities except to their own tenants. Legislation would be required to prevent authorities continuing to lend out of repayments of existing loans; much of the lower end of the housing market would seize up completely; and co-operation with the building societies, who would fear that they would be pressed to make good the reduction in mortgage funds, would be jeopardised.

	1977-78	1978-79
SUBSIDIES	60	90

The figures assume average increases in rents of £1 a week in both 1977-78 and 1978-79. They are net of additional expenditure on rent rebates. Subject to the qualifications in the following sentences, each additional 10p a week on average rents would yield £15 million (net of rebates) in the year in which it was imposed and in subsequent years. But if there were a serious economic crisis, earnings and employment would be depressed, so that the basic level of expenditure on rebates and supplementary benefits would be higher, and the net savings from rent increases would be lower.

Because of the statutory rule against "profits" on local authority housing revenue accounts, legislation would be needed to allow the generality of authorities to raise rents by more than about 80p a week. The Government has no power to require local authorities to raise rents. Very large increases (say, much above £1 a week) might well require legislation conferring such power.

B - SCOTLAND

MORATORIUM ON NEW BUILDING	1977-78	1978-79
(i) 6 MONTHS	30	50
(ii) 12 MONTHS	50	100
IMPROVEMENT INVESTMENT	40	40
MORTGAGE LENDING	12	5
RENT INCREASES	10	16

The comments on the corresponding English items apply, mutatis mutandis. The Scottish Office believe that rent increases of the size required would be totally impracticable.

C - WALES

MORATORIUM ON NEW BUILDING, IMPROVEMENT, MUNICIPALISATION

	1977-78	1978-79
(i) 6 MONTHS	6	10
(ii) 12 MONTHS	16	53

	1977-78	1978-79
MORTGAGE LENDING	6	7
RENT INCREASES	4	6

OTHER ENVIRONMENTAL SERVICES

Possible action: Six or twelve months moratorium on (a) capital construction projects (starts) or (b) capital construction and other new capital expenditure

Effect in Great Britain:	1977-78	1978-79 (£m)
6 months moratorium		
- water authorities (a)	74	132
- environmental and local services (b)	125	-
12 months moratorium		
- water authorities (a)	150	270
- environmental and local services (b)	250	-

Comments:

1. A moratorium on new capital construction projects in the water industry would, as in other fields, hit the construction industry. In addition it could prevent supplies being ready for new housing and industrial development, and could result in very serious problems for some specialist suppliers for the industry (eg. pipe suppliers). DOE consider some firms could be put permanently out of business.

2. DOE consider little would be saved by a moratorium on capital construction projects in environmental and local services because authorities have discretion within the locally determined sector to use resources for construction or other capital items. The above figures assume a halt in virtually all new projects in the environmental and local services element of the locally determined sector and equivalent projects in Scotland.

3. A further possible saving could be made from the community land scheme. Abandonment of land purchases for the time being could yield savings in the region of £55 million in 1977-78 and possibly more in subsequent years.

SECRET

EDUCATION

SCHOOL MEAL SERVICE

This year net expenditure on the school meal service (after deducting receipts from the charge) is expected to be about £400 million (Great Britain). Of that sum, about £115 million is the cost of providing free school meals for pupils and staff who qualify for them. The other £285 million is the subsidy for those who pay for their meals as the present charge of 15p covers only about one-third of the average cost. Existing policy (stated in Cmnd 6393) is to raise the charge progressively, beginning with an increase of 10p in September 1977, so that by 1980 the subsidy is halved and net expenditure on the school meal service is reduced to about £250 million.

2. In estimating whether further savings could be made, it is assumed that in 1977-78 it would be possible to increase the school meal charge by 5p in April 1977 and 5p in September 1977 instead of having a single increase of 10p in September. But it is also assumed that in later years it would not be possible to increase the charge by more than about 10p a year (as assumed in Cmnd 6393). To make savings on existing figures it would therefore be necessary to reduce the unit cost of a meal or the entitlement of staff to free meals, as indicated below. (Some of the savings that could be made in this way have already been used to offset part of the additional expenditure on housing.)

3. If the present hot meal service were replaced by a pre-packed cold meal with milk, it should be possible to reduce the unit cost by about one-fifth. The food costs would be a little higher than at present but the staff costs would be much lower. On the assumption that local authorities accepted the new service and began to introduce it in 1977-78, savings might be up to £35 million in that year and to £75 million in a full year.

4. It should also be possible to cut down the number of free meals provided for staff. Part of the saving would be obtained as a result of reducing the number of kitchen staff. Moreover, if pupils were

/eating packed

eating packed, cold meals, it might be possible to reduce the amount of supervision by teaching staff; then, after negotiation with the teachers' unions, the entitlement of free meals might be limited to staff who were genuinely supervising the service. Depending on the outcome, the savings might be £5 million-£15 million in 1977-78 and £15 million-£30 million in a full year.

5. The possible scope for saving on the existing programme for the school meal service, while keeping to the projected increase in charges after 1977, is:

	£ million, 1976 Survey Prices	
	1977-78	1978-79
Reduction in unit costs	30-35	60-75
Decrease in free meals for adults	5-15	15-30
Increase charge by 5p in April 1977 and 5p in September 1977	15	-
TOTAL	50-65	75-105
Less savings already used for housing	-	25
NET SAVING	50-65	50-80

6. Subordinate legislation would be required, i.e. an amendment to the Regulations made under the 1944 Act about the type of meal to be provided by local authorities.

SECRET

EDUCATION (Continued)

EFFECT OF A MORATORIUM ON CAPITAL STARTS

	SAVINGS £ million 1976 Survey Prices		
	1976-77	1977-78	1978-79
ENGLAND AND WALES			
Six month moratorium	38	72	35
Twelve month moratorium	38	88	49
SCOTLAND			
Six month moratorium	2	14	13
Twelve month moratorium	2	18	21
GREAT BRITAIN (rounded figures)			
Six month moratorium	40	85	50
Twelve month moratorium	40	105	70

NOTES:

1. It is assumed that the moratorium would start immediately (December 1976).

2. The savings would fall on the building programmes of local education authorities for schools and for colleges of further education.

3. It is assumed that the moratorium would apply to all building, that is to projects to provide for basic needs - roofs over heads - as well as to those for improvement or replacement. It would be possible to halt the basic needs projects only if the moratorium were also applied to housing.

HEALTH AND PERSONAL SOCIAL SERVICES (HPSS)

The table below lists available options for reducing expenditure on the HPSS programme. The savings shown assume that, except where indicated, any necessary legislation could be enacted and other preparatory measures taken in time for savings to take effect from the beginning of the financial year 1977-78. The savings fall into two broad categories - increases in yield from charges and reductions in forecast expenditure on the health services. No savings on local authority personal social services current expenditure are identified since it is assumed that, even with the help of virement from the capital programme, the local authorities will as it is be hard pressed to contain this expenditure within the Cmnd 6393 figures.

2. Although all the options listed are technically and administratively feasible, a realistic total saving on charges might be in the region of £40 to £45 million in 1977-78. This might comprise increases in prescription charges and bringing forward by a year the additional increases in dental service charges. Charging for hospital meals is a feasible option but is operationally more complex and should perhaps be regarded as a desirable measure for the longer term. Together with current and capital savings of £60 to £70 million, a realistic total saving in 1977-78 on the HPSS programme would be in the region of £100 to £115 million.

3. In 1978-79 on-going savings from increasing the yield from charges would be slightly less in view of the decisions now taken for that year. It would, however, be possible to make a larger capital saving in 1978-79 - some £50 million on health - if the moratorium on new starts were extended for a further year. On current costs, if expenditure continued to be held to the 1976-77 level, the savings in 1978-79 compared with present Survey figures would be some £65 to £70 million. DHSS believe this would involve an actual cutback in the level of services provided for an increasingly elderly population as well as curtailing the spread of new medical techniques.

4. <u>Available Options</u>

A. INCREASES IN YIELD FROM CHARGES

(£ million. Survey Prices)

Item	Savings 1977-78	Savings 1978-79	Notes
1. Increase in yield from prescription charges	30-35	35	Charges last increased in 1971 since when prices have doubled. Each 10p rise assumed to yield £15m. In addition, there is a reduction in FPS expenditure of perhaps £2½m. Yield from the doubling prescription charges in a full year would thus be £35m. To achieve full year saving in 1977-78 requires decision by 1 December. Negative resolution procedure required.
2. Increases in charges for dental services	10-25	0-15	Charges are to be increased on 1 April 1977 to yield additional £15m (July increases) and in 1978-79 to yield a further £10m. It might be possible to bring forward this latter increase to 1 April 1977. Alternatively a more drastic increase could be considered though strong professional opposition would be likely. Again, negative resolution procedure is required.
3. Hospital meal charges of £1 a day from 1 April 1977	25	25	Possible savings in a full year from levying a contribution towards "hotel" costs. Considerable administrative difficulties and initial administrative costs particularly heavy. Primary legislation required, and if not passed quickly, revenue in 77-78 correspondingly reduced.
4. Reducing exemptions from charges	10-20	10-20	At present, old people, expectant mothers, children and the poor are exempt from prescription and dental charges. Free sight tests and dental inspections also available. Savings could be made by reducing the exempt classes (eg on conservative estimates withdrawing the child exemptions would yield £10m at

(£ million Survey Prices)

Item	Savings 1977-78	1978-79	Notes
			present levels of charges £20m if the charges were doubled). There would be considerable professional opposition, especially from dentists if child exemptions were withdrawn. Primary legislation required.
B. REDUCTIONS IN SERVICES			
1. Health capital	10-15	50	Most of the capital programme for next year already committed, but by cutting the minor works allocation and by further post-ponement of new schemes some £10m might be saved. This would mean a moratorium for the year on all new hospitals and health centre schemes The upper figure of £15m might be reached in 1977-78 if the Liverpool teaching hospital were cancelled.
2. Personal social service capital	5	20	A small cut was made in the July package and some virement to current expenditure has been agreed If there was a moratorium for the health capital programme and for other local authority capital programmes (eg education) a further reduction here would seem indicated.
3. Health current	35-40	65-70	Present provision for hospitals and community health services is £3833m in 1976-77 and £3,870m in 1977-78. If there was no growth the amount saved year by year would increase as long as the policy was maintained. Growth is said to be necessary to maintain existing levels of service and to provide for some continuing spread of new methods of treatment. No growth would mean closure of some institutions with consequent redundancies. There would also be eg reductions in average length of stay in hospitals, extended waiting lists, etc.

(£million Survey Prices)

	Item	Savings 1977-78	1978-79	Notes
4	Further measures worked out with the medical profession to reduce the drugs bill	10-15	0-5	For 1978-79 a reduction of £10m has now been proposed in this respect. If the profession itself could put forward an acceptable scheme in time it would be possible to secure this saving in 1977-78, without the need for legislation.

ANNEX 11

SOCIAL SECURITY

The table below lists available options for reducing expenditure on the social security programme. All would require main legislation except where stated, and it is assumed that the necessary legislation would be enacted in time for savings to take effect from April 1977. Savings are shown for 1977-78 and for 1978-79 where appropriate. The estimates represent **very** broad orders of magnitude, using Survey assumptions for unemployment and the future movement of prices and earnings. The feasibility of some of the savings might also depend on the willingness of the staff to carry out the necessary operations and there is no certainty about this.

2. Apart from the option on child benefit, the savings fall into two broad categories - changes in the statutory method of uprating benefits, and abolition or restriction of existing benefits. On the uprating it is assumed that the present legislation would be amended so as to substitute a discretionary power to uprate at such time by such method or amounts as the Secretary of State determines are appropriate. Whatever the actual method of uprating chosen, there would be no point in replacing it with another specific provision.

3. Available Options

Item	Savings (£m Survey Prices) 1977-78	1978-79	Notes
A. CHILD BENEFIT*			
Continue with present scheme but withdraw child tax allowances for non-resident children from April 1977 pari passu with those for other children	20	15	Cabinet originally decided that CTAs for non-resident children should not be phased out with CTAs generally. It was agreed, however, on 11 November that they should be phased out from April 1978 with a saving of £25m in 1978-79. It would still be possible to start the phasing out from April 1977 which would save £20m in 77-78 and an extra £15m in 78-79. There would be operational problems for Inland Revenue. (Provision would be required in Finance Bill).

*Although it is still theoretically possible to postpone the phasing in of the child benefit scheme itself in April 1977 we think this is now probably no longer operationally feasible.

Item	Savings (£m Survey Prices) 1977-78	1978-79	Notes
B. UPRATINGS			
Amend present statutory requirement to uprate in line with prices or earnings and substitute discretionary power to uprate when and by such method or amounts as is thought appropriate. Savings will depend on timing and amount of upratings. Postponement of November 1977 uprating of all benefits out of 1977-78 would eg, save some £350m in that year; uprating all benefits in November 1977 by net earnings would save:	100	300	Assumes net earnings rise at 4/5ths of rate of gross earnings. Cancellation of the November 1977 uprating could save up to £1,000 million in 1978-79.
C. ABOLITION OF EXISTING BENEFITS			
1. Abolish earnings-related supplement	150	150	Assumes that awards of the supplement would cease from April 1977. Those who already had it would continue to draw it for as long as entitled (at most 6 months).
2. Abolish maternity and death grants	25	25	-
D. RESTRICTIONS ON EXISTING BENEFITS			
1. Remove entitlement to flat-rate unemployment or sickness benefit:			
(i) for first 6 days of complete interruption of employment	70	70	
(ii) for first 6 days of any period of temporary suspension	10	10	Requires affirmative resolution only. Some overlap of savings if both (i) and (ii) introduced simultaneously
2. Raise qualifying age for supplementary benefit to 18	25	25	-
3. Withdraw supplementary benefit from students in long vacation	10	10	Requires extension of proposed short vacation hardship scheme to long vacation.

4. It should be noted that in practice the above savings would apply to a different social security programme base line from that so far displayed in the Survey. This is because the figures are now being revised to take account of the higher unemployment projections in the October National Income Forecast. In completing the programme for the purposes of the Public Expenditure White Paper we propose to make some upward adjustment in the appropriate benefit lines and to make additional provision by way of a margin of tolerance to be combined with the existing real improvement line at the bottom of the social security programme table. The precise details will be brought forward in the White Paper context later, and the changes should not significantly affect the broad estimates of possible savings itemised above.

Occupational pensions

On the assumption that legislation is taken to put the uprating of all Social Security benefits on to a discretionary basis, equity would demand that corresponding action should be taken in respect of occupational pensions. This would mean action on the following lines:-

(i) Public Services (the Civil Service, Local Authority staffs, National Health Service, teachers, police and fire services and other smaller groups including the Judiciary and MPs). For these pensioners the Pensions (Increase) Act 1971 would have to be amended to suspend the statutory right to price indexation in favour of discretionary increases, for so long as has been specified in the general social security field. Armed Forces pensions receive analogous treatment and could be covered by Prerogative Instrument.

(ii) Rest of the Public Sector. This is mainly the nationalised industries field which breaks down into 3 main groups:-

(a) Those whose scheme is linked to the 1971 Act and would thus follow any amendment of that Act, e.g. Post Office and Atomic Energy Authority pensioners.

(b) Those who might be covered by Ministerial directive, e.g. miners and gas and electricity pensioners.

(c) Those who would need to be covered by wider-ranging legislation to suspend the contractual obligations of their pension funds, e.g. steel and airways pensioners and, failing ability to control by Ministerial directive, any under (b).

(iii) Private Sector. Wider-ranging legislation would equally be needed to interfere with the contractual obligations of private pension funds. Even if the difficulties of such legislation were considered to be overriding, it would in any

event be essential in the interests of equity to restrict incentives by way of tax reliefs, where these result in initial pension awards which would then conflict with levels which the Government believed appropriate (in particular the arrangement whereby an out-of-date salary may be uplifted for pension purposes by the increase in the cost of living up to the date of retirement). Any discrimination against the public sector would be strongly opposed by the public sector unions.

2. The regular date for uprating public service pensions is 1 December each year. The Order determining the increase in December 1976 has already been made. The estimated cost was as follows:-

Scheme	Estimated cost (£million)
Civil service	31
Local government	22
National health service	13
Police and fire	10
Teachers	12
Armed forces	22
Total	110

3. Any savings in the financial year 1977-78 could only be made from December 1977. Using the same assumptions about future movements in earnings and prices as for the social security options in Annex 11, a postponement of the December 1977 uprating until beyond the end of 1977-78 would reduce the estimated level of public service pension payments by £43 million in that year and £166 million in 1978-79. A limitation of the 1977 and 1978 upratings to <u>net</u> earnings would reduce the payments by £13 million in 1977-78 and £91 million in 1978-79.

4. Although detailed estimates can only be provided for the major public services, the savings in the rest of the public sector might be up to half as much again. (In very round terms, it can be estimated that each 1% deducted from the RPI statutory increase next

year would save about £11 million; for the rest of the public sector the absolute maximum would be £6 million, but it is unlikely in practice to be as much as that.)

5. These are all cash figures. Public service pensions are handled in the Survey in broadly the same way as pay, so that a change in the uprating would not automatically score as a public expenditure saving at constant 1976 Survey prices, but it should be possible to take credit for the saving as part of a larger package. Depending on the precise arrangements made in the various pension schemes, there should be a saving on the public sector borrowing requirement of an order approaching that indicated in paragraph 3 above.

ANNEX 13

COMMON SERVICES AND SOME OTHER CIVIL WORKS PROGRAMMES

Moratorium on PSA Capital Expenditure (for civil departments)

	£ million	
	1977-78	1978-79
6 months	10	15
12 months	30	45

The estimates are of a moratorium on all building work undertaken by the Property Services Agency (PSA) - ie not only General Office Accommodation for Civil Servants (Common Services) but also Diplomatic accommodation, and work in Prisons, Courts, etc - except for Defence works which are considered as part of the Defence Budget in Annex 1.

A moratorium would delay the Census 1981, the provision of a building for the Welsh Assembly and the timetable for dispersal of Civil Servants, to all of which the Government are at present committed.

The estimated savings would be substantially reduced if exemptions were made on economic grounds, eg for proceeding with necessary work on properties acquired but standing empty, and on grounds of operational priority.

SECRET

Nationalised Industry Prices

It would be possible to make a reduction in public expenditure, under the new presentation, by causing the nationalised industries to reduce their net borrowing requirement from the NLF, which they could do if they were to increase their prices beyond what they are now planning.

2. The industries which present the greatest scope for such increases, because of the market conditions they face, are electricity, gas and telecommunications. Increases in their prices would have the following effects in a full year.

Each 1% on present prices of	Revenue £m.	RPI %
Electricity	45	0.04
Gas	13	0.004
Telecommunications	30	0.012

3. On present plans the electricity industry may not want to take full advantage of the Price Code for their April 1977 price increase (because they are worried about the impact which a maximum increase would have on demand) and neither gas nor telecommunications can make any further increases without breaching the Code. If the fuel industries generally increase their prices in step they might lose some sales to oil, unless the tax on oil went up at the same time. There would also be pressure to increase the electricity discount scheme, and this could mean offsetting public expenditure increases.

4. The scope for price increases, beyond those already planned, in other industries is limited. Both Coal (1% yields £20m) and Posts (½p yields £45m) could make increases but with some risk to their markets. Rail could well lose business to the extent that it is doubtful whether further price increases would reduce their net borrowing requirement at all. Steel and Airways are constrained by the international markets in which they operate.

5. The managements of the nationalised industries could be expected to react strongly against further intervention in their businesses, in the interests of reducing public expenditure, coming on top of the cuts in their investment programmes for 1977/78 imposed in July. Moreover, there is no direct method by which Ministers could force industries to increase their prices beyond what they judged to be commercially necessary; pressure would have to be applied indirectly by reducing NLF finance. Finally, forced price increases would make the handling of NEDO's report on the industries much more difficult, and would be at odds with the Prime Minister's wish to toughen up prices policy.

SECRET

ANNEX 15

IMPLICATIONS FOR THE CONSTRUCTION INDUSTRY

Proposals for moratoria in public sector construction starts should be seen in the context that the construction industry is expected to generate less output in 1977 and 1978 than the depressed level of the current year, falling to an activity rate last met in 1965. About 250,000 jobs have now disappeared since 1973, and some 100,000 more are likely to go by the end of 1978. The July 1976 cuts will be responsible for some 50,000 of these.

2. The reduction in construction employment (not cumulative) would very roughly come to:

	1977-8	1978-9
6 month moratorium	90,000	80,000
12 month moratorium	140,000	165,000

These figures include indirect effects, for example on materials suppliers, assuming that for most programmes a £100 million cut means 13,000 fewer jobs in all.

3. Other types of cut would also have their impact on the construction industry. For example, £100 million of housing improvements in a given year would remove 18,000 jobs. Demand for private housing in any case is highly sensitive to Building Society inflows. In 1977 these could well fall more than currently forecast if the rate paid on their deposits (and as a consequence mortgage rates) cannot be raised sufficiently to ensure a marked improvement in Building Society competitiveness. If these rates remain unchanged, and as a consequence the current low rate of inflow into the Societies were to continue during 1977, then private housing activity could be substantially lower than currently being forecast.

4. Morale in the construction industry was badly shaken by the July cuts. In October the 2 construction EDCs put a paper to NEDC on the future role of the industry which Mr Cuckney/introduced as a plan for survival. It drew attention to the risk that if capacity were run down any further a later upturn in demand for essential industrial building might be hard to meet. The danger from the government's

point of view is that this would lead to unacceptable delays in industrial investment (and already UK performance is worse than that of our competitors) or rapid price escalation such as we saw in 1972-3. The industry would like to see any new cuts at least balanced by counter measures such as an IDC holiday, the abandonment of legislation to extend local authority direct labour activities and better fiscal incentives for industrial buildings. They also point to the risk that the Government might again have to bail out construction companies in financial difficulty to secure the completion of existing public sector projects.

ECONOMY IN CIVIL SERVICE EXPENDITURE

The general position

In the February Public Expenditure White Paper, Ministers announced their intention to find savings in Civil Service manpower costs of £140 million in 1978-79 (£174 million at 1976 Survey prices). So far, they have agreed savings from the civil departments amounting to £118 million in 1978-79, at 1976 Survey prices. They were unable to agree measures to save the remaining £56 million. In the Survey figures as they now stand credit has not been taken for the remaining £56 million, but savings have been found in other areas, and the National Staff Side have been given the impression that the line has been drawn under this exercise. Nor has credit been taken for a contribution by the FCO pending the CPRS study.

2. The Civil Service manpower figures underlying the present Survey expenditure projections are 772,000 at 1 April 1977 and 746,000 at 1 April 1978. However, the size of the civil service on 1 October 1976 was in fact just over 746,000 (it may now be slightly higher). This is some 15,000 lower than provided for, and is the outcome of an intense squeeze on manpower during 1976.

3. If substantial savings were made from among the options described in the other annexes to this paper, this would probably produce marginal reductions in Civil Service manpower. In view of this, and of the current position, it should be possible to hold the strength of the civil service below 750,000 during 1977-78, and to reduce it below 740,000 during 1978-79.

4. This would result in an outturn (at 1976 Survey prices) for 1976-77 some £50 million below the provision in the Survey, and a saving of £30 million in 1977-78.

5. On the assumption that the Survey figures should now be reduced to reflect the shadow target for the FCO's contribution to the savings in paragraph 1 above, there should be a further saving of about £1 million in 1977-78 and £8½ million in 1978-79, subject to the reservation about timing mentioned in CP(76)9.

6. To achieve this outcome will not be easy. It leaves no provision for unforeseen changes in economic assumptions, or for new Ministerial initiatives. The reduced financial provision should be sufficient to cover present policies, but the achievement of savings of this order will depend on Ministers keeping and holding the staff levels

in their departments at an absolute minimum.

A ban on recruitment

7. The suggestion has been made that further savings might be found by a ban on recruitment. The latest annual wastage rate for non-industrial civil servants is 46,000, and a 12-month ban on recruitment would thus at most leave empty about 46,000 posts with a maximum potential saving of about £75 million in the first year. In practice it is difficult to estimate the saving, but it would be much less than this because departments would require the remaining staff to work extra overtime and (most important) would retain staff otherwise due to retire.

8. Such a ban is open to the following objections:-

a. It would be a wholly arbitrary cut, hitting hardest the departments with the highest wastage rates and those which must expand next year to cover essential new work. All departments would be damaged. For example the combined effect of absorbing wastage and cancelling expansion would leave the Inland Revenue short of about 16,000 and DHSS of about 12,500 staff, quite apart from the serious inconvenience of not being able to recruit casual staff to meet peaks of work. The incidence of the ban on local offices would vary unpredictably from small to crippling (clerical labour is not mobile).

b. It could only be absorbed by dropping work, and the £140million exercise has demonstrated the extreme difficulty of going further in that direction. If it were not accompanied by dropping work it would be flatly counter to the Government's undertaking that the Civil Service will be staffed to do the work required of it, and would arouse furious opposition from the unions.

c. Because older staff at the top of their incremental scales would be retained beyond retiring age, we should be employing the old, the sick and the expensive in substitution for those who are younger fitter and cheaper.

d. It would worsen employment prospects for school-leavers while improving them for the over-60s - the exact reverse of present social policy.

9. Industrial Civil Service wastage is about 15% a year. To halt recruitment here might well be to stop production at some Government factories with a loss of export orders.

10. For these reasons, a ban on recruitment is not a viable method of achieving savings. Departments will, however, automatically adjust their recruitment to achieve any reduction in their expenditure provision, eg on the lines of paragraph 4 above.

ANNEX 17

EMPLOYMENT MEASURES

This note examines the scope for possible action if Ministers felt that, as part of a package to reduce public expenditure overall, some increase in the selective employment and training measures should be added back so as to mitigate the level of unemployment next year.

2. At present, these measures are assumed to come to an end over the next 6 months, achieving a peak reduction in unemployment estimated at 200,000 in March 1977 but tailing off to 35,000 by the end of the year. The cost in 1977-78 on this basis is put at £240 million.

3. Until now, extensions have been decided and announced ad hoc, and charged against the contingency reserve. But as a substantial part of the contingency reserve for 1977-78 is already committed, there is likely to be little or no room for charging such extensions to the contingency reserve in that year. Hence the need to decide now how much room should be made for any such expenditure, so that the reductions on other programmes can be set at a level which will produce the required net saving.

4. Some of the measures (job release, work experience) are only just coming into effect, and are experimental. Hence a detailed programme of measures cannot be determined now over the whole year. In the ordinary way, DE and MSC would prefer to extend for 3 months the measures expiring at end-December - temporary employment subsidy (TES) and job creation (JCP) - and reach firm decisions on the 1977 programme in about March. But the following broad options show the orders of magnitude involved.

5. Options

(i) To continue special training measures only

This would cost £40 million gross and would reduce unemployment by about 15,000 over the latter part of 1977.

(ii) As above plus JCP to end-1977

Cost £120 million gross, reducing unemployment by about 35,000

over the last half of 1977. (JCP could if necessary be continued on a reduced level, giving intermediate figures between (i) and (ii).)

(iii) <u>To extend or replace measures to retain peak (March) impact through rest of 1977</u>

Cost about £250 million gross, reducing unemployment at end-1977 by about 165,000. Not all the present measures would need to continue, but TES would almost certainly continue at least in a reduced form (full continuation would cost some £200 million gross), and the option is costed on this basis (with TES giving a favourable cost per job).

(iv) <u>To continue all the present measures through 1977</u>

Cost about £380 million gross, reducing unemployment at end-1977 by about 190,000 - higher than impact of existing set of measures, because some are now tailing off before others take full effect.

6. Any <u>further</u> extension would require new measures, or increased expenditure on existing measures beyond present levels; it would be likely to yield diminishing returns in reduced unemployment.

7. It must be emphasised that these are illustrative options, and that intermediate positions are possible. The estimates are also rough, depending partly on what specific measures were adopted. Some part of the expenditure would fall in the following financial year, but the proportion is likely to be small.

8. The expenditure estimates are the gross costs. The net cost to the PSBR, after allowing for offsets, would be considerably less: for the four options quoted above it could be about £15 million, £50 million, £60 million and £90 million respectively. The scale of the offsets is however uncertain (being dependent on an uncertain assumed effect on unemployment), and the gross cost measures the immediate effect on public expenditure before allowing for such offsets.

9. Moreover, while most of these measures yield more employment for a given sum than other public expenditure, the savings illustrated elsewhere in this paper would themselves lead to an offsetting increase in unemployment of a size depending on the nature of the saving. The beneficial effect of the <u>savings</u> on the PSBR would thus likewise be less than the gross amounts shown in the Annexes. In the public expenditure context, both additions and savings have to be scored gross.

CP(76) 127

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6 December 1976

CABINET

PUBLIC EXPENDITURE: PENSIONS INCREASES IN THE PUBLIC SECTOR

Memorandum by the Lord Privy Seal

INTRODUCTION

1. The Chancellor of the Exchequer has circulated proposals for savings in public expenditure (CP(76) 126). This paper sets out what would be involved in modifying the arrangements for pensions increase in the public sector if it was agreed that this should form part of those savings.

SAVINGS

2. The various groups of workers and the savings at issue are described in Annex 12 to CP(76) 126. So far as the public services alone are concerned, savings in the financial year 1977-78 could only be made from December 1977. A postponement of the December 1977 uprating until beyond the end of 1977-78 would reduce the estimated level of public service pension payments (on the assumptions of CP(76) 126 about earnings and prices) by £43 million in that year and £166 million in 1978-79. A limitation of the 1977 and 1978 upratings to net earnings would reduce the payments by £13 million in 1977-78 and £91 million in 1978-79. The savings in the rest of the public sector might be up to half as much again.

COVERAGE

3. There are over 1 million public service pensioners and over half as many again from the rest of the public sector. Many of these receive very small pensions. Neither they nor the unions concerned and their members will lightly accept the loss of full price indexation. It is in my view essential, in order both to maximise the savings and to minimise the opposition of those affected, that the coverage of any restriction should be as wide as possible. At the very minimum, the whole of the public sector, including the nationalised industries, should be covered. If this is done, and especially if the restrictions are matched by corresponding action on social security benefits, the reaction of the public service unions is unlikely to be extreme.

4. In equity, and more particularly to avoid charges of discrimination against the public sector, whatever restrictions are applied there should be applied also to the private sector. While this possibility should be considered, I recognise that there may be considerable practical problems.

5. There is a particular problem which could be troublesome. Under Inland Revenue rules tax relief is given to permit the uplift of an out-of-date salary for pension purposes by the increase in the cost of living from any of the preceding five years up to the date of retirement (the so-called pre-award dynamisation). There is no such pre-award dynamisation in the main public services. But in a recent nationalised industry case, a man with an actual salary of £17,000 (compared with £22,000 recommended by the Top Salaries Review Body but not yet implemented) has, through the operation of this arrangement, been pensioned on the basis of a notional final salary of £30,000. He had relatively short service but the cost of this arrangement, over the period since its introduction was the equivalent of a tax free addition to salary of some £15,000 a year. Had the man had a full 40 years pension, this figure would have been over £50,000 a year. Tax incentives which have this effect are themselves highly questionable. And there is clearly a strong case for stopping them if inflation-proofed pensions are to stop. It would of course be particularly difficult to let this practice continue for high pensions in the nationalised industries at the same time as we restrict pensions increase for the low average pensions of the public services.

6. There is also a question whether any change would be needed in the tax reliefs affecting the provision for or payments of post-award pensions increases in private occupational schemes. I realise that action on either of these problems raises difficult issues and that an immediate decision is not possible, but officials should be asked to report urgently on the facts of the matter and the most effective way of imposing necessary restraints.

EXTENT AND PRESENTATION OF THE CHANGES

7. We have said many times that we believe in the principle of preserving the purchasing power of all pensions, and indeed inflation-proofing was the cornerstone of the new State pension scheme. We ought therefore to place the necessary restrictions firmly within the context of the current abnormal economic circumstances. The best course would be to suspend the existing automatic links with prices for a limited period of no more than three years on the basis that at the end of that period they should return unless it was otherwise decided. During the period we would decide each year what degree of restriction was necessary in the light of the economic and other circumstances at the time. In the meantime we should also consider whether in the schemes we control we wanted to go over to some other regular basis for fixing increases.

LEGISLATIVE REQUIREMENTS

8. Public service pensioners (those from the Civil Service, local government, the National Health Service, the teaching profession, the police and fire services, Ministers, Members of Parliament and other smaller groups) have a statutory right to price indexation under the Pensions (Increase) Act 1971. The Act would need to be amended to give the Government freedom to decide well before 1 December the annual increases to be given under each annual Order. For the Armed Forces, who follow the Act by analogy by Prerogative Instrument, similar arrangements could be made. The precise form of the amendments requires further study but they should not be complicated or difficult.

9. In the rest of the public sector (mainly the nationalised industries), the basis of awarding pension increases is of 3 kinds:-

a. By direct application of the 1971 Act. Any amendment to that Act would therefore apply here also.

b. By discretion. A Ministerial directive might serve to restrict increases should this be necessary.

c. By contractual right, eg where pensions increase is built into schemes. Wider ranging, but still quite simple, legislation would be required involving the suspension of the contractual obligations of these schemes and of any under b. above not covered by a Ministerial directive.

10. The necessary legislative steps should be taken as soon as possible in the new Session but would in any case have to be completed well before 1 December 1977 in order to affect the 1977 increases under the Pensions (Increase) Act.

CONCLUSIONS

11. If we wish to modify the arrangement for Pensions Increase in the public sector we should take the following steps:-

i. The Pensions (Increase) Act 1971 should be amended so as to give the Government discretion to vary the amount of annual pensions increase for a period of three years on the basis described in paragraph 7 above.

ii. The necessary steps should be taken to ensure uniformity of treatment throughout the public sector.

iii. Officials should submit early and detailed proposals setting out the legislative and other steps necessary to give effect to the above recommendations.

iv. Officials should report urgently on pensions increase in the private sector and pre-award dynamisation generally and on the most effective way of imposing necessary restraints.

P

Civil Service Department

6 December 1976

OFFICE OF THE LORD PRESIDENT
OF THE COUNCIL

Devolution: The English Dimension

A Consultative Document

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Contents

I The devolution background

1. The Government have just published a Bill(1) to give effect to their devolution proposals for Scotland and Wales. The Bill provides for the creation of new bodies which will be directly elected by and answerable to people in Scotland and Wales.

2. The proposals for Scotland and Wales are complex. The Government have already been working on them for over two years. They will now be closely scrutinised by Parliament over a period of several months.

3. The Government have always intended that their review of government arrangements in Great Britain should cover England also. But consultations undertaken in the summer of 1974 showed not only much greater desire for change in Scotland and Wales than in England but also a clearer view as to what form such change should take.

4. The Government announced their preliminary conclusions for Scotland and Wales in September 1974(2) but made it clear that it would be premature to reach any conclusions about change in England until further consultations had been carried out. They decided subsequently to defer these further consultations until they could be conducted against a background of firm proposals for Scotland and Wales.

5. The purpose of the present document is to describe very briefly the main features of the proposals for Scotland and Wales, to discuss the main implications of these proposals for England and to set out the factors to be taken into account in assessing the case for and against various possible changes in England.

6. *Constitutional arrangements in the United Kingdom have developed over the years in a flexible way.* Northern Ireland had a separate Parliament from 1920 to 1973. Scotland has had its own Minister in the Government for many years with an increasing range of functions administered under his direction by officials operating from Edinburgh and working in close contact with representative Scottish bodies. Wales has had a similar though newer and less extensive system. English arrangements have been different again, with a series of specialist Ministers directing functional departments, some of which have regional offices maintaining contact with the interests concerned with a particular function in different parts of the country. The Scotland and Wales Bill does not relate in any way to the system of administration in England and leaves the existing arrangements untouched.

7. This variety of constitutional arrangements has contributed to the flexibility and responsiveness of government since it has been possible to devise machinery suited to the requirements of a particular function in a particular part of the United Kingdom at a particular time, without having to apply identical arrangements everywhere. Requirements will continue to vary after devolution. The Government see great advantage in avoiding the harmful effects of unnecessary standardisation.

(1) The Scotland and Wales Bill, published on 30 November 1976.
(2) Democracy and Devolution: Proposals for Scotland and Wales: Cmnd. 5732.

8. At this stage the Government do not themselves advocate any specific course of action in England. The factors affecting England are singularly complex. It is important that they should be generally understood so that public discussion can be informed and illuminating. In the light of such discussion and any consensus which may result as to desirable change the Government will decide what proposals, if any, they ought to promote.

9. Subsequent sections of this document deal with the constitutional implications for England of the proposals for Scotland and Wales; their industrial and economic implications; the possibilities for change in England; and the factors which have to be weighed in assessing such possibilities. The final section deals with the consultative process and contains a list of questions on which views are invited.

II England after devolution to Scotland and Wales: constitutional implications

10. The English dimension of devolution has to be judged against the background not only of the continuing supreme authority of Parliament but also of the form of the Government's proposals for Scotland and Wales. It is clear, however, from comments made on the Government's devolution policy that widespread misunderstanding still exists about its purposes and effects. Before considering the constitutional implications for England, therefore, this section briefly recapitulates the main features of the devolution policy.

11. The Government see devolution to Scotland and Wales as a means of enabling the domestic affairs of these two parts of the United Kingdom, with their distinctive national traditions, to be administered in closer accordance with the wishes of the people living there. Many of these matters are already administered by the Secretaries of State for Scotland and Wales. Devolution will complement this administrative decentralisation with separate political accountability direct to the Scottish and Welsh electorates and will also reduce the present pressures on parliamentary time. The Government believe that the unified structure of the United Kingdom can accommodate these new institutions.

12. In devising their devolution schemes the Government have sought to identify the areas of activity where decisions affect primarily people living in Scotland or Wales. They consider it important not to devolve to either Assembly powers over activities which substantially affect people living elsewhere or the well-being of the United Kingdom generally.

13. In relation to the matters to be devolved the new administrations will inherit the executive powers that Ministers now exercise. In addition, having regard to the separate system of law in Scotland and the existence of separate institutions and policies in many of the activity areas concerned, the Scottish Assembly will have powers to legislate on most of the devolved matters.

14. Devolution will not, however, affect the supreme authority of Parliament and its ability to make laws on any subject for the whole of the United Kingdom or any part of it. Apart from this the Government and Parliament will continue to be directly concerned with a wide range of important matters in Scotland and Wales—for example, general industrial and economic policies (discussed in Section III), social security, the major nationalised industries, the regulation of commerce, the preservation of law and order. The Government will also have a general power to intervene, subject to parliamentary approval, where action by a devolved administration, or a failure to act, threatens to prejudice an interest for which the Government and Parliament have retained responsibility.

15. It might be argued that in the interests of equal treatment between England and Scotland there should be an English Assembly, separate from Parliament, for business (including legislation) corresponding with that to be devolved in Scotland. The Government firmly believe, however, that establishing such an assembly for England could damage the structure of the United Kingdom in ways which the creation of a Scottish Assembly would not.

16. Thus, it would not be appropriate for Parliament to act both as the legislature for the United Kingdom as a whole and also as the domestic legislature for Wales and, for the present, Northern Ireland but not for England or Scotland. In practice, if an English Assembly were established, Parliament's role would have to be restricted to a limited range of matters. Four separate assemblies would be required in the four countries of the United Kingdom, each with its own Executive.

17. This would amount in practice to a form of federation—a system which was rejected by the Kilbrandon Commission(*). The Government believe that a federal system would not fit the essential character of the United Kingdom as a union of four distinctive national components of very different sizes; and that it would not be compatible, in the particular circumstances of the United Kingdom, with the close economic unity required to meet national needs and public expectations of social parity. England contains almost 85 per cent of the population with a correspondingly overwhelming proportion of resources. No existing federation contains a partner of anything like this preponderance. An English Assembly representing such a large population could hardly avoid becoming a rival to Parliament, particularly if the two bodies were under the control of opposing parties. And because the expenditure needs of the English Assembly would represent such a large part of total programmes, particularly awkward relationships would exist in relation to taxation, resource allocation, regional planning and comparable issues. These difficulties would affect the relationships between Parliament and the three other asemblies also.

18. The setting up of an English Assembly on the lines proposed for Scotland would, compared with the consequences of a Scottish Assembly, involve an enormous diminution of the role of Parliament and its Members. This might be reduced to industrial, economic and financial matters, defence and foreign affairs. The role of central government would be similarly truncated, although reserve powers in the devolved fields would be needed to carry out our international obligations and to deal with EEC matters generally.

19. For these reasons, the establishment of an English Assembly would carry

(*) Report of the Royal Commission on the Constitution 1969–73: Cmnd. 5460 and 5460-I.

grave risks to the continuing political and economic unity of the United Kingdom, the preservation of which the Government have regarded as a firm principle which should govern any proposals for devolution.

20. Some people have accordingly proposed a series of regional assemblies for England. But if each of these were to be given legislative powers the cumulative constitutional and parliamentary effect would be similar to that which would result from a single English Assembly. Moreover, setting up regional assemblies with legislative powers would mean that the legislative framework for such matters as education, health, housing, local government and land use would be largely determined at regional level, leading to possibly marked differences over short distances within England. The Government therefore rule out from further consideration not only the creation of an English Assembly but also a series of regional assemblies with legislative powers.

21. Other possible regional arrangements are considered in Sections IV and V.

III England after devolution to Scotland and Wales: industrial and economic implications

22. Much public comment in England has been concerned with the industrial and economic implications of the Government's proposals for Scotland and Wales. Fears have been expressed that devolution will lead to an accretion of powers and influence to the devolved administrations of a kind likely to prejudice the interests of England and, more particularly, the less prosperous regions of England. These fears are, in fact, groundless.

23. The devolution which is being proposed for Scotland and Wales relates to matters which primarily affect people living in Scotland and Wales and which can be administered separately in either country without side-effects for those living in the rest of the United Kingdom. The Government have made clear[4] that their proposals are designed not to infringe the economic unity of the United Kingdom. This economic unity has many important aspects. They include not only external economic relations, the management of demand in the United Kingdom as a whole and the framework of trade, but also the task of devising national policies to benefit particular parts of the United Kingdom and of distributing resources among them according to relative need.

Regional policies

24. The main purpose of regional policies is to promote investment and employment in those parts of the country which experience persistently above-average levels of unemployment. Such policies cannot be dealt with in isolation from other national economic policies. They must be formulated and implemented for Great Britain as a whole so that priorities can be judged fairly and the resources of the whole country deployed to help solve problems as

(4) Part II of Our Changing Democracy: Devolution to Scotland and Wales: Cmnd. 6348.

they arise anywhere within it. Accordingly the Government will continue after devolution to Scotland and Wales to determine in which parts of Great Britain economic conditions and prospects justify assisted area status and what forms of relief or incentive are to be available to established or incoming employers. And the Government will remain responsible for industrial development certificate policy, which assists the steering of new industrial development to the assisted areas.

25. At present the three main regional incentives to industry are Regional Development Grants and Regional Selective Assistance (both of which are incentives to capital investment) and Regional Employment Premium (which assists with labour costs and is a continuing aid available to established firms). In addition, much of the selective assistance provided under section 8 of the Industry Act, for example under the Accelerated Projects Scheme and Special Industry Schemes, on a national basis is in fact given to investment projects in the assisted areas. All these systems of aid are administered by departments of central government; and responsibility for their administration will remain with central government after devolution to Scotland and Wales.

26. But regional policies are concerned not only with the provision of regional financial aids to employers but also with public investment designed to eliminate deficiencies in the infrastructure and the amenities of the less prosperous areas.

27. Infrastructure development is for the main part in the hands not of the central government itself but of local authorities and public corporations. However, the Government influence priorities, firstly in the settling of the public expenditure programmes for the various services and secondly in the granting of capital expenditure authorisations or approvals to borrow.

28. The Government will retain responsibility after devolution to Scotland and Wales for a number of important forms of infrastructure which form part of a national network—such as railways and ports. Other forms which are more closely related to local needs—for example, housing, roads, water supply and sewerage—will come under the aegis of the devolved administrations but will normally be provided by local authorities or public corporations, in some cases with financial assistance from the block funds paid to the devolved administrations. Certain types of environmental improvement—notably redevelopment and clearance of derelict land—may be carried out by the recently created Scottish and Welsh Development Agencies using resources put at their disposal by the devolved administrations from the wider resources provided for all devolved purposes.

Finance

29. The arrangements for financing devolved services were explained in the White Paper of November 1975[5]—they have since been modified by the withdrawal of the proposal for an optional surcharge on local rates[6]. The essential feature is that there will be a block fund for each administration which will take account both of local needs and of the desirability of comparability of standards in all parts of the United Kingdom. These funds will be voted by Parliament. At the same time a limit will be laid down for the total amounts to be authorised by the devolved administrations for developments

[5] Our Changing Democracy: Devolution to Scotland and Wales: Cmnd. 6348.
[6] Devolution to Scotland and Wales: Supplementary Statement: Cmnd. 6585.

financed by long-term borrowing (eg most capital investment by local authorities). Once these two totals have been settled it will be for the devolved administrations to determine the detailed distribution between the services for which they are responsible. The Government will continue to determine expenditure on the services which remain their own responsibility—whether throughout the United Kingdom, for the whole of Great Britain, for England and Wales or in England alone.

30. The settlement of the block funds and the borrowing limits will be closely linked with the annual public expenditure review carried out by the Government. This settles spending programmes for the coming year and outline programmes for three further years ahead. The devolved administrations will be involved in this process. The block funds will be settled by the Government, subject to the approval of Parliament, and normally, it is expected, with the agreement of the devolved administrations.

31. No neat formula is capable of producing fair shares of public expenditure for England, Scotland, Wales and Northern Ireland in varying circumstances from year to year; this requires both sensitive political judgment and information about relative needs and standards.

32. The Government have already begun work on the scope for improving the base of objective information relevant to the devolved services; and they intend to discuss with the devolved administrations, once they are established, ways and means of achieving this. The objective is to ensure justice to the claims of all parts of the United Kingdom and to make it easier to demonstrate that justice has been done.

33. Once fixed, the block funds will not necessarily remain unchanged. If national economic factors make it desirable in any year to supplement agreed public expenditure programmes, the block funds will be supplemented in the same way as the votes of the central government departments responsible for the services concerned. Similarly, if forecast public expenditure has to be reduced for national economic reasons the block funds will bear their fair share of the cuts. The limits on capital expenditure to be financed by borrowing will also be subject to adjustment as necessary.

Development Agencies

34. As well as engaging in environmental improvements the Scottish and Welsh Development Agencies provide factories and industrial estates and have powers of industrial investment similar to those which are exercisable by the National Enterprise Board throughout the United Kingdom. The Agencies are not responsible for regional selective assistance unless the Secretary of State specifically directs them to handle a particular application, in which case he lays down in detail the basis on which assistance is to be offered and provides the necessary funds.

35. After devolution both Agencies will be financed from the resources available for the devolved administrations and will operate subject to direction by them. As far as industrial investment functions are concerned, however, the administrations will be required to ensure compliance with guidelines laid down by the territorial Secretary of State concerned. These guidelines will be incorporated in statutory instruments which can be annulled by Parliament.

As a result of the guidelines the Agencies will continue to operate on a commercial basis and their powers will not be used to provide "soft" loans or other forms of subsidy (except for the schemes for small grants to rural industries previously administered by the Small Industries Council for Rural Areas of Scotland or, in Wales, by the Council for Small Industries in Rural Areas). Similarly the Agencies will not be empowered to dispose of factories or industrial sites on terms more favourable than those on which the English Industrial Estates Corporation has to operate. Consultation and collaboration between the Agencies and the National Enterprise Board will continue.

36. The Agencies will continue to have no powers to deal with applications for regional selective assistance unless directed to do so by the Secretary of State in a particular case. When a direction is given the Secretary of State will lay down the basis for any offer of assistance and will provide the necessary funds.

37. The Agencies will have to present annual reports to Parliament, covering the functions which are subject to guidelines and any cases where they have been directed to handle applications for regional selective assistance. No doubt these reports will be carefully scrutinised by Members representing other parts of the United Kingdom.

38. Some people believe that English interests would benefit if there were an English Development Agency with a remit similar to that of the Scottish and Welsh Agencies or, alternatively, that there should be a series of regional Development Agencies in England with similar powers. Some of the main factors, for and against, are set out below to assist the discussion.

39. The case which is made for development agencies is that they bring together in a single cohesive organisation various forms of developmental support which would otherwise be channelled through a number of separate organisations. A comprehensive approach to industrial development and promotion is therefore greatly facilitated and, when necessary, action can be taken speedily and flexibly.

40. On the other hand, the functions of the Scottish and Welsh Development Agencies are already carried out in England by different means. For example, factories and industrial estates are made available on a similar basis in the English assisted areas by the English Industrial Estates Corporation, while the Development Commission helps rural areas whether within the assisted areas or not. The industrial development functions of the Agencies are carried out in England by the National Enterprise Board; to develop its awareness of regional needs the Board has established offices in Liverpool and Newcastle. And the environmental improvement powers of the Agencies are exercisable by local authorities. There is no clear evidence that these various functions would be more effectively carried out in England if merged, or that local authorities would welcome a change in the present arrangements in relation to such matters as derelict land clearance.

41. Furthermore, it is doubtful whether a single English Agency, having to co-ordinate a range of environmental and industrial functions in the differing circumstances of assisted areas which are spread from Cornwall to Northumbria, would be accepted as having the close familiarity with the problems of particular

areas which is looked for from the Scottish and Welsh Agencies. On the other hand, if a number of regional Development Agencies were established it would be necessary to avoid the risk of wasteful competition between them to attract industrial investment and employment.

42. These factors have so far been judged to tip the balance of advantage against an English Agency or Agencies. But the Government do not rule out these suggestions and, indeed, would welcome further views on them.

Summing up

43. In brief, the position concerning industrial and economic powers, after devolution to Scotland and Wales, will be that:—

(*a*) the Government will retain direct control over economic management and over regional policy, industrial policy and commercial policy;

(*b*) the Government and Parliament will retain direct control over the amount of the block funds to be allocated to the devolved administrations and over the total of capital expenditure financed by borrowing which they may authorise;

(*c*) the Government will lay down statutory guidelines to control the industrial investment operations of the Scottish and Welsh Development Agencies.

44. These powers will be exercised by the Government with a view to ensuring that industrial investment is "steered" to the assisted areas and that resources continue to be allocated to the different countries of the United Kingdom in accordance with needs. Both England and Northern Ireland will continue to receive their fair shares of resources after devolution; and, in exercising their responsibilities within England, the Government intend to secure fairness for all the different parts. There is, in their view, no reason to suppose that the devolution proposed for Scotland and Wales will in any way prejudice the economic prospects of any part of England.

45. The Government will keep their regional policies under review, having regard to the changing circumstances of the national economy. They will continue to give a high priority to stimulating industrial investment and employment in the assisted areas, whether in England, Scotland, Wales or Northern Ireland. They are prepared to consider an English Development Agency or Agencies, or any other innovation if it can be shown to offer good prospects of success in achieving these objectives.

IV Possibilities for change in England

46. Change in England could take various forms, not all of which amount to "devolution". As used in the Scottish and Welsh context devolution means the transfer of powers from a central authority. Changes in the structure of government in England would constitute devolution only if they involved some

transfer of powers from central government to a lower level.

47. Discussion of the scope for change in the structure of English government has, however, extended more widely than this. It has embraced also the whole question of the relationship between Whitehall and the local authorities; the structure and financing of local government; the allocation of functions between different levels of local government; the role of nominated bodies; and the arguments for and against an enhanced role for government at the regional level.

48. In considering the implications for England of the proposals for Scotland and Wales it is useful to have these issues in mind, although not all of them have direct relevance to devolution. For example, the case for change in the structure and functions of local government in England - essentially the present counties and districts - has no necessary connection with devolution. It is an issue in its own right.

49. Possible changes that have been suggested in the structure of government in England can be considered in two groups, described below as "radical" change and "limited" change. The factors to be weighed in any assessment of these proposals are discussed in Section V.

Radical change

50. Into this group fall various forms of new regional elected authorities with executive powers. Their nature and their relationship to existing authorities could vary very widely, depending on, among other things, the source of their powers; their system of finance; their range of functions; and their number, size and boundaries. The particular forms described in the following paragraphs are no more than illustrations drawn from a spectrum of possibilities.

51. The overriding constitutional and parliamentary objections to a series of elected regional assemblies with powers to legislate on the Scottish pattern have already been considered in paragraph 20.

52. There remains, however, the possibility of creating a series of elected regional assemblies with the ability to exercise functions in specified fields at present carried out by the central government. If these bodies followed the pattern proposed for the Welsh Assembly the administrative policy in such matters as education, health, housing, highways, water supply, local government and land use would be largely determined at regional level. Appropriate financial provision would have to be made, possibly by way of some form of block fund; and a substantial number of staff would be needed to enable the assemblies to carry out their decisions. Devolution to bodies of this kind would enable domestic affairs and priorities to be decided and administered at regional level.

53. A second major possibility would involve not so much the devolution of central government powers but rather the creation of elected regional bodies drawing their powers from local government and nominated bodies, such as the water authorities and health service authorities. It has been argued that there should be about a dozen directly elected regional authorities which might be responsible for planning, infrastructure development, and community land, water and sewerage, health and economic planning functions; these might be accompanied by "multi-purpose" district authorities whose responsibilities might include housing, education, social services and other major functions below the regional tier.

54. The establishment of elected regional authorities of this type would thus in practice directly involve a comprehensive reorganisation of local government. The present two-tier structure could not sensibly be combined with a third elected "local" tier. Many functions of the counties would therefore need to be raised to the new regional authorities and others would be transferred to the districts. This would require a substantial reorganisation of the district authorities, most of which would have to be enlarged in order to handle their new responsibilities. The regional authorities would require major sources of finance and staff.

Limited change

55. Limited changes in governmental arrangements in the regions could involve alterations to existing regional bodies or some adjustments to local government, or both.

56. At the regional level, proposals have been advanced for more effective regional advisory bodies. The present non-elected Regional Economic Planning Councils already bring together a wide range of interests within each region, including local government and industry. But it is argued that the regions should somehow be given a clearer voice, without involving substantial changes in the structure of government in England.

57. Strengthened regional advisory bodies would exist primarily to represent regional interests to central government and advise on regional needs. They might be based on the Economic Planning Councils, whose role could be enlarged to encompass a wider range of central and local government interests. Members might continue all to be appointed; or some might be appointed and others elected indirectly by members of local authorities in the region. Bodies of this kind, without executive powers, would not be large spenders and could operate with small staffs.

58. The development of advisory machinery on these lines might be accompanied by increasing the representation of central departments in the regions and by improving interdepartmental liaison machinery there so that the regional advisory body could work in close co-operation with the officials carrying out executive duties. In this way central departments would be more accessible to regional interests and better informed about local circumstances. This could result in better decision making without altering the responsibilities of Ministers or their accountability to Parliament.

59. There are also options for limited change at the local government level. Wholesale reorganisation of the present structure may not be the only approach. An alternative might be to examine the present framework to identify its strengths and weaknesses, and to see what improvements could be made without tearing up local government by its roots: to embark, in short, on a process of local government reform.

60. The elements which could be considered under this approach include the following:—

(a) Functions. There has been a good deal of criticism of the distribution of functions within the present two-tier system, including for example the functional relationship between districts and counties in the

metropolitan areas, the division of planning powers between counties and districts generally and the extent of the various powers held concurrently by both tiers. The problems which have arisen under the 1974 structure do not affect all areas in the same way. A reform approach could start with a review of the tiers at which local authority functions are performed; desirable changes could take place selectively and if necessary with different patterns in different parts of the country.

(*b*) Boundaries. Changes in functions may call for changes in boundaries. In addition, there will be a case in some areas for adjusting boundaries either because they were unsatisfactorily set by the 1974 reorganisation or because developments since then have made change desirable.

(*c*) *Ad hoc* combinations of local authorities to tackle particular problems where there is a clear need; wide-ranging powers for joint working already exist under the Local Government Act 1972.

(*d*) The scope for democratising nominated bodies, such as water authorities, could also be examined.

61. It would first be necessary to identify and evaluate the deficiencies in the 1974 structure. This consultative process may form the starting point for such an evaluation, leading to consideration of the scope for making improvements and the proper time-scale for change of this kind.

V The factors to be weighed

62. Many factors, both of general public acceptability and of administrative feasibility, are involved in consideration of the various forms of change outlined in Section IV.

63. Before coming to their own conclusions the Government consider it essential to obtain as broadly based an impression as possible of the views of the public on these matters. They wish to establish whether existing institutions are regarded as deficient and, if so, how far and in what ways. To assist public consideration of possible changes this Section sets out the case for change and draws attention to some of the main factors which have to be taken into account in assessing what changes may be practicable.

The case for change

64. The case for change in the structure of government in England has been argued on a number of different grounds, the main features of which can be summarised as follows:—

(*a*) That the central machinery of government—Parliament, Ministers and Whitehall departments—would be more efficient if it could concentrate on matters of genuinely national importance. Ministers and departments are at present overloaded by concern with too much administrative detail and with matters which could with more efficiency and sensitivity be

handled locally. The establishment of assemblies in Scotland and Wales should accordingly be followed up by some corresponding lightening of the pressures on the central government machine in relation to England.

(*b*) That the decisions and processes of central government are too remote from the ordinary citizen. Taking more decisions at a level nearer to the individual would ensure that local knowledge and interests were more fully taken into account and would stimulate participation in local affairs.

(*c*) That important nominated bodies, such as water and health authorities whose operations affect daily living conditions and bear closely on services provided by elected local authorities, should be subject to local democratic control. Either the functions of such bodies should be transferred to elected authorities or, if the bodies are to be retained, their members should be elected locally and not appointed by Ministers.

(*d*) That there is a need for a layer of government to handle functions which would be better dealt with in a context smaller than the whole country but larger than the existing local authorities. Even after the 1974 reorganisation of local government the new local authorities cover too small an area for the exercise of strategic planning responsibilities and their boundaries are too tightly drawn to facilitate the rehousing and redevelopment programmes needed in some of the larger cities. The present division of responsibilities between the county and district levels is not seen as the best available.

The framework for change

65. All these arguments for change place varying degrees of emphasis on the extent to which the over-riding criterion should be that of more efficient administration or more locally responsive government—two desiderata which may not always be reconcilable. In considering what changes may be practicable, and in balancing the benefits gained by each with additional problems which might be created at the same time, it is necessary to take account of the constitutional, financial and other constraints that form the framework within which any restructuring of government in England must take place. These are considered in the following paragraphs.

Constitutional implications

66. The framework in which any restructuring of government in England has to be considered must clearly take account of the limits imposed both by the need to preserve the political and economic unity of the United Kingdom, which the overwhelming majority of people plainly desire, and by the impracticability of federalism in the circumstances of the United Kingdom.

67. But even while remaining within these constraints, some institutional changes would still create major problems. In particular, a system of regional assemblies with executive powers derived from central government would have far-reaching effects on the present structure of ministerial and parliamentary responsibilities, under which Ministers have responsibility for the development of policies and determination of priorities but are accountable to Parliament for their decisions and actions.

68. The transfer to elected English regional bodies of powers at present exercised by Ministers (whether at a departmental headquarters or in a regional office) would have far-reaching constitutional implications. In particular it could directly reduce their ability to maintain national policies on devolved subjects, limit the role of Parliament and restrict the scope of the work of its Members. If regional authorities were able to determine the allocation of resources to particular programmes within their regions (and without this ability the exercise of their powers would in practice be severely restricted) this would fundamentally affect the ability of Ministers to account separately and collectively to Parliament for the policies, standards and priorities of the services they administer.

69. Major organisational change, whether involving devolution of central government functions or the reorganisation of local government, would produce serious administrative problems. It would involve the creation of major new units of administration and an inevitable need for substantial numbers of extra staff. While it is not practicable to put specific costs to the changes, the creation of, say, a dozen regional authorities with powers similar to those of the Welsh Assembly would involve thousands of additional staff and additional costs probably running into hundreds of millions of pounds.

70. The more limited forms of change would not carry the major constitutional implications associated with regional assemblies or authorities, and they would not involve the disruption and cost associated with major comprehensive reorganisation. Limited reform of local government might therefore be the most practicable approach to the shortcomings of local government structure.

71. However, such an approach carries its own dangers. It would be desirable to define as clearly as possible in advance the extent of the changes to be aimed at and the circumstances in which particular changes would be contemplated. Without this, a great deal of the existing organisation below the level of central government could be affected by uncertainties and this might hinder forward planning and efficient administration.

Financial implications

72. Regional assemblies would call for entirely new financial relationships. These bodies would be free, subject to statutory obligations, to allocate resources amongst the services for which they were responsible and develop distinctive policies based on their own view of regional priorities. Some would argue that this power to allocate resources should also extend to all services provided by the local authorities within the region.

73. It would in theory be possible to pay each regional assembly a block fund as is proposed for Scotland and Wales. It is inherent in such a system that the Government's influence over priorities between services and the ability of Ministers to determine national policies and expenditure programmes would be reduced. Indeed some would argue that this would be desirable. In relation to their own directly administered services the regions themselves would settle programmes for large populations and wide areas; and in relation to services administered by local authorities they would ensure that regional priorities were followed (as distinct from national ones, where these differed).

74. Such block funds would make the Government's task of economic

management more difficult. The composition of expenditure is important because different types of expenditure have different effects on important economic aggregates such as the balance of payments, the public sector borrowing requirement and unemployment as well as different effects on the various sectors of the economy. It is true that the Government will not control the composition of expenditure on devolved services in Scotland and Wales. But to extend this relaxation of control to every region in England would have much larger effects and would make it vastly more difficult for the Government to exercise their essential functions in managing the economy of the United Kingdom as a whole.

Boundaries

75. Any study of possible regional institutions of government in England must take account of the problem of defining the areas over which they would operate. The number of the regions, and their boundaries, would need to reflect a balance between administrative efficiency, in terms of the functions for which they would be responsible; the facts of geography; and historical loyalties and traditions. In some places—at Newcastle or Manchester, for example—there is clearly a sense of regional awareness, but in other places not far away this may be difficult to trace.

76. If regional bodies were established with a wide range of executive powers the demarcation lines of regional boundaries would be of increasing practical importance to individuals because the nature and level of government services, and the spending priorities, might differ significantly between neighbouring regions. An important issue for consideration, therefore, is how far—against a historical tradition of common standards—new regional authorities in England could be expected to command, especially in boundary areas, the public support necessary for the acceptance of potentially differing policies and standards, going far beyond the differences encountered in adjoining local authority areas today.

77. Moreover, boundaries suitable for one function are not necessarily suitable for another. This may not be an insuperable problem but nobody can doubt that there are substantial difficulties involved. A clear example is water supply, since the areas covered by the regional water authorities have to be drawn up on the basis of undivided river basins; regions suitable for water supply would make little sense for most other purposes. In the consultative document on the review of the water industry(7), the Government made it clear that they remained committed to the principle of unified river basin management as the basis of the industry's regional structure, although they were well aware of the problems of reconciling the adequate democratic control of water authorities with the large size of some of the river basins.

78. Another example is health, where the boundaries of the regional health authorities must have regard to established patterns of delivery of health care, which are themselves largely determined by the location of major facilities such as the large hospitals associated with universities and their medical schools.

79. Yet another is transport, where the natural basis for control tends either to be national (railways) or local, as with bus operation, though the boundaries

(7) Review of the Water Industry in England and Wales (Department of the Environment, Welsh Office and Ministry of Agriculture, Fisheries and Food—1976).

a national one in which the Secretary of State, with his Ministerial colleagues, sets national policies and objectives and has, in the last resort, power to issue formal directions to the regional and area authorities as to how they should exercise the functions delegated to them. Control of the health service by elected authorities would require a complete redefinition of the central government's role in relation to it and would inevitably diminish its national character.

86. Radical reorganisation of this kind would raise major questions as to how the health service should be financed and what the lines of accountability should be. Major changes of organisation would be expensive both in the administrative costs of planning and carrying them through and also in the effects which organisational upheaval would have on morale and in the conflicts and uncertainty that would accompany it.

87. The Government have appointed the Royal Commission on the National Health Service to consider the best use and management of the financial and manpower resources of the Service. The memorandum that the Commission has issued on its task makes clear that it will be examining the structure of the Service and its relationship to central and local government. It will need to take into account the development of thinking on devolution in England and its own conclusions will make an important contribution to that thinking. A final decision on the structure of the National Health Service must await receipt and consideration of the Commission's Report.

Summing up

88. To sum up, the case for change is seen to lie in:—

(*a*) lightening the burden on central government, enabling it to concentrate on matters of genuinely national importance;

(*b*) bringing government closer to the people;

(*c*) rendering the work of major nominated bodies subject to local democratic control; and

(*d*) providing a layer of government to deal with such matters as may be better dealt with at a level intermediate between central and local government as they now exist.

89. But the case for any particular form of change has to be examined within a framework of practical constraints and implications. On this basis, the viability of possible new forms of government in England depends on the view taken of:—

(*a*) the constitutional implications, including the effect on the powers of Ministers to maintain national policies and on the role of Parliament;

(*b*) the financial implications, including the arrangements for funding any new institutions;

(*c*) the problems of drawing new boundaries; and

(*d*) other implications, including the effects on existing institutions, both during the transitional period and in the longer term, and the extent to which the problems that are seen can be tackled without radical change.

do not in some cases accord with those of any one local authority.

80. Again, regional areas suitable for strategic land use planning purposes might prove too large for other services often proposed for a regional level, such as police and the fire service. If county authorities were to disappear, most existing districts outside the main conurbations would probably be too small in terms of population either for education and personal social services or as equivalents of (or replacements for) area health authorities (now based on non-metropolitan counties, metropolitan districts and London boroughs).

81. It would be desirable to achieve a reasonable balance between regions in terms of size and economic potential, but London and the South East present a special problem from this point of view. The population of the area covered by the South East Economic Planning Region is 17 million people—over one-third that of England, three times that of Scotland and almost six times that of Wales. This problem could not be solved by breaking up the area into artificial sub-units. Any proposals for a regional structure would have to take account of the dominance of the South East in relation to the rest of England, and of London over the rest of the South East.

Other implications

82. The present structures of local government, the National Health Service, the regional water authorities and the police service have been in existence for less than three years. These new structures are still in the process of settling down. The Government are fully aware of the widespread criticism of certain aspects, but any further major redistribution of local government functions would be bound to take a good many years to plan and carry out. And to attempt radical change affecting London and the rest of the country simultaneously would be unprecedented; previous reorganisations affecting London separately were major tasks in their own right. The expected long-term benefits of any change have to be measured against the disruptive effects in the meantime. And if one set of changes follows another the point may come at which the penalties of the process of change outweigh the advantages which it is hoped ultimately to achieve.

83. There is also the effect on the individual citizen. A further reorganisation so soon after the last one would be bound to create confusion in the mind of the average elector. It is also probable that he would feel more remote from the affairs of a local government body administering services over a much wider area—as would certainly be the case with regional authorities.

84. There is at present a direct relationship between local authority boundaries and the boundaries of health regions and areas. Unless the benefits of this relationship were to be set aside any major reorganisation of local government would have to be accompanied by changes in the National Health Service.

85. A reorganisation of local government which involved the assumption of responsibilities for the health service would require a fundamental reorganisation of the National Health Service. This is an Exchequer-financed service with two levels of management accountable to the Secretary of State for Social Services. Virtually all the statutory functions are vested in him and he in turn makes them exercisable by the 14 regional and 90 area health authorities. The service is

a national one in which the Secretary of State, with his Ministerial colleagues, sets national policies and objectives and has, in the last resort, power to issue formal directions to the regional and area authorities as to how they should exercise the functions delegated to them. Control of the health service by elected authorities would require a complete redefinition of the central government's role in relation to it and would inevitably diminish its national character.

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(*d*) other implications, including the effects on existing institutions, both during the transitional period and in the longer term, and the extent to which the problems that are seen can be tackled without radical change.

VI The consultative process

90. As explained in Section I, this consultative document does not put forward proposals for changes in the structure of government in England. The Government wish to hear and consider views and to carry out their own further studies before deciding what, if any, changes to recommend.

91. The main purpose of this consultative document has accordingly been to set out in general terms the broad issues which the Government consider should be before members of the public when they form their own conclusions on whether or not there is a need for change and, if so, what forms such change might take.

92. There can clearly be a variety of replies to the central question which this document poses: are there any specific ways in which the structure of government in England might be altered so as to make it more democratically accountable, responsive and efficient, reduce the burdens on Whitehall and Westminster and develop its full potential for improving the quality of life?

93. There are, on the one hand, those who feel that the predominant requirement at present is for a period of stability and that efforts should be concentrated on making the present system work better. On the other hand, there are people who feel that what is needed is the establishment of directly-elected regional assemblies taking functions from central government, local government and nominated bodies. Between these two positions lies a whole series of intermediate options which shade into each other.

94. These are manifestly difficult matters and need thorough consideration and debate. Behind them lie two questions of great importance to the efficiency of government and to all citizens and taxpayers, namely:—

(*a*) Whether government would be more acceptable, accessible and accountable if there were a new regional layer of democratically elected government exercising functions at present exercised centrally or locally?

(*b*) Whether, if ways could be found of bringing this about, government would be more efficient?

95. What the Government now want is to find out in which ways people in England would like to see our institutions develop. To preserve its vitality a parliamentary democracy must be capable of adapting to changing needs and pressures, external and internal—hence the proposals for Scottish and Welsh devolution and the need for thought and debate about English institutions. It is the purpose of this consultative document to encourage that thought and stimulate that debate.

96. Government departments will be writing direct to bodies with which they are regularly in contact seeking their views on the matters raised in this consultative document. Among the issues on which views are invited are:—

(i) In what fields of government responsibility in England, if any, is it considered that the present level at which decisions are taken (Whitehall/nominated bodies/counties/districts) is wrong?

(ii) Is there a case for an English Development Agency or for English

regional Development Agencies (see Section III)?

(iii) What are the advantages and disadvantages (see Section IV) of—

(*a*) no change;

(*b*) some form of radical change;

(*c*) some form of limited change;

(iv) Do people in England have a sense of regional identity strong enough to support regional units of government?

(v) What principles should determine the size of regional areas? How should the boundaries be drawn? How many regions should there be? What *should be done about London and the South East?*

(vi) If regional units were set up, should their functions be only advisory and co-ordinating or should they have executive powers?

(vii) How should any such units be financed?

(viii) Would the development of regional institutions solve or reduce any national problems? If so, which?

(ix) Would substantial variations between regions in the standard of public services, and the choice of spending priorities, be acceptable?

(x) What are the deficiencies in the present structure, boundaries and distribution of functions within local government? How might they be remedied, broadly within the present structure?

(xi) What is the degree of urgency of any changes in English arrangements which may be desired?

97. Members of the public wishing to express their views on these issues or any other aspect of the matters discussed in this consultative document are invited to write to the Constitution Unit, Cabinet Office, Great George Street, London SW1P 3AQ.

RESTRICTED

European Communities No. (1976)

Developments in the European Communities May – November 1976

Presented to Parliament
by the Secretary of State for Foreign and Commonwealth Affairs
by Command of Her Majesty
1976

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DEVELOPMENTS IN THE EUROPEAN COMMUNITIES
MAY – NOVEMBER 1976

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DEVELOPMENTS IN THE EUROPEAN COMMUNITIES
MAY – NOVEMBER 1976

Section I. Introduction

1. This is a report in the series presented to Parliament by the Government on Developments in the European Communities. It covers the period from 1 May 1976 to 30 November 1976. The aim is to describe major decisions reached during this period and to refer to major work in progress. It deals with developments in the three European Communities—the European Economic Community, the European Coal and Steel Community and the European Atomic Energy Community. Major developments in the process of political co-operation between the Governments of the Nine are described and an account is given of Community business in Parliament. The next report will cover the United Kingdom Presidency of the Council of Ministers which runs from January to June 1977.

Section II. Political Co-operation

2. Consultation continues on a wide range of foreign policy issues among the Nine Member States of the European Communities. At the 30th General Assembly, the Nine voted together on over 80 per cent of all occasions. The Nine continue to support the United Nations Secretary General in his efforts to promote a peaceful solution in Cyprus.

3. One of the recent areas of active co-operation among the Nine has been Southern Africa. On 18 September (designated as "Namibia Day" by the United Nations) the Nine in a message to the United Nations Secretary General reaffirmed their suppprt for the right of the people of Namibia to self-determination and independence. They have also made clear their decision not to recognise the Transkei. On 18 October the Foreign Ministers of the Nine issued a statement on Rhodesia welcoming Her Majesty's Government's convening of a conference to discuss the formation of an interim government in Rhodesia and urging the parties concerned to take advantage of this opportunity to bring about an orderly and peaceful transfer of power to the majority.

4. A highly developed area of political co-operation is the Euro/Arab Dialogue. The Nine attach importance to this means of deepening and strengthening their relations with the Arab world. The first meeting of the General Committee held in Luxembourg from 18 to 20 May emphasised the political as well as the economic significance of the Dialogue. Discussions among experts are continuing in a number of economic, technical and cultural fields.

5. The first conference of Community Ministers of the Interior and Ministers with similar responsibilities took place in Luxembourg at the end of June to discuss matters of common interest, in particular with regard to law and order. Ministers expressed their common resolution to strengthen their co-operation in the fight against organised international crime, particularly terrorism, and agreed upon a programme of specific areas in which existing co-operation between the competent authorities in the Member States could usefully be

extended. This programme covers the exchange of experience of past terrorist incidents and mutual assistance in specific cases; the exchange of technical knowledge related to police work and research; the exchange of police personnel and greater co-operation in police training; and co-operation in aviation security, nuclear safety and the tackling of disasters, including fire. Proposals for giving effect to this programme will be submitted to a second conference of Ministers that is expected to take place in May 1977 during the United Kingdom Presidency of the Community.

Section III. External Relations; Trade and Aid

Greece: Application for Membership of the EEC

6. Negotiations on Greece's application for membership of the Community opened formally in Brussels on 27 July. The first substantive meeting between the Community and Greece at Ministerial level took place in Luxembourg on 18–19 October. This meeting was devoted largely to a discussion of the procedures to be adopted in the accession negotiations.

GATT Trade Negotiations

7. The conference of Heads of State and Governments held in Puerto Rico in June 1976 reaffirmed that the aim should be to conclude the current round of GATT Trade Negotiations by the end of 1977. These are ambitious and complex negotiations and progress has been relatively slow, but much useful ground work has been carried out both on tariffs and on a variety of non-tariff barriers to trade. The Commission represents the Community on the basis of the mandate adopted by the Council of Ministers in February 1975 and in the light of regular co-ordination meetings with Member States.

8. Particular attention is being paid in the negotiations to the problems facing the developing countries. On 5 April the Foreign Ministers' Council adopted a broadly based Community offer containing significant improvements in access for tropical products of interest to these countries. The concessions in the offer will be implemented from 1 January 1977.

Maghreb

9. Interim Agreements between the Community and Algeria, Morocco and Tunisia took effect on 1 July, implementing the trade provisions of the Co-operation Agreements signed in April. Other provisions, which include industrial co-operation and financial aid from the Community, will enter into force when the co-operation Agreements have been ratified.

Mashraq Countries

10. Negotiations with Egypt, Syria and Jordan under the Community's "overall approach" to relations with countries of the Mediterranean Basin were successfully completed in October. (Parallel negotiations with the Lebanon have been held up because of the civil war). The new co-operation agreements will comprise trade and aid provisions broadly similar to those in the Maghreb agreements, and it is hoped that signature will take place before the end of this year.

Israel

11. Negotiations for financial and economic protocols to the 1975 agreement with Israel were completed in October. It is hoped that signature will take place before the end of the year.

Spain

12. The Community is considering a mandate for the resumption of negotiations on a revised trade agreement between Spain and the enlarged Community.

Portugal

13. An additional protocol to the EEC/Portugal free trade agreement and a five-year financial protocol were signed by Foreign Ministers in Brussels on 20 September. The additional protocol supplements and expands the 1972 trade agreement and extends the agreement to cover certain aspects of employment, social security and financial, industrial and technological co-operation. An interim agreement was also signed at the same time to implement the commercial provisions of the additional protocol by 1 November, in advance of full ratification of the protocol. Portuguese Ministers have made clear their intention to apply for full membership of the Community in due course.

Pakistan and Bangladesh

14. A commercial co-operation agreement with Pakistan was signed in June and entered into force on 1 July; a similar agreement was signed with Bangladesh on 19 October. The provisions of both agreements are similar to those already in force with India and Sri Lanka.

Iran

15. The Council of Ministers has endorsed the main lines of the Commission's proposals for a commercial and economic co-operation agreement with Iran. Work continues in the Community on the preparation of a mandate for the opening of negotiations.

Canada

16. The Framework Agreement for commercial and economic co-operation between the EEC and Canada entered into force on 1 October.

Japan

17. The European Commission on behalf of Member States has been engaged in a number of consultations with Japan on a range of issues arising from the continued growth in the imbalance of visible trade between the Community and Japan. The European Council on 29-30 November discussed these problems and issued a statement inviting the Community institutions to give urgent consideration to working out solutions in co-operation with Japan.

State Trading Countries

18. In November 1974, the Community offered to engage in trade negotiations with each of the state trading countries for the conclusion of agreements to replace the previous bilateral trade agreements with individual EEC countries.

In response, the Council for Mutual Economic Aid put forward the draft of a possible agreement earlier this year, on behalf of its nine Member States. The Community replied on 17 November by putting forward its draft of an agreement and reaffirming its willingness to enter into negotiations at an early opportunity on the basis of the draft.

Textiles

19. The Community has concluded further agreements under the GATT Multifibre Arrangement with Egypt, Yugoslavia and Romania. Negotiations are continuing with Mexico, and it is hoped to open negotiations shortly with Hungary and Poland.

Generalised Scheme of Preferences

20. The Commission's proposals for the Community's Scheme of Generalised Preferences, which provides preferential access for developing countries to EEC markets were approved by the Council of Ministers in November 1976. The proposals provide for improved concessions, including increased quotas and ceiling limits for industrial products, except for the most sensitive items, eg footwear, and substantial extensions of the Scheme in the agricultural sector, as foreshadowed in the EEC's offer on Tropical Products in the GATT Multilateral Trade Negotiations. Many of these improvements will be of particular interest to the very poorest developing countries.

21. For textiles the Council agreed that new arrangements will be introduced giving more generous treatment to the less competitive developing countries with some reduction of concessions for the most advanced of the developing countries.

CIEC/UNCTAD

22. After four meetings of the Commissions of the Conference on International Economic Co-operation during the first half of the year discussions on their work programmes for the remainder of the year continued during the summer until an agreement was reached which enabled the Commissions to resume their meetings in September. In pursuance of the resolution adopted by consensus at UNCTAD IV on debt the Community has tabled proposals on the indebtedness of developing countries which are being discussed in the CIEC.

23. The fourth meeting of UNCTAD was held in Nairobi in May. Member States of the Community took part individually, but preparations and negotiating positions were closely co-ordinated. One of the main areas of debate was Commodities, on which the conference adopted a resolution calling for preparatory meetings leading up to a negotiating conference by March 1977 on a Common Fund, and preparatory meetings for international negotiations on individual products to be completed not later than February 1978. Work is currently in progress to establish common positions within the Community in these areas. The first individual commodity meetings—on copper and jute—have already been held in Geneva. The Trade and Development Board, the regular continuing UNCTAD mechanism between Conferences, met in Geneva in October.

The Lome Convention

24. The first meeting of the ACP/EEC Council of Ministers was held in Brussels in July. A further meeting between the Presidents of the EEC Council and the Council of ACP Ministers to discuss a number of issues raised by the ACP countries at the July meeting was held in October. During the latter half of 1976 negotiations for accession to the Convention took place with Sao Tome and Principe, Cape Verde and Papua New Guinea. The Comoros State, the Seychelles and Surinam, formally associated with the Community under Part IV of the Treaty of Rome, became parties to the Convention during the latter half of 1976.

25. Examination of the requests for transfers under the Community's Export Earnings Stabilisation Scheme (STABEX) has been completed and the first transfers were made in July: the payments covered falls in import earnings on nine products from seventeen ACP States. The Commission also made progress in drawing up indicative aid programmes for each of the original 46 signatory ACP States, and projects are now being brought forward for consideration and implementation.

26. The Centre for Industrial Development provided for under the chapter of the Convention dealing with industrial co-operation should become operational during the first half of 1977.

Food Aid

27. The United Kingdom put forward suggestions for "A New Strategy for Community Food Aid to Developing Countries" with a view to improving the developmental impact of food aid. The paper was taken into account by the Council of Development Ministers on 8 November in discussing Commission proposals for a three-year forward plan for food aid.

Aid for Non-Associated Countries

28. The Council of Ministers (Development) agreed on 8 November to spend the 20 mua inserted by the Assembly into the 1976 Budget. The money will probably be spent on projects in India, Pakistan, Bangladesh, Sri Lanka and Bolivia and a grant to the Asian Development Bank for technical assistance.

29. For 1977 the Council has agreed to include a provision of 30 mua in the draft budget, but the use of this money as the first stage in a continuing programme will require a further decision by the Council.

Section IV. Agriculture and Fisheries

Monetary Arrangements

30. During this period there have been further marked changes in the relative market rates of Community currencies thus increasing the difference between these rates and the green rates used for converting the support prices under the Common Agricultural Policy. The Commission proposed at the meeting of the Council on 4–5 October that the sterling green rate of exchange should be devalued by 4·5 per cent and that the Irish green rate should be

devalued by 7·6 per cent, but only the proposal relating to the Irish green rate was accepted. These proposals were debated by the House of Commons on 22 October. At the Council on 25–26 October, a proposal to devalue the green krone by 4 per cent was accepted.

31. The Commission also suggested that from 1 January 1977 an automatic mechanism for the adjustment of green currencies should be applied. Under this proposal, ceilings would be introduced, at different levels for revaluing and devaluing countries, setting the maximum divergence between the green and market rates. In addition, green rates would be periodically adjusted to bring them into line with market rates over a previous 18 month period. The operation of both these mechanisms would be subject to an overriding maximum percentage adjustment, although the Council could decide to waive this rule in particular cases. The United Kingdom has maintained that adjustments in green currencies should be primarily a matter for the country most directly concerned.

Drought

32. In discussion of the problems arising from the drought the Council agreed, in the interest of consumers, to suspend or reduce the common customs tariff on imports of potatoes and a number of other vegetables and, in the interest of farmers, to introduce a limited extension of intervention for cows and to increase the subsidy on skim milk used for animal feed in the drought-affected areas. The Council also noted national measures taken by Member States to alleviate the effects of the drought. These included an increase in the United Kingdom guaranteed prices for milk and for sheep and extra help to farmers to build reservoirs.

Milk Products

33. The Commission put forward during the summer proposals for improving the balance in the Community market for milk products. These include a levy on producers, which would be collected on milk supplies to dairies and on direct sales of dairy products from farms; a corresponding tax on vegetable and marine oils and fats; grants for dairy farmers who undertake to stop marketing milk or to convert to beef and sheep production; the suspension of national and Community aids to investment in the milk sector except in certain strictly defined circumstances; Community aid for accelerated programmes for the eradication of brucellosis, tuberculosis and bovine leukosis; Community aid for milk in schools; and other measures to promote increased consumption of milk and milk products. These proposals which were debated by the House of Commons on 22 October are under consideration in the Council.

34. The Council has adopted a regulation providing aid for the private storage of certain protein products, and has brought to an end the scheme for the payment of deposits on imported and Community-produced proteins involving the incorporation of skimmed milk powder in animal feed.

New Zealand Butter

35. At its meeting in June the Council agreed upon arrangements for imports of New Zealand butter for 1978 to 1980 which had been debated by the House of Commons on 18 May. The quantities which may be imported in

1978, 1979 and 1980 under these arrangements are 125, 120 and 115 thousand tonnes respectively. Within these quantities, imports in excess of 25 per cent of the United Kingdom market for direct consumption in the preceding year may be diverted, if necessary, to other uses. The Council also confirmed that Protocol 18 of the Treaty of Accession remains the basis for continuing imports of New Zealand butter after 1980.

Cereals

36. At its meeting in June the Council agreed upon a test for distinguishing breadmaking and feed wheat to be used in the two tier system of intervention for wheat which has been introduced in 1976–77 so as to achieve a better relationship between support prices for different feed grains.

Sugar

37. At its meeting in June the Council endorsed the agreement negotiated with the ACP countries for imports of sugar in 1976–77.

Mutton and Lamb

38. The Council has continued its examination of the Commission's proposals on sheepmeat and in particular has considered an interim measure to improve conditions of intra-Community trade.

Animal Health

39. The Council agreed at its November meeting to modify the Community's legislation on trade in fresh meat and livestock so as to afford continued animal health protection for the three new Member States.

40. The Council agreed at its November meeting a proposal to protect consumers by setting maximum permissible limits for the extraneous water content of frozen chicken. This will come into force by the end of 1977.

Hops

41. The Council has agreed that the Commission should re-examine the market situation for hops and make any necessary proposals for improving the balance of the market. These are under consideration.

Processed Tomatoes

42. The Council agreed in May upon the minimum price for imports of tomato concentrate from third countries in 1976–77. A special lower price still applies to imports into the new Member States. In July the Council extended to canned peeled tomatoes the accession compensatory amounts payable on exports to the three new Member States; this is to the benefit of United Kingdom consumers.

Agricultural Structure

43. The Council continued its examination of Commission proposals on aid to improve the marketing and processing of agricultural products, on producer groups, on aid to young farmers and on forestry.

Fisheries

44. On 27 July the Council agreed a declaration of intent on the extension of Member States' fisheries limits. In this declaration, the Council endorsed the principle of concerted action on extension, and agreed that a decision on the ways of implementing such action should be taken in the light of the outcome of the next session of the UN Law of the Sea Conference. On 30 October, a meeting of Community Foreign Ministers in The Hague agreed that fisheries limits would be extended to 200 miles in the North Atlantic and North Sea from 1 January 1977. Agreement was also reached on general negotiating directives for the conclusion of fisheries agreements with third countries, and the Commission subsequently entered into negotiations with a number of third countries, including Iceland and Norway. A Fishery Limits Bill was published by the Government at the end of November.

45. The Commission's proposals for the revision of the Community's internal fisheries regime provide for an extension both in time and geographical scope of the derogations in Articles 100 and 101 of the Act of Accession so as to establish a uniform 12 mile exclusive band around the coasts of Member States, within which the historic rights of other Member States would be preserved. Catches in the remaining waters under the fisheries jurisdiction of Member States would be regulated primarily by means of quotas. The proposals are under consideration by the Council.

Section V. Economic and Monetary Questions

The 1976 Budget

46. A supplementary budget was adopted in June to provide for Community assistance towards the costs of reconstruction in Italy following the earthquake in the Friuli region in May. The amount provided was 60 mua (£25 million) and will be used for agricultural reconstruction and infra-structure renewal.

47. A second supplementary budget, totalling 833 mua (about £347 million) was adopted in September. Of this sum 717 mua was required to meet expenditure under the common agricultural policy, including monetary compensatory amounts, and 41 mua to finance additional food aid.

The 1977 Budget

48. The preliminary draft budget for 1977, presented by the Commission in June under the experimental timetable agreed for consideration of the 1977 Budget, amounted to 9,261 mua (about £3,860 million) an increase of some 1,200 mua on the 1976 Budget, including supplementary budgets. It was debated by both Houses of Parliament on 19 July.

49. The draft budget was adopted by the Council of Ministers on 22 July. The Council reduced the amounts included in the preliminary draft budget by 615 mua (about £256 million) to 8,646 mua. The draft budget, together with revised proposals in a letter of amendment by the Commission which revised the total to 8,715 mua, was then sent to the Assembly for their consideration. It was returned to the Council with the Assembly's observations and proposals on 29 October. The Assembly adopted amendments and

modifications which would increase the total budget by 584 mua to 9,299 mua. The Council of Ministers on 23 November agreed to 72 mua of the increases proposed by the Assembly; the draft budget has been returned to the Assembly for further consideration before it is finally adopted by 19 December.

Economic and Monetary Co-operation

50. At their regular meetings Community Finance Ministers have continued to discuss the economic and financial situation within the Community; and this subject was also discussed by the European Council on 29/30 November. The Finance Ministers have also exchanged views on the North-South dialogue, particularly the problem of indebtedness. In July they adopted a decision on the preparation of public budgets for 1977 which laid down economic and budgetary guidelines to be followed by Member States. In September they agreed on a Community position for the annual meeting of the International Monetary Fund in Manila. They also approved the consolidation of $100 million, borrowed by the Community at a floating rate under the Joint Community Borrowing scheme, into fixed interest notes. In November they adopted the annual report on the economic situation in the Community, containing economic policy guidelines for 1977.

51. There has been extensive discussion of proposals launched by the Netherlands Minister of Finance, for greater convergence of economic and monetary policies. These include relating the economic policies of Member States to the Fourth Medium-Term Economic Policy programme, with Community credit facilities being used in support of this objective, and the development of a Community framework for consultation and surveillance of exchange rate policies, based on the IMF " guidelines for Floating " and the concept of agreed " target zones ". After considering the advice of the Monetary Committee and the Economic Policy Committee on these proposals, the Finance Ministers agreed on 8 November that further work should be done in developing certain of Dr. Duisenberg's ideas.

52. Apart from its work on exchange rate policies the Monetary Committee also covered two other means of monetary co-operation in their report to the Council. These were the objectives of monetary policy, and the operation of Euro-currency markets.

Unemployment

53. A further conference on the restoration of full employment and stability in the Community attended by Finance Ministers and Social Affairs Ministers, representatives on both sides of industry and the Commission, was held in Luxembourg in June. The problem of unemployment was discussed in depth and the exchange of views covered a number of specific measures for improving the employment situation, particularly for young people. All participants were agreed on the need for a rapid return to full employment and stability. It was also agreed that a further conference could be convened to review developments in this situation and to take stock of the results achieved by the joint efforts of all parties to the conference. Subsequently the Economic Policy Committee has associated both employers and unions with its examination of the Community's short and medium-term economic prospects.

Taxation

54. Discussion of the draft Sixth Directive on VAT, which seeks to harmonise the structure and coverage (but not the rates) of the tax, has continued. Agreement on the main issues in the Directive would be needed by the end of 1976 to enable the VAT "own resources" system to be introduced by the target date of 1 January 1978. In October a Council of Fiscal Ministers agreed that the proposed Directive should allow Member States to retain particular features which are important in their national VAT systems. Further discussion will be needed on the draft Directive (and subsequently on the detailed mechanisms of the "own resources" system) before final agreement can be reached.

55. The Commission has proposed to extend from 30 June 1977 to 31 December 1977 the first stage in the harmonisation of excise duty on cigarettes, because agreement on the second stage has not yet been reached. The United Kingdom has a derogation until the end of 1977 in respect of harmonisation of tobacco duties.

Section VI. Regional and Industrial Affairs

Regional Development Fund

56. Up to the end of November the Commission had committed £66.25m from the Fund as contributions towards the cost of projects in the United Kingdom. The Commission has produced its first Annual Report on the Operation of the Fund.

Steel

57. The Commission have put forward proposals designed to alleviate the effects of future recessions in the steel industry. In the course of consultations with Government and industry, M. Simonet, the Commissioner responsible for steel, met the Minister of State for Industry on 27 August and again on 4 November. The Government are keeping closely in touch with developments.

Company Law Harmonisation

58. Discussion of the draft Second Directive on the formation and capital of companies has continued with a view to its adoption by the end of the year. Consideration has continued of the draft Fourth Directive on Company accounts; the draft Sixth Directive on prospectuses issued when shares are quoted on a stock exchange; the draft Directive on safeguarding of employees' rights and the Goldman proposals for a Convention on International Mergers. The Commission has made a study of the Wurdinger draft proposals for a directive on related companies and groups. Consideration has begun of the draft Third Directive on Internal Mergers and the European Companies Statute. In May, the Commission put forward a proposal for a draft Seventh Directive on Group Accounts. All these instruments were debated in the House of Commons on 17 June.

Removal of Barriers to Trade

59. The programme for the elimination of technical barriers to trade in the industrial sector has made substantial progress with the adoption during the Luxembourg Presidency of a package of 18 Directives together with four

other Directives concerning braking devices for tractors, non-automatic weighing machines, wire ropes, chains and hooks for use in lifts and units of measurement. Work on the programme is continuing.

Aircraft Construction Industry

60. The Commission have submitted to the Council of Ministers a preliminary report on the aircraft construction industry following on the Council Resolution of March 1975 calling for concerted action and consultation between Member States on industrial policy in this sector. The Member States have prepared a factual report on the feasibility of joint civil aircraft projects.

Data Processing

61. The Council of Ministers has agreed to undertake three projects concerning a data bank for matching human organs and blood, systems for legal information retrieval and studies in computer-aided design. A second group of proposals is under discussion.

Shipbuilding

62. Discussions are in progress on the Commission's Communication to the Council on shipbuilding of June 1976. The Commission is seeking to develop a common approach to the problems of the Community's shipbuilding industry, against the background of a serious structural imbalance between supply and demand. The Council of Ministers has recently approved an amendment to the shipbuilding Directive endorsing the operation of the United Kingdom's cost escalation insurance scheme for shipbuilding.

State Aid

63. The Government has continued to inform the Commission about both individual and sectoral aid proposals prior to their implementation. These have included the measures of assistance already announced for the paper and board industry, the poultry meat processing industry, the textile machinery industry, the printing machinery industry and a number of projects relating to individual firms.

European Investment Bank and ECSC Loans

64. The European Investment Bank has since 1 April 1976 approved loans in the United Kingdom to the value of £84·75 million. In May a loan of £8·6 million was approved towards the cost of a British Gas pipeline network in Southern England. In July a loan of £17·6 million was approved to help finance the Post Office's telecommunications programme in the North of England, together with £5·5 million to assist the British Railways Board in improving its Sea Link system based in Wales, and £26 million to help finance the Electricity Council and Central Electricity Board's Hydro-Electric scheme in Wales. In August a loan of £16·8 million was approved towards the development of an oil field in the Beryl Field by North Sea Inc. In October loans totalling £10·25 million were approved for the British Steel Corporation; £6·75 million to help finance a Billet mill in North East England and £3·5 million for construction of a Plate mill in Scotland. At the invitation of the Government the October meeting of the Directors of the Bank was held in Edinburgh.

65. Loans were also made available under the European Coal and Steel Community Treaty. Since the beginning of 1976 loans totalling £293·93 million have been approved for the United Kingdom steel industry (£17·93 million since April) and loans totalling £32·3 million have been approved for the coal industry (£5·1 million since April).

Section VII. Environment and Transport

Environment

66. Directives have been adopted on dangerous substances in the aquatic environment and on the marketing and use of certain dangerous substances, notably polychlorinated biphenyls. The proposal for a second Community Environment Action Programme is under consideration.

Transport

67. The Commission has granted the United Kingdom a further eight months' deferment from 1 July 1976 of the requirement to apply the EEC Social Regulation on drivers' hours and conditions of work to vehicles on internal United Kingdom journeys. Meanwhile the Council of Ministers is considering a new proposal which would amend the existing regulations.

68. In July, as part of the Luxembourg package of Article 100 Directives, seven motor vehicle lighting Directives were adopted. This represents a significant step towards whole vehicle type approval for cars, which now awaits agreement on a dozen or so further Directives.

69. In July the Commission published important new proposals on transport infrastructure. Under these proposals a committee of officials from Member States would be created to examine proposed infrastructure projects of Community interest and financial assistance could be made available towards the the cost of such projects.

70. In November the Council of Transport Ministers agreed that the system of Community Quotas for international road haulage shall become a permanent arrangement and that the level of quota for 1977 should be the same as for 1976. The Council also adopted a Directive on the minimum level of training for certain road transport drivers.

Section VIII. Social Affairs

71. Consideration continued of a number of further measures in the Community's social action programme, including the draft Directive on the protection of workers in the event of mergers etc (the " acquired rights " Directive), which was debated in the House of Lords on 8 April and in the House of Commons on 17 June, and the draft Directive on the education of migrant workers' children which was debated in both Houses on 10 June.

Social Fund

72. Applications totalling £124 million have been made by the United Kingdom for assistance from the Social Fund for 1976. Allocations amounted to £24 million up to the end of October.

Consultations with representatives of Employers and Unions

73. The Standing Committee on Employment met on 18 May. The exchange of views covered Community action to encourage the employment of young people, the problem of illegal immigration and preparations for the Tripartite Conference on 24 June. It will meet in December to continue discussions of measures to deal with unemployment.

Studies under Article 118

74. In July the Council of Foreign Ministers adopted the Commission's Guidelines for the Development of a Permanent Information System on Social Security in Agriculture.

Section IX. Education

75. Work is continuing on the development of the programme of educational co-operation outlined in the Education Ministers' Resolution of February 1976. Within the United Kingdom, a small pilot project has been started in Bedfordshire to provide teaching for the children of immigrants in their mother tongue and about their culture.

76. At a meeting in November, Education Ministers passed a Resolution providing guidance to Governments on measures to improve educational provision for young people in the transition from school to working life; and to set up a programme of action at Community level for the evaluation and development of national policies in this field.

Section X. Research

77. Following the discussion of guidelines for the 1977/1980 programme of the Joint Research Centre (JRC) the Commission put detailed programme proposals to the Council in May. Ministers responsible for research questions met in October and November to discuss the JRC programme and to resume discussion of the proposal to construct a major tokamak device, the Joint European Torus (JET). In the light of these discussions the Commission are preparing revised proposals for a somewhat reduced JRC programme. Useful progress was made on a number of administrative and financial questions related to JET but further consideration is to be given to its site, for which Culham is a strong candidate.

Section XI. Energy

78. The Council of Energy Ministers met on 19 October for a general discussion of the Community's Energy Policy on the basis of a Commission Communication on the medium term prospects in the energy sector and the need for Community action. This was generally agreed to provide a good basis for further work by the Council. The Council reiterated its fundamental objective of reducing the Community's dependence on imported energy, and asked the Presidency to draw up a programme of work for further meetings of the Energy Council, which should meet again when it appeared possible for decisions to be taken on some of the current topics.

Section XII. Institutional Matters

The Tindemans Report

79. Following the agreement at the European Council on 1–2 April that Foreign Ministers should study the recommendations in the Tindemans Report, Foreign Ministers have considered the report at subsequent meetings. Their views were generally endorsed on 29–30 November by the European Council which agreed to have a yearly look at the progress achieved in various fields.

Direct elections to the European Assembly

80. Foreign Ministers continued their work on the draft Community agreement providing for direct elections to the European Assembly. At the July meeting of the European Council, the major decision on the distribution of seats between the Member States was taken. The United Kingdom will have 81 seats in an Assembly of 410. Subsequent meetings of Foreign Ministers settled the remaining questions thus paving the way for signature of the agreement on 20 September. The full text of the Decision and Act was published in a White Paper (Command 6623) in the European Communities series on 11 October.

81. Meanwhile the Select Committee on Direct Elections in their second and third reports (published on 3 August and 25 November) made a number of recommendations concerning the implementing legislation, the electoral system for the first elections, the procedure to be used for the definition of constituency boundaries and the allocation of seats between the constituent parts of the United Kingdom. The Government are considering these recommendations. The Queen's Speech delivered on 24 November referred to the Government's intention to introduce legislation during the current session of Parliament to make provision for direct elections.

Right of Establishment

82. Work has continued on the mutual recognition of qualifications and the co-ordination of other measures to enable professional people to be employed and to practice anywhere within the Community. Proposals concerning lawyers, nurses, midwives and architects are under consideration.

Passport Union

83. Progress has been made towards the adoption of a uniform style for the national passports of Member States. There are still detailed matters concerning the design and layout to be settled by further discussion. Most Member States expect to be in a position to introduce the uniform style of passport in 1978, although the date of introduction in the United Kingdom remains open.

Special Rights

84. In accordance with the Communique of the Heads of Government meeting in Paris in December 1974, a study has been undertaken of the possibility of granting EEC nationals residing in other Member States certain special rights. It has been decided to concentrate first on the right to vote in local government elections. Other matters, such as freedom of expression and freedom of association, may also be considered.

European Court of Justice

85. The Government have continued to examine cases coming before the European Court with a view to identifying those which raise questions of interest to the United Kingdom. During the period under review, the United Kingdom has intervened, for the first time, in a direct action. Observations were submitted in a further five cases, two of which were the first references to the European Court under the Interpretation Protocol to the EEC Judgements Convention. The Court accepted submissions by the United Kingdom to the effect that, although not yet parties to the Convention or the Protocol, the new Member States were entitled to submit observations.

86. On 15 June 1976 the Court gave its ruling in the case of *EMI Records* v *CBS*, a case referred to it by a Court in the United Kingdom. On the substance of the case the Court's ruling upheld the view advanced by the Government that Community law does not prohibit the proprietor of the same trade-mark in all the Member States of the Community from exercising his rights so as to prevent infringements from third countries. Among the cases on which the Court gave a ruling during the period under review, *Defrenne* v *Sabena* (concerning equal pay), *Watson and Belmann* (relating to the rights and duties of EEC nationals visiting other member countries) and three linked cases concerning national catch quota arrangements for fisheries all raised issues of considerable importance to the United Kingdom. The Court's rulings in these cases may be regarded as generally satisfactory from the point of view of the United Kingdom and as justifying the Government's decision to intervene in them.

Economic and Social Committee

87. In October Mr. B. de Ferranti was elected President of the Committee for the next two years.

Section XIII. Parliament and the European Community

88. On 19 May 1976, the House of Commons debated the procedures for scrutiny of EEC documents and for debate of those recommended by the Scrutiny Committee. The Lord President of the Council undertook in that debate to make a further statement of the Government's views. In a written answer given on 4 August, the Lord President outlined the Government's proposals for changes in procedures. The Government has acknowledged the need for the backlog of outstanding items for debate to be reduced as far as Parliamentary time permits, and for proposals for EEC legislation to be debated at an early stage. Arrangements are being made for the House to be informed of changes in the substance of proposals involving major policy developments so that the Scrutiny Committee may have the opportunity to examine them further.

89. From 1 May to 30 November 1976, the House of Commons Scrutiny Committee examined and reported on 410 Community documents, and the House of Lords Scrutiny Committee on 398. Of these, the House of Commons Committee recommended that 88 documents were sufficiently important to warrant further consideration by the House. The House of Lords made similar recommendations so far as 24 documents were concerned. Debates on 58 documents recommended by the Scrutiny Committee were held in the House of Commons during the period in question, and debates on 14 documents similarly recommended took place in the Lords. Reference to some of these debates has been made in the preceding paragraphs.

30 November 1976

MEETINGS OF THE HEADS OF GOVERNMENT OF THE NINE EEC MEMBER STATES

Date	*Location*	*Ministers attending*
12–13 July 1976	Brussels	The Right Hon. James Callaghan, M.P. Prime Minister
		The Right Hon. Anthony Crosland, M.P. Secretary of State for Foreign and Commonwealth Affairs
29–30 November 1976	The Hague	The Right Hon. James Callaghan, M.P. Prime Minister
		The Right Hon. Anthony Crosland, M.P. Secretary of State for Foreign and Commonwealth Affairs

MEETINGS OF THE COUNCIL OF MINISTERS

Date of Council	*Session*	*Ministers attending*
3–4 May 1976	Foreign Affairs	The Right Hon. Edmund Dell, M.P. Secretary of State for Trade
		The Right Hon. Roy Hattersley, M.P. Minister of State for Foreign and Commonwealth Affairs
		Mr. John Tomlinson, M.P. Parliamentary Under-Secretary of State for Foreign and Commonwealth Affairs
17 May 1976	Finance	The Right Hon. Denis Healey, M.P. Chancellor of the Exchequer
17–18 May 1976	Agriculture	The Right Hon. Fred Peart, M.P. Minister of Agriculture, Fisheries and Food
		Mr. Robert MacLennan, M.P. Parliamentary Under-Secretary of State, Department of Prices and Consumer Protection
31 May–1 June 1976	Foreign Affairs	The Right Hon. Roy Hattersley, M.P. Minister of State for Foreign and Commonwealth Affairs
21–22 June 1976	Agriculture	The Right Hon. Fred Peart, M.P. Minister of Agriculture, Fisheries and Food
29–30 June 1976	Foreign Affairs	The Right Hon. Anthony Crosland, M.P. Secretary of State for Foreign and Commonwealth Affairs

Date of Council	*Session*	*Ministers attending*
19–20 July 1976	Foreign Affairs	The Right Hon. Anthony Crosland, M.P. Secretary of State for Foreign and Commonwealth Affairs The Right Hon. Roy Hattersley, M.P. Minister of State for Foreign and Commonwealth Affairs
19–20 July 1976	Agriculture	The Right Hon. Fred Peart, M.P. Minister of Agriculture, Fisheries and Food Mr. Robert MacLennan, M.P. Parliamentary Under-Secretary of State, Department of Prices and Consumer Protection
22 July 1976	Budget	Mr. Robert Goldsmith, CMG U.K. Deputy Permanent Representative to the European Communities represented the United Kingdom
26 July 1976	Finance	The Right Hon. Harold Lever, M.P. Chancellor of the Duchy of Lancaster
27 July 1976	Foreign Affairs	The Right Hon. Roy Hattersley, M.P. Minister of State for Foreign and Commonwealth Affairs
9 September 1976	Agriculture	The Right Hon. Fred Peart, M.P. Minister of Agriculture, Fisheries and Food
20 September 1976	Foreign Affairs	The Right Hon. Anthony Crosland, M.P. Secretary of State for Foreign and Commonwealth Affairs The Right Hon. Dr. David Owen, M.P. Minister of State for Foreign and Commonwealth Affairs
20 September 1976	Finance	The Right Hon. Harold Lever, M.P. *Chancellor of the Duchy of Lancaster*
4–5 October 1976	Agriculture	The Right Hon. John Silkin, M.P. Minister of Agriculture, Fisheries and Food Mr. Robert MacLennan, M.P. Parliamentary Under-Secretary of State, Department of Prices and Consumer Protection
18–19 October 1976	Foreign Affairs	The Right Hon. Anthony Crosland, M.P. Secretary of State for Foreign and Commonwealth Affairs The Right Hon. Bruce Millan, M.P. Secretary of State for Scotland The Right Hon. Dr. David Owen, M.P. Minister of State for Foreign and Commonwealth Affairs

Date of Council	*Session*	*Ministers attending*
19 October 1976	Energy	The Right Hon. Anthony Wedgwood Benn Secretary of State for Energy Dr. Dickson Mabon, M.P. Minister of State, Department of Energy
21 October 1976	Fiscal	Mr. Robert Sheldon, M.P. Financial Secretary, Treasury
21 October 1976	Research	Mr. Gerald Kaufman, M.P. Minister of State, Department of Industry Mr. Alexander Eadie, M.P. Parliamentary Under-Secretary of State, Department of Energy
25–26 October 1976	Agriculture	The Right Hon. John Silkin, M.P. Minister of Agriculture, Fisheries and Food The Right Hon. Joel Barnett, M.P. Chief Secretary, Treasury Mr. Robert MacLennan, M.P. Parliamentary Under-Secretary of State, Department of Prices and Consumer Protection
4 November 1976	Transport	Mr. Stanley Clinton Davis, M.P. Parliamentary Under-Secretary of State, Department of Trade
8 November 1976	Finance	The Right Hon. Denis Healey, M.P. Chancellor of the Exchequer
8 November 1976	Development Co-operation	Sir Donald Maitland, C.M.G. U.K. Permanent Representative to the European Communities represented the United Kingdom
15–16 November 1976	Foreign Affairs	The Right Hon. Anthony Crosland, M.P. Secretary of State for Foreign and Commonwealth Affairs The Right Hon. Dr. David Owen, M.P. Minister of State for Foreign and Commonwealth Affairs Mr. Edward Bishop, M.P. Minister of State, Ministry of Agriculture, Fisheries and Food Mr. Hugh Brown, M.P. Parliamentary Under-Secretary of State, Scottish Office Mr. John Tomlinson, M.P. Parliamentary Under-Secretary of State for Foreign and Commonwealth Affairs

Date of Council	*Session*	*Ministers attending*
18 November 1976	Research	Mr. Alexander Eadie, M.P. Parliamentary Under-Secretary of State, Department of Energy
22 November 1976	Finance	Sir Donald Maitland, C.M.G. U.K. Permanent Representative to the European Communities represented the United Kingdom
22–23 November 1976	Agriculture	The Right Hon. John Silkin, M.P. Minister of Agriculture, Fisheries and Food
		The Right Hon. John Morris, Q.C., M.P. Secretary of State for Wales
		Mr. Gavin Strang, M.P. Parliamentary Secretary, Ministry of Agriculture, Fisheries and Food
		Mr. Robert MacLennan, M.P. Parliamentary Under-Secretary of State, Department of Prices and Consumer Protection
23 November 1976	Budget	The Right Hon. Joel Barnett, M.P. Chief Secretary, Treasury
29 November 1976	Education	The Right Hon. Shirley Williams, M.P. Secretary of State for Education and Science and Paymaster General
		Mr. Alec Jones, M.P. Parliamentary Under-Secretary of State, Welsh Office

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7 December 1976

CABINET

SCOTLAND AND WALES BILL - POST-ASSENT REFERENDA

Memorandum by the Lord President of the Council

INTRODUCTION

1. Second Reading of the Scotland and Wales Bill will take place on 13-16 December inclusive. The Ministerial Committee on Devolution Strategy has already given some consideration to the Bill's Parliamentary handling at their meeting on 16 November (DVY(76) 5th Meeting); they rejected the possibility of referenda before Parliament considered the Bill but deferred a decision about the desirability of referenda after the Bill had completed its passage until a more up to date assessment of Parliamentary opinion had been made.

2. There is now a fairly widespread expectation among the Press and general public that there should and will be some form of referenda on the devolution question and Ministers have already promised that if proposals are made during the Bill's passage for referenda at a later stage, the Government will consider them. An Early Day motion calling for referenda before the Bill is introduced has been signed by 76 Government backbenchers.

3. I believe that we should offer referenda in Scotland and Wales, post-Assent to the Bill; and that we should announce this on Second Reading. Reasoned amendments have already appeared on the Order Paper with more than 30 signatures, declining to give a Second Reading to the Bill "unless a referendum is held before the Bill comes into effect to ascertain the wishes of the people of Scotland and Wales". It is clear therefore that the issue is going to be raised again and again during Second Reading, and for a substantial number of MPs may become the criterion by which they decide whether or not to vote for the Bill. For a constitutional Bill of this nature it is important to have a substantial majority at Second Reading, and I believe the offer of referenda will significantly increase that majority.

4. I also believe that the decision to offer referenda will be widely welcomed in Scotland and Wales, and that the referenda themselves will show that there is substantial support for our devolution package.

TIMING OF ANY CONCESSION

5. If the promise of referenda is to be used as a bargaining counter, it should be deployed at the stage in the Bill's passage where it is likely to be of most value.

6. To announce post-Assent referenda during the Second Reading Debate would have the advantage that the Government would be making a generous, not a grudging, concession: an announcement in the opening speech would have a certain dramatic quality, or in the winding-up speech it could be seen to be taking account of the views expressed during the debate.

7. On balance, I believe we might get the most benefit by indicating, at the opening of Second Reading, that we saw a great deal of weight in the case for referenda; and then, subject to views expressed in the debate, by announcing firmly during the winding up that we would table proposals for post-Assent referenda, in Scotland and Wales only, on the proposals as they emerge in the Bill. (We need not, at that stage, commit ourselves on whether there might be a further question on separation or on any other details about how the referenda might be conducted).

8. Restricting the referenda to Scotland and Wales will be of crucial importance. The inclusion of England might well lead to a hostile overall vote, dominated by the large English majority. In proposing referenda we must therefore be satisfied that we shall be able to put through the proposal in a form that limits the voting to Scotland and Wales. Amendments that committed us to United Kingdom-wide referenda would, in my view, be worse than no referenda at all.

CONCLUSION

9. I invite my colleagues to agree:

a. that referenda on devolution are now inevitable;

b. that it would be helpful if it were made clear at the beginning of the Second Reading debate that the Government were sympathetic to the idea of post-Assent referenda;

c. that an announcement should then be made at the end of the Second Reading debate that the Government would table proposals for referenda in Scotland and Wales, to be held after Royal Assent, on the proposals approved by Parliament.

M F

Privy Council Office

7 December 1976

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13 December 1976

CABINET

ECONOMIC MEASURES AND THE IMF

Note by the Chancellor of the Exchequer

1. I attach a draft of the Statement to the House which I wish to make on Wednesday 15 December.

2. The Statement in its present form is subject to minor alteration of language and of presentation and in particular it does not include figures of the individual savings. These are to be listed in a table to appear in the Official Report, a copy of which is attached. I am still considering how best figures or details could be added to the Statement itself.

D W H

Treasury Chambers

13 December 1976

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1. With permission Mr. Speaker, I shall make a statement about the further measures which the Government are taking to promote the Nation's economic recovery and to achieve the fastest possible return to a high and sustainable level of employment.

2. The measures I announced to the House on July 22nd aimed to ensure that the essential increase of output, exports and investment in our manufacturing industry was not threatened by excessive borrowing in the public sector. Their objective was to get the PSBR down to £9 billion in 1977/78 or about 6% of GDP as then forecast at current market prices.

3. Since then the economic outlook, both of Britain and the world as a whole, has darkened considerably. Nearly all industrial countries suffered a check in their economic recovery during the summer; and, although recovery has resumed they foresee a lower growth next year both in their trade and output than they expected a few month's ago. Since Britain's growth must be based primarily on exports the lower increase in world trade must by itself reduce the prospects for growth in the British economy. In addition, sterling has had a very troubled year, and since July has depreciated again. During October

/ this

this further depreciation was as much as 12 per cent, though recently sterling has improved and this figure is back to 6 per cent. Even at this level, the depreciation worsened the outlook for inflation and will tend to reduce domestic demand in real terms. Moreover, the difficulty we faced during the last summer in financing the public sector borrowing requirement by means which did not refuel inflation has required us to increase interest rates to levels which, if they had to be maintained without any clear prospect of relaxation, could have serious consequences for industrial activity and investment.

4. These developments have undermined business confidence and damaged the prospects for inflation and employment. The combination of lower growth and higher interest rates now make it likely that without further action the PSBR next year would be about £10½ billion as against the £9 billion we expected following the July measures. Moreover, this increase in the money value of the PSBR represents a bigger increase in the share it takes of GDP, since GDP is likely to be lower. We therefore need to make adjustments in our plans which will keep our economic recovery on course and restore confidence both at home and abroad. We must be able to avoid the sort of pressure on the exchange rate we have seen this year and re-establish control over domestic monetary conditions while looking forward to a

gradual but steady decline in interest rates. Both of these objectives require us to reduce the size of the PSBR as now foreseen.

5. Meanwhile we need to replenish our reserves after repaying our drawings of $1.545 billion on the swap facility set up in June. We must also finance the external deficit still to be expected next year before the increase in oil production from the North Sea and our increasingly effective competition with foreign products, both in domestic and international markets, move our balance of payments into substantial surplus by 1978. It is for these reasons that the Government have applied for a standby credit from the International Monetary Fund and begun talks about the sterling balances. A successful outcome of these discussions will in itself give us much more stability in the exchange markets and help to restore both internal and external confidence.

6. If, on the other hand, we were to fail in making the necessary adjustments to our plans, then we would

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fail to satisfy our financing requirement at home and abroad. Such a failure would destroy all our hopes of achieving our objectives for economic recovery and a return to higher employment. In that case all the sacrifices we have made in the last few years would have been in vain, all the gains we have already achieved in the social and economic fields would have gone to waste.

7/8 The Government is determined that the necessary adjustments shall be made - and that they shall be sufficient to guarantee success. But it is determined also that in making these adjustments it does not jeopardise either the Social Contract on which the fight against inflation must depend or put at risk the industrial strategy which is the foundation of our hopes for reversing the decline in the relative performance of our manufacturing industries. For this reason, though painful reductions in expenditure must be sought in many areas, the Government will be increasing expenditure on further measures to help employment and on industry. And it has decided to spread the adjustment needed over two years not one, so that the reductions in public expenditure are greater in the second year when output is

/likely..

likely to be rising faster. We are therefore concerned to see that resources freed by reductions in lower priority expenditure should be absorbed as fast as possible in productive industry. The measures I shall now describe will cover the next two years. But we need a medium programme for national recovery to ensure that we enter the 1980's with the prospect of an economy fully restored to balance, with high levels of output, employment and real wages and an industry which is vigorous, expanding and profitable.

5

Reduction in the Public Sector Borrowing Requirement

9. The immediate objective of the measures which I am announcing this afternoon is to reduce the public sector borrowing requirement to about £8.7 billion in 1977/78 and somewhat lower in money terms in the following year. Expressed as a percentage of GDP it will fall steadily, from 9% in the current year to 6% in 1977/78 and 5½% in 1978/79. On this basis we can look forward to a steady reduction in the rate of domestic credit expansion, accompanying and reinforcing the reduction in the rate of inflation, from a figure now put at £9 billion in the current year to some £ 7.7 billion next year and £ 6 billion in 1978/79.

10. These objectives are calculated on the basis of the economic prospect as I now see it. If the forecasts at the time show the economy growing from the beginning of 1978 to the end of 1979 at a rate of more than 3½% a year, I intend to make a further fiscal adjustment in the 1978 Budget - of between £½ billion and £1 billion, depending on the buoyancy of demand at that time - to ensure that domestic conditions do not obstruct the shift of resources into exports and investment.

7

Expenditure or Taxation

11. The fiscal adjustment in both years will come mostly from savings in public expenditure rather than increases in taxation. This is for two reasons. First, although the level of our public expenditure, as a proportion of GPD, is no higher than in some other industrialised countries, it has grown much more rapidly in recent years than our industrial output, and our industrial output itself is relatively low. Second, and perhaps this is not unconnected with our low level of industrial output, people at work are already highly taxed on their incomes, and face a further drop in their living standards in the coming year. I do not believe it would be right to burden them with the lion's share of the fiscal adjustment which is now necessary; and inadequate financial incentives to work and to invest could put our economic recovery at risk.

12. Savings in public expenditure must therefore produce by far the greater part of the adjustment needed. On the other hand, the savings needed are on nothing like the draconic scale suggested by some outside commentators. I think that there has been a growing consensus among responsibl economists that savage and indiscriminate cuts of that order

would do irreparable damage both to the structure of our social services and to the prospects for employment. They would imply a massive and immediate contraction of demand which is the last thing British industry wants to see at present.

Public Expenditure

13. The White Paper which we published in February this year set our medium-term strategy for public expenditure.

14. Pursuing this strategy, we have held expenditure in this financial year within the planned level by the rigorous application of cash limits, new arrangements for regular consultation with the local authorities, and our determination to keep within the contingency reserve. We have also carried out the 1976 public expenditure Survey on the basis of keeping within the White Paper plan for each year, taking account of our July measures as far as 1977/78 is concerned.

15. In order to achieve the PSBR and DCE targets to which I have referred, we have now decided to reduce public expenditure programmes further by £1 billion in 1977/78 and £1½ billion in 1978/79 at 1976 Survey prices. The details are being circulated in the Official Report and are available in the Vote Office, but I will now describe the main changes.

16. Once again we have avoided mechanical cuts across the board and have not reduced the main social security benefits, although we are concerned about the narrowing gap between them and the income of those in work. Public service pensions will, however, produce a cash saving, by uprating at less than full indexation in line with prices as is at present required by the 1971 Act. Further economies will be made in expenditure on the Civil Service both this year and next. Local Authority current expenditure is now more strictly influenced by the central government through the recent reduction of the main RSG from 65% to 61% in 1977/78. We are not re-opening that settlement.

Local Authority Capital Expenditure

17. But there will be a reduction in housing capital investment by local authorities, housing associations and new towns. This programme has grown rapidly, and without these adjustments there would have been a substantial overspend both in 1977/78 and in 1978/79.

18. New construction will be suspended or curtailed in several other central and local government programmes, including roads, other environmental services, school building, Government accommodation, and capital spending by the Water Authorities.

Community Land Act

19. Borrowing approvals will be reduced to achieve a slower build-up of land acquisitions under the Community Land Act.

Food Subsidies

20. The planned programme for phasing out the Government's food subsidies will be accelerated and will be completed in 1977/78. The effect of this acceleration on the index of Retail Prices will be ¼ of 1 %.

The Defence Budget

21. In an exercise of this magnitude, spending in support of our external policies must inevitably play its part. Despite the big cuts which we have already made in defence expenditure, we cannot achieve the necessary reductions in public expenditure and the PSBR without a major contribution from the Defence Budget. The Secretary of State for Defence will make a further statement in due course.

Overseas Aid

22. There will be reductions in the provision for overseas aid which, until now, has been almost entirely protected from expenditure savings. The Government have taken this decision with great reluctance. But the Aid Programme will continue to increase substantially in cash terms, and we do not expect any reduction next year in the proportion of GNP devoted to aid.

Nationalised Industries

23. Under the new treatment of the nationalised industries on which we have consulted the Expenditure Committee, we shall in future be including in public expenditure the Government finance for these industries, rather than their investment programmes as such. We intend to agree with the industries action which will reduce this Government financing through increases in revenue as well as economies in spending.

Regional Employment Premium

24. As I told the House in July, the Government wants to move progressively towards a more selective approach towards assistance for industry.

It is doubtful whether REP now fulfils the original purpose of attracting employment to the regions. We therefore believe that it should now give way to more selective measures and it will be withdrawn by Statutory Order early in the New Year. I shall be describing in a moment other measures in the industrial field designed to assist employment and investment.

Export Credit

25. The refinancing by the Government of fixed rate export and shipbuilding credit imposes a major charge on public expenditure and the PSBR. This has been growing rapidly, and is now forecast to exceed the figures in Cmnd. 6393. Partly to deal with this, I have asked the clearing banks to finance from their own resources an additional £100 million of fixed rate sterling business in each of the next two years and I am glad to say they have agreed in principle to do so. It remains a vital part of our economic strategy to encourage exports; but we believe that a lot can be done to reduce the burden of medium and long-term export credit on public expenditure, the PSBR and the balance of payments by financing in foreign currency instead of sterling. We are therefore taking steps to facilitate the use of foreign currency financing and to control the rate at which new offers of fixed rate sterling finance will be approved by ECGD with the aim of reducing expenditure on refinancing by £100 million in 1977/78 and £200 million in 1978/79, below that shown in Cmnd. 6393. While on the subject of exports I should add that the Government are aware of the concern of industry about the future of the cost escalation scheme which, as matters stand, is due to end in March 1977. We now propose that it should be continued for a further year.

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The necessary draft order will be laid before the House in due course. Our intention is to maintain the present terms of the scheme for eligible contracts financed in foreign currency or sold for cash. However, as an encouragement to financing in foreign currency the minimum thresholds of cover applicable to contracts financed by sterling credit will be increased by 2 per cent.

26. Revised expenditure programmes for 1977/78 and 1978/79, taking account of these measures and of other adjustments made during the public expenditure Survey, will be set out in the public expenditure White Paper in due course. These decisions will reduce planned expenditure by a little over £1 and £1½ billion in the next two financial years.

/ 27.

Measures to Help Employment and Investment

27. On the other hand, we have decided to add to expenditure in two areas which we believe should have the highest priority - incentives to increase industrial investment and expansion, and measures to reduce unemployment.

28. There will be a big increase in the resources of the National Enterprise Board and the Scottish and Welsh Development Agencies. A new selective investment scheme will be introduced to follow the very successful Accelerated Projects Scheme. It will give help to manufacturing companies for major projects designed to improve capacity and performance. I will allocate £100 million to this scheme in the first instance; the rate at which this is spent will depend on how many good schemes come forward for support. The money will be spent over a period of years. Further money will also be made available for additional sectoral schemes in support of the industrial strategy, and for other measures to help industry. Taken together, I have allocated £80 million in each of the next 2 years for these purposes.

29. There will be an increase of £120 million in 1977/78 in spending on measures to reduce unemployment. New applications for the Temporary Employment Subsidy are due to close at the end of this month and for the Job Creation Programme shortly after. We have decided to extend these two schemes to the end of April, and then to review their future along with the other new schemes which the Government

has recently introduced. This additional expenditure will fully offset the impact on unemployment during 1977 of the other measures which I have announced and will mean that the net effect of the whole package will be to reduce unemployment next year.

Indirect Taxation

30. To finance the additional expenditure on investment and employment, I must look for some contribution from the specific Revenue duties, which are fixed in money terms and are therefore continually eroded by inflation.

31. I have decided to use my Regulator powers to increase by 10 per cent all the revenue duties charged on tobacco and alcoholic drinks. The increases will come into force for the Customs duties on imported tobacco at midnight tonight, and for the duties on tobacco products and drinks on 1 January. They will have no effect on prices during the Christmas and New Year holidays.

32. If fully passed on, these duty increases, taking into account the consequential increase in VAT, will add rather over ½ per cent to the RPI. They will raise the tax charge on a pint of beer of average strength by a little under 1p, and on a standard bottle of spirits by about 31p.

They will increase the charge on a standard bottle of table wine by about 5p, and on a bottle of fortified wine such as sherry by about 7p. The tax on a packet of 20 filter cigarettes of average size will be increased by about 4p. The additional revenue raised will be £50 million in the remainder of this financial year and £280 million in 1977/78.

33. I believe the British people will accept these increases in the cost of less essential goods are unjustified at this time, particularly when the proceeds are intended to create more jobs and more investment.

Sale of BP Shares *

34. There is one further step which we proposed to take to reduce the Public Sector Borrowing Requirement in 1977/78. Two years ago the Government rescued the Burmah Oil Company from severe financial difficulties, and as part of a package of support the Bank of England bought Burmah's holding of shares in the British Petroleum Company. These shares amounted to just over 20% of BP's issued ordinary stock; taken together with the Government's existing holding there is now 68% of this stock in public hands.

* Provisional: see Mr. Lord's submission of 10 December

35. We now propose to sell enough of Burmah's former shareholding in BP to reduce this total holding to 51%. The acquisition of the ex Burmah BP shares counted as public expenditure at the time and it is reasonable that we should take credit for the sale as part of our present measures. As the House will be aware, the Burmah Oil Company have instituted proceedings against the Bank of England for the return of the BP shares which they formerly held. Although we are advised in the firmest terms that Burmah's claim is without merit, so long as it is being pursued it may prove an impediment to a successful sale. We therefore hope that the Company can be persuaded to withdraw the claim or to change its form so that it becomes a suit for damages rather than for restitution. But if the impediment is not removed, the Government will sell an equivalent number of BP shares from their original holding, and in due course will make good their holding by transferring to the Treasury an equivalent amount of the BP stock acquired from the Burmah Oil Company and now held by the Bank of England.

Incomes Policy

36. The twin pillars of the Government's economic strategy are the Social Contract with the trade union movement and the industrial strategy. It has been, and continues to be, a common objective of the Government and the TUC to continue the attack on inflation. By the middle of 1977 most of the effects on our price level of the sharp depreciation of sterling between March and October of this year will be behind us, and inflation should once more start falling. To maintain a continued fall in inflation through 1978 we shall need agreement between the TUC and the Government on how to pursue the attack on inflation while permitting greater flexibility in pay negotiation in the period after July 1977. I hope it will be possible for us to reach agreement on this in time for me to take account of the outcome in settling the levels of income tax in the next Budget.

37. If, at the time I settle my Budget for 1977-78 I judge that we have over-estimated the size of the adjustment needed to reduce the PSBR to £ 8.7 billion and if, as I expect, a satisfactory agreement has been reached with the TUC and the CBI on the next pay round, then I propose to use the available margin to reduce the present burden of income tax which I believe to be too heavy, especially at the higher and lower earnings levels.

38. In this context there are also important questions, which I shall want to consider with the TUC and other interested bodies, concerning the interlocking effects of changes in earnings, social security benefits and rates of direct and indirect taxation.

Taxation of Export Earnings

39. There is one aspect of taxation which I would like to start considering at once. I believe it is important to find ways of improving the tax treatment of employees who live in this country but who work abroad on increasing our exports. The people I want to encourage are those at the sharp end of exporting - the business of selling British goods overseas - as well as those who contribute to our overseas earnings by working for a period overseas, for example in construction projects. I have therefore asked the Inland Revenue to issue a Consultative Paper which will outline proposals to give the reliefs which are at present allowed

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to those with separate jobs abroad to anyone who works for a period abroad, and which will also modify the rules governing the allowance of expenses incurred abroad. I have authorised them to seek the views of interested bodies, with a view to legislation being included in next year's Finance Bill.

Domestic Monetary Effects

40. I have already described the targets for the PSBR which we have set for 1977-78 and 1978-79 in order to create monetary conditions which will encourage investment and growth and will help to control inflation. We are also setting monetary targets expresse in terms of Domestic Credit Expansion rather than money supply During a period when we shall be seeking to put our balance of payments right, this will be more appropriate than a target for M3. The IMF agree with this view.

41. DCE will be kept to £[9]billion in the year up to 20th April 1977 and £[7.7]billion in the year ending 19th April 1978, and I expect a further reduction in the following year to £[6.0]billion. The growth of M3 which will accompany DCE at these rates will depend on a number of factors, especially progress on the balance of payments. For 1976/77 again on a banking month basis the growth of sterling M3 is likely to be between 8% and 13%. It is too early to give an

/ estimate

estimate for 1977/78. But our targets will now be in terms of DCE.

42. The major reduction in the PSBR between this year and next means that the financing needs of the public sector will make a smaller demand on the available savings of the community. These targets for DCE should, therefore, provide sufficient room for the essential needs of industry for investment and industrial expansion. I have made it clear in the Letter of Intent that I will review the targets in 6 months time to ensure that that is so. It will, however, continue to be necessary to ensure that monetary conditions do not imperil our other policies. The Supplementary Special Deposits scheme which I recently re-activated will contribute substantially to this. Technical adjustments in either direction may be needed in the Special Deposits field, depending on our success with gilt sales. Their aim will be to preserve orderly conditions in the money markets without relaxing control over liquidity and the monetary aggregates. I also hope that our success with the IMF application and the measures I am now announcing will make it possible to maintain control of the monetary aggregates while reducing interest rates from present exceptional levels. The reduction may need to be limited in the first instance but should gather force as our policies are seen to succeed in turning round the balance of payments and securing a further restoration in the rate of inflation.

Summary

43. To sum up, the Government's measures amount to a total fiscal adjustment of £1½ billion in 1977-78. In addition, the PSBR will benefit from the reduced cost of debt interest resulting not only from the lower borrowing requirement, but also from the lower level of interest rates to which I am confident that these measures will lead. On this basis, taking account of the change in our prospects since last summer, I forecast that the PSBR will be within the target of £8.7 billion described in the Letter of Intent.

/ 44. For 1978-79

44. For 1978-79 the fiscal measures I have described take us most, but not all of the way, towards the PSBR target of that year. A further fiscal adjustment of about £½ billion will be needed to achieve the target. It is far too soon to say whether that adjustment would be most appropriately put
taxation of
on/public expenditure. That will not be considered till well over a year from now.

The Economic Prospect

45. I now turn to the economic effects of the measures. Taken by themselves without regard for their consequences on the behaviour of the economy as a whole, the reductions in public expenditure and increases in Revenue duties would tend to reduce growth and employment; on the other hand the further measures which we are taking to reduce unemployment and encourage investment will have an opposite effect. The conventional economic arithmetic would show an increase in unemployment next year of about [40,000] from the first set of measures and a reduction in unemployment of about [60,000] from the second. So on balance the net effect of the package could be to reduce unemployment next year by up to [20,000]. The same conventional arithmetic would produce a figure of a net increase in unemployment of [100,000] by the end of 1978, if no further measures were taken meanwhile.

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But, as I have said, we shall be reviewing the future of Job Creation and temporary employment subsidy next April together with the possibilities of other schemes for reducing unemployment. Moreover the gradual fall in the interest rates which can be expected to follow the measures will in itself in due course generate more investment and more demand for goods like houses and consumer durables which are critically affected by the rate of interest.

46. However, it will be clear from what I have already said to the House, that this kind of arithmetic is seriously misleading in our present circumstances. If we are to make a true comparison, we have to consider what would have happened if the Government had failed to take the measures which the economic prospect requires. On that basis, the comparison is clear and unambiguous. The measures I have announced will enable us to regain control of our currency and to open up a firm path towards overseas balance, greater stability of prices, and fuller employment. These cannot be achieved overnight. But without

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the measures they could not be achieved at all.

47. Dr. Witteveen, the Managing Director of the International Monetary Fund, has told me that he supports both the economic strategy I have described and the measures the Government are taking. He will recommend the Executive Directors of the Fund to accept my request for a stand-by credit of $3.9 billion. I am circulating in the Official Report the text of my Letter of Intent to him.

47a. Before the Fund Board meets there will be a meeting of the so-called Group of Ten countries, who stand ready, under the General Arrangements to Borrow, to provide the Fund with the useable currencies it needs for large drawings if its own available currencies are inadequate. I am confident that, in a matter of days after the end of the year, the operation will be complete and the reserves replenished.

47b. The standby arrangements this time cover a two year period, so that we can have a steadier pace of adjustment. In total we shall be able to draw up to nearly $4 billion, of which about $1 billion immediately and about $1¼ billion more before the end of 1977 <u>or</u> over $1½ billion more during the financial year 1977/78. This, I am confident, will transform the external financing position in 1977.

[TO BE DRAFTED LATER]

48. [Safety net] ..... and I believe that this endorsement of our policies by the world's official monetary authority and by representatives of the world's strongest economies will relieve the pressures on sterling which have damaged our economic prospects in the last 12 months while the prospective arrangement for the sterling balances will help to relieve the risk of such pressures in future years. That alone should do much to restore the confidence on which all aspects of our economic performance critically depend. [The Government are releasing today the first economic forecast published under the

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provisions of the Industry Act 1975, and this will give the House a picture of the economic prospects following the measures I have announced. Over the next 12 months I expect a growth of total output of about 2%, more or less, depending primarily on our export performance. I do not see a prospect of a fall in unemployment; indeed I fear there is likely to be some further rise. But if so this will be the consequence, not of todays measures, but of the lower growth now expected all over the world and of the other factors I have already mentioned. The current account deficit, which has totalled £1.7billion in the first 11 months of this year is likely to fall next year and there is good hope of reaching a substantial surplus in 1978/79 - this could amount to £2-3billion.

Given continuing moderation in the increase in wage costs, the rate of price inflation should enter once again on to a downward path after the middle of next year, and in the second half of the year may be running at an annual rate of 16%.

49. Next year will be a difficult year of transition. I believe that the policies we are pursuing will ensure that it is a transition to a much more firmly

/based

based prosperity. We owe this opportunity in part to the development of North Sea oil production, but our economic strength depends also on the use we make of that opportunity. We must use it not only to resume the growth in our living standards but also - and in the long run this is more important - to rebuild the capital base of our manufacturing industry. I believe the late seventies and early eighties should be a period when a steady increase of output, employment and living standards is combined with the repayment of our external debt during the process of recovery. We shall at last be standing on our own feet, with an economy more healthy and efficient than we have seen at any time since the war.

50. It is in that belief that the Government have decided these measures, and that I commend them to the House.

SECRET

PUBLIC EXPENDITURE REDUCTIONS

£ million(1)

Programme No (where applicable)	Expenditure	1977-78		1978-79	
1.	Defence Budget	100		200	
2.	Overseas aid	50		50	
3.	Food subsidies	160		57	
4.	Regional employment premium	150		170	
	Refinancing of fixed rate export credits	100		200	
	Capital spending at OFEs for industrial training	10		10	
5.	Nationalised industries(2)	100		100	
6.	Road construction	75		50	
	of which - England		63.8		42.5
	Scotland		7.5		5.0
	Wales		3.7		2.5
7.	Housing	-20		300	
	of which - England		-18.0		255.0
	Scotland		-		30.0
	Wales		-2.0		15.0
8.	Regional water authorities construction	75		130	
	of which - England		63.8		110.5
	Scotland		7.5		13.0
	Wales		3.7		6.5
	Local environmental services construction and other capital	50		50	
	of which - England		42.5		42.5
	Scotland		5.0		5.0
	Wales		2.5		2.5
	Community land	35		35	
	of which - England		29.9		29.0
	Scotland		2.7		3.0
	Wales		2.4		3.0
9.	Courts - purchase of sites	2		-	
10.	Education - construction	22		11	
	of which - England		18.7		9.3
	Scotland		2.2		1.1
	Wales		1.1		0.6

(1) 1976 Survey prices except where otherwise stated

(2) Reductions in requirements for Government finance.

CP(76) 132

COPY NO 81

13 December 1976

CABINET

MARATHON (UK) LIMITED

Note by the Secretary of State for Scotland

I attach for consideration, a note about the very difficult situation which has arisen at the Marathon Oil Rig Yard at Clydebank. I am bringing this matter to Cabinet now because of the urgency: other current Ministerial commitments preclude prior discussion of my proposals by EI Committee.

B M

Scottish Office

13 December 1976

CONFIDENTIAL

CABINET

MARATHON (UK) LTD

Memorandum by the Secretary of State for Scotland

1. Marathon (UK) Ltd are now within days of completing their last order, a jack-up rig for Abu Dhabi which left their yard at Clydebank on 8 December for final fitting out on the lower reaches of the Clyde. They have no immediate prospect of further work and although a recovery in the market for exploration drilling rigs is expected before long, they therefore propose to pay off the bulk of the labour force of 1,400 and mothball the yard. The issue for Government is whether we wish to keep this company in existence in the UK to build drilling rigs. If so it will need Government support to stimulate orders until the market revives. The management have issued redundancy notices affecting 1370 employees with 1,050 to take effect on 17 December.

2. The company claim that, early in 1976, before the redundancy provisions of the Employment Protection Act came into force, they gave notice of redundancy to all their employees because of a shortage of work. They have taken the view that this notice still stands, and so they are not subject to the requirement of at least 90 day period for consultation with unions and notification of the Government. The Department of Employment, however, has doubts whether the company has satisfied the notification requirements, at least for the 400 employees until recently supported by the temporary employment subsidy: it does not know whether the unions would take a similar view with regard to the period of consultation, and whether they would then seek to enforce their rights to 90 days pay. If the company felt itself constrained to continue the employment of its whole labour force for the full 90 days, this would cost about £1m and could conceivably result in liquidation without even such preservation of facilities as would be achieved by mothballing.

3. The Marathon Company of Houston, an established rig building company in the United States, took over the Clydebank yard in July 1972 from Upper Clyde Shipbuilders following the bankruptcy. The company have concentrated on building oil exploration rigs of the jack-up type which is the standard instrument for exploration in water depths up to 300 feet. They have designs also for mini-semi-submersible rigs which they have not yet built but which would be suitable for drilling in deeper water. They are the only company in the United Kingdom manufacturing this type of equipment and their product is suitable for exploration drilling in the southern part of the North Sea, the Moray Firth, Cardigan Bay, the Celtic Sea and the South Western approaches. It has an important market overseas and all of the rigs made in Clydebank so far have been exported.

4. The company has, apart from Clydebank, two yards in the United States and one in Singapore. They have a high reputation for their equipment and their drilling rig is one of the leading designs on the world market. When they took over the Clydebank yard they were given substantial assistance by the last Government amounting to £6 million in loans and preference shares.

5. Despite losses in the early years which were aggravated in 1974 through the effects of the three day week, the company has made remarkable progress in improving their productivity and efficiency. At the outset a large rig took 820,000 man hours to build but by the end of 1975 this had been reduced to 690,000 - striking distance of the figure achieved by Marathon Singapore. With the exception of its first rig and a drillship conversion with which they started operations each of company's rigs has been built at a profit and delivered on time. A net trading profit of £134,000 was achieved in 1975 and the unaudited profit for the first six months of 1976 was £55,000 despite a shortage of work during part of that time. Despite the Clyde's reputation for labour difficulties the company managed to slim its labour force from 2,000 to the current level of 1,400 with only one total stoppage - 4 days in 1974 - since

the company began operations. This labour force is sufficient to build two rigs simultaneously in the yard and has therefore been substantially surplus to requirements in the last six months when the yards final order, the Abu Dhabi rig, was being completed.

6. The reason for the present difficulty is the world wide shortage of orders for all types of exploration drilling equipment. All of the company's yards are affected, not only Clydebank. When this situation became apparent in the early part of this year we provided a Government indemnity to assist the company in securing an order from Abu Dhabi. This order which is the final one now being completed has been ahead of schedule and productivity has remained good. Despite the uncertainty with no further work on the order book good industrial relations have been maintained and the Government indemnity will only be called upon to meet the cost of laying off labour in the event of no further work following on.

7. The company's main prospect of new work is an order for a rig on which it is negotiating with Petro Baltic, a Russian, East German and Polish consortium. The only competition is from Finland. Marathon rates its chances of success at 50:50, but does not expect a decision in less than three months. If in the meantime the yard were mothballed through lack of work its chances of securing the Petro Baltic order, or indeed any other, would be greatly reduced. Another possibility is a repeat order from the National Drilling Company of Abu Dhabi who have said that they will be placing an order for a specialist rig in 1977 worth $20 million and have indicated their hope to continue business with the Clydebank yard.

8. In the longer term there is a general agreement confirmed by Department of Energy assessments that the market for offshore drilling equipment will recover. As the world price of oil rises many countries are likely to intensify their exploration effort offshore and the offshore supplies office expect that the market for jack-up rigs, which are cheaper and less seriously

over-subscribed than semi-submersibles or drillships, will be the first to recover. It is hard to predict with any accuracy when this recovery will take place but a continued shortage of orders through the first half of 1977 seems inevitable.

9. If Marathon are to be kept in being at Clydebank and to have any chance of securing these valuable orders for our own offshore or for export when the recovery comes, some sort of bridging operation by Government would be required. The cost of placing an order would be approximately £12 million, but there would be a fair chance that the full cost of the order could in due course be transferred to Petro Baltic or some other customer. At worst there would be a completed rig available for charter and for eventual sale through which a substantial proportion of the cost if not the whole of it would be recovered. If on the other hand the yard is closed, in the present climate of high unemployment there will be a certain cost in unemployment pay and loss of tax revenue of £3-4 million a year without considering the secondary effects on suppliers of equipment. There could also be a claim of £½m on the Government indemnity to meet 50% of the cost of 90 days' wages due under the Employment Protection Act; and if the company goes into liquidation instead of meeting its share of the liability there would be a claim of about £1m on the redundancy fund.

10. I recognise the danger that our treatment of this yard may be thought to set a precedent for the shipbuilding industry which is beset by equally grim prospects. On the other hand our failure to act at Clydebank would have widespread political repercussions and would certainly greatly intensify pressure to avoid shipyard closures on the Clyde notably at Scotstoun whose record is in every respect much inferior to Clydebank.

11. I believe that Marathon is a special case which should be treated separately from general shipbuilding problems, both because the company is not included in our nationalisation plans and because it produces specialist equipment for the oil industry which is not made elsewhere in the UK. As the major oil producing

country in Western Europe it is a cause for criticism that our industry has not produced far more of the large number of rigs and drillships now used on our own waters. Quite apart from the important export opportunities there will plainly be further requirements for this equipment in support of our own developing oil and gas industries which will be a burden on our balance of payments if it all has to be imported. For this reason there are energy policy considerations as well as industrial grounds for ensuring the continued existence of the UK's only major producer of exploration rigs. For these reasons I propose that we maintain it on a minimum basis so that it will be there to take orders in the future. A condition of supporting it would be that the labour force be further cut from 1,400 to 800, the number that would be required for construction of a single rig instead of two simultaneously. If we could keep it going for nine months on this basis, there would be a good chance that it would survive to benefit from the market recovery.

12. In view of the energy considerations I suggest that the best way of ensuring continued work at Marathon is by asking BNOC to place an immediate order. BNOC has not developed exploration capacity as yet and would not readily place an order unless financed by Government to do so but they have a substantial stake now in a number of oil fields and will play an increasingly important part in development of the continental shelf in the years ahead. BNOC would be free to use the rig or to charter it in the event of it remaining unsold by the time of completion and their involvement would help to avoid setting an awkward precedent for the shipbuilding industry in general.

13. The financing of such an order could be undertaken through Industry Act assistance. Of the total production cost of some £12m (say £13m allowing profit for Marathon) about 50% represents the cost of imported materials which could not be provided by UK manufacturers. The expenditure would fall fairly evenly over the building period of 9 months with the signing of a contract involving a 10% deposit. Subject to Treasury borrowing consent, BNOC (and Marathon)

appear to qualify under section 10 of the Industry Act 1972 for credit arrangements at lower than commercial interest rates through the banks. The normal rate of credit of 80% of the total cost would in this case be reduced to 50% to take account of the inadmissible cost of imported materials. The remaining £6m could qualify for loan assistance under section 7 of the 1972 Act but this is in excess of the sum remaining available within my Department's estimates. There is, in any case, no provision for major rescue cases in this vote and, as is normal, I therefore propose that a sum of £6.5m should be made available from the contingency fund, to be loaned through my Department on terms to be agreed with the Treasury, with the normal section 10 facilities being extended for the remaining £6.5m.

CP(76) 133 COPY NO 81

14 December 1976

CABINET

WINDSCALE: NUCLEAR WASTE PROPOSAL

Memorandum by the Secretary of State for the Environment

1. I have before me a planning application submitted by British Nuclear Fuels Limited (BNFL) for the development of nuclear reprocessing facilities at Windscale. The application has been considered by the Cumbria County Council who have resolved that they are "minded to approve the application" but have referred it to me as a major departure from the County development plan. This is because the application raises major issues of national importance which the Council have rightly decided they are not competent to resolve. I now have to decide whether or not to call in the application for a formal inquiry.

2. The question was considered at the Ministerial Committee on Energy on 24 November, but the main question was not resolved and I was invited to consider it further, including different possible ways in which an inquiry could be held, and the likelihood of delays involved. My colleagues' major concern was that delay might put at risk the contract for the reprocessing of Japanese uranium oxide fuel and damage our international reputation in this field. The attached paper sets out the results of my considerations and my views on the type of inquiry that would be most suitable.

3. I have given this matter full and careful consideration. In my view it would be inconceivable for an issue of this importance not to be the subject of a planning inquiry. In all conscience I do not see how we could proceed otherwise.

4. There is legitimate and growing public concern over the reprocessing of uranium oxide fuel; the recent unfortunate leakage of radioactive material at Windscale has inevitably added to this concern. In my view it is essential to make an early announcement that the Windscale application will be the subject of an inquiry. This will enable the environmental and safety issues at stake to be properly and responsibly considered.

5. I therefore seek my colleagues' agreement to the making of such an announcement.

P S

Department of the Environment

14 December 1976

WINDSCALE - NUCLEAR WASTE PROPOSALS

Memorandum by the Secretary of State for the Environment

1. On 24 November the Ministerial Committee on Energy (ENM) considered a memorandum from me in which I proposed that the planning application from British Nuclear Fuel Ltd (BNFL) in respect of certain nuclear waste reprocessing facilities at Windscale should be called in. The Committee were divided and I was therefore asked to consider again the desirability of calling in the application and, if so, alternative means by which a decision on the application itself might be reached

2. Background.

Earlier this year BNFL made application to the Cumbria County Council for planning permission for the development of nuclear reprocessing facilities at Windscale. This was a single application (a point to which I return later) but the proposed developments effectively fall into three parts:

i. improved arrangements for handling and reprocessing irradiated Magnox fuel;

ii. development of a pilot demonstration plant for vitrifying long-lived radioactive waste;

iii. new facilities for reprocessing uranium oxide fuel both from the current generation of UK Advanced Gas Cooled Reacters (AGR's), and from overseas.

3. When the County Planning Committee considered the application on 2 November they resolved that they were "minded to approve the application" but decided to refer it to me as a major departure from their development plan. In doing so they have in effect, placed responsibility for the final decision on me.

4. ENM have already agreed that there is every advantage in allowing the first two parts of the application to proceed. This can be done by inviting BNFL to withdraw their single application and to resubmit it in separate parts. Where there was disagreement in ENM was as to whether the application for uranium oxide plant should be called in, and be subject to an inquiry.

5. I have given the matter considerable further thought, and I remain firmly of the view that some form of public inquiry is essential before the construction of the uranium oxide plant can be permitted.

6 There is increasing public anxiety about the safety and possible environmental effects of the technology involved in the reprocessing of uranium oxide fuel on the scale proposed. The recently discovered leakage of radio-active material from one of the existing magnox silos installations at Windscale can only add to this concern. Sir Brian Flowers, until recently Chairman of the Royal Commission on Environmental Pollution, has urged that the planning application should be called in.

7 Unless the public can be provided with some real reassurance about the nature and safety of the proposed development at Windscale, opposition to nuclear programmes will increase to a point where there may be strong political pressure against further developments of any kind. I am therefore convinced that some form of public inquiry should be undertaken. I realise that there is a risk that the establishment of an inquiry would cause the loss of the £400m Japanese contract for the reprocessing of nuclear fuel, so the more speedily the inquiry can be undertaken the better.

Form of inquiry

8 I have examined a number of different means of holding an inquiry, and I have concluded that I have two basic options from which to choose - a non-statutory committee of investigation or a normal planning inquiry.

A non-statutory committee of investigation

9 If BNFL in submitting fresh planning applications were to omit the proposal for the uranium oxide plant, and ad hoc committee of investigation could be established, conducted by some knowledgeable and respected figures, into the safety and environmental implications of the proposed operations. If the report were sufficiently reassuring and BNFL then submitted their application for the uranium oxide plant, I would feel justified in not calling it in.

10 The advantage of operating by way of a non-statutory investigation would be that the terms of reference could be directed to the issues which cause most public concern (and which transcend the local planning consideration) and the procedure might be more rapid, since it would not be necessary to comply with statutory requirements for planning inquiries.

11 I would instruct the investigating panel to have its report ready in about 6 months. However, the disadvantage with this course is that if the report were equivocal I would be in much the same position 6 months hence that I am in now, and I would have no alternative but to call in the application for a statutory enquiry. I might also be criticised for attempting to "short circuit" the statutory procedures.

Statutory enquiry

12 The other option is to arrange for BNFL to withdraw the present application, resubmit 3 separate ones for the 3 components of the present application, and then call in for a public enquiry the one which relates to the facilities for reprocessing uranium oxide. I estimate that it would take 9-12 months before a decision could be announced. A variant of this option would be to establish a Planning Inquiry Commission (PIC) which might be more appropriate to the particular issues which the Windscale case raises. Many people have asked for this on the grounds that it would be a much better method of considering the wide range of issues giving cause for public concern. But a PIC is an untried procedure and by its very nature would be likely to prolong things still further.

Conclusion

13 In my view there is no question that some form of enquiry must be held. Of the two main options described above, I favour the second - immediate call in, followed by as rapid a public local inquiry (rather than a PIC) as can be arranged. I realise that this may risk the loss of the Japanese contract - although the extent of this risk is difficult to determine - but I nevertheless believe it the right course.

CP(76) 134 COPY NO 81

15 December 1976

CABINET

DEVOLUTION TO SCOTLAND AND WALES: POST-ASSENT REFERENDA

Memorandum by the Lord President of the Council

1. On 9 December the Cabinet agreed that the details and implications of post-Assent referenda on devolution to Scotland and Wales should be examined by the Ministerial Committee on Devolution Strategy, with a view to decisions by the Cabinet early in the New Year.

2. Parliamentary developments now make it highly desirable for us to be ready to move more rapidly.

3. There are 130 signatures to a Second Reading Motion by Mr Leo Abse and others in the following terms:-

> "That this House cannot approve the Scotland and Wales Bill unless a referendum is held before the Bill comes into effect to ascertain the wishes of the people of Scotland and Wales".

Because of the support for this Motion, the Speaker was at one stage very inclined to call it; and although it is defective in form, the House authorities ruled that the effect of its carriage would have been to defeat the Bill as it now stands. In that event the Bill could have proceeded only by starting again with referendum provisions included.

4. Following extended discussions with the Speaker, it now seems almost certain that the Motion will not be called. But in view of the degree of support for it - and there are indications that a lot of further names may be added - its not being called will create wide-ranging resentment in the House, which, in my view, cannot but react unfavourably on the extent of support for the Bill at Second Reading. I believe that referenda on devolution are, in fact, now inevitable; and that, to ensure a sound position on Second Reading, we need to give a firm commitment to them, in principle, during Thursday.

5. I suggest that the terms of a statement might be on the following lines:-

"The Government have given further careful thought to the question of referenda on the devolution schemes as they emerge from consideration by Parliament. My rt hon Friend the Prime Minister promised the House, when he opened this debate on Monday, that the House would be given a full and early opportunity to consider this important issue in the light of clear proposals by the Government. I can now say that these proposals will be based upon acceptance of the principle that referenda should be held in Scotland and Wales before the respective schemes can be put into effect. We shall bring forward new clauses accordingly, at Committee Stage, for the consideration of the House.

At that stage the House will need to discuss carefully the detailed features of referenda. We shall have to address such issues as the precise question or questions to be put, the arrangements for counting, and other aspects such as those the House will recall from our discussions on the referendum on the European Community renegotiation. These are complex matters, which cannot safely be decided now. The Government will cover them in thoroughly worked-out proposals at Committee Stage".

6. As the Annex to CP(76) 135 indicates, there will be many detailed aspects of the referenda on which we shall need to reach conclusions before putting our proposals to the House. But at this stage only the decision in principle is needed.

7. I invite the Cabinet to agree that at a suitable stage tomorrow afternoon we should announce, in the terms set out in paragraph 5 above, that the Government will introduce at Committee Stage proposals for post-Assent referenda in Scotland and Wales.

M F

Privy Council Office

15 December 1976

CP(76) 135 COPY NO 81

14 December 1976

CABINET

DEVOLUTION TO SCOTLAND AND WALES: POST-ASSENT REFERENDA

Note by the Secretary of the Cabinet

1. An alalysis by the Constitution Unit of the characteristics and implications of possible referenda on devolution to Scotland and Wales after the passage of the Scotland and Wales Bill is circulated at Annex herewith.

2. Paragraphs 16-20 discuss whether English and Northern Ireland voters should take part. Paragraphs 23-26 discuss whether there should be a question on independence as well as the basic question on the Scotland and Wales Act.

3. The Lord President of the Council will circulate separately his own assessment and recommendations.

JOHN HUNT

Cabinet Office

14 December 1976

ANNEX TO
CP(76)135.

DEVOLUTION TO SCOTLAND AND WALES :
POST-ASSENT REFERENDA

A. SUMMARY AND CONCLUSIONS

1. This paper surveys the general considerations about referenda on devolution after Parliament has passed the Scotland and Wales Bill. It offers no judgment on the main issue of principle. It concludes, however, that if there are to be referenda the form that would be simplest, most convenient and most likely to meet the requirements of Ministers would be:-

a. Simultaneous but separate referenda in Scotland and Wales (paragraph 9).

b. Decision by simple majority of those voting (paragraph 10).

c. Once-for-all, not repeatable (paragraph 11).

d. The outcome to be a direct trigger for action, not just advisory to Parliament (paragraph 13).

e. Voting to be confined to those resident in Scotland or Wales, as appropriate (paragraphs 15-20).

f. Voters to be asked in substance simply whether or not they wanted the provisions of the devolution Act to be implemented in Scotland/Wales (paragraphs 21-22).

The biggest potential difficulty seems likely to relate to the question of who should be asked (paras 15-20). A case can be made for extending the questions to the English (and Northern Irish). This could lead to a very awkward outcome. There would accordingly be grave risks in embarking on the referendum route unless Ministers were satisfied that it will prove practicable to limit the referenda to those resident in Scotland or Wales.

B. GENERAL CONSIDERATIONS

The Concept

2. Referenda before Parliament's detailed consideration of the Bill would delay devolution a full year. A separate referendum Act would be needed, and by the time this was passed and the referenda conducted there would be too little time left for the main Bill in the 1976/77 Session. There is the further point that such

referenda would relate to devolution proposals which Parliament might later change significantly.

3. No similar objections arise if the implementation of devolution, after Parliament has passed the Bill, requires popular approval by referendum. The Assemblies cannot reasonably come into existence before the spring of 1978 in any event. The referenda could fit (though tightly) into the autumn of 1977. Their holding, by prolonging the period in which commitments on practical implementation (eg buildings and staff recruitment) were formally at risk, would certainly be an inconvenience to planning, but hardly enough to imperil the general timetable, provided a robust view were taken on what work could continue.*

4. It would be simplest, and would save Parliamentary time, to provide for referenda in the Scotland and Wales Bill itself rather than separately.

5. It would be a constitutional novelty to make the force of an Act of Parliament effectively† conditional upon a plebiscite. The result could be a temporary legal oddity - if the Scottish scheme were approved and the Welsh one rejected, living and dead elements would be intermingled in the Act. There is however nothing unworkable about this, and it would in any event be possible (perhaps under contingency provision in the Bill) to tidy matters up fairly promptly by consolidation procedures.

Merits

6. The background to the general case for and against referenda is that

a. The passage of the Scotland and Wales Bill seems of the first importance to the Government and the Union.

b. On current evidence, the Parliamentary risks to this passage are uncomfortably high.

c. Considerable value should therefore be attached to any measures likely to reduce these risks.

*For example, by not halting work already in hand on buildings, and by allowing at least internal Civil Service "trawls" for staff to proceed.

†Whether this would also be the formal position is considered in paragraph 13 below.

7. The case for referenda is that there is widespread and still growing pressure for them, notably from the Press, Opposition figures and some of those Government supporters in Parliament whose hostility endangers the Bill. There are many signatures to pro-referendum motions on the House of Commons Order Paper. In both Scotland and Wales the public seem increasingly ready to take for granted, and to welcome, the prospect of a referendum. The pressure reflects inter alia a belief that it is, at best, unproven that the people of Scotland and Wales want devolution. Conceding post-Assent referenda:

a. would meet this widespread demand, which is becoming almost an expectation;

b. would be a conciliatory gesture by the Government to those who are uneasy or sceptical;

c. would destroy or weaken one of the weapons in the hands of some of those determined to be hostile;

d. might make it easier for those Conservatives who are not totally hostile to soft-pedal outright opposition (on the grounds that popular vote can be left to settle the main question) and adopt a constructive approach to the detail;

e. would offer the Conservative Party, whose opposition to Welsh devolution runs deep, at least the possibility that popular vote would kill this scheme for them, thus rendering it less necessary for them to use Parliamentary obstruction.

These are the main advantages in relation to the Bill's passage. There could be important advantages in the longer term - assuming that referenda had the outcome for which the Government would hope - in underpinning the operation of devolution by demonstrating that it was welcomed by the people, and not foisted upon them. The more close-run the Bill's passage in Parliament, the greater the case for wider legitimation.

8. The main counter-arguments are these:-

a. Referenda on devolution would extend a device to which there is much constitutional objection. Its adoption soon after the European Community referendum might heighten risks of addiction. The formal constitutional

objections might be greater than in the European case. The devolution referenda would in effect decide whether an Act of Parliament should come into operation, and this moreover in a strictly domestic subject.

b. Government supporters in Wales have made clear that they would greatly dislike the idea. (But they would presumably dislike still more the Bill's loss, which is what referenda would be designed to avoid. In any event, it seems unlikely that their displeasure could worsen the voting position in Parliament.)

c. While there seems little risk that Scotland would say No, the possibility is less remote in Wales. (If it materialised, the Government's prestige would suffer a set-back, but perhaps not a disastrous one; the people would have spoken, on an opportunity specially created by the Government, and the Government might feel able to accept the outcome with calm.)

d. Any outcome, even if formally favourable to devolution, which rested on materially less than half the total electorate might be politically awkward, especially if nationalist parties had campaigned for abstentions; it could be argued that the settlement lacked full-hearted consent.

e. Referendum provisions would add to the Bill's controversial substance and the tightness of the time allocation (given that the Prime Minister has promised scope for their full discussion). Even if referenda diminished general objections to the Bill, they would not meet them all. The provisions would moreover open new areas for argument (paragraphs 24-26 below).

f. It is not clear how much extra support, in terms of specific votes, could be bought by proposing referenda. Relatively few anti-devolution MPs appear to rest their case primarily on doubts about whether the people of Scotland or Wales want devolution. Some anti-devolution MPs might find certain features (eg. not asking England - paragraphs 16-20 below) more objectionable than having no referenda at all.

g. Referenda could expose divergences within the prospectively devolved territories - for example, within a Scottish Yes, Shetland might voice a strong No.* (But it is not easy to see what Shetland could then do to harm

*After the European referendum precedent, it would seem impossible to avoid some breakdown of the results.

the devolution settlement. It would seem both politically and administratively out of the question to let Shetland opt out of Scotland for devolution purposes.)

j. Once the principle were conceded, it might not be easy to ensure in Parliament that the referenda took the form desired, and in particular that England was excluded from voting.

k. The outcome could mean that Parliament had wasted much scarce legislative time. The possibility of this would not help constructive discussion during an arduous Committee stage.

C. THE FEATURES OF POST-ASSENT REFERENDA

9. There would be two separate referenda - one about Scotland, one about Wales. They would be simultaneous. (A Scottish one held first and producing an overwhelming Yes might increase the chance of Yes in Wales; but this is conjectural, and different timing would be hard to justify.)

10. The outcome should depend on simple majority of votes. Regrettable though it might be if a result were decided 51 : 49 on a low poll, it seems impossible to lay down minima for majority or turn-out (especially as nationalist parties might urge abstention).

11. The referenda should be once-for-all affairs, to be held within a set time. Though there is a case for repeatability in the event of a No answer, this would risk making the subject a running sore; in addition the "dormant" provisions might progressively become outdated in detail.

12. Presumably in any referenda members of the Government would campaign unitedly; the special considerations which led to a different arrangement for the European referendum do not apply.

13. It seems inevitable that the outcome of the referenda should itself be decisive - a direct trigger to the Act's implementation, not just a finding advisory to Parliament. While it would be technically possible to make it advisory*, this would be an empty concept if a result was clearcut and could pose a very awkward Parliamentary situation if a result was not. It would also import another stage of delay.

*For example, the fixing of appointed days for the Act's coming into force might require Order in Council following affirmative resolution, which in turn would need debate and vote by Parliament after and in the light of the referenda results.

14. The most difficult problems concern who should be asked, and what they should be asked.

Who Should be Asked

15. All Parliamentary voters* in Scottish and Welsh constituencies should clearly be eligible to vote in the respective referenda. For reasons of definition and practicability it would not be possible (even if, which is debatable, it were logically appropriate) to give any special voice to others who regard themselves as Scottish or Welsh but who currently live elsewhere, though their exclusion will no doubt give rise to complaint.

16. The difficult issue is whether votes in England and Northern Ireland - and logically also, in each case, the voters of the "other" devolved territory - should take part. Some MPs - primarily perhaps anti-devolutionists - must be expected to argue that they should, on the basis that devolution is a new form of partnership and that all partners should have a say. (Sir Harold Wilson, when Prime Minister, virtually said as much ≠ when indicating difficulties about devolution referenda.)

17. There are however serious drawbacks about letting all parts vote. "Outside" voters, standing to be less affected, will naturally know much less and care much less about the problem than Scottish/Welsh ones. Yet because of their numbers they could easily produce, even on a low poll plainly reflecting comparative indifference, an overall result contrary to the overwhelming vote of those most directly affected. This would seem both unfair and a sure recipe for major conflict, with anti-Union parties the political beneficiaries.

18. The exclusion of outside voters could be justified in debate both on these grounds and on the grounds that the United Kingdom interest and views will have been looked after by the United Kingdom Parliament; that England, with over 80% of the membership of that Parliament, will have had its say amply there; and that the case for ascertaining Scottish and Welsh opinion by some special device is precisely that they are heavily outnumbered in Parliament (Scotland 8 : 1, Wales 17 : 1) and have no other instrument to speak for them on something of such special and lasting importance and of far greater concern to them than to the rest. These points are of considerable presentational value, but it could still be argued that they do not go to the heart of the matter; in the last resort

*And probably peers, as in the European referendum.
≠ Hansard col.

the argument that changes in the terms affecting some members of a partnership should be put to all its members, rather than just those more immediately affected, is a telling one.

19. Ministers could however also draw attention to the fact that the repeatable Northern Ireland border plebiscite, although concerned with the territorial limits of the United Kingdom, is confined to voters resident in Northern Ireland.

20. The case of those who criticise the exclusion of England and Northern Ireland voters will be at its most formidable if they can reasonably allege that the devolution settlement gives Scotland and Wales special privileges - "having their cake and eating it" - and that England/Northern Ireland should be asked whether they are prepared to tolerate this favoured treatment. The most likely ground for such a claim would be unchanged numbers and role for Scottish and Welsh MPs at Westminster. Any concession the Government were to make in this respect (eg an agreement to refer the question of numbers to the Speaker's Conference if the Scotland and Wales Bill became law) would thus ease indirectly the task of defending the exclusion of English and Northern Ireland voters from referenda. But it would also mean that the package the Scots were being invited to approve was less clearly defined; it might subsequently turn out to have involved a relative reduction in their representation at Westminster - a factor which some Scots might feel would make the devolution package significantly less advantageous, or even, overall, disadvantageous.

<u>What Question(s)?</u>

21. The referenda would have to ask whether or not the voters wanted the schemes set out in the Act to be put into practice. The precise wording would need careful thought (though in general it would seem desirable to seek wording which set devolution plainly within the context of continued union).

22. Any form of the question offering more than two options ought to be ruled out. Two options only should tend to maximise the Yes vote and (by much the same token) the difficulties posed for separatists. Three or more options would heighten the risk of a politically if not formally indecisive result, with no absolute majority for any one option. Options like "more devolution" or "less devolution", as some opinion has suggested, would wholly lack precision. They might imply,

quite wrongly, that the Government believed technically workable devolution schemes of radically different kinds to exist, and their formulation and meaning could provoke endless argument during and after the Bill's passage.

23. There remains the issue of whether any further questions beyond the basic ones should be put. The main candidate would be a question about separation - does Scotland/Wales want to remain part of the United Kingdom?

24. The main attractionsof this are:

a. It would meet a widely-expressed view.

b. Big majorities in favour of staying in the United Kingdom - say four or five to one in Scotland and ten or more to one in Wales, as seems within the range of reasonable possibility - would be a heavy blow to the nationalist parties and indirectly an aid to the practical and constructive working of the devolution settlement, as weakening any claim that devolution was merely a staging post on the road to the goal that the people really wanted.

25. The main considerations on the other side are these:-

a. Having a question on separation would be widely interpreted as meaning that the Government accepted this as a serious and realistic issue on the United Kingdom's political agenda.

b. The precision of the question would be illusory. On what terms would it be assumed that independence would come? In Scotland, the SNP might secure an inflated vote for separation by putting across a glamorised having-it-both ways picture of what it entailed - eg. all the oil revenue, little or none of the United Kingdom's international debt, and continuing "UK" privileges on the Eire model or better. At best posing such a question would raise much argument about terms; and the Government might find it uncomfortable to enter this debate, since it could amount to the appearance of a "shadow" negotiation about independence in public. However the argument went, it might mean giving the SNP the limelight and the chance to make the running, swinging the focus of the referendum campaign away from the Government's devolution scheme.

26. There are various further considerations against having a question on separation:

a. The device works as the Government would want only if there is an overwhelming dismissal of separatism. This may be judged probable; but opinion polls have in the past shown figures as high as 30% in Scotland in favour of "dominion" status.* A 70 : 30 result (given that the Scottish situation is widely seen as a developing and not a static one) might not amount to a conclusive defeat of separatism.

b. The ostensibly separatist vote might be inflated by non-separatist voters using their answers tactically to express discontent with the Government, or with particular limitations of the devolution scheme, or with the general condition of Scotland/Wales.

c. Against the background that the prospect of North Sea oil as a UK asset is a vital element in the UK's creditworthiness abroad, the very posing of the separatist question could have undesirable effects, especially if the matter hit the headlines at an economically critical time - foreign observers might conclude that separatism was a serious possibility. These effects could be deepened if the referendum campaign highlighted, however hypothetically, the terms of separation (paragraph 25b above), and still further if the eventual result in Scotland were less than overwhelmingly in favour of the Union.

d. The result on the separatism question might weaken the force of a Yes vote on the "devolution" question. It might be argued (particularly if the nationalists had campaigned for Yes on devolution) that the "separatist" vote on the second question ought in logic to be deducted from the "pro-devolution" vote on the first; and that devolution as a stable settlement did not therefore have the full-hearted consent of the Scottish/Welsh people. In effect, the addition of the second question could be claimed to produce a "multi-option" result, and so could prolong controversy and uncertainty and undermine readiness to concentrate on making devolution work.

*A recent poll in the Scottish "Daily Record" gave a figure as high as 44% in favour of independence; but there is room for doubt about its soundness.

e. There is much less clear logical justification for a question on separatism than for the first question. The first question is the trigger for action; the second one would not be. Its inclusion would widen and lengthen debate on the Bill, to no precise operational end.

f. Once one adds to the first and "operational" question, it may be progressively less easy to resist adding yet further ones (eg. about more or less devolution; or the Conservative scheme; or Liberal ideas on federalism).

f. It might be less easy to justify the exclusion of English and Northern Irish voters in relation to a new question of such fundamental constitutional importance.

h. It might also be less easy to justify excluding "non-resident" Scots and Welsh, yet the practical difficulties of bringing them in would be, at best, very formidable.

27. On balance, the arguments in paragraphs 24-26 point against having a further question on whether or not Scotland/Wales should remain part of the United Kingdom.

Subsidiary Aspects

28. Various subsidiary aspects would need to be considered if referenda were to be held - matters like the organisation of the count, the circulation of information, and expenses of any campaigning groups. The precedent of the European referendum is available, and there is no reason to foresee in these respects any problem so acute as to weigh heavily in the main decision.

Cost

29. No detailed costing is feasible in advance of detailed planning. But on the analogy of the European referendum it seems unlikely that the cost, for Scotland and Wales combined, could exceed £3M A sum of this order, though in itself an unwelcome new charge on the contingency reserve, does not seem to rank as a major factor.

Cabinet Office Constitution Unit

14 December 1976

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CP(76) 136

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15 December 1976

CABINET

SOCIAL SECURITY (MISCELLANEOUS PROVISIONS) BILL

Memorandum by the Secretary of State for the Home Department

1. As invited by the Cabinet at their meeting on 9 December (CM(76) 40th Conclusions, Minute 1), the Home and Social Affairs (HS) Committee today considered the handling of the Committee Stage of the Social Security (Miscellaneous Provisions) Bill.

2. The two most contentious provisions in the Bill are Clause 4, which restricts occupational pensioners' unemployment benefit, the Clause 13 which withdraws students' access to Supplementary Benefit in the short vacations. The Standing Committee on the Bill had its first meeting on Tuesday 14 December. Government backbenchers on the Standing Committee include Mr George Cunningham, who has declared his opposition to Clause 4 but did not vote against the Bill at Second Reading. Conservative and Liberal Members on the Standing Committee will be united in opposing the Clause. Clause 4 is expected to be reached on Tuesday 21 December; Clause 13 seems unlikely to be reached before the middle of January at the earliest.

CLAUSE 4

3. The decision to restrict payment of unemployment benefit to occupational pensioners was taken and announced as part of the July package. On the basis of the present provision, savings would be £9 million in 1977-78 and £14 million in a full year. In the light of the Second Reading Debate, HS Committee considered two possible concessions:

a. To raise from £25 to £30 the weekly level of occupational pensions above which unemployment benefit begins to be reduced. This would exempt some 3,000 out of the 16,000 or so occupational pensioners who would be affected at the present £25 level. It would reduce the full year saving by £3 million.

b. To make the provision a temporary one, by allowing it to lapse automatically or making it subject to renewal by affirmative resolution after a period of some years.

4. The Committee were unable to reach any clear view on whether these concessions would carry the provision through Committee Stage or whether, even if they succeeded in that, the provision would then survive Report Stage. The attitude of those who oppose the principle of the provision may be altered by the consultations with the Post Office Engineering Union, the Confederation of British Industry and the Trades Union Congress which have still to be completed and by the Chancellor of the Exchequer's statement on the IMF negotiations. So far as the Committee Stage is concerned, a good deal may also hinge on the responsiveness or otherwise of Mr George Cunningham to the concession proposed at a. above.

5. In the circumstances the Committee felt that it would be reasonable to give the Secretary of State for Social Services and the Minister of Social Security discretion, in the light of their continuing consultations -

i. to raise the weekly limit from £25 to £30 either by Government amendment or by accepting an amendment from Mr Cunningham if he agreed to put it down;

ii. to offer, but only as a last resort in the Committee Stage itself, the concession of making the provision temporary (thus preserving the principle of the National Insurance benefit).

6. The Committee did not consider that if the first of these concessions seemed likely to fail, there would be any point in raising the proposed limit to £35 (which would reduce the full year's savings from £14 million to £9 million).

CLAUSE 13

7. This Clause, when conjoined with regulations to abolish student access to unemployment benefit in the short vacations, would secure savings of some £13 million a year. The provisional view of the Secretary of State for Social Services and the Minister for Social Security is that some concession will be required at Committee Stage. But since this will not be reached until mid-January at the earliest and further consultations are required with the Department of Education and Science, the Supplementary Benefits Commission and other Departments concerned, HS Committee agreed to defer their consideration of possible concessions until an early meeting after the Recess.

M R

Home Office

15 December 1976

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17 December 1976

CABINET

SESSION 1976-77: LEGISLATIVE PROGRESS AND PROSPECTS

Memorandum by the Lord President of the Council

1. At our discussion in the Cabinet on 11 November I was asked to make regular reports on the progress of the legislative programme. My minute to the Prime Minister of 24 November set out the order of priority which I proposed for the Bills with firm places in the programme. This memorandum summarises Parliamentary progress so far, and looks ahead to the position which will face us after the Christmas Recess.

PROGRESS SO FAR

2. We have surmounted those hurdles which had to be cleared before Christmas, though in one or two cases with not much to spare. The Scotland and Wales Bill has secured its Second Reading. The Aircraft and Shipbuilding Industries Bill has been passed by the Commons, with the Speaker's certificate that it complies with the requirements of the Parliament Act, and is now before the Examiners in the Lords; their conclusion on whether the Bill is hybrid is expected by the end of the Recess, possibly before Christmas. The Fisheries Limits and National Insurance Surcharge Bills have been passed by the Commons, and Royal Assent is expected by Christmas. The Social Security (Miscellaneous Provisions) Bill is now in Standing Committee in the Commons. The two major Lords Bills of the Session (Criminal Law and Patents) have been launched; the former has received its Second Reading, and the latter has Opposition agreement to the use of the Second Reading Committee procedure in the Commons.

POSITION AFTER CHRISTMAS: GENERAL

3. The greater part of the Parliamentary time on the floor of the Commons between Christmas and Easter will be taken up by the Scotland and Wales Bill, on which we aim to make progress in Committee at the rate of two days a week; by Supply at the rate of one day a week; by Private Members' Bills on Fridays; and possibly by the Budget. The rest of the available time will be devoted principally to making progress on the remaining

Bills in Part I, and the Bills in Part II, of the list attached to my minute of 24 November; but there will also be other unavoidable calls on this time, some of which might arise urgently, eg Rhodesia. This is a very heavy programme, and I remind colleagues of the limits imposed, both on the floor and in Standing Committee, by our voting strength. The Chief Whip and I will do our best, but we cannot guarantee that all Bills will reach Royal Assent by the date desired. I shall adhere to the priorities set out in my minute of 24 November, on which I had few comments from colleagues, but will take account of the points made to me about the priority of the Transport (Finance) and Job Release Bills.

AFTER CHRISTMAS: INDIVIDUAL BILLS

4. Scotland and Wales. The biggest single issue which faces us in managing the Parliamentary programme after the Christmas Recess is the handling of the Scotland and Wales Bill, and in particular whether to seek an early timetable Motion. This question will require fine judgment, and I am still considering with the other Ministers most concerned how we can best proceed. I hope to put forward recommendations shortly.

Water Charges Equalisation. The opposition to this Bill which has developed made it imprudent to take Second Reading on a Friday, the only time available before Christmas. I will do what I can, but unless there is some way of cutting down very considerably the time required between the Royal Assent and implementation of the new charges, it now seems unlikely that these charges could come into operation next April.

Food Subsidies. As a consequence of our recent decisions on public expenditure this Bill is no longer required. The saving in Parliamentary time, like the Bill, will be small, but nonetheless welcome.

Direct Labour Organisations. This Bill is not yet ready for introduction, but the existing powers must be renewed by the end of March, while the proposed extensions of those powers will be highly contentious. I am in touch with the Secretary of State for the Environment about the handling of this Bill.

It would be feasible, at the cost of some inconvenience, to combine the Bills on the ECGD Liability Limit, the IMF and Overseas Resources Development and Overseas Aid. Doubts have been raised by the Ministers responsible for these Bills whether the saving in Parliamentary time would be worth while and this question is to be discussed by the Legislation Committee on 21 December.

Homelessness. This Bill would have the first call on any spare Parliamentary time available, but Mr Stephen Ross MP who came fourth in the ballot for Private Members' Bills has said that he wishes to promote a Bill on this subject. The Ministers concerned are considering whether it would be practicable and desirable to let him have the Government-drafted Bill.

CONCLUSIONS

5. Colleagues will wish to take note of the position described above. I believe that the only issue on which collective discussion is required at present is the handling of the Scotland and Wales Bill. At some point after the Recess we shall need to consider once more the Bill on Direct Elections to the European Assembly, and to give some thought to the likely timing of the legislation on Price Control and Counter-Inflation. Our next general review of progress on the legislative programme might usefully take place a few weeks after Parliament has returned.

M F

Privy Council Office

17 December 1976