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10 DOWNING STREET

Dr. Penelope Rowlatt,
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Treasury Chambers,
Parliament Street,
London, SW1P 3AG.

13 December 1982

Dear Dr Rowlatt,

OIL TANKER DRIVERS: CONTINGENCY PLANNING

Tim Burr wrote to John Vereker here on 8 December, with some remarks about the use of the price mechanism, which I understand were based on your advice. I thought it might be helpful, therefore, if I replied direct to you.

You attach great weight to "the probable failure of the price mechanism, in the circumstance envisaged, to achieve the optimum allocation which it should in principle provide". You seem, therefore, to believe that the allocation, if left to a central directorate, will be superior; but you do accept that "distortions and difficulties will arise". You demonstrate your argument by proving that the "perfect competition paradigm" and the "optimum allocation" will "cease to apply when an economy deviates from an instantaneously clearing perfectly competitive market in which all participants have perfect information". The remainder of para 4 from (a) to (d) reflects on the possibilities and magnitudes of such deviations.

I must say frankly that this methodology seems to me absurd. There cannot conceivably be any economy which is "an instantaneously clearing, perfectly competitive market in which all participants have perfect information". No such state could exist anywhere or at any time in the real world. It is simply an ideal state which can be used for developing predictions which, we believe, may be useful for organising our information on the real world.

The approach in Burr's letter is analagous to arguing that the law of gravity cannot conceivably be of any use because it is postulated in a perfect vacuum and at sea level. But you can never drop anything actually at sea level and stay there, and furthermore physicists have proved that there is no such thing as a perfect vacuum. But even though the circumstances in the real world markedly depart from these assumptions, the law of gravity has been, and is, jolly useful. It is certainly much better than many competing theories. So I am not impressed by the argument that the real world, in fuel allocation, does not exhibit the characteristic assumptions of a perfectly competitive system. In his correspondence with Desmond Scarr, John Vereker did not suggest that it did. He said that the surest way of allocating spare capacity in accordance with demand is to use the price mechanism;

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that such a method would minimise the economic damage of scarcity; and that allocation by central directorate would involve immense difficulties of policing and administration.

This seems to me to be right. The acid test of the efficacy of the free market solution, as distinct from the dirigiste approach, is to be found in the facts and not in speculation about deviations of what the analyst imagines the world is like from ideal types. So far as I am aware, all the studies I have seen point to the efficacy of the price system for allocations of scarce supply. In the particular area of fuel supplies, I believe the most authoritative studies have been carried out by Maurice Adelman of Massachusetts Institute of Technology. There are, however, other studies by James W. McKie of the University of Texas. These studies may have been misguided, wrong, misleading, irrelevant and not applicable, etc. But I have never seen a convincing case marshalled against them. There's the rub.

Finally, I think there is good reason to believe that it is the general policy of the Government to rely on the price mechanism for the allocation of scarce fuel supplies under conditions of temporary "shortage". A seminar given by Adelman in 1981, under the auspices of the CPS, was attended by the Secretary of State for Energy and representatives of the Treasury. David Howell, if I understood him correctly, made it clear to the seminar that if there were a temporary disruption in oil supplies the British Government did not intend to use the dirigiste system of rationing; they would rely on the price mechanism. Subsequently, Adelman wrote to me to confirm that this was my understanding of the Secretary of State's position. I explored it with the Department and the Secretary of State, and David Howell's Private Secretary, in a letter of 10 September 1981, confirmed that it was - "...the Government would very much prefer to rely as far as possible, in a shortage, on normal market forces ...". Of course, there may have been changes since that date of which you are aware, and of which I am quite ignorant. But if so, I would like to know.

I am sending a copy of this letter to the other recipients of Burr's.

Yours sincerely

Alan Walters

ALAN WALTERS