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PART A

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PART A

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PART A

Chancellor's (Lawson) Papers:

THE CONFEDERATION OF BRITISH INDUSTRY ECONOMIC PROGRESS REPORT

DD's: 25 Years

D Anderson
1/11/95

RD5.37

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

26 January 1987

David Nickson Esq CBE DL
President
Confederation of British Industry
Centre Point
103 New Oxford Street
LONDON
WC1A 1DU

1 - Mr ~~MacDonald~~.

2 - N1

Dear David

Thank you for your letter of 13 January and the details of members of your Task Force and its terms of reference.

I warmly welcome this initiative and the degree of interest it already seems to have generated. I gather the CBI staff have already had a discussion with my officials since you wrote, and I look forward to being kept in touch with the exercise as it proceeds.

Yours ever
Nigel

NIGEL LAWSON

cc CST
FST
EST
MST
Sir P Middleton
Mr F E R Butler
Mr A Wilson
Mr Monck
Mr Cassell
Mr Burgner
Mrs Lomax
Mr Ilett
Mr Wynn Owen
Mr Molan
Mr Gray

27/1

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RESTRICTED

FROM: N MONCK

DATE: 11 September 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr A Wilson
Mr Cassell
Mr Burgner
Mrs Lomax o/r
Mr Culpin
Mr Ilett
Mr P Gray
Mr Hudson
Mr M Call

Thanks. Sounds no worse. Re your para 5 + the para 7, I have no objection to TB being quoted in this context, but I am v. doubtful as to the accuracy of this particular quote. Pse let me see the full text ASAP. NL

REPORT OF THE CBI CITY/INDUSTRY TASK FORCE

You may be interested to see the attached near-final version of this report or at least to read the Summary. It calls for no action from you. The report was largely blessed by the the Task Force on Wednesday and will be published on 14 October with other documents for the CBI conference on 1-3 November. It will be relevant to your speech to the Stock Exchange Conference for Industry on 26 October. Full versions of the draft report are available on request, but as the report is over 50 pages long most of those on my copy list will receive only Sir David Nickson's foreword and the Executive Summary (which will be slightly amended, as indicated in manuscript).

2. The main message of the report is that there is a problem of short-termism in the sense that "many UK companies have given insufficient weight to long term development", poor competitiveness of British businesses and a low share of investment in the GDP; but the City is absolved ("... this does not arise primarily from City pressures" but mainly from underlying economic/political factors, including inadequate profitability). Myths about City pressures need to be debunked. Most financial institutions are long term investors.

3. Secondly, the report says that there is a "communications and educational gap between companies, their owners and those providing finance". This should be tackled through:

- Companies telling the market more about strategic intentions and about spending on research and development, and innovation generally. This should be voluntary not statutory. (It is feeble on disclosing R & D expenditure - see para 93 - where it says only that there is a need to "examine" a new accounting standard; a draft of it has already been issued).

- Non-executive directors playing a greater role, providing a link between owners and management.
- Management should discuss with pension fund trustees their responsibilities as shareholders as well as to beneficiaries.
- Better trained investment analysts.
- Stronger institutional links between the City and industry. (The Bank of England is considering forming a group of 20 institutions which might meet to discuss who should do what when the Bank became concerned about particular companies which lacked a strategy or faced financial difficulties.)

4. Thirdly, the report makes several points on takeovers, some of them familiar: it

- welcomes the DTI Takeover Panel proposals but says that surveillance powers and sanctions may need to be strengthened further;
- wants the market to decide contested bids "except where competitive or national strategic issues are involved, eg national defence interests or major regional concerns" (the latter point is at odds with current and proposed DTI policy). References to the MMC should be supported by detailed reasoning and should not prevent UK-based firms from achieving international competitiveness;
- rejects new obstacles to bids, (though para 151 seems to favour checking foreign bids). But wants greater transparency of shareholdings;
- wants merger and acquisition accounting standards to be tightened.

5. You are quoted in para 7 (along with Labour and Liberal documents). These quotations support the statement that concern about the City's effect on short-termism is found right across the political spectrum. Mr Call is trying to find a quote from a Conservative party document which might be substituted for the one from your speech.

6. David Walker, who is quoted at least twice (Preface and para 119), has clearly been influential on the report.

Conclusion

7. The report is not very strong on analysis or compelling evidence. But apart from any mild problem arising from para 5 above, the thrust of it should not be awkward. It does not deny the short-termism problem in industry and most of the recommendations are not addressed to Government. IAE and FIM will provide briefing before publication.

N MONCK

(TITLE TO BE AGREED AT 9 SEPTEMBER MEETING)

Report of the CBI City/Industry Task Force
Chaired by Sir David Nickson KBE, DL

October 1987

(TITLE TO BE AGREED AT 9 SEPTEMBER MEETING)

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CHAIRMAN'S FOREWORD

The CBI's City and Industry Task Force was conceived immediately after the 1986 National Conference. The catalyst was a remark made by David Walker of the Bank of England in his speech to the Conference in which he said:

> "I regret the polarisation between City and industry often found in discussion on this subject. Relationships between finance and industry are complex, and to say that there are no easy solutions to problems that arise is neither to duck the issue nor to be complacent. It is just realistic. Equally, whatever attraction some have seen in the past in other systems such as the universal banks in Germany, we have to work with the captial market-based system that we have in this country and, if we are not satisfied with it, make it work better."

It seemed to me that the CBI with its widely based membership, covering all aspects of the financial world and Industrial and Commercial companies both large and small, was well suited to study and comment upon the relationships between the City and Industry.

With the enthusiastic encouragement of Sir Terence Beckett, the former Director-General of the CBI, I therefore invited a number of prominent individuals drawn from our members to serve on a Task Force with a view to reporting back in a year's time to the 1987 Conference.

This document represents our views. Essentially it is about attitudes rather than actions. The synopsis covers our main conclusions and the report itself is supported by detailed working papers which we have considered at six meetings during the year, five held at Centre Point and one, thanks to the interest of the Lord Mayor, at the Mansion House.

Our debate has concentrated on two key areas. The first is the whole question of communications and relationships between the City and Industry. The second is the issue of takeovers and acquisitions which, while representing only a small part of the whole subject, tends inevitably to cause the most concern, the greatest attention in the Press and media and the greatest difficulty in terms of regulation and control.

We have attempted to take a long-term view rather than seeking to provide solutions on more specific topical issues that have arisen during the year These are more appropriately the perogative of other organisations such as the Government itself, the Stock Exchange, the Takeover Panel, the new regulatory authorities under the Securities and Investment Board, the various committees established by Institutional Investors, and the Accountancy and Legal professions.

We have received the widest degree of positive support and encouragement from all sides. Many people have provided much invaluable advice information and opinion and in the process spent much time in assisting us. We are extremely grateful to them all.

CBI staff have provided excellent support and shown great skill in producing the working papers and then in refining much information and debate into this final report.

Finally, I would like to thank the distinguished members of the Task Force itself for agreeing to serve on it, for providing such a full attendance at all our meetings and for their advice and support, which have enabled us to produce a unanimous report.

The success of the Task Force will ultimately depend upon how our report is received at the Conference and subsequently on the how we follow this through. The Task Force itself will meet only once more, early in 1988, to review progress and to recommend to Council how responsibility for continuing the initiative within the CBI should be established. It will also determine how our recommendations for change and action by others should be pursued.

We hope that this report will be widely read and studied, that it will help to demonstrate that the City and Industry do for the most part work well together in the national interest and that they are interdependent. But certain things do indeed need changing not least the efforts on all sides to improve communications and understanding.

EXECUTIVE SUMMARY

There is widespread concern, on both sides of the Atlantic, that the level of understanding and commitment between financial institutions and industrial companies is unsatisfactory, and that this is damaging to the long term development of the industrial sector.

This concern has been heightened by the wave of mergers an acquisitions over the last few years. Quite apart from questions about the ways in which some bids have been conducted, critics of the wage of mergers assert that the atmosphere they create has encouraged - if not forced -managers to take a short-term view at the expense of the investment essential to longer run competitiveness. While the need for British industry to invest in the future has never been more apparent, it is alleged that industrial logic and the need for international competitiveness within the manufacturing sector in particular have been sacrificed on the altar of quick speculative gains; while the interest of the other stakeholders in the future of the business, including the workforce, suppliers, and the local community, have effectively been ignored by the market.

However, it is not only takeover bids which have given rise to this concern. Many industrialists feel that the financial institutions which largely own British industrial companies do not understand their problems and opportunities, take major decisions affecting a company on superficial evidence, and do not provide the support, either critical or constructive, which is to be expected from equity ownership.

Many business leaders share these views and strongly support them. This was clear in a debate at the 1986 Annual Conference of the Confederation of British Industry.

The extra media attention devoted to the financial sector has, probably not helped. Discussion of daily movements in share prices, bid prospects and monthly official statistics on money supply, balance of payments and prices can appear to support the view that the City is interested only in the short-term. The activities of arbitrageurs - not to mention the extensively publicised stagging profits on recent privatisation issues - have reinforced the image of the market as a casino or race meeting, where companies are 'put into play' and the market is determined by speculators rather than responsible owners of companies.

Recognising the strength of feeling among CBI members, and the potential damage to the nation's long-term prosperity that could result if relations between the City and Industry deteriorate, a 29-strong Task Force chaired by the CBI's President, Sir David Nickson, has examined the basis of the concerns and the steps needed to correct the situation. The Task Force comprised senior executives from both "sides" in the debate. The accompanying report represents their unamimous conclusions and recommendations.

Underlying much of the concern is the fact that, despite the remarkable turnaround of the past few years, there remains a sizeable gap between the UK and its major OECD competitors in terms of productivity and profitability of manufacturing - particularly when relative inflation and interest rates are taken into account.

The Task Force found that at the heart of the problem lies a communications and educational gap between companies, their owners and those providing finance. Though many companies, have established good links, their example needs to be followed more widely. In West Germany, France and Japan effective communications are facilitated by an industrial structure that is, in effect, controlled by the banks. But this has come at the cost of rigidities which are now being removed, and are causing some stress in these economies.

Direction of later amendments

The Task Force believes that the communications challenge here at home can be met by

(i) Companies making more effort themselves to keep the market informed about their longer term strategic intentions and spending on research and development, as well as training and other aspects of innovation in particular. A voluntary approach is far preferable to statutory intervention which will introduce unwarranted inflexibility and legal complexity.

(ii) Financial analysts being better trained in the skills necessary to provide a strategic assessment of a company's prospects, particularly at the more senior level. At present, the quality of analysts can appear very uneven.

[Executive directors - normally]

(iii) Non-executive directors playing a greater part in company affairs, providing a link between owners and management and a possible channel of communications with firms' professional advisers. Independent non-executive directors should comprise a sizeable minority on all but the smallest public company boards and strengthen then by adding to their range of skills and experience.

Discussions with

(iv) [Closer terms of reference for] pension fund trustees, [which reflect] about their responsibilities as shareholders, in addition to their responsibilities to employees and pensioners for the performance of the fund.

Delete

(v) Institutional links between the City and Industry being strengthened. [A 'Ginger Group' of major institutions perhaps working through the Bank of England could provide a means of drawing the attention of Chairmen of any major concerns in the City about their companies performance.] In any event, the CBI plans to strengthen its own ability to contribute to and follow up the debate on City and Industry relations.

Other steps will be required to correct the underlying economic causes of short-term bias. The CBI plans to address many of these issues by setting out its views on "A Strategy for Industrial Competitivenss". The Government also has an important role to play, not least in ensuring tht public sector purchasing is used to promote long run industrial competitiveness.

The Task Force also considered ways in which mergers and acquisitions are regulated and accounted for. It concluded that:

(vi) The Department of Trade's current proposals for the revision of the Takeover Panel were a step in the right direction, but the Task Force felt that the surveillance powers and sanctions available to the Takeover Panel [should] be strengthened. further

may need to

The contrast with West Germany is instructive:

	West Germany	UK
Change in Retail Price Index (Year to June 1987)[1]	0.2%	4.5%
Average Short-term Interest Rates (Year to June 1987)[1]	4.3%	10.3%
Productivity: manufacturing output per man-hour in mid-1986 (Index: US = 100)[2]	87.0	37.0
Average pre-tax returns in manufacturing (1986)[3]	17%	8%

Notwithstanding the unpalatable realities of international competitiveness of manufacturing, the Task Force found no evidence to link attitudes of the City directly to the long run decline of the Nation's manufacturing sector - nor to its resurgence in recent years. Rather, it found that six commonly held perceptions were simply not supported by the available facts. They were part of a pervasive mythology that needs to be de-bunked in the interests of both City and Industry alike. Instead, the Task Force concluded:

- The evidence suggests that many British companies have given insufficient weight to long term development, but that this does not arise primarily from City pressures. It arises mainly from underlying economic/political factors, including inadequate profitability.

- Most financial institutions (which own around 60% of UK equities) are long-term investors, not surprisingly in view of the long-term nature of their obligations. Moreover, the shareholders' average holding period is anyway not the critical issue; it is company time horizons, and their readiness to invest for the longer term, that matter.

- There is no general shortage of funds for good small or high-risk ventures, though financing costs are sometimes high.

- The cost of City facilities has fallen since Big Bang, as competitive pressures have had their effect.

- In 1986, British business spent more than twice as much on fixed investment and research and development as it did on acquisitions; for the period 1980-1986 the ratio was 5:1.

- The evidence does not indicate that managers of successful companies under threat defer worthwhile investments to enhance their current earnings. Acquisitions are an expensive way of changing management; in the four mega-bids referred to, the cost exceeded £5 million per Director of the acquired companies. They are also risky. In North America some two-thirds of contested bids fail; and more are failing in the UK (in 1985 only one in four companies "got away"; in 1986 it was one in three). But the threat of takeover is a spur to management performance.

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1 National Sources.

2 G F Ray Labour Costs in Manufacturing National Institute Economic Review, May 1987

3 OECD. (Though these figures are standardised by the OECD, as they are produced from accounting data using different conventions, they may not be strictly comparable.)

(vii) The market and shareholders should be left to decide the outcome of contested bids, except where competitive or national strategic issues are involved, eg national defence interests or major regional concerns. In such cases, the Secretary of State would retain the power to refer a bid, provided detailed reasoning is given. But competition and merger policy must not stand in the way of UK based firms achieving or retaining international competitiveness and a scale of operations appropriate to what is now a global market.

(viii) No attempts should be made to "tilt" the playing field in favour of defendants. All the many proposals to this end considered by the Task Force were found wanting. Nevertheless, a greater transparency of shareholdings is desirable and disclosure should be encouraged.

(ix) Merger and acquisition accounting standards should be tightened, so that bidding companies cannot use merger accounting rules for acquisitions. At present it is possible to inflate earnings and mask the true effect of acquisitions, by what amounts to creative accountancy.

The report of the Task Force will be debated at the CBI Annual Conference in Glasgow in November; and any subsequent recommendations will be reviewed by the CBI's National Council immediately after the Conference Debate. The Task Force itself plans to meet again, early in 1988, to review progress. The issues involved are too pressing to permit any relaxation.

SETTING THE STAGE

1 Britain is enjoying an economic renaissance. For the first time in a century, the nation's share of world exports is on a rising trend; we are at the head of the OECD in terms of growth in manufacturing output and productivity. In company after company, new working practices have replaced the old, payment systems have been changed, new plant and equipment has been installed and management strengthened. The immediate prospects are promising: CBI Trends Surveys show that business remains confident and plans to invest ahead of the likely 4% growth in output in 1987.

2 Investment is the key. Despite the achievements of the past few years, there remains a very substantial productivity gap abroad between British manufacturers and their OECD competitors. Privately funded research and development have also been declining in real terms. The profitability of manufacturing is still too low relative to our competitors and the cost of finance.

3 In such circumstances it is of vital importance that a sound relationship exists between those that provide investment finance and the managers of Britain's businesses. Of late, there have been disturbing signals that all is not well.

4 It is not surprising that concern should have surfaced in the CBI, whose membership is drawn from the whole range of business interests, industrial, commercial and financial. Some of the issues began to be aired at the 1985 Harrogate National Conference. The 1986 CBI National Conference divided equally on a motion attacking "short-termism" in the City:

> "Government and financial institutions in particular must recognise that if manufacturing industry is to survive, a long-term view must be taken in terms of financial returns, rather than the short-term view forced by them on British managers".

It then passed a motion criticising the high level of takeover activity:

> "This conference believes that mergers and acquisitions are not necessarily a bad thing but regrets that too many are pursued for the wrong reasons".

5 In response to this degree of concern, CBI President Sir David Nickson set up a Task Force to examine a wide range of issues in the area of City/Industry relationships. The Task Force had the following terms of reference:

> To advise on measures to enhance the relationships and communications between the City and Industry and thereby to encourage positive action by Industry and the City to improve the performance and international competitiveness of British Business.

To review:

a) The criteria for the assessment of companies' performance with particular reference to the longer term and to consider the implications for merger activity and industrial structure.

b) The relationship of major shareholders to the United Kingdom companies in which they invest.

6 The Task Force concluded that changes are necessary in the relationships between the City and Industry if the momentum behind the recent renaissance is to be maintained. Specifically, the Task Force has concluded that sound relationships between Industry and the City need to be built on:

i <u>An appreciation of the realities underlying the poor profitability of British manufacturing relative to our OECD competitors</u>. The Task Force found that the debate on short-termism is frequently ill-informed: assertions are simply not reflected in the facts. But toothache is no less painful, because it is imaginary. So myths and realities must be distinguished one from the other, and sometimes uncomfortable realities confronted directly. The purpose of Chapter One is to identify both the realities and the pervasive mythology that has grown up around them.

ii <u>Improved communications in all directions</u>. Companies need to communicate more effectively with shareholders, banks and other sources of finance - not to mention the trustees of their own pension funds. At the same time, owners need a reliable means, short of supporting an acquisition, of upgrading management performance where this falls short. Chapter Two sets out the views of the Task Force on how the necessary improvements can best be achieved.

iii <u>Recognition that mergers and acquisitions can play a key role in restructuring the economy</u>. Acquisitions are risky for bidders; more often than not, they create wealth only for the selling shareholders. Other stakeholders involved in a business - the workforce, suppliers, customers, the local community - are crucially affected by acquisitions and their long run interests need to be taken into account. But so long as companies underperform in the eyes of their owners, there needs to be scope for new management to be introduced. There is no case for introducing more arthritis into an economy historically resistant to change. But, in the current jargon, takeover battles must be fought on a level playing field -tilted neither towards the bidder nor the defender and allowing the market to decide the outcome on the merits of the case. Chapter Three sets out the recommendations of the Task Force to ensure that any past abuses are avoided in the future.

1 - MYTHS AND REALITIES

7 The popular mythology of relations between City and Industry emphasises their separateness. The development of London as a major international financial centre is often seen as irrelevant to the needs of industry and commerce in the UK - at worst it is seen as an impediment. Such views range across the whole political spectrum:

"Many industrial companies find it (the City) values their shares by present profits rather than future prospects, and that those who fail this test are vulnerable to takeover. The perverse result is to inhibit management from investment in research and development which will only show a return in the long term, for fear that the necessary reduction in distributed profits will reduce share prices in the short-term. Thus the short term perspective which the City adopts in share dealing obliges industry to manage on the same short-term horizon".

(The Labour Party: Making the City Safe, March 1987).

"The City has a short-term approach ...... Such attitudes from the investment community act as a real deterrent to company managements from the taking of the long view. The new growth is often pruned rather than the dead wood. What Harold Macmillan, fifty years ago, called 'casino capitalism' is not serving British industry well".

(The Liberal Party: Investing in our Future: Tackling short-termism in the British Economy, September 1986).

"The big institutional investors nowdays increasingly react to short-term pressure on investment performance ... (they) are unwilling to countenance long term investment or a sufficient expenditure on research and development".

(The Chancellor of the Exchequer, The Rt. Hon. Nigel Lawson MP, June 1986).

8 Concern within the CBI had been heightened by a number of factors. The internationalisation of capital markets opened the way for greater foreign control of UK companies and the entry of new international players to UK capital markets. The level of takeover activity in 1986 was at an all time high, exceeding the previous peaks in 1968 and 1972 by some 18% in real terms. Unlike the earlier waves, the recent one has been characterised by a relatively small number of very large acquisitions: in 1986, the top five mergers accounted for nearly 60% of the amount paid. Apparent abuses of existing rules and regulations for conduct in takeover situations have been a source of widespread concern within the business community. The new regulatory structure for financial markets associated with the "Big Bang" changes, combined with the reported increases in compensation for relatively young staff in the City, did little to reassure industrial managers in particular.

9 The charge against the City is that it is too ready to sacrifice the long-run interests of the nation as a whole and of management and the workforce in particular, to the short-run interests of shareholders. The charge against business, on the other hand, is that it has failed to secure real longer-term growth in value - partly because of the threat of being acquired.

10 The wide currency given to such views and beliefs can obscure the fact that the "City" and "industry" do work, in the main, in joint harness effectively and well for the benefit of the economy. There are, of course, aspects of their relationship where improvements can be achieved. However, before these areas can be identified, the facts behind some of the commonly held views must be established. Many of these perceptions do not stand up to close examination; but some painful realities must also be recognised as such.

UNCOMFORTABLE REALITIES

11 Until very recently, international growth rate comparisons made depressing reading in the UK and this poor performance over many years provides the most obvious indication that we have something to learn from our competitors. Table 1 compares the UK's performance since 1960 to the OECD average and some of our main competitor countries. (To eliminate differences due to growth of the labour force, this is in terms of GDP per capita.) In every period the UK has been below the OECD average and often substantially below some of our main competitors. This has been reflected in the fact that our living standards have also fallen relative to other countries. By 1985, GDP per head in the UK was 5 per cent below France, 8 per cent below Japan and 11 per cent below West Germany[1].

Table 1: GROWTH RATES OF GDP PER CAPITA IN OECD, 1960-86
% a year

	UK	W Germany	Japan	USA	OECD
1960-68	2.4	3.3	9.4	3.1	3.9
1968-73	2.9	4.1	7.3	2.2	3.7
1973-79	1.4	2.6	2.5	1.6	1.9
1979-83	0.3	0.6	2.8	-0.3	0.5
1983-86	2.7	2.8	3.6	3.3	2.9

Source: OECD Historical Statistics and National Accounts

12 One major source of differences in economic performance is the share of national resources devoted to capital investment. As Table 2 shows, Japan's outstanding growth has been associated with much higher investment than other OECD countries, while UK investment has been below the OECD average. Sluggish growth in the US has also been associated with low investment. However, while insufficient investment may have been a contributory factor, it is clearly not the whole story. Detailed studies of comparative economic performance[2] have found that British machinery is both less technically advanced and less well maintained and utilised than in more competitive countries. This points to inadequacies in both innovation and training.

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1 OECD, National Accounts 1987, special supplement. Purchasing power parity exchange rates are used in this comparison.

2 For example "Productivity, machinery and skills in a sample of British and German manufacturing plants" by Daly, Hitchens and Wagner, National Institute Economic Review, February 1985.

TABLE 2: GROSS FIXED CAPITAL FORMATION (EXCLUDING RESIDENTIAL CONSTRUCTION)

% of Gross Domestic Product

	UK	W Germany	Japan	USA	OECD
1960-67	14.3	17.9	26.1	13.4	15.9
1968-73	15.2	17.2	27.5	13.8	16.7
1974-79	15.2	14.8	24.4	14.0	16.5
1980-85	13.7	14.7	23.8	13.9	15.7

Source: OECD Historical Statistics

13 Comparisons of innovation expenditure immediately face a problem of definition. The Frascati definition of scientific and technological innovation, now used by the OECD, identifies seven stages in the innovation process: research and development (R & D), new product marketing, patent work, finance, design engineering, industrial engineering (tooling) and manufacturing start-up. Of these, only expenditure on R & D is quantified on an international scale. Table 3 shows the UK's performance in business R&D expenditure falling behind our major competitors in recent years. Industry's own contribution - at less than 1 per cent of GDP - has been particularly low. By contrast, Germany and Japan have intensified their research effort during the 1980's.

TABLE 3: BUSINESS ENTERPRISES' EXPENDITURE ON R&D
% of Gross Domestic Product

	1981		1983		1985	
	Total	% Financed by Industry	Total	% Financed by Industry	Total	% Financed by Industry
UK	1.50	(61.3)	1.39	(63.3)	1.39	(61.2)
France	1.18	(67.8)	1.22	(73.0)	1.29*	(71.3*)
Germany	1.70	(81.8)	1.80	(82.2)	n.a.	n.a.
Japan	1.41	(97.9)	1.63	(98.2)	1.72*	(98.3*)
US	1.77	(68.4)	1.94	(67.5)	2.07	(67.1)

*1984

Sources: OECD Selected Science and Technology Indicators 1979-86; British Business, 27 February 1987.

14 These figures confirm a trend going back to the 1960's. Though figures comparable with those in Table 3 are not available over a long time period, total national expenditure on R&D, which includes Government's own research effort (often for military purposes), has increased from less than 1½ per cent of GDP in 1964 to over 2½ per cent in both Germany and Japan. Over the same period, UK total R&D expenditure has been constant at around 2¼ per cent of GDP; in the US it has fluctuated around 2½ per cent.

15 Moreover, the case for investing in the UK has not been strong when compared to Germany for example. Despite the notable advances of the past few years, there remains a long way still to go:

- UK productivity still lags well behind West German levels, partly because of German attention to training at all levels and the pre-eminence of business and engineering within Germany that goes back many decades.

- Profitability in the UK manufacturing sector as a whole (as measured by the rate of return on assets) although improving, still appears to be much lower than in West Germany, where companies enjoy lower interest rates and business activity is less heavily taxed.

- Manufacturing output in the United Kingdom has fallen over the last decade by 3 per cent compared to a rise of 16 per cent in West Germany. As a result, UK manufacturing now accounts for a much smaller share of GDP than is the case in West Germany:

16 These realities cannot be ignored. Both the Government and the CBI must be concerned to help business tackle the underlying problems directly. The question that the Task Force had to confront was this: Is the City part of the problem or part of the solution? Have the owners of manufacturing industry contributed to the situation, by excessive preoccupation with short-term results; or have they simply reacted to poor management performance in a way consistent with a need to protect shareholders and clients longer-term interests? This is where the myths come in.

PERVASIVE MYTHOLOGY

17 Before discussing some of the myths current in the debate about "Short-termism", it is necessary to define what is meant by the 'City'. It is not a simple homogeneous body. Historically and geographically the City is the Square Mile administered by the Lord Mayor and the Corporation of London. Nowadays the label usually denotes the financial centre clustered in and around this area though many important financial institutions are based outside it and there are several financial centres (eg Edinburgh). The idea of a financial centre implies some unity and interconnection, but the City is much less of a unity seen from inside than from outside.

18 The 'City' is itself an industry in its own right, or rather a collection of industries. It exports, invests, trains and employs people and provides business for a number of ancilliary activities. In 1986, net overseas earnings of financial institutions topped £9 bn. There are essentially three main divisions within the City, though there are many subdivisions and overlapping activities.

(a) The Markets

These are The International Stock Exchange, Lloyds, the option market, the commodity markets and the other markets in money and foreign exchange. Over the last few years all these markets have been affected by the greater international mobility of funds. This has opened up scope to much greater competition and has allowed companies to look to foreign as well as domestic markets for finance.

Immense amounts of money are transacted on the financial markets. London still houses the world's largest foreign exchange market where around $50 billion of business is transacted every day. The London Stock Exchange, where the total value of UK equities now stands at approaching £500 billion, has seen the developments of Big Bang with all its attendant changes. Large sums of money seeking a good return pose both an opportunity for business as well as a challenge to the competitiveness of British Industry.

(b) The Financial Institutions

The City is home to the major UK banking and investment institutions, as well as an increasing number of foreign banks and financial institutions. The banks include as well as the big four clearing banks, merchant banks who are primarily involved in raising finance for commerce as well as fund management for pension funds and industrial investors. The investment institutions include insurance companies, unit trusts and investment trusts; each has their own characteristics and caters for different forms of investment. Over the post-war period, they have come to control an increasing proportion of UK equity (Table 4), partly because of economies of scale in investment management, but also because of the tax-incentive for investors to channel their savings in these forms.

TABLE 4: INSTITUTIONAL OWNERSHIP OF UK EQUITIES

(UK company securities: ordinary shares)
% at year end, market values

	1963	1975	1985
Pension Funds	6.5*	17.5	32.2
Life Assurance	3.4	10.5	17.6
General Assurance	0.4	1.9	2.0
Unit Trusts	0.8	4.2	4.6
Investment Trusts	4.4	6.2	3.3
Institutions	15.2	40.3	59.7

Source: CSO Financial Statistics; Bank of England and * Wood Mackenzie.

Note: The remaining percentage of total shareholdings is accounted for by individuals, Government, charities, banks, other companies and overseas investors.

(c) Professional Services. The City houses many accountants and solicitors, who support the functions of the main institutions and industry.

Within these three broad groups each of the sectors has its own distinctive characteristics, and there are often further subdivisions within a sector eg commercial banks, merchant banks, foreign banks, etc. Other bodies overlap those divisions and perform a variety of functions, eg stockbrokers who as well as making a market in equities, provide advice and other broking services to clients. So "the City" is a fairly wide and loose term. It is important to recognise this when general statements are made about it.

19 Against this background, the Task Force has examined a number of assertions commonly made in the debate on short-termism to establish whether they stand up to critical scrutiny in light of the available facts. In the rest of this chapter, six commonly held perceptions are examined in turn:

(i) The 'City' has been largely responsible for short-term performance pressures on companies

(ii) Financial institutions are not long-term investors in companies

(iii) The 'City' is not prepared to raise funds for small companies or high-risk ventures

(iv) The cost of City facilities has risen since Big Bang

(v) British companies grow by acquisition rather than by the creation of new assets

(vi) Takeover activity inhibits business performance

From an examination of these statements, it will become clear where there are genuine problems and how the Task Force can make its contribution to resolving them.

Perception #1: The 'City' has been largely responsible for short-term performance pressures on companies.

20 There is a widespread suspicion that British companies' poor performance in investment, research and development, training and innovation is attributable to pressure from investors in the financial markets who are seeking short-term returns. This is the essence of the "short-termism" hypothesis. It is a strong allegation and therefore deserves serious and detailed consideration.

The role of financial markets

21 The first point to note is that financial markets are only one potential source of pressure on companies to neglect the longer-term and boost current performance. Other possible sources include:

- the need to maintain price competitiveness in difficult market conditions;

- a lack of confidence in market prospects;

- uncertainty about the price of inputs arising from wage inflation;

- Chief Executives frequently set very challenging short-term targets for themselves and for management. Rewards for achieving these targets are increasingly provided by performance related bonuses which may provide an incentive for short-term performance

- high real interest rates;

- exchange rate fluctuations; and

- "stop-go" policies and changes in Governments.

22 The impact of such factors on business decision-making should not be understated. The extent to which exchange rate instablility and high real interest rates, in particular, have inhibeted companies' investment plans has been highlighted by a recent CBI Survey of Finance Directors [1].

23 The debate surrounding the role of financial markets focusses on the equity markets. It is argued that stock markets lay too much weight on current profits and current dividends. Firms respond to this pressure by pursuing short-term profit goals because they are concerned about their share price, particularly because of the threat of takeover. There are two strands to this argument. The first concerns the way stock markets assess the performance of firms. The share price of the company should reflect the discounted value of the company's stream of future cash flows. Cash flows (and hence profits) in the near-term will necessarily be given a higher weight as future returns must be discounted to reflect the cost of capital. The latter will comprise the real interest rate, plus a premium for the risk attached to the company's proposals.

24 Could differences in the cost of capital between the UK and other countries therefore account for our stock markets appearing to be more short-term than our competitors? Certainly, in recent years real interest rates have been high in the UK relative to Germany and Japan. Their impact could also have been compounded by habits of mind associated with the inflationary experiences of the 1970's. However, allegations of short-termism go back beyond the last few years. Before the 1980's real interest rates in the UK were in line with, or below, our main competitors and the average premium for risk on equity capital (the amount by which the rate of return on equity exceeds that on riskless Government bonds) at around 8-9 percentage points has also been in line with other countries. The growing internationalisation of capital markets should reduce any differences in the real cost of capital between countries.

25 Allegations of "short-termism" in financial markets therefore implies that investors and analysts give more weight to the near term than is justified by the cost of capital. Evidence frequently cited includes

- the emphasis placed on the current year's dividend and earinings announcements and the share's price-earnings multiple, when evaluating share prices; and

- the short-term pressures that fund managers themselves feel under when their performance is reviewed so frequently.

26 Attention to the current year's results and to price earnings multiples does not constitute evidence that financial markets are taking too short-term a view:

- Short-term profitability can be consistent with good long-term performance; indeed the two are associated more often than not.

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1 Survey of UK monetary policy's impact on business, CBI, August 1987

- Dividend and earnings announcements are a major and a very important source of news. Such announcements convey (and are generaly accompanied by) major information about the future. Ananlysts would there fore be negligent to ignore them. In particular, firms frequently use dividend payments as a signal of future performance prospects. A large body of research, including a survey of finance directors conducted by Jeremy Edwards and Colin Mayer in November 1984 [1], shows future profitability to be an important factor in determining the current year's dividend payment. Markets must obviously take this into account.

- Although the denominator of the price earnings ratio reflects current earnings, the numerator is the current share price. Since share prices should reflect the expected value of all future cash flows, the price earnings ratio can also be viewed as a long-sighted measure.

- This can be seen in the fact that analysts' assessments vary greately from sector to sector. Industries where long-term investment is crucial, such as oil and pharmaceuticals enjoy high price earnings ratings, reflecting the long-term growth prospects expected from current investment.

- Equally, this is reflected in considerable variation in price earnings ratios within sectors. Companies with good growth prospects have high price earnings multiples, and companies where the quality of earnings is poor have low multiples. Clearly PE ratios reflect far more than just short-term profit performance.

- If there is any controversy about PE ratios arising out of empirial academic studies on financial markets, it reflects a slight concern that the shares of companies with good growth prospects may have been <u>over-valued</u> rather than the other way round.

27 There is also a very large body of evidence derived from studies which have investigated whether share prices properly reflect available information. The consensus view which emerges is that the stock market operates efficiently in this respect. Indeed there is little if any evidence to suggest that share prices fail to reflect publicly available relevant information, which would be the case if firms with good long-term prospects were persistently undervalued. Furthermore, various US studies indicate that share prices typically react <u>favourably</u> to announcements of decisions on capital expenditure, and research and development. The Department of Trade and Industry are planning a similar analysis for the UK."

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1 J Edwards and C Mayer "An Investigation into the Dividend and New Equity Issue Practices of firms: Evidence from Survey Information". IFS Working Paper 80.

2 See, for example Simon Keane "Stock Exchange Efficiency: Theory, Evidence and Implications," 1985.

28 The worry about short-term performance pressures on fund managers is also an area of misunderstanding. The concern is that measuring managers quarterly prevents them taking a long-tem view. This misconception arises from inappropriate comparisons with the position of a manager in industry. Industrial managers faced with the requirement to maximise accounting profits each quarter might be tempted to increase short term profits by selling the firm's long-term future short. They could cut current "investments" which promise future benefits, but where these will not show up until the longer-term. By then, the manager in question might well have moved on. Such investments would include spending on R & D, training, maintenance, fixed assets and strategic marketing.

29 Fund managers, however, are evaluated quite differently. The change in the market value of their portfolio is compared against the market index, or with other funds' performance. Faced with the demand for better short-term performance, the fund manager, unlike his industrial counterpart, cannot sell the future short. The only way he can outperform is to identify undervalued shares and buy them, and/or overvalued shares and sell them. Though in the short-term luck and market fashions will play a part, over a period of time this can be achieved only through thorough, insightful investment analysis of a company's short and longer term prospects. Evidence that fund managers do behave in this way is provided by a recent survey carried out on behalf of the City Capital Markets Committee [1] which indicated that some fund managers responsed to pressures for better performance by seeking misvalued shares. This frequently involved taking greater account of expected earnings and future prospects. Moreover, by trading on the basis of this assessment, the fund manager reveals information to the market and as a result share prices should more accurately reflect company prospects.

30 This does not mean it makes sense to hire and fire fund managers on a single quarters' figures. Consistent outperformance is rare and it will also take many years to tell luck from judgement. But the regularity with which fund managers are replaced is, anyway, overstated in popular mythology. A Task Force survey [2] found that roughly half the pension funds employing external managers still used the same managers as 5 years before. Amongst the very largest funds, who used in-house managers, 90 per cent had not replaced their investment managers in the last 5 years.

<u>Long-term investment decisions</u>

31 It therefore seems difficult to sustain the argument that stock markets systamically take too short-term a view. However, if companies believe that they do, or if the market gets it wrong in some cases, is this having a serious impact on companies' long-term decisions? Apart from a natural desire to further its shareholders' interests, there are several other reasons why a firm might be concerned about its stock market rating and short-termism in financial markets might have an effect on innovation, training and investment decisions.

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1 Bank of England Quarterly Bulletin, May 1987

2 CBI City/Industry Task Force, Working Paper on Pension Fund Management.

- The threat of takeover. If the share price is depressed, the firm may be a tempting target for predators. 85 per cent of directors and chief executives of top non-financial UK companies responding to a Financial Weekly survey (12 February 1987) reported that the takeover boom had led to managers taking a greater interest in short-term performance.

- The belief that raising new equity capital may become more difficult. This was a major reason given by firms for resisting a cut in dividends in the survey of finance directors by Edwards and Mayer.

- Managers can be tied into share option schemes, where their own financial prospects depend on the firm's stock market rating.

32 A survey of a selection of UK quoted companies, conducted on behalf of the Task Force (see Appendix B), sought to establish how financial market pressures might have prevented companies taking investment decisions in their long-term interest. Table 5 shows respondents' answers to the question:

Please indicate the significance of certain constraints in preventing you from taking strategic investment decisions in the long-term interest of your company, such as higher spending on fixed investment, research and development, training or marketing?

TABLE 5: CONSTRAINTS ON LONG-TERM INVESTMENT

% Respondents mentioning	OF MAJOR SIGNIFICANCE	SIGNIFICANT	NOT SIGNIFICANT
a) shortage of capital	5	10	85
b) cost of capital and/or fears of an inadequate rate of return	24	53	23
c) exchange rate uncertainties	2	26	72
d) a lack of confidence in market prospects	9	39	52
e) weakness in your share price or rating	7	34	59
f) fear of takeover	0	12	88
g) pressure from financial institutions/analysts	4	19	77

Source: CBI survey of UK company Chief Executives, 1987 (see Appendix B)

33 The survey asked specifically about three possible barriers to investment from financial markets:

- fear of takeover;

- weakness in the share price or rating;

- direct pressure from financial institutions and analysts.

The most striking conclusion was that, despite the fact that almost half of the companies surveyed had been identified as targets in press takeover speculation over the last three years, only 12 per cent replied that fear of takeover was a significant constraint. None identified it as very significant. The number identifying direct pressure from analysts and brokers as a significant constraint was only slightly higher, at 19 per cent. On the other hand, 39 per cent of companies did reply that weakness in their share price was a significant constraint. Such firms could be lowly rated because of their reluctance to invest, poor prospects and/or a low opinion of management and it may not be wholly inappropriate that their investment is discouraged. However, while this is not direct evidence of firms responding to short-term pressures it illustrates how they might impact on company behaviour.

34 Table 5 also allows this to be put in perspective. It shows that **financial market activities were not the most important constraining influence on firms' investment plans.** Firms operate in an uncertain world in which they have to compete with other firms for factor inputs as well as product market share and it would be unrealistic for them to expect there to be no constraints exist upon long-term decisions. Not surprisingly, over 75 per cent of respondents felt constrained by either the cost of capital or fear of an indadequate return on their investment. Lack of confidence in product market prospects was also a widely quoted constraint upon the long- term decisions of firms. Though exchange rate uncertainties are not directly identified as a major constraint, exchange rate considerations may also be reflected by lack of confidence in market prospects. In line with the current consensus, the firms surveyed do not appear to suffer from a quantitative shortage of capital.

35 In summary therefore, although there is a lot of casual discussion about short-term pressures from financial markets affecting business decision making, the evidence does not seem to indicate that it is a significant problem for a majority of firms. In so far as companies do feel they are adversely affected by the assessment of investors and analysts, there may be a lot of scope for improving communications between companies and their investors. This will require co-operation on both sides and some ideas for how this process can proceed are put forward in the next Chapter of this report.

Perception #2: Financial institutions are not long-term investors in companies

36 A view that is frequently associated with the "short-termism" hypothesis is that the source of short-term pressures are the financial institutions who hold the majority of the equity of British companies. As Table 4 (paragraph 24) shows, there has been a shift in share holdings towards institutional investors since the early '60s at the rate of almost two per cent per year. The Task Force survey also confirmed that many companies now look for a payback over a shorter period, when evaluating an investment proposal, than in the last decade. However, respondents to the survey indicated that higher interest rates and adverse market conditions were just as important as financial market pressures in causing such changes. This evidence does not suggest that the shift towards institutional ownership has been responsible for an increasing preoccupation with the short-term.

37 Attention is frequently given in this debate to the rate at which major financial institutions turn over their stock of equities. Table 6 indicates a gradual increase in turnover up to the beginning of 1986, when the main shareholding institutions held their stock on average for over five years. Unit trusts and investment trusts turn over their portfolios more rapidly. Since Big Bang, a lowering of transactions costs has been accompanied by a sharper increase in turnover. Compared with the first ten months of 1986, provisional data indicate that the value of daily turnover in UK equities was some 21 per cent higher after 27 October. On the same comparison, the number of bargains was up by 40 per cent[1]. It is therefore possible that holding periods may recently have shortened.

Table 6: Stock Turnover of UK Equity (%)

By:	1979	1981	1983	1985	1986*
Pension Funds	12.1	12.1	15.5	16.8	19.0
Life Assurance	7.0	9.4	12.4	13.5	17.4
General Insurance	15.2	12.5	12.9	15.6	17.3
Investment Trusts	18.5	22.2	30.5	37.6	34.3
Unit Trusts	35.0	40.6	43.3	47.2	52.6
All Institutions in UK Equities	13.2	14.1	17.0	19.1	21.9

* First half of 1986
Source: Wood MacKenzie & Co Ltd.

Note: Turnover is defined as sales plus purchases of equity, less net investment, divided by two (for each sale there is an equivalent purchase).

38 However there can be no unqualified supposition that increased turnover directly translates into short-term pressures on companies.

- The Task Force's survey of companies did not reveal any major differences in perceptions of short-termism between companies reporting an increase in turnover post-Big Bang and those who did not.

- Turnover in markets is necessary to ensure a certain degree of liquidity. A large number of the increased transactions have been between market-makers. It is difficult to say whether this reflects greater "switching" by institutional investors.

- Turnover by insightful and informed investors is essential to keep the market efficient and to keep prices in line with underlying values. Furthermore, in a period when dealing costs fall, more information-motivated deals will jump the dealing cost hurdle, turnover will inevitably increase and prices should respond even more rapidly than before. The post Big Bang increase in turover was thus entirely to be expected, and can be seen as consistent with greater market efficiency and liquidity.

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1 The Stock Exchange _Quality of Markets_ Second Report, March 1987.

- Turnover varies within different categories of institutions as well as between them. Some institutions split their holdings into core and discretionary funds. Only in the latter are investments very actively managed, with fund managers' performance being closely assessed. In particular, the amount invested in indexed funds, where turnover is restricted to that necessary to maintain a balanced portfolio, has grown.

39 So while it is not surprising to find that financial institutions are long-term investors in companies - after all pension funds and insurance companies have a clear interest in the long term performance of the shares they hold, since they must be in a position to fund long term obligations - undue alarm should not be registered at variations in share turnover. While shareholder commitment must be welcomed and encouraged it should not be confused with investor inertia and inactivity. As one commentator has pointed out.

> "If 'long-termism' amongst institutional investors means that they neither reduce their holdings nor indicate any other way to its board their concerns about a company of which they are members, it is not clear how such 'long-termism' differs from inertia. With the benefit of hindsight, it is not difficult to call to mind situations in the last few years where a shorter-term approach, equivalent to less patience, not to say less passivity, on the part of institutional shareholders might with advantage have been adopted at an earlier stage."
>
> (David Walker, Executive Director, Bank of England, February 1987)

40 This also relates to the issue of whether a clear interest in the long-term performance of shares might be fostered by amending the capital gains tax regime so as to encourage the holding of shares for longer periods. The Task Force did not believe that this issue could be examined in isolation but needed to be looked at in relation to wider issues such as fiscal neutrality.

Perception #3: The City is not prepared to raise funds for small companies or high-risk ventures

41 Whether industry has adequate access to funds from financial institutions has been widely debated, well before Big Bang. The report of the Wilson Committee (1980) concluded that there were no major financing gaps except for small firms. The Loan Guarantee Scheme was one specific attempt to fill this gap. A number of other developments have also helped to improve the availability of finance for small and growing businesses.

42 Lending by the clearing banks is by far the most important source of finance for smaller firms, with some £18-20bn of outstanding loans and overdrafts to businesses with turnover of less than £1 million. Recently, the banks have expanded their term lending to small businesses, reducing the reliance of small businesses on short-term funds. As well as the Loan Guarantee Scheme, there have been a number of other recent developments which have improved the access of smaller companies to equity capital as a means of financing expansion. Table 7 provides a summary of the main sources of funding for smaller businesses, apart from traditional bank lending.

43 Some £228m of equity and loans were provided by venture capital companies to UK firms in 1984, in amounts of between £100,000 and £1 million. This was an increase of 35% on the previous year, illustrating the fast growth of this sector. In addition, the major banks and financial institutions have their own venture capital funds. In total, not far short of £1 billion was raised for smaller business in 1984 (the latest year for which figures are available).

TABLE 7: SOURCES OF FUNDS TO SMALLER BUSINESSES
(excluding traditional bank lending)

Source	Year	£'000 per company involved Usual Range (1) Minimum	Maximum	Median	Total per annum (£m)
USM	1984	600	3,200	1,600	262
OTC	1983/4	240	3,200	1,300	39
BES: direct	1983/4	5	150	40	66
BES: Approved Funds	1983/4	50	500	200	39
Venture capital(2)	1984	250	750	400*	228
3i	1984/5	10	500	90	270
Loan Guarantee Scheme	1984	1	75	33*	75
Local Enterprise Boards(3)	1985	100	750	350	18

* Mean

(1) The figures cover 80% of financings, ie ignoring 10% extremes.

(2) Venture Capital Figures include BES approved funds.

(3) The Enterprise Board figures are for West Midlands Enterprise Board - some other boards lend at lower levels.

Source: National Economic Development Council, CFI External Capital for Small Companies, A Review of Recent Developments 1986.

44 The junior stock markets are of particular importance as a source of finance for sums in excess of £1m. Over £1bn has been raised to date on the USM and, though precise figures are not available, the OTC is thought to be around one-sixth of this size. The Stock Exchange Third Market has got off to a slow start, where to date only 12 companies have a quotation. There are also a number of small companies with a full Stock Exchange listing using this as a major source of finance.

45 The Business Expansion Scheme and investment by 3i's are major sources for investments of under £½ million. The Loan Guarantee Scheme (LGS) is particularly important for amounts of less than £100,000. In 1984, some 2,460 guaranteed loans were made of less than £75,000 (the LGS limit) totalling £75m. This represents almost twice the amount provided by the BES and 3i combined in sums of less than £100,000. There are also a large and growing number of institutions serving specific regional and local initiatives, which include the Scottish and Welsh Development Agencies, six Local Enterprise Boards and over 250 Local Enterprise Agencies. Although the precise roles of these institutions vary, most provide grants and loans, sometimes on preferential terms, as well as advice to small and medium-sized firms.

46 This is not to say that some firms do not experience problems raising capital and that efforts to match viable investment proposals to sources of finance should not continue. Specific problems which are encountered include:

- high fixed costs when raising small amounts of equity;
- a lack of sound professional advice to companies preparing investment proposals;
- the inability of potential investors to weigh up risks in a start-up.

47 However, in general companies are able to meet their financing needs. As a recent NEDO study of 176 small and medium-sized firms in the electronics sector concluded:

> "80% of all fund raising attempts reached a successful conclusion. Around 90% of companies seeking either loan or equity capital received offers, and 90% of the offers of both forms of finance were accepted. It was concluded from this that there was no evidence of a large scale failure by sample firms to meet their financing needs".

NEDC "Finance for Growth"
September 1986.

48 It has been suggested that the CBI should have a more active role in providing specific advice to smaller companies or helping them to present business proposals. The Task Force did not support this view. There are already a large number of companies and financial institutions very active in this field. On the other hand, the CBI does provide a forum - particularly at a regional level - where advice can be shared through seminars and workshops and this would be encouraged to continue.

Perception #4: The cost of City facilities has risen since Big Bang

49 The cost of dealing in the most actively traded stocks and shares has certainly fallen since Big Bang. Table 8 below shows the changes in the various components of the transactions costs for a typical alpha stock (the most actively traded securities). The most significant reduction has been in Stamp Duty, but commissions have also been reduced as well as the "market touch", the difference between the best bid and best offer price as a percentage of the share value.

TABLE 8: EQUITY TRANSACTION COSTS BEFORE AND AFTER BIG BANG

% Share price for an alpha stock

% of Share Price	**£1000 Deal**		**£500,000 Deal**	
	Before	After	Before	After
Stamp Duty	1.0	0.5	1.0	0.5
Commission	1.7	1.5	0.4	0-0.2
Market Touch	0.4	0.3	0.4	0.4
TOTAL	3.1	2.3	1.8	0.9-1.1

Source: Bank of England Quarterly Bulletin, February 1987

50 There is less information about recent trends in the costs incurred by firms when raising new capital. A large element of the direct expenses of a large rights issue is the underwriting cost, the majority of which is the sub-underwriting undertaken by the large insurance companies. There is little evidence so far that underwriting costs have fallen since Big Bang except for privatisation, though there is also no suggestion that they have risen. The professional charges associated with an issue of new capital are usually a small proportion of a large issue, (say £100 million) accounting for only 0.2 per cent of the value of the issue. However, for a small issue or when a company coming to market, these costs can account for around 5 per cent of the issue or more. Clearly the amount charged will depend on the complexity of the transaction. Again, there is little evidence about the trends in these changes since Big Bang. However, as competition increases it is likely that these costs will actually fall.

TABLE 9: EXPENSES OF AN ILLUSTRATIVE FINANCING OPERATION
% of amount raised

	£7 million offer for sale	£100 million rights issue
Capital duty	1.0	1.0
Stock Exchange Listing Fee	0.1	0.01
Advertising Costs	1.4	0.01
Printing Costs	0.4	0.02
Receiving banks charges	1.0	0.04
Accountants fees	1.3	0.05
Legal fees	1.4	0.02
Issuing bank fees	2.0	2.0
Advisers' fees	0.2	
Total	8.0	3.16

<u>Source</u>: Bank of England Quarterly Bulletin, December 1986

Perception #5: British companies grow by acquisition rather than by investing in new assets.

51 While it is too early to draw definite conclusions on the impact of 'Big Bang' on the market for finance, the evidence to date suggests that transaction costs in trading securities have fallen and the liquidity of markets has increased. However, the impact on the cost of raising new capital is less certain, though a reduction may follow as financing arrangements adapt to the new competitive market environment. The direct costs involved are substantial, as Table 9 suggests. There may also be an element of "underpricing" with a new issue, where the company fails to realise the full market value of the equity it has issued.

52 The high level of takeover activity in 1986 prompted a lot of the anxiety which led to the formation of the Task Force. It is important to set this in perspective. Expenditure on mergers and acquisitions by industrial and commercial companies in 1986 was indeed a record high in real terms, though it only just exceeds the totals of 1968 and 1972. However, as a proportion of the capital assets of companies, the value of takeovers in 1986 (5%) stood below the peaks of 1968 (9%) and 1972 (6.5%). Measured in this way, only six years ago in 1981, saw a record low level of takeover activity. It is also true that over half the expenditure on mergers and acquisitions in 1986 was accounted for by four very large takeovers.

53 Expenditure on mergers and acquisitions should also be set in perspective against the amounts spent by companies on innovation and creating new assets. Even in 1986, with such a high level of takeover activity, companies spent £25 bn on fixed investment and about £5 bn on research and development, compared to the £13.5 bn which was spent on mergers and acquisitions. More typically, over the preceding six years, companies spent on acquisitions only 17% of the amount they invested in buildings, plant and machinery.

Table 10: EXPENDITURE BY INDUSTRIAL AND COMMERCIAL COMPANIES

£billion, at 1986 prices

	Fixed investment	Mergers & Acquisitions
1980	21.5	2.1
1981	19.3	1.4
1982	18.7	2.7
1983	18.1	2.6
1984	21.3	6.3
1985	24.2	7.3
1986	24.9	13.5

Source: Financial Statistics

54 Moreover, the extent of actual consummated takeover activity may tend to be exaggerated in the public mind. Many contested bids do not in fact succeed precisely because institutional shareholders tend to support the incumbent management. In 1985, only one in six bid defences succeeded but, by 1986, the odds had shortened to 1 in 3. After a successful defence, the would-be predator is left with heavy costs and an often dented reputation unless another predator or "white knight" succeeds and the original predator is able to sell his stake at a profit. Some companies have clearly grown particularly rapidly as the result of acquisitions, though many acquisitions themselves may lead to subsequent investment and increased in efficiency. Furthermore, seen in perspective, the main source of expansion for the company sector as a whole - by a long way - remains internally generated growth through investment, training and research and development.

Perception #6: Takeover activity inhibits business performance

55 There are two concerns about the way in which takeovers impede business performance:

i Mergers and acquisitions may take place which do not seek to improve the underlying economic performance of the companies in question and hence the shareholders, customers and employees may have been better served if the companies had remained separate.

ii The threat of takeover is an impediment to business performance and causes companies to defer worthwhile long-term investments.

The evidence on both points does not support the connection between takeover activity and poor business performance.

Post-acquisition Performance

56 Studies which use accounting information to assess the post-merger peformance of companies are fraught with difficulties, not least because of the obfuscating effects of different post-merger accounting methods and the impossibility of establishing how the companies would fare in the absence of the takeover. It would certainly be wrong to assume that pre-merger profitability would have been sustained, since many mergers occur because of the companies in question do not expect to achieve this. Numerous studies which have looked at change in the acquirors' and acquirees' market values as a measure of shareholders' gains from mergers have concluded that the shareholders of the acquiring company are, on average marginally better off, while those of the acquired company are substantially better off. While these studies show that only just over 50 per cent of bids bring profits to the acquirors shareholders, they do indicate that, on average, acquisitions result in a higher market capitalisation for the combined entity than for the two original firms run separately. However, while on average, acquisitions have brought net gains to shareholders, there are many other interested parties - managers, employees, customers, suppliers and the tax authorities - who may either gain or lose. Research has shed very little light on the latter issues, and it therefore has to be acknowledged that however important shareholder interests and market valuations may be, they do not provide the entire picture.

57 A recent study in the United States confirms, indirectly, the uneven performance of acquired companies: a high proportion of acquisitions, particularly in fields where the acquirer had little prior experience, have subsequently been divested. Table 11 summarises the findings. There are two possible interpretations. The high level of divestment can be taken as evidence of disappointed shareholder expectations, mistaken strategic moves and lost opportunities from which it will take time for the company to recover. The second interpretation, however, is that subsequent divestment may always have been the intention of the acquiring managment and that restructuring and divestment may in itself have been a profitable activity for the acquiror.

TABLE 11: DIVERSIFICATION AND DIVESTMENT BY 33 LARGE AMERICAN COMPANIES, 1950-80

	Proportion Divested %
All acquisitions	53%
Acquisitions in entirely new fields	61%
Acquisitions in unrelated new fields	74%

Source: Michael Porter, Harvard Business Review, May - June 1987.

58 On the other hand, it seems quite clear that the threat of takeover can actually improve business performance. One major study (1) indicates that most target companies in abandoned contested bids achieve higher profitability in the year after the battle, which continues in many cases for three years afterwards. Often the would-be acquiring company similarly shows results better than those achieved before the unsuccessful bid. The evidence, therefore, reinforces the point, which is frequently made, that the threat of takeovers can be a spur to management to carry out necessary restructuring of the business.

Impact on Investment

59 It also sometimes alleged that companies under threat of takeover may defer worthwhile investment in order to raise their current earnings. Those surveys which have asked companies whether this is the case do not support this view. Over 80% of the firms covered by the survey undertaken by the Task Force on financial pressures and company attitudes (see Appendix B) had been involved either in takeover activity directly or in press speculation. Yet not one said that fear of being acquired was a major constraint on long-term decision-taking. Further evidence pointing in the same direction comes from a telephone survey of Finance Directors conducted for Deloitte Haskins & Sells in April 1987[2]. Even those companies believing that the City inhibits industry (a minority amongst those surveyed) ranked mergers/takeovers/asset stripping as the least potent of the five reasons put forward as causes.

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1 Dr P Hall and Professor J F Pickering "The Determinants and effects of actual and contested mergers" E.A.R.I.E. Conference 1986.

2 Research into the relationship between the City and Industry, Deloitte Haskins and Sells, April 1987

60 Against this, the takeover process is a costly one. It has been estimated that the expenses incurred by all parties to bids amounted to about £600m in the first six months of 1986. Related to acquisitions of, say, £6.75 billion over the same period, costs were running at about 9% of the value of transactions. Expenses alone in the major acquisitions carried out in 1986 amounted to over £5 million for every main board director of the companies being acquired. Such costs do not measure the diversion of senior management from the development of the business, a frequent matter for complaint by those who have fought off a hostile bid. However, the evidence does indicate that for bids which succeed, shareholders still benefit even after taking these costs and the bid premium into account. Similarly, the evidence in paragraph 58 above suggests that shareholders gain even from "failed" bids. However, while hostile bids may have more than covered their costs, they remain a very expensive way of gingering up or replacing managements who are not performing up to expectations. A key issue therefore is whether there is a more cost effective way of achieving the same objective.

Putting problems in perspective

61 To sum up the Task Force's conclusions so far, the case against the City - that it has caused British industry to be less profitable than its OECD competitors - is not substantiated by the evidence. Nonetheless, the unpalatable facts remain. Britain's investment performance has been poor and manufacturing has declined in relative importance and in absolute terms to a far greater extent in the United Kingdom than among our EEC partners, for example. Many industrialists perceive the attitudes of the City to be a contributory factor. In the era of investment that must now follow the recovery of the past few years, such uneasy relationships could constitute a national competitive handicap which can be ill afforded. The next Chapter of this report therefore suggests how relationships between the City and Industry can be improved.

2 - IMPROVED COMMUNICATIONS

62 The need for effective communications between owners of companies, the providers of finance and those managing business is so obvious that it should not need to be restated. Yet, at the heart of the problem that the Task Force has been addressing, lies a series of communications failures. Too often, owners have not communicated effectively with management. Companies have not communicated well with all their various stakeholders. Banks, and the professional advisers to companies, have sometimes felt unable to "level" with their clients. Companies have not always communicated effectively with their pension fund trustees and some of those managers complaining of short-term pressures have been applying it themselves through their own activities as trustees.

63 Without effective communication at all these levels, the era of investment will be still born. So the Task Force has considered what can be done. This Chapter summarises in turn:

(i) The lessons to be learned from abroad, particularly in West Germany, France and Japan where institutional links between owners, sources of finance and management may have contributed to the relative health of their manufacturing sectors.

(ii) Proposals for improving the situation in the United Kingdom, recognising that wholesale importation of foreign approaches is not practicable.

LESSONS FROM ABROAD

64 Many people in the UK, particularly industrialists, have on occasions looked enviously towards foreign systems of industrial finance and called for fundamental domestic reforms.

65 It is common practice to divide the world's major financial systems into two broad groups. The so called 'bank based' systems, characteristic of Japan and the continent of Europe, which have been associated with significantly higher post-war growth rates, and the 'market based' systems of the UK and US. Although such a clear and simplistic distinction is inevitably an over-generalisation there are certain important differences in the way in which industrial finance has traditionally been organised within these two categories.

Bank/Industry Links

66 The links between commercial banks and their industrial clients have been much closer in Germany and Japan than either the US or the UK. In France, similarly close ties have been developed between industry and the state-backed lending institutions. It is possible to trace these close links to peculiar historical situations in each economy.

67 Before the last war the Japanese economy was characterised by a number of industrial groupings or "zaibatsu". These consisted of interlocking relationships between industrial and commercial firms, banks and other financial institutions all under the ultimate control, through holding companies, of a few wealthy families. The Japanese post-war reconstruction programme outlawed such holding companies but the zaibatsu have subsequently reappeared in a less formal framework of interlocking reciprocal shareholdings. The latter day groupings are less influential than their pre-war counterparts but the principle of group membership is firmly established within Japanese business. Reciprocal directorships and business clubs also unite industrialists and financiers in a less formal way.

68 Japan's high economic growth during the 1960's and early 1970's was accompanied by tight credit conditions. Japanese corporations, suffering a chronic shortage of funds, depended heavily on the banks. Recent deregulation and improved treasury management have made Japanese firms more anxious to reduce their funding costs by shopping in world markets. These improvements have helped to build up large cash surpluses within Japanese industry which are now more likely to be reinvested in world capital markets rather than plant and machinery. Treasury managers of Japanese firms have become more anxious to both minimise their funding costs and maximise their return on investments.

69 Evidence of Japanese firms repaying long-standing domestic bank loans and turning down their bankers' requests for fixed interest deposits is plentiful. During the early 1970's about 80% of available cash was placed in fixed interest rate deposits, but by the early 1980's this percentage had dropped to around 30 - 40%, and by 1984 virtually all funds available were going into certificates of deposit or into foreign currency deposits with market rates. As a result, Japanese banks now look more towards medium and small firms to provide them with business.

70 What is of particular relevance to the UK City/Industry debate is that, despite this loosening of the formal business ties between the larger Japanese firms and their banks, the overall links between the two parties remain stronger than elsewhere. Though the large corporations may not need their domestic banks as much as they used to, corporate and personal links built up over many years continue to benefit both sides. In particular, Japanese banks have helped their clients to participate in international capital markets, for example, by guaranteeing Eurobond issues.

71 In Germany the present close involvement of the banks in industrial affairs stems largely from their intervention to rescue firms from the brink of liquidation. Recovery packages have usually been launched in return for reciprocal claims upon the firm's assets, supervisory board memberships, and/or promises of future business. Such an arrangement then leaves the two parties bound by an implicit contract for an indefinite period of time. Reliance upon debt finance, often provided on a long-term basis, has been seen by many as an important factor in the establishment of stable bank/industrial relations in Japan, Germany and France. Table 12 seems to confirm this view. On the other hand researchers who have looked at market value, rather than book value ratios find that US and Japanese firms have identical gearing.

TABLE 12: CAPITAL GEARING

Debt as a % of Equity 1979 - 1985 (average)

Japan	79
France	64
W Germany	59
UK	54
US	38

Source: OECD Financial Statistics

Note: Gearing is measured by the ratio of net outstanding debt to equity among industrial and commercial companies. International differences in accounting practices mean such figures should be interpreted with care.

72 However the differences in gearing ratios are in some cases, not very significant and it is difficult to argue on financial grounds tht high grearing is good per se. Also over the period the UK and US gearing ratios have been rising while those for Japan and Germany have fallen. In any case, the distinction between "debt" and "equity" obscures a more significant international difference between the ways in which the providers of debt and equity perform their risk sharing function. The providers of debt finance in Japan, Germany and France have traditionally adopted a more long-term view of an investment, based upon a close relationship with the borrower firm. In these countries, banks are prepared to reduce interest rates, reschedule loans, preside over managerial changes, and/or extend further finance should the need arise. These are the functions usually associated with a risk sharing equity investor.

73 Germany is the clearest example of a bank based financial system experiencing internal stresses and strains. There is a growing body of opinion among industrialists that the German banks have too much influence in the affairs of industry. There are accusations of monopoly power as well as a desire for greater emphasis upon equity capital as a preferable long-term corporate base. The West German Federal Cartel Office has demanded a legal limit on bank shareholdings, suggesting 5% of equity. No limit yet applies. Banks own about 5% of all quoted domestic shares, and control more than 25% of the 33 largest industrial companies. This concentration is increasing. There is also an intricate web of cross-shareholdings and supervisory board memberships which serves further to enhance the banks' influence in the affairs of industry.

74 Several critics of the German Banks regard their domination as a hindrance to private enterprise (though not, apparently, to industrial performance). Many neutrals have said that the concentration of shareholder power with the banks has led to complacency among German managements. This follows from the belief, sometimes admitted by the banks, that they lack the necessary ability to assess risk and profit potential in rapidly changing markets.

75 The pattern of shareownership in bank based systems is also very different. One factor common to all three economies is the concentration of large numbers of shares in the hands of a small number of shareholders, who hold equity for strategic control proposes.

- In Germany, shares of any but the top 20 companies are notoriously illiquid with huge blocks of voting stock stowed away with controlling families and institutions, such as German and Swiss banks and insurance companies.

- In France, according to the Commission des Operations de Bourse, 50% of the shares of listed companies are in the hands of one or two major shareholders. These controlling shareholders further protect their position by such arrangements as double-voting, alliances and self-control techniques.

- Similarly, in Japan, a high proportion of total equity is not actively traded by its owners, largely because of the system of cross company shareholdings already mentioned.

76 This system of long-term share ownership is often viewed with envy by British industrialists who readily contrast it with their own experience. However, there are disadvantages in having such a narrow shareholder base. Major among these is the relatively underdeveloped nature of the stock markets as a source of industrial finance in these economies.

Stock Markets

77 In Germany, there appears to be a deep reluctance among industrialists to go public and list their company on a stock exchange. Of the 1.9m businesses registered in Germany just 7,000 have gone public and only 467 have a listing on a stock exchange. Both the government and the German exchanges are trying to encourage more public listing of small and medium sized firms. There are, however, several barriers to this. Companies see the markets as lacking in liquidity and being largely dominated by the banks. Many German entrepreneurs, who have technical backgrounds, are not well informed on financial matters and usually turn to the banks for advice. On top of this, managers are reluctant to expose themselves to the greater disclosure and performance requirements often thought of as being part and parcel of a stock exchange listing.

78 In France, equity transactions currently account for only 20 per cent of deals struck on the Paris Bourse and the authorities are anxious to increase French industry's use of the market. The last three governments have done much to encourage a shift towards equity capital, mainly through tax incentives for investors buying shares. One factor common to both France and Germany is the relative lack of non-bank investing institutions. Historically, the banks have been the main channel for savers' funds in both countries and consequently the predominant source of external funds for industrial investment. By contrast, their UK counterparts have, until recently, tended to be more specialised allowing the development of institutions outside the banking sector.

79 Due to Japanese industry's traditional preference for debt finance as its major source of funds, the Tokyo stock market has remained until recently, relatively underdeveloped. Even with the dramatic increase in capitalisation and its growing sophistication, the Tokyo exchange is still underused as a source of funds for Japanese industry. One reason for this is the continued dependence of Japanese industry upon debt finance but another is the relatively high costs involved in issuing new equity on the Tokyo exchange. This latter barrier is a major reason for the increased exploitation of international capital markets by Japanese corporations.

80 However, in each of the three "bank based" economies (Japan, Germany and France) identified above, the system appears to be changing. There is a realisation in all three countries that equity finance is preferable for long-term corporate growth. In the case of equity finance, servicing costs are linked to available profits, hence reducing the risk of cash-flow problems. Thus in an era of rapid structural change (eg Japan) and depressed current profitability (eg Germany), companies need to supplement internal funds by access to a well-functioning external equity market.

81 Recent developments both within individual countries and in the international environment have caused a convergence in the way in which the world's major economies structure their industrial finance. The growth in information technology has hastened the globalisation of financial markets, which bring together people and insititutions from different cultures, accustomed to different practices and different standards. There have been two main consequences for the issuers of shares. Firstly, the revolution of information technology has broken down barriers of time and place and made worldwide instantaneous transmission of information and instructions are commonplace. This represents a risk of greater volatility in market prices as more major players make their money by taking positions quickly before the market moves. Secondly, the variety of choice, the opportunities for hedging and diversification and the ease of mobilisation and transfer of capital have led to a significant widening of the market for equity. From the commercial point of view there are plainly advantages in this.

82 The effect of these developments will be to make the financial systems in Japan, Germany and France more akin to those in the UK and US. To the extent that these changes are a response to dissatisfactions with the traditional methods of finance in Japan, Germany and France, the UK would be unwise to attempt to move towards a more "bank orientated" system. Also many features of the UK financial system have served its users well over the years, not least its flexibility and the number of rescue and restructuring packages that have been organised through the equity market and prevented bankrupcies among UK quoted companies.

83 In fact it is very doubtful whether the structure of the UK financial system could be fundamentally changed. An examination of the origins of systems of industrial finance shows them to be the product of historical development and targetted government policy has played only a minor role in the establishment of present day systems. Each country's system has developed both in response to the specific internal needs of the domestic economy as well as the historical and social structures of each country and it would be impossible to transplant one country's system of finance on to foreign soil without taking adequate account of the prevailing situation. Any policy prescriptions for the UK must be of a kind that can be built upon the existing system of industrial finance.

84 The main lessons that can be learnt thus relate more to the relations between individual lenders and borrowers and investors and businesses rather than to the wider structures and constraints within which these two groups operate. Traditionally, lenders in Japan, Germany the USA and France appear more willing to share in the risks associated with industrial activity. The ability of investors to do this is closely related to the links that banks and financiers have established with their industrial clients. **In particular, better communications between owners/lenders and managers have played a vital role in the development of knowledge and understanding among investors.**

85 The challenge to UK companies is to develop the effective communications network which characterises the situation in West Germany, France and Japan while avoiding the rigidities which have led to the stresses described above. In the next section, this theme is discussed further and specific proposals are developed.

THE CHALLENGE AT HOME

86 To ensure that financial markets work efficiently, market participants must have adequate information. This highlights the importance of good communications. The Task Force has found that in the majority of cases where differences of opinion existed between the City and Industry these arose from misunderstanding which could have been avoided by better communications and better education. Several commentators have echoed this theme:

> "I would like to see a commitment to communication between the City and Industry - then perhaps we can dispense with such nonsense as short-termism, and talk of divisions between City and business."
>
> Sir David Plastow, Chairman Vickers plc, Speech to the National Association of Pension Funds, February 1987.
>
> "Shareholders, large or small, want to know about the people, their philosophy and aspirations which are incorporated in the company they own. The more this can be communicated to them, the more likely it is that a bond of loyalty and trust will be created, strong enough to withstand those periods when the shareholders' rewards - increasing dividends from increasing earnings - are more difficult to provide".
>
> David Tucker, Director M&G Group plc, London, Treasurer's Club, January 1987.
>
> "The key factor is open and regular communications between the company and its shareholders. This communication has to be a continuous process - it is not something to be switched on when a hostile predator appears over the horizon and switched off again when the threat disappears".
>
> Sir Ronald McIntosh, Chairman APV Baker Plc, May 1987, in a statement to shareholders.

87 Just as there is a myth that the City is a homogeneous body, the Task Force found that, when addressing communications, it was quite inappropriate to talk of communications in terms of just the 'City' and industry. There are a number of different audiences that a company seeks to address in its communication with the City: shareholders, potential investors, financial analysts and bankers. Equally there is a number of different channels of communication. The Task Force highlighted the importance of the City Press and media and the inter-play between stockbrokers analysts, companies and the Press. Given the complex relationships, the Task Force felt that rather than develop specific guidelines of best practice, it was more important that all concerned appreciate the need for better communication between and within their organisations.

88 Specifically, the Task Force has concluded that:

(i) Companies must make more effort to keep the market informed. It is not unknown for Chairmen simultaneously to complain of the City's "failure to understand what we are all about" and to be extraordinarily reluctant to provide information to the very people who need to know.

(ii) The quality of analysts needs to be improved; at present it can appear very uneven. The educational initiatives and programmes of the Society of Investment Analysis and other responsible bodies deserve the strong support of City institutions.

(iii) Non-Executive directors and Chairmen should provide an effective link between owners and management, and a channel of communication with firms professional advisers - so that the City's unvarnished view of management's performance is communicated effectively.

(iv) An effective dialogue between companies and the trustees of the funds they sponsor should be developed on issues of mutual concern and interest.

(v) Institutional links between the City and Industry need to be strengthened.

The rest of this Chapter discusses each of these conclusions in turn.

Keeping the Market Informed

89 The Task Force believes that companies should try to keep the market as well informed as possible. This will involve recognising that they have a problem to deal with in informing their shareholders better; organising themselves for the task in terms of designating responsibilities for carrying it out; and communicating all the information that is in the public domain. The Task Force emphasised the need to give investor relations a high priority within the company and deal with this subject formally at a senior level. It is frequently the specific responsibility of the Chairman, though he may choose to delegate this to his Chief Executive or Financial Director. Many Chairmen of companies in the United States spend the majority of their time communicating with investors and analysts.

90 However, companies face a dilemma in their choice of channels of communication. If they provide market-sensitive information only on a request to a small group of shareholders/analysts, they run the risk of breaking Stock Exchange rules, and in an acquisition situation those of the Takeover Panel, by not treating shareholders equally. If individuals act on such inside information ("insider dealing") they may be in breach of the law. On the other hand, to make available to all shareholders information that is only required by a few, can be very costly and time-consuming. Management is required to use its judgement in ensuring that all the relevant facts were in the public domain, while using cost-effective means of communicating them. Two areas where voluntary disclosure could bring worthwhile benefits are research and development and training.

i) Research and Development.

91 Shareholders and analysts appreciate that companies must invest in the future, but need to have a specific understanding of their business objectives and plans for achieving them. One important step towards this improved understanding would be for companies to disclose more information, both qualitative and quantitative, about their innovation activities. One important element of innovation, but by no means the only one, is Research and Development.

92 There is currently a debate within Government about imposing some form of statutory requirement on companies to disclose their R&D spending. The Task Force did not favour statutory disclosure. It would focus excessive attention on R&D in isolation from the rest of the innovation process, from which it should not be divorced and give only a partial picture, by showing only the quantity of resource input to the R&D process while saying nothing about quality, or of the effectiveness of the R&D in leading to a useable product. In some cases, particularly for single product companies and those who do not carry out R&D regularly, disclosure would mean revealing commercially sensitive information to competitors.

93 The Task Force, while supporting moves towards greater disclosure of companies R&D effort, felt that this should stop short of compulsion. The Task Force did, however, accept the need to examine a new accounting standard for the treatment of R&D expenditure in company accounts.

ii) Innovation other than R&D.

94 Innovation is much broader than R&D expenditure. It includes training, licensing, patenting, product and Design Engineering, and Market Research and Market Development.

95 Investigation of practice in other European countries and the USA showed that nowhere is disclosure of expenditure on these activities a legal requirement, though data on them are frequently assembled for day-to-day management purposes. In the case of Training, voluntary disclosure of expenditure is common in Germany, and in France expenditure is disclosed as a result of the national requirement for a minimum spend on this activity, with tax penalties if this is not achieved.

91 The Task Force felt that the disclosure of information about innovation was important in informing the market about a company's affairs. It recommended that companies should be encouraged to provide, on a wholly voluntary basis, more information in Annual Reports about factors (in addition to R&D) which contribute to innovation. However, there is a need for further work to identify how these functions might be accounted for. The CBI survey (summarised in Appendix B) revealed a preference among firms for providing details of new products, as opposed to innovation expenditures. This emphasis could stem from the difficulties involved in producing a meaningful figure for expenditure on such items as R&D and training. Table 13 shows respondents' answers to the question:

What information do you provide on a regular basis to major institutional shareholders/financial analysts on your long-term plans and proposals?

TABLE 13: INFORMATION DISCLOSED

	% Survey Respondents
Profit forecasts	20
Expenditure on R & D	20
" on training	6
" on other long-term development plans	29
Details of new products	50

Source: CBI Survey of Shief Executives, 1987 (see Appendix B)

iii) The Annual Report.

97 Judging the effectiveness of the various methods used to disclose information is less clear-cut. Nearly all firms use their annual reports as a means of communicating such information to all shareholders. Indeed, most firms also see their annual reports as the most important method of communication with institutional shareholders. Personal contacts, individual briefs and City presentations are all used as channels of communication, but are generally regarded as less important than the company's report.

98 In addition to setting guideline principles for items that might be included in companies' Annual Reports, the Task Force recommended that there should be a change in company law to permit companies the option of setting out an abridged version of the Report to all shareholders, leaving them the option of obtaining the full Report, free of charge on request. This would have a significant advantage to companies in terms of the lowering of costs. The Task Force welcomed the investigation of this issue currently being undertaken by the Department of Trade and Industry.

99 In terms of the Full Report the Task Force agreed the following recommendations on its content and style. With appropriate, though not excessive, regard for confidentiality, items which should be included are:

- the objectives of the company
- the philosophy to achieve these objectives
- a report on how these objectives have been attained
- details of the company's business and the scale of its operations
- any recent changes in the nature of the company's business
- aspects of the company's long-term strategy; for example, research and development expenditure, details of new products, and the company's policy on training and management development

- likely developments in the company's main markets

- details of executive and non-executive directors of the company, including age, experience and qualifications.

100 Companies must obviously keep in mind the cardinal principle that market sensitive information given to major shareholders should be made available to all with a stake in equity. As noted earlier, The Stock Exchange and the Takeover Panel require this; and the release of price sensitive details to some parties exclusively may put them at risk for insider trading if they want to deal on the basis of what they have heard. However, there are clearly instances where it may not be useful or practicable to put background information at the disposal of all shareholders - for example, where there is a special briefing of brokers analysts knowledgeable about a particular industry. Whilst in principle one can distinguish between new price-sensitive facts and the gloss which a company's senior officer may choose to put on existing detail already known to the market, in practice the line is not always clear cut. In case of doubt, the advice must always be to publish.

101 Taking all these considerations into account the Task Force considered some ways in which the flow of information to the small private shareholders might be improved. One suggestion which was felt to merit further investigations was that companies should publish in their Annual Report the names of brokers from whom the private investor could then obtain elaboration and analysis.

<u>The role of Analysts</u>

102 Analysts employed by financial institutions and stockbrokers are a key channel of communication between the company and its owners. From a company perspective, the quality of analysts can appear dangerously uneven. Poor analysts can give the City a bad name if they give industrialists the impression that the company's rating relies excessively on current dividends and earnings or other short-term financial indicators and demonstrate only the haziest understanding of the markets, technology and competitive pressures under which a company is operating. It is sometimes commented that few UK analysts and research departments have had practial experience of industry, unlike the United States where such experience is more common.

103 It is obviously important for analysts to make assessments based on a strategic assessment of the companies' prospects not just earnings per share or other readily available financial information. "Good" analysts have an understanding of the market in their particular sector, and the underlying forces at work, as well as of the companies' objectives and competitive strengths and weaknesses. More such analysts are needed, and the Society of Investment Analysts' various educational initiatives and programmes deserve the strong support of City institutions.

The Press and Media

104 Although the Task Forces brief was concerned primarily with relationships between City and Industry it is impossible to discuss the subject of communications and information without reference to the financial press and media. The role of the financial journalist is vital to the free flow of information between companies and shareholders. It is particularly important to the smaller and private shareholders who do not have daily access to information via screens and computers.

105 The daily listing of prices is in itself an invaluable service and editoral comment and advertisements covering company results are an essential part of the flow of information which help to make the market operate efficiently. The regular flow of information and commentary between companies, analysts and financial journalists conducted in the financial columns of newspapers as well as business programmes on radio TV also helps to create a better degree of public understanding.

106 However, as well as being educational and informative, these channels are open to the abuse and misuse of information. The practice of companies providing information to one journalist on an exclusive basis in order to obtain favourable publicity is questionable. Also, speculation about possible takeovers in financial columns, often without any foundation other than City rumour, could actually distort share prices. The Task Force believes that the extent to which share prices can be manipulated by such press comment and the scope for profit by those initiating the rumours requires more detailed attention and investigation both by the Regulatory authorities and by the Press Council.

More use of Non-Executive Directors

107 When chairmen recommend to colleagues and shareholders that non-executive directors should be taken on to their boards, their chief purpose is to bring in people whose skills and experience will add to the range of those of the executive members and blend with them. It is this consideration which is uppermost rather than the need to fill a particular quota or find resources for particular committees of the board. However, the non-executives, when they are of the right calibre, and adequate in number, offer some guarantee to investors that independent judgement is being exercised in the directors of the company's affairs and thus serve a number of purposes. They can reinforce the viability of the company to investors, offer a conduit for misgivings by the institutions if they believe that the executive of the company is not performing as he should and generally provide the checks and balances which form part of the two-tier board system in some Continental countries but which do not sit comfortably with our traditions, legal framework, or best practice.

108 The Task Force endorses the Code of recommended practice on non-executive directors prepared by PRONED[1], a project chaired by Sir Adrian Cadbury and sponsored (among others) by the CBI. For the purposes of the Code, an independent Non-Executive Director is one who has the integrity, independence, personality and experience to fulfil the role of the Non-Executive Director effectively. Independence is more likely to be assured when the Non-Executive Director:

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1 Bank of England Quarterly Bulletin, May 1987.

(a) Has not been employed in an executive capacity by the company on whose Board he or she sits within the last five years:

(b) If a professional adviser, is not retained by the company (whether personally or through his or her firm) on a continuing or regular basis: and

(c) Is not (whether personally or through his or her employer) a significant customer of or supplier to the company.

109 The Code, published in April this year, recommends that, in larger quoted companies where the turnover is £50 million or more or whose employees number 1000 or more, the Board should normally include at least three independent Non-Executive Directors. Independent Non-Executive Directors (including the Chairman, if he or she meets the criteria above) should comprise about one-third of the Board. In smaller quoted companies, or in larger companies which have small Boards, the provisions of the Code should be followed in a manner and to an extent appropriate to the size of the Board and commensurate with the company's resources.

110 The main tasks of the Non-Executive directors are to contribute an independent view to the Board's deliberations; to help the Board provide the company with effective leadership; to ensure the continuing effectiveness of the Executive Directors and management; and to ensure high standards of financial probity on the part of the company. If they are to succeed in these tasks the Non-Executive Directors will need to enjoy the full support of the Chairman, and will need to be provided with the information which in their view they require in order to carry out their duties. They will also need to receive such information in sufficiently good time to enable them to give it their proper consideration.

111 The Non-Executive Directors should be consulted on major issues of audit and control. Their task will be facilitated by the establishment of an Audit Committee whose functions should be to consider important financial information, the adequacy of systems of financial control, the scope of the audit and the auditors' remuneration; and to put recommendations on these matters to the Board. The committee should be composed mainly or wholly of Non-Executive Directors, and its Chairmanship and quorum should reflect this. Non-Executive members of the Committee on it should have the right to see the auditors alone if they wish.

112 The Board's most important functions include:

- the appointment, dismissal and remuneration of top executive management;

- the appointment and dismissal of Directors to or from executive positions, especially that of Chief Executive;

- the appointment and remuneration of all Directors.

The execution of these functions will be facilitated if an Appointments and Remuneration Committee is established, the majority of whose members are Non-Executive Directors.

113 Non-Executive Directors should normally be appointed on the understanding that they are joining the Board for a specific term, subject to re-election by rotation in the usual way. After the expiry of this term, renewal should not be considered to be automatic by either party.

'Ginger Groups'

114 Non-executive directors also have a role in communicating shareholders' concerns to management, particularly on management performance. Too often, this channel of communication has not been open and the only way shareholders can convey their dissatisfaction has been to sell in the market. Where the shareholders are a Pension Fund or other investment institution, the Task Force felt that the investment manager should be encouraged to seek ways of conveying concern about an investee company's activities to its management, if necessary, in association with other major shareholders. One idea considered was that there might be some independent person of stature, possibly working under the auspices of the Bank of England, with whom an insitutional investor could consult, with a request that this individual talk to a senior non-executive director of the business. The Task Force felt there was much merit in this idea and asked that it be followed through with the appropriate bodies.

Dialogue between Companies and Pension Fund Trustees

115 Pension funds taken as a whole constitute the single largest category of institutional investors; by the mid 1980s, pension funds held about a third of all UK quoted equities. Occupational pension fund assets have their origin primarily in contributions paid by companies and their employees those assets in turn are heavily invested in the equity of other firms. They consequently form a network of ties between companies, although they are rarely seen in this light.

116 The management of pension fund assets is a complex process, with legal responsibility for the stewardship of the fund lying with trustees, but involving in various ways the sponsoring company, investment manager, other specialist advisers and scheme members and beneficiaries. There can also be constraints and obligations imposed by trust deeds. Many pension fund trustees hold senior management positions within the companies sponsoring the relevant pension fund. Such individuals are acting as shareholders in their trustee role and as managers responsible to shareholders in their management role.

117 Pension funds accordingly occupy a unique position in relationships between industry and commerce and shareholders. They have a key role to play in enhancing relationships between the City and Industry to the general benefit of the economy as a whole. The Task Force does not accept the charge that pension funds have acted in a manner which is detrimental to the success of the UK economy. However, there is scope for improving the arrangements for the management of pension fund investment and its deliberations the Task Force has sought ways of building upon the success of existing arrangements. In view of the importance and complexity of the subject, a special working party was set up to assist the Task Force's work in this area and more detailed analysis of the issues is contained in a separate working paper.

118 Communications between the parties involved in pension fund investment are complex because of the variety of pension arrangements, the diversity of those involved and the special legal responsibilities which rest with trustees. At their most simple level in a funded occupational pension scheme providing defined benefits, the interests of the various parties may be outlined as follows:

- the sponsoring company, which in many cases is the effective guarantor of benefits and the major source of contributions to the fund and this has a very real interest in its proper management;

- the trustees, who have legal responsibility for the stewardship of the fund (although they may delegate functions to an investment advisory committee etc);

- the investment manager, who manages the fund on a day to day basis in accordance with any guidelines and objectives set by the trustees.

Others involved in various ways include actuaries, pensions consultants and other professional advisers to the parties mentioned above plus, of course, the boards of those companies in which the fund invests. This, it must be emphasised, represents a very simple summary of the position where a company operates a self administered pension fund.

119 Given the interest of companies in the proper stewardship of the pension funds which they sponsor, the Task Force recommends that companies, where they have the power to appoint trustees, should review their trustee arrangements, in relation to:

- the responsibilities of pension funds as shareholders (for example, the exercising of voting rights);

- the setting of achieveable objectives and guidelines for investment managers; in particular the risk profile which investment managers adopt (as suggested by David Walker in his speech to the 1986 CBI Conference).

- self investment (ie investment by the pension fund in a company's own stock)

- arrangements for the appointment of investment managers and monitoring their track record.

120 In order to assist companies in discussing all these areas, checklists of issues are set out in Appendix C. The Task Force is very conscious of the constraints imposed by time and resources, but its members nonetheless take the view that managements should endeavour to hold constructive discussions with trustees on their approach to these and other appropriate matters.

121 This dialogue should also be external to cover communications between the trustees and the investment managers (through the investment advisory committee or other such intermediate body, where one exists). Though it is impracticable to lay down precisely the form these communications should take or the issues to be covered, investment guidelines and monitoring of the fund's record should clearly feature in them. Trustees may also wish to take account of the views of investment managers in the development of policy.

122 Investment managers clearly have the main responsibility for ocntacts with those companies in which the fund holds shares. Subject to any requirements imposed by trustees, pension fund managers, they will necessarily act for the most part like other institutional shareholders in day-to-day relations with those companies in which the funds they manage are invested, subject to the considerations concerning communications between companies and shareholders discussed above.

Stronger Institutional Links Between Industry and the City

123 All the recommendations in this chapter are designed to help communications on a day-to-day level. The Task Force also looked at the future institutional framework for relations between the City and Industry with a view to strengthening existing links and providing a forum for resolving any future problems.

124 Co-operation rather than an arms length or adversarial relationship, was the theme that should be encouraged, and educational bridges need to be built to improve understanding of the problems and constraints encountered on both sides. A rapidly changing and increasingly international financial market will clearly place strains on existing relationships, as the recent debate on pre-emption rights has shown. It is important that the institutional framework for resolving these issues is adequate.

125 The CBI itself has an important role to play with its blend of industrial and financial sector membership. Existing CBI Committees provide an important framework for such discussions; and there is already a mix between City and Industry representatives on the key standing committee's, such as the Economic and Financial Policy Committee and the Companies Committee. The Director-General's City Advisory Group is also an important forum for representatives from the City and a small number of City-based companies.

126 Like all economic questions, the City/Industry debate has a regional dimension. The City, after all is based in the more affluent South East and as the concentration of industry has proceeded, many more employees working a long way from London have found themselves affected by decisions taken in the capital. While critical views of the City are perhaps more frequently expressed further away from London, where more feel threatened by the actions of the financial centre (and are less dependent for their livelihood on it), there is not a simple North-south divide and there are many more influences on a region's development than sheer distance from London. It is worth emphasising again that London is not the only financial centre described by the "City". Edinburgh is also a major centre and other regions also have investment locations (eg Manchester and Norwich).

127 The regional network of the CBI is therefore an important avenue for achieving better co-operation. Task Force issues were considered by the CBI Regional Councils during the summer period and the CBI, with the help of the City Communications Centre, also staged a number of separate seminars and conferences outside the South East aimed at provoking discussion and debate on City/Industry matters. These often produced lively and fruitful debates and the strong impression that was left was that each sector had learnt considerably about each other's operations and objectives. The Task Force welcomed this discussion and recommended that, as major issues involving relationship between City and industry arose, this theme of consultation/debate within the CBI regionsshould be pursued. There were clearly important concerns outside of the South East and these needed a proper forum for views to be expressed.

128 The Task Force welcomed the recent establishment of the Stock Exchange Listed Companies Advisory Committee. This is an independent body of top level industrialists, which will meet half yearly.

129 Finally, both City and Industry could benefit from an increased level of secondment between the two. Several of the Industry members of the Task Force relayed experiences where their company had benefited from such an exchange. The Task Force recommends that the CBI collect examples of good (or at least successful) practices from both financial institutions and companies who had benefited from such exchange, encourage this practice more widely.

3 - MERGERS AND THE MARKET

130 The Task Force fully recognises that improvements in communications and management performance are not a sufficient answer to the need to improve City/Industry relations. The evidence cited above notwithstanding, there remain real concerns among CBI members at the power of the market, the uncertainty of long term commitment, and the effective disregard of the other stakeholders in a business when decisions affecting a company's future are being determined.

131 Contested takeover bids arouse particular passions - especially when set in the context of the gradual accretion of financial and management power in London and the South-East and the demise of independent companies based elsewhere that are able to contribute to the local community. It is worth recalling that recent successful urban renewal initiatives in such North American cities as Atlantic City, Baltimore, Cleveland, Philadelphia and Pittsburgh could not have been undertaken if some world class local businesses had not been willing and able to contribute. Many Scotsmen are concerned that their country has become a branch economy; the same sentiment is widespread in the North of England and South Wales in particular.

132 In the USA and the UK merger and acquisition deals worth \$180 billion and \$25 billion were recorded in 1986. However, whilst acquisitions have historically (on average) added value for shareholders, they are clearly not a prerequisite for industrial success, since contested takeovers are virtually unheard of in West Germany and Japan. The present merger wave, like that of 1968 and 1972, is coinciding with a bull market in shares, rising profits, and the ability of companies to assume more debt to finance acquisitions. It has lasted longer than its predecessors and has now run for approximately three years. It is slightly larger in terms of the real value of acquisitions than in other peak years, but a major characteristic not revealed by bald facts and figures is the bitterness, intensity, commitment and publicity with which many of the takeovers have been pursued, not to mention the increased expense. Of the record number of mergers investigated by the MMC in 1986; only four were approved. Two were refused and six laid aside because of questions of competition and public interest.

133 It has been suggested that one of the factors that has been partly responsible for the recent level of takeover activity is the role of "deal orientated" advisers. As profitability has improved and with a sustained bull market, companies have ample cash, and the facility to borrow large additional sums backed by highly rated paper. Acquisition and subsequent asset disposal or re-structuring often appears to provide much greater short-term benefits than could be achieved by applying cash or borrowing facilities to direct investment in plant equipment or research and development.

134 It is certainly true that in the intensely competitive period in the financial world of the last three years that fees for merger and acquisition activity have played an increasingly important part in the earnings of merchant banks and stockbrokers. In addition, the traditional longstanding partnership between client and merchant banker is changing, partly as a result of the amalgamations following Big Bang and partly because of the readiness of client companies to use a new adviser for a particular deal. This in turn has increased the incentive among corporate finance advisers to generate new business in this way. Many companies known to be interested in growth by acquisition receive either from their retained advisers or from others suggestions for possible takeover targets. One Finance Director was recently quoted as saying that he received up to six freelance unsolicited merger and acquisition proposals in a day.

135 But the charge that the City alone is responsible for high levels of takeover volume cannot stand up. The fact always remains that it is the boards of industrial and commercial companies who have to take the decision to make an acquisition. They have the responsibility for accepting advice and proposals and in due course initiating the bid that may follow them.

136 A related concern is the effect of advancing financial technology and the growing sophistication of the deals used to finance acquisitions. International markets in interest rate swaps and rate caps have made higher gearing and increased debt more acceptable. Highly leveraged deals have dominated the United States takeover scene and such packages could extend, with more frequency, to Europe and particularly to the United Kingdom.

137 The United Kingdom remains probably the most open market in the world. With vast sums of money accumulating worldwide, not just across the Atlantic, there are those whose ability to raise finance in international markets and to stretch financial sophistication to the utmost may be matched by their unwillingness to co-operate with the self-regulatory system for takeovers in the United Kingdom. There are genuine fears that appeals to abide by not only the letter, but also the spirit, of the City Takeover Code are unlikely to cross international boundaries. Pressure on advisers to push rules to the limit will inevitably continue and there will be increasing pressure to use the rules creatively rather than simply to accept the established interpretation.

138 Such concerns, coupled with doubts about whether all takeovers have been based on industrial logic, meant the Task Force could not ignore this issue. They also led some members of the Task Force to consider if changes should be made so that mergers and acquisitions were more difficult to achieve. In the context of mergers and acquisitions, it was important to distinguish between (a) tightening up the conduct of acquisitions to remove abuses, and (b) 'tilting the (acquisitions) playing field' in favour of the bidder or defendant. Specifically, the Task Force concluded that:

(i) The proposals of the Department of Trade and Industry for strengthening the regulation of takeovers should reduce the scope for abuse inherent in the current arrangements.

(ii) The market should be left to decide the outcome of contested bids, except where regional, competition and strategic issues are involved.

(iii) No attempt should be made to "tilt the acquisition playing field" in favour of the bidder or defendant; all the proposals to this end considered by the Task Force were found wanting. Nevertheless, a greater transparency of shareholdings is desirable and disclosure should be encouraged.

(iv) Merger and acquisition accounting standards should be tightened.

STRONGER TAKEOVER REGULATION

139 The Task Force considers that the present system of takeover regulation should be strengthened in an attempt to curb abuses and undesirable practices, but that the basic approach towards takeovers and mergers should remain neutral. Self-regulation is strongly favoured as opposed to statutory control, as it has the advantage of flexibility and allows a quick response to changes in the commercial environment. The Task Force is in favour of the Takeover Panel keeping its non-statutory status, and of its disciplinary measures being backed by the statutory powers of the SIB (though some members feel that more legal backing may have to be introduced in the future).

The Takeover Panel

140 At present many of the procedures relating to takeovers are governed by the Takeover Panel, a non-statutory body made up principally of representatives from The Stock Exchange, investment institutions and clearing banks. The Panel administers and enforces the City Code which is a set of rules governing the ways in which takeovers and mergers are conducted. The Stock Exchange expects that all listed companies involved in takeovers and mergers should adhere to the rules. The Code has as its basis the equal treatment of shareholders. The first general principle states that:

> "All shareholders of the same class of an offeree company must be treated similarly by an offeror".

Another important concept is that an offer to all shareholders must be made before the 30% ownership threshold is passed. The Code does not concern itself with either promoting or deterring takeovers. The Task Force believes that this approach is correct.

141 The Takeover Panel is part of the City's system of voluntary self-regulation. It has no statutory powers. If, following a complaint, a breach of the Code is discovered, the Panel may have recourse to private reprimand, public censure or, in a more flagrant case, to further action designed to deprive the offender temporarily, or permanently, of his ability to enjoy the facilities of the securities markets. Until recently the Panel has been regarded as relatively successful, the most frequent complaint being its over cautious and legalistic style. However in view of the way the rules have recently been stretched its status has come into question. The discussion has centered on whether the Panel should remain an independent body which relies on businessmen playing by the rules or whether it should have statutory backing. However, the issue is not simply whether a statutory system is better than a non-statutory one, as the law has been stretched or flouted recently too; the more pressing question is the effective resourcing and policing of the existing rules and the law.

142 The Task Force considers that the Takeover Panel needs to be made more effective in order to cope with the changing City environment as there now appears to be less respect for non-statutory rules. The lack of effective surveillance of share dealing in the past and also the lack of intermediate sanctions between public censure and de-listing have been particular weaknesses. The proposals put forward by the Department of Trade and Industry (DTI) for the reinforcement of the Takeover Panel in 1987 meet many of our concerns, and because of this the Task Force fully supports them. The measures are aimed at strengthening the regulation of takeovers, and it is intended that there will be improved monitoring and investigative capabilities given to the Panel. These will further add to the arrangements already in existence with The Stock Exchange. These proposals will also make available the sanctions of the Securities and Investment Board and recognised self-regulating organisations, and they will require authorised investment businesses to co-operate with inquiries and investigations carried out by the Panel.

143 The new DTI proposals should be considered in the context of the Financial Services Act as it is this Act which led to the formation of the Securities and Investment Board and the self-regulatory organisations, which feature in the DTI proposals. The Act establishes a framework which includes wide-ranging statutory powers, most of which can be transferred by the Secretary of State to a designated agency, funded by the financial services industry, such as the Securities and Investments Board. The provisions of the Act mean that when it is fully enforced new sanctions will be available. It will be a criminal offence to carry on investment business without authorisation. The penalty for doing so can be a prison sentence of up to two years. It will also be possible to withdraw authorisation from an investment business. Moreover, at the discretion of the courts, contracts made by unauthorised persons may be declared void and their firms thus exposed to financial loss from aggrieved parties. This structure of the new system is such that most businesses will obtain authorisation through recognised self-regulatory organisations such as the SA, FIMBRA, IMRO and LAUTRO (Securities Association, Financial Intermediaries Managers and Brokers Regulatory Association, Investment Management Regulatory Organisation, and Life Assurance and Unit Trust Regulatory Organisation).

144 In supporting the DTI proposals the Task Force is endorsing the continuation of this system of self-regulation. Self-regulation requires the practitioners to consent to the system and in the case of the City Code to adhere to the principles as well as to the detailed rules. However, in a competitive world the City must recognise that the goodwill and confidence of those seeking to raise funds is a perishable commodity. The expectation of high standards of professionalism and business ethics has been the cornerstone of its success in the past.

145 As this report has already shown, companies can use a number of international financial centres to raise funds; London's share of the world market for financial services is already under pressure. The Big Bang and increased competition bring new pressures and greater potential awards and inevitably, some will be tempted to cut corners. But only their colleagues, and just possibly their clients, will know who they are. They must be ruthlessly exposed and dealt with harshly by the City itself, if its financial standing is not to be prejudiced. Both parties need to recognise that they have both a legal and moral responsibility to preserve the spirit as well as the letter of the Code if self-regulation is to survive.

CONCERN FOR THE NATIONAL INTEREST

146 The preceeding discussion on the Takeover Panel has emphasised non-statutory control. The Task Force believes that in relation to the question of takeovers and mergers in general the role of the Government should be to decide on questions of competition and other issues of wider public interest which the financial markets may not take in to account. CBI's policy on merger legislation has recently been submitted as part of the Government's review of competition law and policy. Whatever the Government concludes will have to take account of proposals which have existed for some time in Brussels for pre-merger control by the European Commission where trade between Member States is affected. The fact that the UK is increasingly part of the unified market of Europe can not be absent from any examination of competition policy for the longer term.

147 The Task Force supports the broad thrust of the latest CBI submission and supports the objectives of merger policy developed in it including:

a Competition and merger policy must not stand in the way of UK-based firms achieving or retaining international competitiveness. The need to compete within the global market needs to be given proper consideration.

b The need for greater predictability in merger policy to enable companies to frame business strategies with confidence.

c The need for increased speed in dealing with investigations.

d A system in which detailed reasoning accompanies decisions for or against the referral of a merger bid on grounds of public interest should be introduced.

148 With the wider international spread of production, a growing number of markets are characterised by a high degree of competition from other countries. The existence of a national monopoly of production in one such market is therefore unlikely to exclude competitiveness and may be necessary, in certain cases, if UK firms are to retain international competitiveness. Whilst control is essential in sectors in which there is little international competition, the focus of policy should be on preventing abuse of market dominance or a reduction in competition which is not compensated for by competitive gains.

"LEVEL PLAYING FIELD"

152 The Task Force believe that takeover bids need to be conducted against the background of a calm and rational stock market. Instead, there is often frenetic activity which was until recently spurred on by advertising companies. Undesirable practices include putting unfair pressure on target shareholders by telephoning them during the period of a bid and activities designed to artificially increase the value of the agressors' shares. There may also be a strong temptation for large shareholders to opt out of their responsbility to rationally decide the future of a company by selling in the market during the period of a bid.

153 The role of the arbitrageur, who aquires a major stake to "put a company into play", is particularly regretable and has come in for special criticism. The Governor of the Bank of England in a speech to the Yorkshire and Humberside Branch of the CBI last March said in reference to such activity:

> "The aim is to pressurise a company's management into action dedicated solely to a favourable impact on the share price in the short-term, partly or even primarily at the expense of the future. The consequence is often a protracted period of unfocussed uncertainty which inflicts quite unnecessary damage, weakening a company's management and distracting them from longer-term objectives, sapping the morale of its workforce, and making employees feel individually insecure to the point of leaving".

154 The introduction of tax disincentives could perhaps be considered in an effort to make the market calmer around the period of a bid. It might, for example, be made more costly to sell shares when over a certain percentage of the equity has been held for less than one year.

155 Recognising the strength of feeling within industry against hostile takeovers, the Task Force specifically considered four possible means of deterring unwelcome bids:

(i) Imposing additional costs on the unsuccessful bidder

(ii) Restricting dealings in shares during the bid period

(iii) Shortening the bid period

(iv) Making the disclosure of holdings more transparent

In each case practical problems, and the feeling that actively deterring hostile bids would not always be to the benefit of all stakeholders in a company, meant that the Task Force could not support the measures proposed. However, further consideration should be given to ways of improving the transparency of shareholdings through greater disclosure. The arguments are rehearsed below.

149 In order to increase the speed of the referral process the Task Force endorses the proposal made by the CBI that a form of opposition procedure should be introduced in UK merger policy. This would seek to expedite the preliminary investigation of mergers. For example, bids notified to the regulatory authorities would be allowed to proceed unless opposed within a fixed period of, say, 30 days. Unless the regulatory authorities made known their intention to investigate, the merger would be allowed to proceed. Similar procedures exist in other countries and would help speed up decisions. Such an opposition procedure should not preclude the continued practice of providing confidential guidance.

150 Experience both here and in other countries suggests it is not possible to codify criteria for reference of bids covering all possible circumstances. There are also cases in which genuine issues of wider public interest arise. The Government should therefore retain discretionary powers to intervene in the public interest. Thus when the OFT/MMC decides against investigation on the narrower test of its impact on competition at home and abroad, the Secretary of State should retain the power to refer a bid on other grounds, <u>provided detailed reasoning is given</u>. Such reasoning would help to ensure that there is an opportunity for open public debate on wider issues of public interest in merger policy decisions.

151 One such issue is the extension of foreign ownership of UK companies. The Bank of England imposes specific restrictions on overseas holdings in UK Clearing Banks in excess of 15%. Following a similar logic, there should perhaps be a similar check to prevent foreign ownership extending too far throughout British Industry, particularly in the case of strategic industries. Under the 1975 Industry Act the Government can block the takeover of a key company. Although this power has to be exercised sparingly because of the UK's international obligations governing reciprocity of access to overseas markets, it is frequently alleged that foreign investment rules and takeover practice in other countries raise similar obstacles for British firms seeking to acquire an overseas company. The task of getting countries to live up to international obligations under the EEC and OECD tends to be a long term one which has to be pursued with determination. In the short-term the Government should be willing to act vigorously when UK companies are under threat of takeover as apart of a concerted strategy and these concerns ought to be registered by the relevant CBI Committees.

Imposing Additional Costs on the Unsuccessful Bidder

156 The costs to the target company of an unsuccessful bid could be imposed upon the bidder in a number of ways. One suggestion was that the offeree's expenses in defending an unsuccessful hostile bid up to a maximum liability of say 1% of the offer value, with a suitable minimum should be paid by the unsuccessful predator. Another, was that a bidder could be required to put on deposit in joint names a sum related to the size of the acquisition to be made which would be forfeited to the target company if a particular level of acceptances were not received.

157 The Task Force concluded, however, that increasing the expected costs of a bid would reduce the likelihood of bids, and this would not be in the interest of shareholders. A substantial minority of contested bids fail, and in the event of failure the direct costs to the offeror can be substantial (these costs may be recouped, it is true, in some instances by profits on the disposal of shares in the target company). The apportionment of costs could be particularly onerous if a second bidder became involved. Although some members of the Task Force have sympathy with the aims of the proposal the majority of the members felt that the arguments listed above were decisive.

Restricting Dealing in Shares During the Bid Period

158 Another proposal under debate was that dealings in the shares of both the offeror and offeree could be prohibited during the bid period, except in the case of hostile bids wholly for cash, or in securities with no equity element. Quotation of both companies could be suspended immediately following the announcement of a bid. To avoid hardship and inconvenience to small investors, dealing could be allowed by or on behalf of individuals in a specific maximum amount at a price fixed for the whole of the bid period, at the levels applicable to offeror and offeree when the bid was made.

159 An important consideration however is that a total or partial ban on share dealings during the period of bid would deny shareholders vital information about how other market participants view it. Indeed, it is possible that the suspension of share dealing could benefit the predator, as the information revealed by the target company in defence would not be reflected in the share price.

160 A related issue is whether advisers should be suspended from dealing in the shares of a company they are councelling, from the date of a bid, as a means of preventing stock price manipulation. Whilst some members of the Task Force agreed with the sentiment of this proposal, practical difficulties exist. In particular, adivsers who have purchased shares and have not been a party to the deal would perhaps be unnecessarily penalised. Also, the fact that the measure would be retrospective could give rise problems of enforcement. Making the disclosure of holdings more transparent would be the most fair and efficient way of ensuring that this type of problem does not arise.

Shortening the Bid Period

161 Shortening the bid period would reduce the distracting effects of hostile bids on the management of the offeree and offeror companies. that a bidder may make a profit on the disposal of the shares of a target company. Although some members of the Task Force have sympathy with the aims of the proposal the majority of the members felt that the arguments listed above were decisive.

162 However, shortening the period of a contested bid could benefit the bidder rather than the target company. Whereas the former can prepare arguments and offer documents, agree tactics and produce advertising material well in advance, target companies are often taken unawares and have to react at short notice and under very considerable pressure. Time is likely to be more valuable, therefore, to the target company than to the bidder.

Making the Disclosure of Holdings more Transparent

163 Most nominee holdings are an administrative convenience for the fund managers concerned and do not involve any further intent. However, there are two sets of circumstances in which boards of directors wish to know the identity of significant shareholders in their companies. First, for the general purpose of communication with shareholders and second, to have warning of a shareholder who may wish to build up a stake in the company in order to launch a bid for it. With this in mind the Task Force considers that the provisions relating to the disclosure of beneficial owners behind nominee holdings should be tightened up in the near future to make it easier for companies to ascertain the ownership of their shares. Moreover, companies should have easier recourse to disenfranchisement of those who refuse to reveal their identity for no good reason. The Task Force recognises that there may be practical difficulties in across the board enforcement of such a policy particularly in relation to bearer shares or ADRs. Under present rules the threshold for revealing the identity of a beneficial ownership is 5%. The Task Force supports the new DTI proposal of a reduced deadline for the disclosure of interests of 5% or more. Consideration might also be given to lowering the threshold further, say to 3%.

164 In relation to takeover bids a special problem area is where parties associated with companies engaged in a takeover battle buy stakes in order to boost the share price. It is important for the operation of the market that such dealings are made transparent and the Task Force supports the Takeover Panel's new requirement that in the course of a bid, dealings by shareholders having 1% or more are disclosed.

TIGHTER MERGER AND ACQUISITION ACCOUNTING

165 Merger and acquisition accounting is of particular interest to the Task Force because the controversy that surrounds this topic relates to the quality of companies' communications with their shareholders. The variety of methods of accounting for mergers and acquisitions makes it possible for two firms of a similar size, undertaking acquisitions in similar circumstances, to report widely differing profit trends depending upon the accounting method used. The variable reporting of profits can mislead inexpert investors who do not fully understand the implications of the method chosen. The picture can be complicated also by the use of writedowns and provisions which can raise profits in

future years. The laissez-faire atmosphere in this area of accounting has often had the effect of disguising to a significant degree the full cost of acquisition. This adds to the risk that some mergers and acquisitions may have taken place for the wrong reasons. Another inadequacy of the present system is that private companies are at a disadvantage because merger relief and merger accounting favour those whose shares are readily marketable.

166 An outline of the main methods of accounting available to businesses undertaking a combination is given in Appendix D together with some of the problems associated with each. Regulation in the area of accounting standards is by Statement of Standard Accounting Practice (SSAP), and is voluntary for companies though binding on their auditors. The Task Force supports this method of regulation as it is able to adapt to changing circumstances quickly and we support the need for a review of merger and acquisition accounting practice by the accountancy bodies. The Accounting Standards Committee will be undertaking such a review later this year.

167 In order that the CBI could put forward recommendations for change on the issue of merger and acquisition accounting, a Consultation Paper was circulated widely in July 1987. The comments expressed as a result will be summarised and form the basis for recommendations which will be sent to appropriate bodies. The recommendations listed below are those of the CBI Working Party on Merger and Acquisition Accounting and not of the Task Force. Nevertheless, they represent a case which needs to be answered in the Task Force's view. Broadly summarised the proposed changes are:

a Most business combinations should be regarded as acquisitions. the consequences of an acquisition never to be passed through the profit and loss account, the method of elimination preferred is amortisation over a realistic useful life through the profit and loss account.

b Acquisition accounting should be applied in respect of all acquisitions.

c Merger accounting, and its associated techniques such as merger relief, should be applied in respect of all true mergers.

d Each technique should be sufficiently well defined to prevent abuses in the way they are applied.

e There should be one specified method of accounting for goodwill. As most of the anomalies and abuses that arise from goodwill result from the elimination against reserves, thereby permitting part of the consequences of an acquisition never to be passed through the profit and loss account. The method of elimination preferred by the CBI Working Group is amortisation over a realistic useful life through the profit and loss account.

168 To implement these changes, the CBI Working Party on Merger and Acquisition Accounting believes that SSAP 22 and SSAP 23 should both be withdrawn and replaced as a matter of high priority by a SSAP on mergers and a SSAP on acquisitions, including goodwill and fair values.

169 The SSAP on mergers should define a merger as a combination in which there is no dominant party; and merger accounting should be the required method of accounting for all mergers. The benefits of the merger relief provisions of the Companies Act should only be available when merger accounting is required. If necessary an amendment to the law should be made.

170 The SSAP on acquisition should define an acquisition as any business combination other than a merger; and acquisition accounting should be the required method for all acquisitions. The SSAP should require goodwill to be written off through the profit and loss account over its useful life.

THE FUTURE OF REGULATION

171 Self-regulation should continue to be the main way in which the City is controlled. The non-statutory status of the Takeover Panel should be retained and its powers of surveillance strengthened. Its ability to enforce a variety of sanctions should also be increased. The Task Force supports the DTI review of the Takeover Panel, but acknowledges that if the strain on the present system continues from those who are not prepared to abide by the spirit and the rules of the City Code, further statutory regulation could not be resisted.

172 In the field of merger and acquisition accounting a number of recommendations have been made. It is hoped that if implemented these would make the financial information presented to potential investors in the market-place a more straight-forward representation of the financial state of companies. The Task Force has not had the opportunity to examine these complex proposals in detail but feels that they merit thorough consideration by means of the CBI's detailed consultations with its members which are now in hand.

THE FOLLOW THROUGH

In 1987, the British economy is growing more rapidly than almost all other developed countries, and certainly faster than our main competitors: the US, Japan and in Europe. The challenge is to build on this and provide a climate in which companies can invest for the future with the active co-operation of their shareholders and bankers.

Since the announcement of the formation of the CBI's City/Industry Task Force, there has been a gradual calming in the climate of City/Industry relations. This is a positive step in itself; the activities of all sectors of the economy must be harnessed if the forward momentum of recent years is to be maintained and the era of investment is to become a reality. The Task Force has sought to contribute to this process, and to enhance the understanding of the issues involved, by putting problems into perspective, exposing myths as well as unpalatable realities, suggesting ways in which communications can be improved and encouraging a calmer and more rational approach to mergers and acquisitions.

This report represents a beginning not an end. The Task Force believes that the debate should continue. There are real issues of concern between the two sectors and it is important to have in shape the proper institutional framework for views to be expressed and appropriate action recommended.

The exisitng CBI Committees provide a framework for considering most City/Industry matters after this report has been debated at the 1987 National Conference and within the CBI National Council, and they will consider and carry forward the work and recommendations of this Task Force. When issues arise in future that require careful consideration, the CBI is in an excellent position to set up an ad hoc group drawn from all the relevant parties. The Task Force itself will meet again early in 1988 to review progress.

APPENDIX A: MEMBERSHIP OF THE TASK FORCE

Sir David Nickson KBE DL (Chairman)	President, CBI Chairman, Scottish & Newcastle Breweries plc
Mr Ron Artus	Group Chief Investment Manager Prudential Corporation plc
Mr Ian Butler	Chairman, Cookson Group plc Chairman, CBI Companies Committee
Mr Raymond Cazalet	Director Henderson Administration Group plc
Mr Ferrier Charlton CBE DFC	Senior Partner Linklaters & Paines
Sir John Clark	Chairman and Chief Executive The Plessey Company plc
Mr Ian Hay Davison	Arthur Andersen & Co
Mr Robin Fox	Vice Chairman Kleinwort Benson Ltd
Sir John Hedley Greenborough KBE	Past President, CBI Chairman, Newarthill plc Deputy Chairman, Lloyds Bank plc
Mr George Gwilt	Managing Director The Standard Life Assurance Co.
Sir Ralph Halpern	Chairman & Chief Executive The Burton Group plc
Mr Daniel Hodson	Group Finance Director Unigate plc
Sir Derrick Holden-Brown	Chairman & Chief Executive Allied-Lyons plc
Mr Hugh Jenkins	Group Investment Director Allied Dunbar Assurance plc
Sir Hector Laing	Chairman United Biscuits (Holdings) plc
Mr Richard Lloyd	Chairman Hill Samuel & Co. Limited
Sir Raymond Lygo KCB	Chief Executive British Aerospace plc

Sir Jeremy Morse KCMG	Chairman Lloyds Bank plc
Mr Tommy Macpherson CBE MD TD DL	Chairman Birmid Qualcast plc
Professor Paul Marsh	Faculty Dean and Professor of Management & Finance London Business School
Mr Paul Nicholson	Chairman & Managing Director Vaux Group plc
Mr Tim H Norman	Chairman & Managing Director Spafax Holdings plc
Mr John Quinton	Chairman Barclays Bank plc
The Lord Remnant CVO	Director Union Discount Company of London plc Chairman, Touche, Remnant & Co
Mr Graham Ross Russell	Deputy Chairman The Stock Exchange
Mr R A Stormonth-Darling	Deputy Chairman Mercantile House Holdings plc
Mr Alan Stote	Group Chief Executive The BTS Group plc Vice Chairman CBI Smaller Firms Council
Mr Martin G Taylor	Director Hanson Trust plc
Mr R E Utiger CBE	Chairman TI Group plc

APPENDIX B: SURVEY OF COMPANY ATTITUDES TO "SHORT-TERMISM"

1 This survey was commissioned as part of an attempt to quantify the extent of any perceived "short-termism" problem in the UK and also to shed light upon the nature and form of "short-termism" itself. The precise mechanism by which any short-term pressures are transmitted from financial markets to the firm is both at the centre of the current debate and a subject hitherto lacking in quantitative research. Short-termism is more likely to flourish in the context of poor communications between the City and industry. Thus the questionnaire was also designed to focus on the effectiveness of present methods of communication and ways in which these could be improved.

2 The survey took the form of a written questionnaire entitled "Financial Pressures and Company Attitudes" and was sent to the Chief Executives of 200 UK parent companies during April 1987. Together with responses to a preliminary pilot study, a total of 109 fully completed replies were received. An additional 11 firms replied but, for various reasons, felt unable to take part in the survey. The sample covers all regions of the UK but is intentionally centered on the manufacturing sector, to the extent that 75 per cent of respondents undertake some manufacturing. If calculated on the basis of numbers employed, the firms that responded to the survey represent about 22 per cent of total employment in the manufacturing, construction, distribution, transport and communications sectors (SIC's 3-7). There has been a higher response rate from the larger firms that received the survey, the "average" sample firm employs 24,000 people and has an annual turnover of £1.2 billion. On the other hand, a quarter of respondents have turnovers of less than £250 million, and 10 have turnovers of less than £100 million.

3 The main findings of the survey were the following:

(i) The majority of comapnies that completed the questionnaire were satisfied that financial institutions adopt a sufficiently long-term perspective when evaluating their company (see paragraph 4 and Table B-1 below).

(ii) There is some evidence of a trend towards shorter investment horizons, which seemed mostly to reflect higher real interest rates and adverse market conditions in recent years.

(iii) By far the most important factors constraining the long term investment decisions of firms were the cost of capital and lack of confidence in their market prospects. These dominated the influence from financial market pressures. Shortage of capital was seen as the least important factor."

(iv) There appears to be little or no correlation between firm size, gearing or level of institutional shareholding and the perception of a short-termism problem.

(v) The most widely reported mechanism by which any short-termism in financial markets impacts upon the long-term decisions of firms is via a weakness in a firm's share price.

(vi) Surprisingly, few firms reported being constrained by the fear of takeover, despite widespread press takeover speculation.

(vii) Firms perceive short-termism to be more of a problem in the context of fixed investment than long-term R & D and training decisions.

(viii) Only 20 per cent of respondent companies felt that present links with their institutional shareholders were satisfactory. More personal contacts, especially at Board level, as well as a greater exchange of information are seen to be the best ways of improving communications.

(ix) Respondents were strongly in favour of continuing the existing practice of voluntary disclosure of expenditure on training and R&D in the company's accounts.

The extent of a "Short-termism" problem

4 The majority of companies that completed the questionnaire were satisfied that financial institutions adopt a sufficiently long-term perspective when evaluating their company (see Table B-1). This survey of managers' attitudes shows that the perception of a short-termism problem is perhaps less widespread than some commentators have suggested. On the other hand a significant minority of respondents did identify a problem. [The figures in this and subsequent tables show the number of respondents.]

Table B-1 **Are you satisfied that Financial Institutions take a long-term and strategic evaluation of your company?**

YES	**57**
NO	**38**
Did not answer:	**14**

5 There appears to be little or no direct relationship between the responses to the above question and firm size, gearing or the proportion of institutional shareholders in a company. A company's proximity to London has been viewed as both an encouragement to the transmission of short-term pressure and also advantageous for the development of beneficial long-term links. The survey has identified no clear relationship either way, but some firms situated in the furthest regions are among those that complain most about "short-termism". Conversely other regional producers are perfectly satisfied with their dealings with the City.

6 What is clear is that attitudes vary considerably and depend crucially upon a firm's own first hand experiences of financial institutions. It is interesting to note that firms that have raised new equity capital since Big Bang do not seem to have responded differently from those who have not. The responses outlined in Table B-1, are obviously a reflection of opinion among industrialists at one particular point in time and do not account for underlying trends.

Table B-2 In what ways have the criteria that you employ in evaluating an investment proposal changed since the late 1970's?

Higher rate of return/shorter payback period	50
No change	42
Lower rate of return/longer payback period	11
Did not answer	6

7 Table B-2 shows that a number of firms have shortened their investment horizons since the late 1970's. Any change in the method of evaluating an investment project could be the result of a number of different influences, this was the subject of a further question (see Table B-3). Adverse economic conditions and high real interest rates over the period, as well as financial market pressures, were all considered important in this shortening of horizons. Lower inflation was a major factor leading to lower rates of return/longer payback periods among some firms, though this is not inconsistent with the other responses if companies are referrnig to nominal rates of return.

Table B-3 Please rank the following as contributory factors to any changes.
(Write 1 for most important, etc).

	Ranked			
	1	2	3	4
Adverse economic conditions	14	12	8	1
High real interest rates	20	11	5	1
Financial market pressures	18	10	5	1
Others (specifically lower inflation)	6	0	0	0

8 There is, then, evidence that a significant minority of firms surveyed perceive a "short-termism" problem. In addition to this investment horizons appear to have shortened recently in many firms, but this may be the understandable result of high real interest rates and adverse economic conditions as much as increased financial market pressures.

Methods by which Financial Market Pressures could affect the decisions of firms

9 The distinction between the desire of financial institutions to return a short-term profit and the failure of firms in the UK to undertake sufficient long-term investment is crucial to the "short-termism" debate. There are several theories about exactly how pressures from financial markets may impact upon the decisions of firms, but none has been substantiated by quantitative research.

10 Increased turnover of shares since Big Bang is often used as evidence of increasing "short-termism" in financial markets. Indeed 60 per cent of respondent firms have seen turnover in their shares increase (on average by 50 per cent) since October 27th 1986. Interestingly, among those firms that were dissatisfied with the long-term attitude of financial institutions the proportion that also experienced an increase in turnover was not significantly different from the sample as a whole. On this evidence it appears that increased turnover of shares does not, in itself, affect the perception of a "short-termism" problem among managers.

11 Over 80 per cent of firms surveyed have been involved in takeover activity, either directly or via press speculation, within the last three years. The high concentration of large firms in our sample and the exclusion of subsidiaries means that the overwhelming majority were bidders in actual takeovers or takeover attempts. On the other hand, half the companies surveyed have been tipped by the Press as target companies.

Table B-4 **Have you in the last three years been involved in a takeover or merger?**

YES:	**70**	**If "yes", as a bidder company:**	**45**
		as a target company:	**11**
		as a partner in an agreed merger :	**14**
NO:	**35**		
Did not answer:	**4**		
	109		

Has your company been the subject of takeover speculation in the press or media in the last three years either as bidder or target company?

YES:	**74**	**If "yes", only as a bidder:**	**16**
		only as a target:	**27**
		both target and bidder :	**24**
		did not say :	**7**
NO:	**32**		
Did not answer:	**3**		
	109		

12 Despite this high level of involvement in takeover activity not one firm indicated that fear of takeover was a major constraint when taking long-term decisions as Table B-5 indicates. This result may stem from the high proportion of large firms in the sample and may also reflect an attitude apparent among several firms that takeovers are a two way process, with "winners" as well as "losers". The latter point is born out to some extent in Table B-6 where 10 firms stated spontaneously that, far from being constrained by a fear of takeover, they have actually felt under pressure from Financial Markets not to go ahead with acquisitions themselves.

13 However, despite the evidence on the direct impact of the threat of takeover, weakness in a firm's share price or rating is seen to be an important factor by a significant minority of firms preventing them from taking long-term strategic investment decisions. This may be due to:-

(a) the threat of takeover, though companies are reluctant to admit directly that they have felt constrained by it;

(b) concern that a weak share price may hamper a firm's capacity to raise new equity capital in the future;

(c) managerial share option schemes, which directly link the formers' own financial prospects to their firm's stock market rating.

14 A low rating discouraging investment is not necessarily a "short-termism" problem. Arguably, lowly rated firms may have the worst prospects and/or managements and represent the poorest in the economy for future investment, or they may be lowly rated precisely <u>because</u> of their reluctance to invest.

<u>Table B-5</u> **Please indicate the significance of certain constraints in preventing you from taking strategic investment decisions in the long-term interest of your company, such as higher spending on fixed investment, research and development, training or marketing?**

	OF MAJOR SIGNIFICANCE	SIGNIFICANT	NOT SIGNIFICANT
a) shortage of capital	5	10	89
b) cost of capital and/or fears of an inadequate rate of return	25	56	25
c) exchange rate uncertainties	2	27	75
d) a lack of confidence in market prospects	9	41	54
e) weakness in your share price or rating	7	36	58
f) fear of takeover	0	13	90
g) pressure from financial institutions/analysts	4	19	78

<u>Other Constraints on Firms' Investment Decisions</u>

15 Firms operate in an uncertain world in which they have to compete with other firms for factor inputs as well as product market share. It is thus unrealistic for a firm to expect to operate in an environment where no constraints exist upon it's long-term decisions. Firms would naturally be expected to identify pressures other than those originating directly from financial markets. It is then not surprising that over 75 per cent of respondents felt constrained by either the cost of capital or a fear of an indadequate return on their investment. Lack of confidence in product market prospects was also a widely quoted constraint upon the long-term decisions of firms.

16 Exchange rate uncertainties are not directly identified as a major constraint, though exchange rate considerations may be also reflected by lack of confidence in market prospects. Also, in line with the current consensus, the firms surveyed do not appear to suffer from a quantitative shortage of capital.

In what areas do firms experience major constraints upon their long-term decisions?

17 It may be the case that firms in the UK do not feel constrained to the same extent when undertaking different categories of long-term investment. Table B-6 shows that it is in the context of fixed investment decisions that most firms feel under pressure from financial markets to achieve rapid results.

Table B-6 **In which of the following areas, if any, have you felt constrained by financial markets? (Firms classified as being "constrained by financial markets" replied that either e,f, or g were of significance in Table B-5)**

Fixed Investment	37
Research and Development	12
Training	4
Marketing	7
Others (specifically acquisitions)	10
None	4

City/Industry Communications

18 "Short-termism", as perceived by industrial managers, cannot necessarily be blamed on financial institutions if the latter are provided with insufficient information to build up an accurate picture of a company's long-term plans. If, when they have no evidence about a firm's long term prospects, the short-term performance of that firm is below what would otherwise be expected, financial institutions are naturally likely to place pressure on the firm to redress the balance. This could clearly be an element of the short-termism problem and one to which the survey was directed. Questions asked centred on both the type and effectiveness of current communications and ways in which these could be improved.

19 When asked about the type of information they disclosed on a regular basis Table B-7 shows a preference among firms for providing details of new products, as opposed to innovation expenditures. This emphasis could stem from the difficulties involved in producing a meaningful figure for expenditure on such items as R & D and training.

Table B-7 **What information do you provide on a regular basis to major institutional shareholders/financial analysts on your long-term plans and proposals?**

20	Profit forecasts
20	Expenditure on R & D
6	" on training
29	" on other long-term development plans
50	Details of new products

20 Judging the effectiveness of the various methods used to disclose information is less clear-cut. Nearly all firms use their annual reports as a means of communicating such information to all shareholders. Indeed, most firms also see their annual report as the most important method of communication with institutional shareholders. Personal contacts, individual briefs and City presentations are all used as channels of communication but, are generally regarded as less important than the company's report.

21 Only 20 per cent of respondent companies felt that the present links with their institutional shareholders were satisfactory. The firms surveyed felt that communications could be improved by more direct contacts, particularly at Board level, also companies felt that they could beneficially give more information on their long-term plans but in return they wanted institutions to reveal more about how they assess company performance.

22 Despite the generally held belief that communications should be improved, the majority of firms favoured a continuation of voluntary disclosure of information in their company accounts (see Table B-8). A substantial minority did, however, favour some shift towards a statement of recommendated practice or SSAP for R & D spending.

Table B-8 **How should companies be required to disclose total expenditures on (i) training and (ii) research and development in their accounts:**

	Training	R & D
Voluntary	73	61
Statement of recommended practice	9	10
Statement of standard accounting practice	14	25
Statutory	2	2
Did not answer	11	11
	109	109

APPENDIX C: PENSION FUND INVESTMENT MANAGEMENT

Members of the Task Force approved a series of checklists which they believe should assist companies in reviewing their trustee arrangements and provide a useful starting point for dialogue between company managements and trustees.

1. Trustees' Appointments and Support

The following checklist is intended to assist company managements in reviewing their trustee arrangements:

(a) Bearing in mind that trustees have considerable powers and responsibilities, are arrangements for the selection of trustees appropriate in order to provide members of the right calibre and mix of experience on the trustee board, including member trustees where appropriate?

(b) Are the terms governing the trust adequately expressed and sufficiently clear (especially as to powers of delegation and investment) to enable the trustees to undertake their responsibilities satisfactorily?

(c) Do all trustees understand fully their powers and responsibilities and the approach they should adopt in exercising these? Should training arrangements for trustees be reviewed in order to assist them in fulfilling their role properly, particularly in the investment area?

(d) Do the trustees receive sufficient information about the fund and its investments and is the necessary professional assistance from independent actuarial and investment advisors available to help them interpret that information? Have the trustees adequate access to objective professional advice to enable them to carry out their responsibilities properly?

(e) Are meetings held sufficiently frequently for trustees to fulfil their obligations?

(f) Are there adequate arrangements for the trustees to report on their stewardship of the fund to both employees and sponsoring company? Are arrangements adequate for regular discussion between company management and trustees of investment issues?

2. Shareholders' Responsibilities

The following checklist sets out the main issues in the area of shareholders' responsibilities:

i) Voting rights

a) Bearing in mind the additional costs and potential benefits, should the pension fund aim to exercise its voting rights on a regular basis as a matter of course?

b) If not, should a policy be developed after consideration of the views of investment managers, the sponsoring company and employees as appropriate, specifying the circumstances (eg contested takeover bids) in which the trustees would wish to be consulted and perhaps vote and who should be involved in the voting decision? In considering the merits of establishing a policy the responsibilities of trustees and the concerns which might arise over decisions affecting the sponsoring company should be kept in mind.

c) If voting rights are to be exercised as a matter of course, should a policy be developed to distinguish the contentious and significant issues from others and to specify who should be involved in deciding how the fund's votes should be cast on issues falling in the different categories? In developing such a policy, considerations will include the need for clear arrangements and the need to keep administration to the minimum consistent with the proper discharge by the trustees of their responsibilities.

d) Whatever the policy developed, does it specify clearly who has the power to decide how the fund's voting rights should be used, if they are to be exercised at all?

ii) "Ginger Group" Activities

a) Should investment managers be encouraged, at their discretion and in suitable circumstances, to seek ways of conveying concern about an investee company's activities to its management and seeking ways of strengthening its operations in association with other major shareholders?

iii) Other improvements in communications

a) Should investment managers be encouraged to seek more information from those companies in which the fund is most heavily invested on aspects of policy important for business success? Such aspects might include research and development, design and marketing, application of new technologies, training and good employee communications and involvement.

3. Setting Investment Guidelines and Objectives

The following checklist covers issues related to the setting of guidelines and objectives for investment managers:

a) Should the trustees with the benefit of professional advice, and bearing in mind their responsibility for the diversification of investments and suitability of the investment vehicle, agree at least some guidelines for fund managers.

b) What items should be specified in the guidelines? Should certain types of investment be excluded as unsuitable should asset allocation and sectoral ranges be set? Trustees will need to bear in mind the restrictions imposed by the Financial Services Act and to ensure that they do not unwittingly act as investment advisers.

c) In setting guidelines, trustees will need to be conscious that imposition of any excessive constraints, for example excluding investments in certain sectors or countries as a matter of principle, might be held to run counter to their duties to care for the interests of beneficiaries.

d) Should trustees set investment objectives for fund managers on the basis of professional advice, bearing in mind the advantages of clarifying what the investment managers are expected to achieve?

e) In what terms should the objectives be set? Has account been taken of the fund's overall strategy and long term liabilities?

f) Should a risk strategy be developed by the trustees in discussion with others, including the fund managers?

g) Are the investment guidelines and objectives fully compatible?

h) Are arrangements for the regular review of investment objectives and guidelines satisfactory?

4. Self Investment

The following checklist set out the key issues for consideration on self investment:

a) Does the Trust Deed include specific requirements or restrictions of any sort in relation to self investment?

b) If the Trust Deed allows flexibility on self investment, would it be advisable for a decision to be taken by the trustees, on the basis of their views on the balance of the arguments after discussion with the sponsoring company, whether to rule out self investment in equities or other assets under any circumstances as part of the investment guidelines? There may be fewer reservations about self investment, for example, where the fund is managed by external managers.

c) If the trustees do not rule out self investment in all circumstances, should a clear policy be developed in consultation with the fund managers for inclusion in the investment guidelines setting limits on the extent of self investment in equities and any other assets and the circumstances in which shares in the sponsoring company will be bought and sold? A relevant factor, particularly where external fund managers are involved, will be whether the fund managers would normally hold shares in the sponsoring company on their own merits.

d) In setting any limits on the extent of self investment, it may be useful for trustees to bear in mind the Disclosure of Information Regulations issued under the Social Security Act 1985, which require reports to scheme members to include details of self investment of any type above five per cent of the fund's net assets in the employer or an associated company and the limits set by the Occupational Pensions Board. Trustees will also wish to bear in mind the need for diversification of investments.

e) In setting any policy to cover the circumstances in which purchases or sales of shares in the sponsoring company may take place, appropriate factors to be considered are likely to include whether fund investment is handled by an in-house or external manager. It may also be appropriate to set out clearly how decisions on the holding or sale of shares in the sponsoring company would be reached in the event of a takeover bid for that company.

5. Appointment of Investment Managers and Fund Monitoring

The following checklist is intended to identify issues concerning the appointment of investment managers and the monitoring of their performance:

a) Are arrangements adequate for the monitoring of the fund's investment record against the objectives agreed by trustees?

b) Where an external measurement service is used, do the trustees receive sufficient professional (eg an actuarial and investment matters) advice to enable them to undestand and interpret the results in their proper context and over a suitable timescale?

c) Are arrangements adequate for the discussion of the fund investment record between trustees, their advisers and the fund manager? In the discussions, is sufficient attention given to the fund manager's adherence to investment guidelines and risk strategies and the achievement of specified investment objectives?

d) In reviewing the appointment, retention and dismissal of fund managers, is proper weight attached to other factors apart from the past performance record and is the mechanism for appointing and dismissing managers deemed to be satisfactory?

APPENDIX D: MERGER AND ACQUISITION ACCOUNTING ISSUES

1 The way in which acquisitions are subsequently accounted for can have the effect of simultaneously enhancing the reported earnings of the acquiring company and masking the true cost of the acquisition. In an attempt to deal with the problems involved, Statement of Standard Accounting Practice (SSAP) have been issued covering acquisition accounting, merger accounting, merger relief and the way in which goodwill should be accounted for. This appendix summarises some of the issues involved, for the two relevant SSAPs:

(i) SSAP 23, which covers merger and acquisition accounting

(ii) SSAP 22, which addresses the problems of accounting for goodwill

SSAP 23 - Accounting for Mergers and Acquisitions

2 An acquisition takes place when one company buys another company or business. Both the consideration given and the assets acquired are stated at their fair values. Thus the assets are recorded at their cost to the acquiring company and not the cost to the original owner. When the fair value of the consideration given exceeds the fair value of the assets acquired, the difference arising is called goodwill.

Acquisition Accounting

3 Some of the main features of acquisition accounting are:

(a) Goodwill arises and is written off, either immediately directly against reserves, or by charging amortisation against profits in future years. The majority of companies write it off against reserves.

(b) Assets recorded at fair values generally give rise to higher depreciation charges after the combination, thus reducing profits.

(c) Profits of the new subsidiary are included in the group accounts from the date of acquisition.

It is useful here to consider a number of inter-related problems in connection with the use of provisions, fair value and goodwill which have been the subject of much discussion within the accounting profession.

4 The use of provisions has been criticised because a number of companies have set up unusually high liabilities and provisions when acquiring a company. These may cover not only liabilities deemed to exist at the date of the acquisition (though previously unrecorded), expenses incurred in connection with the absorption of the acquired company and reductions in values of assets, but also future operating losses (or reduced levels of profit) of the subsidiary acquired. (Raising provisions for future losses is specifically permitted by SSAP 22, paragraph 14, despite being forbidden by International Accounting Standard 22, paragraph 12). The effect of raising such provisions is that an expense or future loss which would otherwise be charged against

profits of a future year can be channelled directly to reserves as part of goodwill write-off. It is also possible to set up "prudent" provisions which, when subsequently found to be excessive, can be fed back into profits in future years. All these effects can significantly flatter the operating results achieved in the years following the acquisition.

5 The fair value concept is entirely appropriate in acquisition accounting, nevertheless it brings with it particular problems of subjectivity and scope for manipulation as a wide range of arguments can be found to support a wide range of possible values. The effect of attributing low fair values to stocks acquired, for example, is to increase goodwill and to increase the future profits reported from sale of those stocks.

6 If goodwill were required to be amortised against future profits, benefits from attributing low fair values would substantially disappear. An Accounting Standards Committee (ASC) working party is addressing the fair value problem. Further aspects of the accounting treatment of goodwill are dealt with in paragraphs 16 - 21, below. Depending on the approach to fair value, provisions, and goodwill, distortions can be created in the reported results and trend of results. The danger is that these will in turn affect economic decisions such as raising of finance and share dealings.

Merger Accounting

7 The rationale for merger accounting is completely different from that for acquisition accounting. The latter focuses on the cost to one enterprise of acquiring the business of another, whereas merger accounting looks at a business combination as essentially an exchange of interests between the shareholders of two or more enterprises implying an element of continuity. In a merger, no net assets leave the combining enterprises; instead, the voting rights and equity interests in the combined enterprises are allocated to the former bodies of shareholders in such a way as to reflect the agreed values of their respective enterprises.

8 Merger accounting reflects this rationale by the following features, which distinguish it from acquisition accounting:

- Assets of the combining enterprises are recorded at their existing book values, rather than at fair values, though some adjustments may be made to ensure consistency of accounting policies in the consolidation.

- No goodwill is recognised.

- Profits from the subsidiary are consolidated from the start of its financial year rather than from the date of the combination, and comparative figures are restated.

9 SSAP 23 sets out certain criteria which must be satisfied for merger accounting to be used:

a the business combination must result from an offer to holders of equity shares and the holders of all voting shares which are not already held by the offeror, and

b the offeror has secured, as a result of the offer, a holding of at least 90% of all equity shares (taking each class of equity separately) and the shares carrying at least 90% of the votes of the offeree; and

c immediately prior to the offer, the offeror does not hold 20% or more of all equity shares of the offeree (taking each class of equity separately), or shares carrying 20% or more of the votes of the offeree; and

d not less than 90% of the fair value of the total consideration given for the equity share capital (including that given for shares already held) is in the form of equity share capital; not less than 90% of the fair value of the consideration given for voting non-equity share capital (including that given for shares already held) is in the form of equity and/or voting non-equity share capital (SSAP 23 paragraph 11).

If all these criteria are met either acquisition or merger accounting may be used.

10 The main emphasis of SSAP 23 is to test whether a significant amount of resources has left the group. This is not restrictive and it allows merger accounting to be used for business combinations which are in substance acquisitions. Some of the methods used to achieve this include:

(i) Prior Disposals or "Buy Back" Schemes. One of the conditions relating to merger accounting in SSAP 23 is that the investor does not hold 20% or more of the target company's equity or shares carrying 20% or more of the target's votes. It is possible for a company to build up a large percentage of the shares in a potential target company and then to sell temporarily sufficient shares (to an understanding bank) to fit this regulation before making a takeover.

(ii) Vendor Placings and Vendor Rights. If merger accounting is used then 90% of the consideration given for equity shares must be in the form of equity shares. SSAP 23 merger accounting conditions are, however, based on the concept of "no significant cash resources leaving the group" rather than "continuing shareholders". A vendor placing involves the offeror exchanging shares with its target. The shares issued are then placed in the market by a merchant bank on behalf of the target company's shareholders so that they effectively receive cash.

Vendor rights is a variation whereby the shares are offered to the offeror's existing shareholders.

(iii) Preference Share Issues. SSAP 23 excludes preference shares from the definition of equity. The target company can issue to its equity shareholders preference shares, which can be bought for cash just before the takeover is agreed. This enables the acquiring company to pay the most part of the purchase consideration in cash in return for the preference shares, issuing only a nominal amount of shares for the remaining equity.

11 Regardless of the form that a business combination may take, or the form of the consideration given, the facts relating to such combinations almost invariably indicate that a change in ownership interest has occurred; one company has gained control over the resources previously controlled by another and the individual shareholders' relative voting power has changed. Further, business combinations almost invariably result in one company which is the dominant, continuing management force.

12 In most combinations the dominant entity is clearly identifiable. It is usually the larger company in terms of total assets or current or prospective earnings and in return for the merger its former shareholders (or their assignees) receive the majority of voting rights. Even where the sizes of both companies are similar or when a smaller company takes over a larger one, there is generally a clear dominant entity. Whilst some individual members of the management of the less dominant company may become part of the management of the continuing entity, it is rare that their power to direct a business is not in material respects altered or shared following the combination.

13 Merger accounting is sometimes seen as having the following advantages over acquisition accounting, from the point of view of the accounting company:

- Depreciation charges following the combination do not increase to reflect the fair values of individual assets at the date of acquisition. Reported profits are therefore enhanced. Similarly, disposals of assets immediately following the combination will generate profits that include a large measure of holding gains arising prior to the combination. Under acquisition accounting only any excess over fair value at the date of acquisition would be recognised as profit.

- There is no goodwill to be written off, either immediately against reserves or by amortisation against future profits.

- A merger even at a late stage in the financial year can transform reported profits for the whole year, since the combining enterprises are consolidated as though combined for the whole period.

The choice which companies now have means that they can choose an accounting method which best satisfies a desired profit trend or financial position, but it may be considered inappropriate because it is at variance with the economic reality.

Acquisition Accounting and Merger Relief

14 Merger relief is quite properly used in conjunction with merger accounting, nevertheless it can also be used in conjunction with acquisition accounting. This combination is often thought of as being

the 'best of both worlds' in that the recorded cost of the acquisition is reduced by using the nominal value of the shares issued in the combination rather than the market value. The effect will be that relatively little or no goodwill will need to be written off. There is no 20% limit to the amount of any pre-offer holding of equity nor is there any 10% overall cash offer limit. The relief can be used in the normal public company takeover bid situation where the offeror wishes to build up a significant holding in advance of making any formal offer.

15 Where merger relief is used with acquisition accounting the results of the subsidiary are only consolidated at the date of combination, not from the start of the earliest period presented - but this may enhance the trend of reported earnings.

SSAP 22 - ACCOUNTING FOR GOODWILL

16 SSAP 22 entitled "Accounting for Goodwill" became standard accounting practice on 1 January 1985 and accepts two methods of accounting for goodwill following acquisitions.

(a) Immediate elimination of goodwill against reserves.

(b) Capitalisation and amortisation of goodwill over its useful life against operating profits in future years

17 The rationale for immediate elimination against reserves is that purchased goodwill represents a residual after valuing all other assets and is of a nature similar to that of self-generated goodwill. The key difference is that it is being paid for at one time rather than being built up over time. The aim is therefore to bring purchased goodwill on to the same basis as self-generated goodwill as quickly as possible. Writing-off against reserves achieves this without affecting earnings per share.

18 The rationale for amortisation of goodwill over its useful life is that goodwill represents a cost of earning profits and as such should be matched against profits. Regardless of whether it is thought acceptable that radically different options should be available and also whether the rationale for each method is accepted, there are problems associated with both.

19 One option available in SSAP 22 is writing off goodwill immediately on acquisition. If this is chosen a decision must be taken as to which account will be used for the write-off. Variations that have arisen over the last few years have included the creation of negative reserves, the use of the revaluation reserve and the decision of the courts in effect to allow the use of the share premium account for this purpose. All these devices have encountered criticism:

- The creation of a negative reserve can be achieved by allowing goodwill acquired on consolidation to be written-off to a newly created reserve with an initial nominal balance. While this is not illegal it is artificial and prevents the write-off affecting retained profits.

- The use of the revaluation reserve is questionable from the provisions of the Companies Act. The Act sets out the circumstances when amounts standing to the credit of the account may be released. There is no reference to goodwill, and from this it may be argued that the reserve is not available for goodwill write-off.

- Many acquiring companies do not qualify for merger relief and have to set up a share premium account. The use of this reserve is closely controlled, but the Courts are allowing companies to reduce their capital by cancellation of the share premium account. This creates a reserve against which the goodwill is then written off. But, irrespective of the reserve used, writing off goodwill direct to reserves allows a group to report an apparent profit in a situation where it has clearly made a loss. For example, if group A buys B for £20m, and assesses the fair value of B's assets at £12m, it will record £8m goodwill, and can write that off to reserves. On subsequently selling B for £18m, A's consolidated accounts will record a profit of £6m through the profit and loss account, whereas it has in reality, made a loss of £2m. This misrepresentation occurs whether or not the second transaction was premeditated at the time of the first.

20 The other option in SSAP 22 allows goodwill to be amortised through the profit and loss account and the major difficulty in this area is the length of time of amortisation. Sometimes periods as long as forty years have been used. In such cases, the effect is that the balance sheets of later years reflect not so much the goodwill originally produced as the internally generated goodwill that has replaced it.

21 In service industries goodwill is a very major factor in the purchase price. Amortisation of goodwill through the profit and loss account, over, say, ten years, is likely to affect profits significantly. The profits related to such an investment might be normal but the goodwill content of the investment itself might be very large.

RJ8.34 RESTRICTED

07-pm 16/9

FROM: J M G TAYLOR

DATE: 15 September 1987

MR MONCK

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr A Wilson
Mr Cassell
Mr Burgner
Mrs Lomax
Mr Culpin
Mr Ilett
Mr P Gray
Mr Hudson
Mr Call

REPORT OF THE CBI CITY/INDUSTRY TASK FORCE

The Chancellor was grateful for your minute and enclosure of 11 September. He has commented that the draft report is something of a mouse.

2. He has noted the intention to quote him (paragraph 7 of the draft report). He has no objection to being quoted in this context, but is very doubtful about the accuracy of the particular quote. He would like to see the full text of these alleged remarks as soon as possible.

JT

J M G TAYLOR

3764/020

Papers PSa

RESTRICTED

FROM: P D P BARNES
DATE: 15 September 1987

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Sir P Middleton
Sir T Burns
Mr A Wilson
Mr N Monck
Mr Cassell
Mr Burgner
Mrs Lomax
Mr Culpin
Mr Ilett
Mr P Gray
Mr N Hudson
Mr M Call

Mr Monck tells me that he pressed for the point at 'X' to be included earlier. The point at 'Y' is, apparently, a bee in Banham's bonnet.

1. I agree v. much with John's 2 points – it is a pity the Report was not more forthright [illegible]
2. The Report is to be published on 14 Oct – good time for [illegible] 26 Oct.

REPORT OF THE CBI CITY/INDUSTRY TASK FORCE

The Economic Secretary has seen Mr Monck's submission to the Chancellor on the 11 September.

Y/ 2. The Economic Secretary thinks it unfortunate that the report does not mention, let alone welcome, the growth of direct individual shareholding. He thinks that individual shareholders are likely to be loyal to management if it performs and communicates well and to make it less subject to short-term performance pressures. He thinks that management in its turn has a duty towards this growing body of shareholders.

Y/ 3. Apart from this, the Economic Secretary thinks the report surprisingly realistic. However, he thought that the sentence on page 3 of the executive summary that read, "the Government also has an important role to play, not least in ensuring that public sector purchasing is used to promote long run industrial competitiveness," was omnious, as such statement usually mean that the Govenment should buy British or pay over the odds.

PB

P D P BARNES
Private Secretary

41a/3

CONFIDENTIAL
until 00.30 am Monday 21 September 1987
then UNCLASSIFIED

FROM: **PETER CURWEN**
DATE: 18 September 1987

1. MR DAVIES
2. **CHANCELLOR OF THE EXCHEQUER**

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Monck
Mr Odling-Smee
Mr Scholar
Mr Sedgwick
Mr Bottrill
Mr Culpin
Mr S J Davies
Miss O'Mara o/r
Mr Pickford o/r
Mr Allum
Mr Barrell
Mr Brooks
Mr Hudson
Mr Price
Mr Dyer (+ 1 for No.10)
Mr Call
Mr Cropper
Mr Tyrie
HB/003

Nisjel

CBI MONTHLY TRENDS ENQUIRY AND STAFF FORECASTS : SEPTEMBER 1987

The CBI's latest Monthly Enquiry is to be released at 00.30 on Monday 21 September.

Enquiry results

2. The Monthly Enquiry into manufacturing - summarised in the attached table -covers only five of the questions in the quarterly survey: current levels of home and export orders and of stocks, and expected trend in output and domestic prices over the next four months. The Enquiry was conducted between 28 August and 16 September, covering 1,479 respondents.

3. The balances on total order books and export order books both show modest falls between August and September, but they remain at historically high levels. Stock levels have improved and remain adequate to meet demand. The expected rate of growth of output prices has been broadly unchanged since June. The main results are outlined below, with seasonally adjusted figures (produced by CSO, BUT NOT PUBLISHED) in brackets:

	August	**September**
Total order books	+11 (+11)	+9 (+10)
Export order books	+5 (+9)	+3 (+8)
Stocks	-1	+3
Volume of output	+38 (+42)	+30 (+33)
Average domestic prices	+21 (+26)	+20 (+27)

Points to note

4. The balance on the export order books has fallen back from the record levels of June and July. However, the balance is still positive and has only been bettered on 5 other occasions since the question was first asked in its present form (April 1977). The balance on total orders has now been positive for 8 consecutive months, having been positive on only 1 occasion between April 1977 and January 1987. The balance of firms expecting to increase output over the next four months has fallen back from its record level in August but it is at about the same level as the average between May and July and it is very high by historical standards. On this basis, the CBI expect manufacturing ouptut to continue to grow strongly but at a slightly steadier rate than in previous months.

Peter. S. Curwen

PETER S CURWEN

CBI Monthly Trends Enquiry

RESULTS SEPTEMBER 1987

Manufacturing Industry: 1479 **respondents**

Conducted between 28 August and 16 September 1987

The figures are percentages based on a weighted sample.

Excluding seasonal variations, do you consider that in volume terms:

	Above Normal	Normal	Below Normal	N/A
(1) a. Your present total order book is	25	58	16	+
b. Your present export order book is	24	53	21	1

(firms with no order book are requested to estimate the level of demand)

	More than adequate	Adequate	Less than adequate	N/A
(2) Your present stocks of finished goods are	14	62	11	12

What, excluding seasonal variations, is the expected trend over the next four months with regard to:

	Up	Same	Down	N/A
(3) Volume of output	39	52	9	-
(4) Average prices at which domestic orders are booked.	23	72	3	1

Percentage Balance

		Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
1a	Total Order Book	-23	- 9	-10	-15	+ 2	+ 4	+ 1	+10	+ 3	+ 6	+11	+ 9
b	Export Order Book	-22	-10	- 7	-13	- 2	0	- 6	0	+ 9	+10	+ 5	+ 3
2	Stocks	+10	+11	+ 5	+10	+ 6	+ 7	+ 5	0	- 1	+ 1	- 1	+ 3
3	Volume of Output	+13	+13	+10	+15	+29	+34	+25	+31	+37	+23	+38	+30
4	Average Prices	+14	+19	+26	+30	+34	+25	+26	+28	+19	+19	+21	+20

COMMENT

Total order books remain buoyant, with a balance of 9% of firms reporting order books above normal, compared with 11% in August.

Export order books remain above normal, for a balance of 3% of firms, but are now not as strong as in Midsummer.

Stocks of finished goods remain adequate to meet expected demand; a balance of 3% report stocks more than adequate, up from August when a balance of -1% felt stocks were less than adequate.

Manufacturing output is expected to continue to grow strongly, but at a slightly steadier rate than in previous months. A balance of +30% expect output to grow in the next four months, down from +38% in August.

The rate of increase in manufacturers' average prices remains steady, with a balance of +20% of respondents expecting to increase prices in the next four months.

MR 4/44

RESTRICTED

PWP

FROM: A P HUDSON
DATE: 18 September 1987

CHANCELLOR

cc: Mr Monck
Mr Call

REPORT OF THE CBI CITY/INDUSTRY TASKFORCE

... Please see Economic Secretary's suggestions below, with Jonathan's comments.

2. Nick Monck asked me if I could trace the source of the
... quotation from you (see flag). It comes from your Bow Group speech about City issues in June 1986 (attached). As you suspected, it is not accurate, because of the abbreviation. Your point was that managers complain that institutional shareholders are unwilling to countenance long-term investment etc - you were not asserting that yourself.

3. I spoke to the CBI. They did not make the abbreviation themselves, but lifted the quotation from the FT's report of your speech. They really should know better by now than to believe all they read in the newspapers!

4. Clearly if the CBI are too quote you, they must do so accurately. They are happy to do this, even though the full quotation does not fit their purpose nearly so well. Is that OK? Or shall we ask them to take it out altogether? We have not managed to find an alternative suggestion from a Party document.

APH

A P HUDSON

As I suspected. The CBI are free to quote from my Bow Gp speech if they wish, but only if they use the full quotation, with no words omitted. NL

RH12.53 IN CONFIDENCE

cc Mr Monck
Mr Call

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

21 September 1987

Andrew Sentence Esq
Confederation of British Industry
Centre Point
New Oxford Street
LONDON
WC1

Dear Andrew,

CBI CITY/INDUSTRY TASKFORCE

... We had a word about the source of the Chancellor's remarks about institutional investors. I attach the full press release that was issued when he spoke to the Bow Group on 9 June 1986. The relevant remarks are on the first page.

As I told you on the phone, the Chancellor is happy to be quoted, provided you use the full quotation with no words omitted. I would be grateful if you could let me know, just before you finalise the Report, what you are proposing to quote.

Yours sincerely,

Andrew Hudson

A P HUDSON

4,2/112 rec mr call

NOT FOR PUBLICATION, BROADCAST OR USE ON CLUB TAPES BEFORE 7 PM ON MONDAY, 9 JUNE 1986

EXTRACT FROM THE CHANCELLOR OF THE EXCHEQUER'S SPEECH TO THE BOW GROUP, ON 9 JUNE 1986, ON "BIG BANG AND BEYOND"

The Big Bang and its associated changes also provide a further opportunity for a wider spread of direct ownership of British industry and commerce by the British people.

As we increase the number of individual shareholders, we may be able to some extent to reverse the long term trend to institutional ownership of British industry.

That is something greatly to be desired.

Quite apart from the positive benefits of individual share ownership, the big institutional investors nowadays increasingly react to short-term pressure on investment performance.

As a consequence many British industrial managers complain that their institutional shareholders are unwilling to countenance long term investment or a sufficient expenditure on research and development.

They fear that any such investment by their company may leave them easy victims to take-over by a predator.

Ironically, most of the solution to this problem lies in the hands of the industrial managers themselves. For, wearing another hat, as trustees of their pension funds, they are the very people who are putting this short term pressure on the institutions.

But an increase in the number of individual shareholders will also help, since the small shareholder tends to be more committed to the company in which he invests - if it has served him well over the years - and prepared to take a longer view.

For this reason I hope that companies will welcome the number of small shareholders who will apear on their registers over the next few years as a result of Personal Equity Plans - even if it involves them in extra costs.

The international community has already shown its confidence in the new environment in which London's markets will work - through its cheque book.

Our systems work without prejudice as to nationality, but we are not prepared to make this one-sided.

If British institutions are not allowed to operate in overseas markets on equal terms with domestic institutions, foreign institutions must not be surprised if we restrict their operations here.

It has been particularly difficult for British financial institutions to operate freely in Japanese markets.

My Ministerial colleagues and I have been making this position clear to the Japanese authorities, and the results are beginning to be seen.

Over the last year or so six UK houses have been granted licences to operate in Tokyo and more are in prospect.

The first UK house has bought a seat on the Tokyo Stock Exchange and Barclays is one of several foreign banks to have been given trust banking licences.

But much remains to be done.

As a final sanction, the Government is taking statutory powers to allow it to refuse to authorise or to remove authorisation from any financial institution whose national authorities do not provide reciprocal facilities for British institutions.

Having used heavy earth-moving equipment to level our own playing field, we do not take kindly to being forced to play uphill and into the wind when we play away.

PWP

FROM: A P HUDSON

DATE: 21 September 1987

PS/ECONOMIC SECRETARY

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Sir P Middleton
Sir T Burns
Mr A Wilson
Mr Monck
Mr Cassell
Mr Burgner
Mrs Lomax
Mr Culpin
Mr Ilett
Mr P Gray
Mr Call

REPORT OF THE CBI CITY/INDUSTRY TASK FORCE

The Chancellor has seen your 15 September minute.

2. He, of course, agrees very much with the Economic Secretary's point about direct individual shareholding - it is a point he has made on frequent occasions, and he thinks it most regrettable that the Report has ignored it.

3. He notes that the report is to be published on 14 October, in good time for his Stock Exchange speech on 26 October.

APH

A P HUDSON

RJ11.12 UNCLASSIFIED

FROM: N G FRAY

DATE: 22 September 1987

MR CURWEN

CBI MONTHLY TRENDS ENQUIRY AND STAFF FORECASTS: SEPTEMBER 1981

The Chancellor was grateful for your minute of 18 September, the contents of which he has noted.

Nigel Fray

N G FRAY

Monday, September 28, 1987

THE INDEPENDENT

Ridley sets out strategy to win fight over poll tax

By Andrew Marr
Political Correspondent

THE ONLY alternatives to the poll tax are ghettoes of poverty or the end of local democracy, ministers will tell the Opposition when the Commons battle opens this autumn.

Nicholas Ridley, Secretary of State for the Environment, and his minsterial team, has completed plans for dealing with the deep unpopularity of the proposed "community charge" among Tory voters and MPs.

Mr Ridley fired the opening shot at the weekend in a speech arguing that previous government efforts to halt spending by the town halls, such as ratecapping, had gone so far that local democracy itself was now in danger of being killed off.

"Any further measures to constrain or limit local spending from the centre would virtually spell the end of local government as a separate elected element in the land," he told Tory councillors in Coventry. The alternative was to give back responsibility to local electors through a non-progressive tax, which encouraged them to vote.

Senior Tory critics have been studying the possibility of promoting a local income tax. But Mr Ridley attempted to head them off by saying that this would mean the better-off fleeing to low-tax, Tory-controlled areas.

"As they arrived, so the low-tax Tory council's income would increase, and they could cut the rate of income tax even further," he said. "So you would get low-tax areas for the better off and high-tax areas for the less well off; with massive social segregation. That would worsen the problems of inner cities, the last thing we need.

"There could be no more insane policy than to give Labour councils a tax with which they could drive out the better-off."

Mr Ridley and his colleagues will tell sceptical Conservative backbenchers that they should make a "leap of imagination" to see how the poll tax could end the bruising confrontations between ministers and left-wing Labour councils, such as Liverpool.

"I envisage a new world in which the relationship is no longer embittered by central government interference in local authority affairs, or by local government determination to challenge central government and threaten its management of the economy," Mr Ridley argued.

Instead, the battle would be between voters and the local politicians.

Michael Howard, the local government minister directly involved in the poll-tax legislation, seized on the opportunity offered by the admission of Labour's frontbench spokesman, Jeff Rooker, that his party had no local government policy to say: "What this does for the image of his boss, John Cunningham, is interesting to consider because Dr Cunningham has been the Labour Party's principal spokesman on these matters for some years now.

"What has he been doing all this time? Why on earth has he not been formulating a policy? You can expect us to be exploring these questions," he told a Conservative local government policy seminar.

THE TIMES

CBI chief attacks new tax

By David Walker

The man who has probably most influenced Mrs Thatcher's thinking on the future of local government has advised that the proposed community charge should be scrapped.

Mr John Banham, former controller of the Audit Commission and now Director General of the CBI, has offered to help the Goverment draw up new proposals.

Leading article............17

He has sent a four point plan to the Department of the Environment following a request to the CBI ruling council that he be empowered to carry out confidential negotiations "to get the Government off the hook".

Mr Banham's handling of the Liverpool budgetary crisis and studies of council spending did much to convince the Prime Minister that her distrust of the municipalities was right; but now he has caused embarrassment by proposing a complete reworking of Government policy.

He is suggesting that the cost of schools, social work and other national services should be transferred entirely to the Exchequer. This proposal, which has been around for some years, has always been strenuously resisted by both the Environment Department and the Treasury.

The plan for a uniform business rate would be dropped and the financial contribution of business to local government reduced.

There would be a complete end to subsidy of such council services as housing. Council rents would be expected to rise to a market level, possibly by an average of £5 per week per dwelling.

Charges for other services would fully cover costs. A small community charge would be retained to pay for such things as street lighting.

Business-related services, such as refuse collection, would be paid for by rates on business property collected locally.

Mr Banham's involvement in the debate has caused ructions within the CBI. Although his action was in line with its new policy, announced a fortnight ago, of collaborating with the Government in solving problem and adopting a "pro-active" approach, it is understood that his initiative has aroused opposition among members of the CBI's governing council.

He had promised in his letter that his rescue plan was in line with Conservative commitments. But he has since been asked to retrieve the proposals and do more work on them.

Mr John Banham, who opposes the community charge

According to a CBI official the grand plan for local government is now "simmering on the stove" and would not come back to council for approval in the immediate future.

Mr Banham recently saw Mr Michael Howard, the Minister for Local Government, and accounts of the meeting differ. Officially, Mr Banham was informing the minister of the CBI's thinking on the Government's plan for transferring rates on business property from local councils to a central fund; but Mr Banham was anxious to expand the CBI's contribution well beyond interest group politics into a general critique of local government finance.

One result of the Banham scheme would be a large reduction in rates payable by business.

The CBI has previously argued for derating of business to cut £2 billion off its rates; Mr Banham's plan would save £1.6 billion.

8/1

Confederation of British Industry
Centre Point
103 New Oxford Street
London WC1A 1DU
Telephone 01-379 7400
Telex 21332
Facsimile 01-240 1578

Director-General
John M M Banham

Secretary
Maurice Hunt

CBI

PWP

A P Hudson Esq
Treasury Chambers
Parliament Street
London
SW1P 3AG

29 September 1987

cc Mr Monck
Mr Call

Dear Mr Hudson

CBI CITY/INDUSTRY TASK FORCE

I have been putting the final touches to the Task Force Report so I am replying to your letter of 21 September to Andrew Sentance.

It was kind of you to supply a copy of the full text of the Chancellors speech and it is clear that our earlier quote was inaccurate. The quote that we have in the final copy, which is now with the printers, is:

"Quite apart from the positive benefits of individual share ownership, the big institutional investors nowadays increasingly react to short-term pressure on investment performance. As a consequence, many British industrial managers complain that their institutional shareholders are unwilling to countenance long term investment or a sufficient expenditure on research and development".

Thank you, again, for drawing this matter to our attention.

Yours sincerely,

[signature]

G Foster
Senior Economist
Economic Policy Department

CONFIDENTIAL

CHANCELLOR

FROM: B H POTTER

Date: 30 September 1987

cc: Sir Peter Middleton
Mr F E R Butler
Mr Monck
Mr Hawtin

Nigel thanks

MEETING WITH CBI PRESIDENT ~~MR~~ Sir. DAVID NICKSON

I attach a briefing note for your meeting with Mr Nickson. I assume he wishes to discuss the CBI's latest proposals for reform of local government finance, announced last week. Mr Nickson may wish to plead the case. But as the brief explains, he may equally wish to make clear that the CBI is not fully committed to them.

X

Barry H. Potter

BARRY H POTTER

MEETING NOTE FOR MEETING WITH CBI PRESIDENT ON BUSINESS RATES

Background

1. The CBI at first supported the "Paying for Local Government" proposals. But this support was made conditional upon a 25% reduction in the proposed uniform business rate, relative to average business rate bills.

2. This line was held until the CBI budget representation this year, but never pursued strongly. The CBI were somewhat reassured by:

(i) the proposed power in the Bill to limit the increase in the UBR each year to the annual increase in the RPI; and

(ii) the decision that the Chancellor would have the powers to determine the level of the UBR.

CBI revised proposals

3. Following John Banham's appointment as the Director General, there was a thorough review of the CBI's line. The proposals which emerged are by no means new: John Banham put them forward in a personal capacity when he was at the Audit Commission.

4. The CBI's revised plans are based on distinctions between the following types of local authority service:

(a) "National" services - eg schools and personal social services; these would be run by central government; it follows that they would be paid for from central taxation;

(b) Business related services - eg refuse collection and planning permissions; these would be paid for by a local business rate;

(c) Marketable services - eg services like housing that are currently subsidised, would be put on a full cost recovery basis; costs would be met from rents, fees and charges;

(d) Other services - eg street lighting would be paid for through a small Community Charge.

5. These proposals are by no means universally supported within the CBI. Several members of the policy-making Economic and Financial Committee are opposed to them and concerned about the implied attack on Government policy. (There is also another strand within the CBI that would prefer freezing present business rates and uplifting them in line with the RPI (the scheme in Scotland). We are not certain of the CBI President's stance. But DOE think he may be more minded to support the original CBI line, ie broad support of Government policy, than the revised proposals.

6. Mr Banham was told by Mr Howard about a month ago that Ministers could not be expected to change track now on the reform of local government finance. We also understand that Mr Ridley has conveyed the same message to Mr Banham. (You should also be aware that Mr Nickson is due to meet Mr Ridley at a separate meeting tomorrow.)

<u>Line to Take</u>

7. You will first wish to probe Mr Nickson's appreciation of the CBI's stance on these revised proposals. What is the strength of support for the new line? It would be helpful to find out Mr Nickson's own position.

8. If Mr Nickson presses the new CBI package you will wish to reinforce the message that there can be no substantive change in the Government's plans for introducing the Community Charge and the NNDR in 1990. You may like to remind Mr Nickson that the NNDR (and the revaluation) are to be phased in over a period of 5 years. This should avoid excessive increases in business rate bills.

9. You could also indicate that many elements in the CBI's revised proposals are consistent with Government policy. The Government favours more fees and charges being set for marketable LA services. The Government is also committed to reducing excessive subsidies to services like housing; and the Local Government Bill will encourage further contracting out of services to industry. The objectives underlying the CBI's and Government proposals are the same: to keep down business rates and the Community Charges.

PS/CHANCELLOR

1 ~~Approx~~ one suggested amendment

2 C/content?

CR 13/10

OK as

FROM: B H POTTER

Date: 13 October 1987

cc: PS/Chief Secretary
Sir Peter Middleton
Mr F E R Butler
Mr Anson
Mr Monck
Mr Hawtin
Mr P Gray
Mr Fellgett
Mr Call

CBI CONFERENCE ON RATING REVALUATION: SPEECH BY CHRISTOPHER CHOPE MP (JUNIOR DOE MINISTER)

Mr Chope (DOE Parliamentary Under Secretary) is to address a CBI one-day conference on rating revaluation next week.

2. As you know, the CBI have recently been voicing doubts about the proposed introduction of the NNDR. The CBI President has seen both Mr Ridley and the Chancellor over the last two weeks; the President (backed by other CBI council members and staff) is talking to Mr Ridley again tomorrow. DOE are anxious to take a placatory line at the CBI conference next week.

3. Accordingly they have included a paragraph in the speech (attachment A) which draws attention to the effective capping of the real NNDR rate, and the possibility of less than full uprating as an irreversible reduction in the real level of business taxes. As drafted, in my view, it goes too far; it hints that such a reduction will be forthcoming. (You will recall the original CBI line that a 25% decrease in the NNDR was required.) But we may not want to resist the line absolutely, given the possible advantages of sustaining CBI support for the NNDR as the Bill goes before Parliament.

4. I have therefore redrafted the paragraph as at attachment B. It links any real reduction in the NNDR to particular

contingencies. More importantly, it makes clear - for the first time in public - that the Chancellor has the final say on the NNDR poundage. We see advantages in getting this on record before any DOE attempt to renege on the agreement.

5. In view of the latter point, you may wish to clear the revised paragraph with the Chancellor.

Barry H. Potter

BARRY H POTTER

DOE PROPOSED DRAFT IN MR CHOPE'S SPEECH

That brings me to an important point about the NNDR, which many people may not have realised. We have guaranteed that the rate poundage will not rise by more than the Retail Price Index each year. That in itself is a very major benefit. But we have been very careful to leave open the possibility that it could rise by less. We shall also have the power, each year, to decide that uprating should be by less than the increase in the RPI. I am making no promises as to how we will use that power; but we could use it, for example, if it became apparent that more of local authorities' spending could be met from fees and charges, or if the Chancellor decided in his budget judgement that it would be sensible to shift the balance of business taxation. And it will be a one-way ratchet: if in one year the power was used, next year indexation would start from the new, lower base in real terms.

B

TRESURY DRAFT

That brings me to an important point about the NNDR, which many people may not have realised. We have guaranteed that the rate poundage will not rise by more than the Retail Price Index each year. That in itself is a very major benefit. But we shall also have the power, each year, to decide that uprating should be by less than the increase in the RPI. Before the NNDR poundage is set for each year, it would be open to the Chancellor , as part of his Budget judgement, to decide on a less than full uprating. [~~for example if there were unexpected buoyancy in the yield of the NNDR or if he decided at some time that it would be sensible to shift the balance of business taxation.~~]

And if he wants to do so, then the following year revaluation would start from ~~the lower~~ that lower base.

4306/025c2

Papers Pse

FROM: S J FLANAGAN

DATE: 13 October 1987

MR PICKFORD

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
PS/Sir Peter Middleton
Mr Cassell
Mr Monck
Mr Burgner
Mrs Lomax
Mr Allen
Mr Ilett
Mr Gray
Mr Wynn Owen

REPORT OF THE CBI CITY/INDUSTRY TASK FORCE

The CBI will be publishing this report at a press conference on Wednesday 14 October at 11.30am. Press reports have already appeared. Mr Monck's minute of 11 September to the Chancellor provides a fuller account of the report.

2. The report concludes that the UK does suffer from "short-termism", poor competitiveness and low investment, and although the latter have improved dramatically in recent years, British performance is still behind that of our major competitors. But the idea that the City is responsible for short-term attitudes is attacked as a "myth". The main causes are seen as "underlying economic and political factors, including inadequate profitability". The report finds that financial institutions are, on the contrary, long-term investors.

3. Most of the report's recommendations are aimed at improving communications within and between industry and the City, through greater disclosure of long-term intentions (especially R&D spending), better training of analysts, more use of non-executive directors, discussion between pension funds and their companies about the former's role as shareholders, and more institutional links between City and industry (centred, unsurprisingly, around the CBI).

Line to take

4. The Chancellor has commented internally (Mr Taylor's minute of 15 September) that the report is "something of a mouse" (the analysis is not very rigorous and the recommendations are unimaginative), but you will not want to use that publicly. You can, though, welcome the attention that CBI have been paying to

the problem of "short-termism", and the contribution their report makes to understanding the problem. Two possible queries that may be raised are:

What is the Government's response to the report?

Main recommendations of the report are not addressed to Government. But it welcomes emphasis on improved communications and links between companies, shareholders and the City.

Was the Chancellor myth-making when he spoke of short term pressures (p.7 of the report)?

No. He was pointing out the sort of commonly held view which gave rise to the CBI City/Industry Task Force. The report recognises that there is a problem of "short-termism" in industry.

Steve Flanagan

S J FLANAGAN

Distillers may cost Guinness extra £150m

22

GUINNESS may be made liable by the Takeover Panel to pay an extra £150m for the takeover last year of the Scotch whisky group, Distillers.

By Jeremy Warner
Business Correspondent

The panel has begun a belated investigation into possible breaches of the takeover code by Guinness and its associates after complaints from a number of institutional investors about failure to take action.

The deliberations centre on whether the company should have been obliged to make a higher bid to Distillers shareholders.

A full meeting of the panel took place in conditions of strict secrecy on 2 September to study the implications of a particularly controversial shares deal which occurred in the closing stages of the Distillers bid fight.

If the case against Guinness and its associates is proved, the company would be liable to make a payment of an extra 70p a share to former shareholders of Distillers, though there would be no legal obligation to do so.

The panel is studying an episode that took place a week before the takeover battle closed, when a key block of 10 million Distillers shares owned by Warburg Investment Management — about 2 per cent of the total — was sold to clients of Cazenove, Guinness's stockbroker, at a price which was 70p a share higher that the value of Guinness's cash offer for Distillers.

The transaction attracted a complaint from the rival Distillers bidder, Argyll Group, which also made a bid for the shares but was unable to match the Cazenove price. Cazenove told the panel that the clients were unconnected with Guinness and the matter was dropped.

The panel has now established that the £70m worth of shares were bought by clients of Bank Leu, the Zurich bank which played a key part in the covert Guinness share support operation and whose chairman, Dr Arthur Fürer, was a director of Guinness.

Under the takeover code Bank Leu was an associate of Guinness, which meant that the purchase should immediately have triggered a £150m increase in the value of the brewer's bid.

All those involved in the transaction were summoned to the panel meeting on 2 September and sworn to secrecy because of the price-sensitive nature of the deliberations.

THE TIMES

Short City view of industry 'a myth'

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By Our City Staff

The CBI's City/Industry task force, formed in response to differences between industrial and financial groups at last year's CBI conference, has rejected the idea that the City takes a short-term view of industry.

It dismisses such a view as mythology rather than fact — except in the vital context of takeover bids.

The task force, whose report will be published this week, wants a code of conduct which aims at reducing the role of arbitrageurs in takeover bids.

The CBI is to consider a call for a stiffer regime of short-term capital gains tax, possibly replacing long-term gains tax, to discourage speculators who try to drum up bids by building stakes in companies.

The report will back initiatives for changes in merger accounting. It is also likely to urge better training for City investment analysts.

But the task force has found difficulties in implementing the suggestions of Mr David Walker, the Bank of England director, for regular close contact with big institutional investors and obligatory disclosure of research and development spending.

Daily Telegraph

City not out for fast profit says the CBI

2.

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A DETAILED REPORT by the Confederation of British Industry City/Industry Task Force, due out on Wednesday, has found "no clear" evidence" to suggest that the City is preoccupied with short-term performance and out to make a quick profit.

The "unanimous" report, which covers takeover bids and mergers, "short-termism" and the relationship between the City and industrialists since Big Bang, unsurprisingly does not go as far as supporting the radical changes that some businessmen had been calling for.

It does, however, offer guidelines on a code of conduct between companies and institutional investors and makes recommendations on the course of conduct during takeover bids.

The 28-strong Task Force team is chaired by CBI president Sir David Nickson

THE INDEPENDENT

Institutions return to property market

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INSTITUTIONAL investors are returning to the property market after a prolonged absence, and the amount spent by insurance firms to buy property is twice what it was this time last year.

In its latest bulletin on institutional investment, surveyor Fletcher King reports a "significant revival of interest by pension funds and insurance companies," a trend which it expects to continue."

Although in the second quarter of 1987 there was a fall in the net amount pension funds invested directly in property, with sales receipts — at £393m — £120m more than expenditure, the underlying trend on purchases is up.

"Pension funds and insurance companies are using the improved market to rationalise their portfolios by significant bouts of selling to property companies," the report adds.

MONDAY, OCTOBER 12, 1987

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CHAIRMAN'S FOREWORD

The CBI's City and Industry Task Force was conceived immediately after the 1986 National Conference. The catalyst was a remark made by David Walker of the Bank of England in his speech to the Conference in which he said:

> "I regret the polarisation between City and industry often found in discussion on this subject. Relationships between finance and industry are complex, and to say that there are no easy solutions to problems that arise is neither to duck the issue nor to be complacent. It is just realistic. Equally, whatever attraction some have seen in the past in other systems such as the universal banks in Germany, we have to work with the capital market-based system that we have in this country and, if we are not satisfied with it, make it work better."

It seemed to me that the CBI with its widely based membership, covering all aspects of the financial world and industrial and commercial companies both large and small, was well suited to study and comment upon the relationships between the City and Industry.

With the enthusiastic encouragement of Sir Terence Beckett, the former Director-General of the CBI, I therefore invited a number of prominent individuals drawn from our members to serve on a Task Force with a view to reporting back in a year's time to the 1987 Conference.

This document represents our views. For the most part it is about attitudes rather than actions but where we think change is needed we have made specific recommendations. The synopsis covers our main conclusions and the report itself is supported by detailed working papers which we have considered at six meetings during the year, five held at Centre Point and one, thanks to the Lord Mayor's personal interest, at the Mansion House.

Our debate has concentrated on two key areas. The first is the whole question of communications and relationships between the City and Industry. The second is the issue of takeovers and acquisitions which, while representing only a small part of the whole subject, tends inevitably to cause the most concern, the maximum attention in the Press and media and the greatest difficulty in terms of regulation and control.

We have attempted to take a long-term view rather than seeking to provide solutions on more specific topical issues that have arisen during the year. These are more appropriately the prerogative of other organisations such as the Government itself, The Stock Exchange, the Takeover Panel, the new regulatory authorities under the Securities and Investments Board, the various committees established by institutional investors, and the accountancy and legal professions.

We have received the widest degree of positive support and encouragement from all sides. Many people have provided much invaluable advice information and opinion and in the process spent much time in assisting us. We are extremely grateful to them all.

CBI staff have provided excellent support and shown great skill in producing the working papers and then in refining much information and debate into this final report.

Finally, I would like to thank the distinguished members of the Task Force itself for agreeing to serve on it, for providing such a full attendance at all our meetings and for their advice and support, which have enabled us to produce a unanimous report.

The success of the Task Force will ultimately depend upon how our report is received at the Conference and subsequently on the how we follow this through. The Task Force itself will meet only once more, early in 1988, to review progress and to recommend to Council how responsibility for continuing the initiative within the CBI should be established. It will also determine how our recommendations for change and action by others should be pursued.

We hope that this report will be widely read and studied, that it will help to demonstrate that the City and Industry do for the most part work well together in the national interest and that they are interdependent. But certain things do indeed need changing not least the efforts on all sides to improve communications and understanding.

EXECUTIVE SUMMARY

There is widespread concern, on both sides of the Atlantic, that the perceived short-term orientation of financial investors in stocks and shares is damaging to industrial competitiveness by discouraging companies from undertaking long-term investment in fixed capital, Research and Development and training.

This concern has been heightened by the number of mergers and acquisitions over the last few years. Quite apart from questions about the ways in which some bids have been conducted, critics of the wave of mergers assert that the atmosphere they create has encouraged - if not forced - managers to take a short-term view at the expense of the investment essential to longer run competitiveness. While the need for British industry to invest in the future has never been more apparent, it is alleged that industrial logic and the need for international competitiveness - within the manufacturing sector in particular - have been sacrificed on the altar of short-term financial gains; while the interests of the other stakeholders inthe future of the business, including the workforce, suppliers, and the local community, have effectively been ignored by the market.

However, it is not only takeover bids which have given rise to this concern. Many industrial managers feel that the financial institutions which largely own British industrial companies do not understand their problems and opportunities, take major decisions affecting a company on superficial evidence, and do not provide the support, either critical or constructive, which is to be expected from equity ownership.

Many business leaders share these views and strongly support them. This was clear in a debate at the 1986 Annual Conference of the Confederation of British Industry.

The extra media attention devoted to the financial sector has probably not helped. Discussion of daily movements in share prices, bid prospects and monthly official statistics on money supply, balance of payments and prices can appear to support the view that the City is interested only in the short-term. The activities of arbitrageurs - not to mention the extensively publicised stagging profits on recent privatisation issues - have reinforced the image of the market as a casino or race meeting, where companies are 'put into play' and the market is determined by speculators rather than responsible owners of companies.

Recognising the strength of feeling among CBI members, and the potential damage to the nation's long-term prosperity that could result if relations between the City and Industry deteriorate, a 29-strong Task Force chaired by the CBI's President, Sir David Nickson, has examined the basis of the concerns and the steps needed to correct the situation. The Task Force comprised senior executives from both "sides" in the debate. The accompanying report represents their unanimous conclusions and recommendations.

Underlying much of the concern is the fact that, despite the remarkable turnaround of the past few years, there remains a sizeable gap between the UK and its major OECD competitors in terms of productivity and profitability of manufacturing - particularly when relative inflation and interest rates are taken into account.

The contrast with West Germany is instructive. Average pre-tax returns in manufacturing are still almost double those in the UK (17% compared to 8% in 1986)[1] and, according to one recent estimate, average manufacturing productivity is also around twice British levels.[2] This is not to say that the best British companies are not competitive with the German counterparts; but the average standard needs to be raised much higher. The task faced by British companies is not made any easier by the fact that UK short-term interest rates in the year to August 1987 averaged 6 percentage points higher than in Germany and inflation over the same period was 4 percentage points higher.[3]

Notwithstanding the unpalatable realities, the Task Force found no evidence to link attitudes of the City directly to the long run decline of the nation's manufacturing sector - nor to its resurgence in recent years. Rather, it found that many commonly held perceptions were simply not supported by the available facts. They were part of a pervasive mythology that needs to be de-bunked in the interests of both City and Industry alike. Instead, the Task Force concluded on the basis of the evidence available to it that:

- Many British companies have given insufficient weight to long term development, but that this does not arise primarily from City pressures. It arises mainly from underlying economic and political factors, including inadequate profitability.

- Most financial institutions (which own around 60% of UK equities) are long-term investors, not surprisingly in view of the long-term nature of their obligations. Moreover, the shareholders' average holding period is anyway not the critical issue; it is company time horizons, and their readiness to invest for the longer term, that matter.

- There is no general shortage of funds for good small or high-risk ventures, though financing costs are sometimes high.

- The cost of City facilities has fallen since Big Bang, as competitive pressures have had their effect.

- Expenditure by UK companies as a whole on mergers and acquisitions is much less than they spend on organic growth through investment. Even in 1986, with such high takeover activity, British business spent almost twice as much on fixed investment as it did acquiring other companies.

- Managers of companies under threat of takeover do not defer investments to enhance their current earnings. Indeed, the threat can be a spur to management performance. However, acquisitions are not necessarily the best way of improving management; they can be expensive and are also risky for predators. The best estimates for recent years suggest that some two-thirds of contested bids fail[4] in the UK.

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1 Gross operating surplus, expressed as a percentage of capital stock. OECD. (Though these figures are standardised by the OECD, as they are produced from accounting data using different conventions, they may not be strictly comparable.)

2 G F Ray Labour Costs in Manufacturing National Institute Economic Review, May 1987

3 National Sources. Change in Retail Price Index: UK 4.4%, W Germany 0.5%; Average short-term interest rate: UK 10.3%, W Germany 4.3%.

4 Bank of England Quarterly Bulletin, May 1987.

The Task Force found that at the heart of the problem lies a communications and educational gap between management, owners of companies and those providing finance. Though many companies have established good links, their example needs to be followed more widely. In West Germany, France and Japan effective communications are facilitated by an industrial structure that is, in effect, controlled by the banks. But this has come at the cost of rigidities which are now being removed, and are causing some stress in these economies.

The Task Force believes that the communications challenge here at home can be met by

(i) Companies making more effort themselves to keep the market informed about their longer term strategic intentions and in particular about spending on research and development, as well as training and other aspects of innovation. A voluntary approach is far preferable to statutory intervention which will introduce unwarranted inflexibility and legal complexity.

(ii) Financial analysts being better trained in the skills necessary to provide a strategic assessment of a company's prospects, particularly at the more senior level. At present, the quality of analysts can appear very uneven.

(iii) Independent non-executive directors should comprise at least a sizeable minority on all but the smallest public company boards, adding to the range of skills and experience available to the company. There may even be exceptional circumstances when it is desirable for a Non-Executive Director to play a role in communicating shareholders' concerns about management performance to the Chairman and/or Chief Executive.

(iv) Discussion between company managements and the trustees of their pension funds on the ways in which the funds fulfil their responsibilities as shareholders, in addition to their responsibilities to members and pensioners.

(v) Institutional links between the City and Industry being strengthened. The CBI plans to enhance its own ability to contribute to and follow up the debate on City and Industry relations.

The Task Force also considered ways in which mergers and acquisitions are regulated and accounted for. It concluded that:

(vi) The Department of Trade and Industry's current proposals for reinforcing the capabilities of the Takeover Panel were a step in the right direction, but the surveillance powers and sanctions available to the Takeover Panel may need to be strengthened further.

(vii) The market and shareholders should be left to decide the outcome of contested bids, except where competitive or national strategic issues are involved, eg national defence interests or major regional concerns. In such cases, the Secretary of State would retain the power to refer a bid, provided detailed reasoning is given. But competition and merger policy must not stand in the way of UK based firms achieving or retaining international competitiveness on a scale of operations appropriate to what is now a global market.

(viii) No attempts should be made to "tilt" the playing field in favour of defendants. All the many proposals to this end considered by the Task Force were found wanting. Nevertheless, a greater transparency of shareholdings is desirable; company managements have a right to know, as far as is practicable who holds their shares and some further tightening of disclosure requirements may be required.

(ix) Merger and acquisition accounting standards should be tightened. The present degree of flexibility in this area may have the effect of masking the true effect of acquisitions.

Other steps will be required to correct the underlying economic causes of short-term bias. The CBI plans to address many of these issues by setting out its views on "A Strategy for Industrial Competitiveness". The Government has an important role to play, not least in ensuring that public sector purchasing is used to promote long run industrial competitiveness, sterling remains competitive and public expenditure does not crowd out company investment - by raising the cost of capital above that available in other OECD countries.

Companies themselves, especially if they aspire to compete in the world league, must take a long view; and in this context five years can be a relatively short time. However, many Company Chairmen in Britain today feel they cannot afford the luxury of a longer perspective. A combination of factors, both within industry and external to it, lead many British industrialists to hesitate before undertaking major projects that could take perhaps seven to ten years to pay off. Yet it is the ability to invest for longer term growth that underpins the success of all world class companies.

The risks attached to investing long-term may be great, but the penalties for not doing so are even greater. Without domestically based world class companies there is a danger that Britain could become a satellite economy. Already, there are too few world class British based manufacturing concerns who are world leaders. Of the 100 largest non-oil industrial companies in the world (ranked by sales), only 5 are wholly based in Britain (8 are West German and 15 Japanese).[5] So the challenge to Industry, to the City and to Government remains, to create a climate where British business can afford to take the long view and is actively encouraged to do so.

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5 Fortune Magazine.

Confederation of British Industry
Centre Point
103 New Oxford Street
London WC1A 1DU
Telephone 01-379 7400
Telex 21332
Facsimile 01-240 1578

From
Sir David Nickson KBE DL
President

CBI

RP

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London
SW1P 3AG

13 October 1987

~~Not Press~~ For normal action

Dear Nigel

I am enclosing a copy of the CBI City Industry Task Force Report entitled: "INVESTING FOR BRITAIN'S FUTURE"

As I think you know, we have been working on this for a year and a list of members of the Task Force is contained in the Report. The Report is unanimous. It will be published on October 14th and will be thoroughly debated at the CBI National Conference in Glasgow on November 3rd.

I hope you will feel that it is a helpful contribution to the understanding and better relationships between financial institutions and industrial commercial companies.

Yours ever

David

Letter only to all

CH/EXCHEQUER
REC. 19 OCT 1987
ACTION Mr S Flanagan
COPIES TO CST FST PMG EST
Sir P Middleton
Mr ~~Cassell~~ Monck
Mr Burgner
Mr P Gray
~~Mr~~ Mr Cropper

ps2/34R UNCLASSIFIED

FROM: CATHY RYDING
DATE: 14 October 1987

MR B H POTTER

cc PS/Chief Secretary
Sir P Middleton
Mr F E R Butler
Mr Anson
Mr Monck
Mr Hawtin
Mr P Gray
Mr Fellgett
Mr Call

**CBI CONFERENCE ON RATING REVALUATION:
SPEECH BY CHRISTOPHER CHOPE MP (JUNIOR DOE MINISTER)**

The Chancellor was grateful for your minute of 13 October.

2. The Chancellor suggests that the final sentence of the Treasury draft at B be redrafted as follows:

> "Before the NNDR poundage is set for each year, it would be open to the Chancellor, as part of his Budget judgement, to decide on a less than full uprating. And if he were to do so, then the following year indexation would start from that lower base".

CR

CATHY RYDING

Confederation of British Industry
Centre Point
103 New Oxford Street
London WC1A 1DU
Telephone 01-379 7400
Telex 21332
Facsimile 01-240 1578

From
John M M Banham
Director-General

CBI

*With top copy of attachments

CH/EXCHEQUER
REC. 16 OCT 1987
ACTION Mr Potter*
COPIES TO PS/CST
Sir P Middleton
Mr FER Butler
Mr Anson
Mr Monck Mr Hawtin
Mr RIG Allan
Mr P Gray Mr Cropper Mr Tyrie

Shall I action out for advice?

yr psr (as pr. sp. advisers)

CR 15/10

14 October 1987

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
11 Downing Street
London SW1

Dear Chancellor

When David Nickson saw you recently, he repeated the CBI's long-standing concerns about the proposals for implementing the Government's Manifesto commitments in respect of the reform of Local Government Finance.

The concerns of our members are two-fold. First they believe, almost universally, that the proposed flat rate community charge on all adults will represent an administrative nightmare and is a serious political mistake and, as very strong supporters of the Government in general, they want to see such mistakes avoided. Second, from the beginning when it was first proposed, they considered the uniform business rate to be misconceived and potentially very damaging to a number of businesses - including many who will have a key role to play in the inner city and education initiatives by which we (and the Government) set considerable store. A motion to this effect was passed at our 1985 Conference.

While the first concern may not, technically at least, be a matter for the CBI, the second most certainly is. It cannot make sense for business to be paying very substantial amounts for services it is not receiving while there is a serious backlog of investment in innovation, plant and equipment and training which must be removed if British business is to be internationally competitive.

These concerns are not new. We only wanted to support the principles in the Green Paper on condition that there would be a substantial reduction in the overall burden of business rates. But, in the uncertain period before the General Election there was no way in which the CBI was prepared to "rock the boat" on this issue when so much else was at stake.

2/

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer

We recognise, too, that simply complaining about the situation is no answer. After all, we share the Government's stated objectives as well as the conviction that the status quo is unsatisfactory. We have therefore undertaken our own detailed review addressing, from first principles, the question: how should Local Government be paid for? The result is set out in the attached memorandum. This has been prepared with the assistance of the Chartered Institute of Public Finance and Accountancy.

The issues involved have been discussed exhaustively within the CBI at regional and national level, and most recently at a meeting attended by Chairmen or Chief Executives of many of our largest members. It is likely to surface at our forthcoming National Conference on November 2/3 either in the debate on inner cities or during the debates on members' resolutions critical of the proposals; these have already been submitted. The nearly unanimous view of those consulted is that the proposals set out in the attachment represent a better way of achieving the objectives that we share with Government. We hope, therefore, that they will receive serious consideration before the legislation is presented to Parliament.

It would be most unfortunate if Government were to underestimate the strength of feeling within business on this issue. The CBI is anxious to work with Government on the initiatives in inner cities, education, training and management development. We do not want these initiatives to be prejudiced by the business rate issue. We do not intend to publish the memorandum for the time being; and we will decline any public comment on the substance of the memorandum until Government has had the opportunity to review it and react in detail.

I have written in similar terms to David Young; and I have given a copy of the memorandum to the Policy Unit in Downing Street.

Yours sincerely

John M M Banham

What a nothing?!

JMMB/fb
enclosure

LIFTING THE BURDEN ON BUSINESS:

AN ALTERNATIVE APPROACH

TO PAYING FOR LOCAL GOVERNMENT

SUMMARY

Memorandum by the Confederation of British Industry

14 October 1987

The Confederation of British Industry (CBI) welcomes the Government's determination to tackle the question of how Local Government should be paid for. Business rates have risen in real terms by 30% or more in recent years, and now cost over £6 billion a year. And the CBI supports both the principles set out in the Green Paper, Paying for Local Government, and, with the solitary exception of the Uniform Business Rate, the specific commitments included in the Conservative Party Manifesto - The Next Moves Forward.

But the proposals for implementing the Government's strategy, which were not included in the Manifesto, are unsatisfactory from a business point of view:

- Businesses and other non-domestic ratepayers will continue to pay some £2 billion a year for services from which they derive little (if any) direct benefit. This at a time when business needs to invest more, not least in Inner Cities and training. £2 billion is roughly equivalent to the total of privately funded expenditure on research and development, or around 25% of annual capital expenditure in manufacturing.

- The Uniform Business Rate (UBR) unhooks local authorities from business. Local authorities will have no incentive at all to provide services to business or to take business's interests into account in planning decisions; nor would they be able to attract new businesses on the basis of careful spending policies. Furthermore, the UBR represents a potential hostage to fortune in that it could easily be used by some future administration to increase the overhead burden on business.

- The proposal to set the UBR at the average current rate poundage will consolidate the present levels, which the CBI regards as excessive; opportunities have been identified for value improvements of over £2bn per year, of which £500 million have been agreed with local authorities. Yet no benefit from future improvements in efficiency will pass to business.

- Combined with the planned revaluation, there will be very large (ie 25-30%) increases in existing business rates outside Inner London and the North of England. In some cases, rates could well double. Some manufacturing concerns, with little realistic prospect of relocating or renegotiating rents in the short-term, will be forced to close. There will, of course be compensating benefits to business in the North, but even here, some sectors will be hit - major retailers have estimated that rates on certain types of property may rise by 50-100%.

- Accountability for local services will remain confused since three quarters of local expenditure will be determined centrally. There will be no relationship between what local business pays and the services it receives. The same will apply to domestic households. This will be particularly so during the extended transition period.

- The proposals appear inconsistent with the Government's plans for national initiatives in education and Inner Cities: The cost of local taxation per household in Hackney, for instance, would double to over £1,200 a year.

The Government's reaction to CBI concerns has been to state that there is no alternative. The choice is said to lie between an unsatisfactory status quo and pressing ahead along the lines now being proposed.

The CBI has concluded, on the contrary, that there is a viable alternative. It is described in more detail in the memorandum of which this is a summary. It has been prepared with assistance from the Chartered Institute for Public Finance and Accountancy (CIPFA) as a contribution to thinking on a difficult and a complex subject of great concern to business.

The CBI Alternative

Any alternative approach to paying for local Government supported by the CBI must be consistent with the Government's reliance on local accountability to control expenditure within broad limits, flexibility and simplicity. It must also reflect the requirements of sound management: delegation of authority and responsibility as far down the line as possible matched by effective local accountability, and positive incentives and encouragement to achieve better value for money.

The CBI proposes that different types of local service should be financed differently, to reflect the desired pattern of accountability and responsibility. The services provided by Local Authorities should be divided into four categories as follows:

Category	Examples	Funding Method
National Services, locally administered	Secondary education Children in care	Specific Exchequer grants* for each service
Property and Business Services	Fire protection Refuse collection Non-Advanced Further Education	Non-domestic rates (75%) and Community Charge Exchequer block grant*
Community Services	Primary and nursery education Care for the Elderly	Community Charge Exchequer block grant*
Marketed Services	Council housing Leisure services	Rents and charges (and Social Security)

* As at present, specific Exchequer grants must be spent for a specified service; and block grant may be spent on different services within its category as the Local Authority sees fit.

The Exchequer would make specific grants to the relevant authorities to cover the cost of such national services such as Polytechnics, Secondary Schools, School meals and milk (part of the Welfare State, in effect) and all child care services. The present block grant to local authorities would be reduced, pound for pound, to compensate the Exchequer.

Local businesses would contribute, via business rates, towards the local cost of those services (only) from which they benefit directly. These include Non-advanced Further Education, Police, Fire, road maintenance, street lighting, refuse collection and disposal, museums and libraries. For purposes of illustration, it has been assumed that, nationally, non-domestic ratepayers would meet 75% of the costs of the relevant services. Local business representatives would be co-opted onto the relevant local committees.

Council housing and leisure services - for which there is a local market - would be expected to be self financing; there would be no cross-subsidy for tenants or users, other than that provided by the Social Security system. This would mean that pricing 'signals' would be realistic. In particular, Council tenants would not be deterred from buying their houses by rent levels which fail to cover the cost of keeping the property in decent repair.

Every household would receive an annual bill to cover the cost of community services and the balance of property and business services. The cost incurred by each authority (ie county and district) would be separately identified. The collection and other costs would be considerably lower if the charge were levied on a per-household, rather than per-adult, basis - possibly with a reduction for pensioners living alone; and there would be other benefits as well. But there could be some loss of accountability. Both approaches (or indeed the retention of rates) are possible within the framework of the CBI proposals.

In addition, the CBI proposals include some other semi-technical, but nonetheless important, features:

(a) Exchequer block grant, of £3.4 billion a year based on 1986/7 costs, would compensate those authorities which have particularly heavy needs for community or property needs eg because there is a high local crime rate, the risk of fire is unusually high, there is a high proportion of primary school children or elderly people within the community. Mostly, the authorities that will receive block grant on this basis will be in deprived inner city areas.

(b) Revaluation would only affect the distribution of the local rate burden among local businesses; it would not influence the total amount of local rate to be financed. And there will be no need for a domestic revaluation.

(c) There would be a national minimum business rate, of 114p in the pound, before revaluation. This would affect only a very small handful of authorities. Elsewhere, business rates would reflect the local cost of services from which the local business community is benefitting.

(d) The business rate would be capped, so that increases would not exceed the rate of change in the retail prices index.

Financial Implications

The table below shows the way in which local services would be funded under the different schemes.

PATTERN OF NET FUNDING FOR LOCAL GOVERNMENT SERVICES
£ billion (England only). Based on 1986/7 estimates

	Government Plans	CBI Proposals
Exchequer grants		
- Specific grants	£2.8bn	8.4
- Block grant	9.0	3.4
Community Charge	7.4	7.4
Non-domestic rates	7.9	6.1
Reduction in Subsidy (gross)	-	1.2

The total under the Government's proposal is £450 million greater than for the CBI proposal, reflecting recent Scottish estimates of the extra cost of collecting the Community Charge from all adults. Increases in Social Security will reduce by £250 million the extra cost to users as a result of reduced subsidies - the increased cost to the Exchequer is almost exactly balanced by the reduction in non-domestic rates in Government and Crown property.

Under the Government's proposals, business rates would, overall, remain at their current level; but there would be very substantial variations from region to region following revaluation. Under the CBI proposals, however, business rates would contribute 75% of the cost of those services (only) from which business benefits directly and would be unaffected by revaluation. The table shows the estimated impact of the two schemes.

NON DOMESTIC RATES PAYABLE BY REGION AFTER REVALUATION
At 1986/7 prices

	Current	Government Plans	CBI Proposals
Greater London	£ 2,147m	1,949	1,512
South-East	1,471	1,795	1,052
East Anglia	258	229	198
South-West	538	678	464
East Midlands	549	497	447
West Midlands	736	905	572
Yorks & Humberside	716	551	622
North-West	958	879	829
North	487	354	389

The effect on domestic households will be neutral as between the Government and CBI schemes; but there will be a smaller increase in the more deprived areas under the CBI scheme than would have been the case if the Government's plans had been implemented; and there will be a smaller reduction in the more affluent areas. The following Table shows the changes in local taxation per household in two samples of authorities, one relatively deprived and the other relatively prosperous.

CHANGES IN TAXATION PER HOUSEHOLD
Based on 1986/7 Estimates

	Government Plans	CBI Proposals	Government Plans	CBI Proposals
	£	£	%	%
Deprived Authorities	+171	+71	+39	+16
Prosperous Authorities	-147	-55	-34	-13

* * * * * * * * * * *

The benefits of the CBI proposals would be substantial. The Government's stated objectives and Manifesto commitments would be met in full. The criticisms levelled at the Uniform Business Rate and the administration of the Community Charge could largely be overcome. Market forces would be allowed to operate where local markets exist. Accountability for local services would be much clearer, both nationally and at the local level. There would be every incentive for local people (including the business community) to press for implementation of the value improvements already agreed to be available - worth at least £500 million a year. Major problems on revaluation could be avoided. And the new scheme could be implemented without an extended transition period.

In short, there **is** an alternative way of paying for the business and property services of local government worth serious consideration.

ED41PKSQR10L

CONFIDENTIAL

FROM: S D KING
DATE: 23 OCTOBER 1987

PPS

Ch
Pretty good, though some weakening in export orders.
NL 28/10

cc Sir P Middleton
Mr Sedgwick
Ms O'Mara
Mr Curwen.

CBI QUARTERLY INDUSTRIAL TRENDS SURVEY – OCTOBER

I attach the results of the latest survey, which is due to be published next Tuesday, together with my own, very provisional, estimates of the seasonally adjusted figures. The survey took place before recent problems in the equity market, although the CBI think that the results would hold allowing for these events.

SK.

S D KING

PS/ SIR T BURNS

CBI INDUSTRIAL TRENDS SURVEY

Summary of results from April 1986 to July 1987

TOTAL TRADE		Apr 86	Jul 86	Oct 86	Jan 87	Apr 87	Jul 87	Oct
1 Optimism re business situation		+ 8	- 9	0	+12	+29	+25	+23
3 12 month forecast of capital expenditure authorisations compared with previous 12 months on:								
a buildings		-15	-15	-13	-10	- 3	+ 1	-3
b plant and machinery		+10	+ 5	+ 8	+10	+13	+20	+17
4 Firms working below capacity[1]		57	48	49	50	49	45	+41
6 Numbers employed	- past 4 months	-17	-20	-17	-16	-10	- 7	+4
	- next 4 months	-14	-21	-19	- 9	- 4	- 3	+2
7 Volume of new orders	- past 4 months	0	- 6	0	+14	+26	+24	+25
	- next 4 months	+16	+ 4	+18	+20	+25	+25	+25
8 Volume of output	- past 4 months	0	- 2	- 1	+ 9	+19	+23	+19
	- next 4 months	+14	+ 5	+13	+15	+22	+23	+25
10a Stocks of raw materials	- past 4 months	- 5	- 7	- 4	- 8	- 6	+ 3	0
	- next 4 months	-12	-17	-19	- 6	- 6	- 3	-8
b Stocks of work in progress	- past 4 months	0	- 8	- 2	- 8	- 5	+ 6	+7
	- next 4 months	- 8	-13	-12	- 5	- 6	+ 1	+1
c Stocks of finished goods	- past 4 months	- 3	- 2	- 7	- 6	- 7	- 4	-7
	- next 4 months	-10	-16	-14	- 5	- 8	- 5	-8
11 Average unit costs	- past 4 months	+19	+11	+ 6	+15	+25	+10	+22
	- next 4 months	+18	+ 8	+11	+29	+18	+11	+19
12a Average domestic prices	- past 4 months	+20	+ 6	+ 3	+13	+20	+16	+18
	- next 4 months	+19	+11	+14	+30	+26	+19	+23
14 Four month forecast of factors likely to limit output[1]								
Orders or sales		81	81	75	82	72	69	65
Skilled labour		13	12	12	9	12	18	19
Other labour		1	1	1	1	2	3	5
Plant capacity		13	14	13	15	25	22	24
Credit or finance		8	4	4	3	4	3	3
Materials/components		3	7	6	5	4	6	8
Other		2	3	3	2	2	4	2

EXPORT TRADE		Apr 86	July 86	Oct 86	Jan 87	Apr 87	Jul 87	
2 Optimism re export prospects		+12	-10	+11	+20	+24	+24	+14
7b Volume of new export orders	- past 4 months	- 1	-10	-11	+ 7	+15	+23	+9
	- next 4 months	+17	- 3	+15	+21	+20	+17	+17
9b Volume of export deliveries	- past 4 months	+ 5	- 7	- 5	+ 7	+15	+23	+13
	- next 4 months	+20	- 1	+11	+21	+22	+21	+21
12b Average export prices	- past 4 months	+ 9	- 3	0	+ 9	+18	+ 9	+6
	- next 4 months	+11	- 1	+20	+29	+15	+13	+21
15 Four month forecast of factors likely to limit export orders[1]								
Prices		65	60	61	61	59	60	56
Delivery dates		10	8	13	13	15	12	15
Credit or finance		11	9	12	9	9	13	6
Quota and licence		11	11	13	11	10	13	11
Political/economic conditions abroad		30	31	29	26	25	28	28
Other		9	11	11	10	10	9	13

1 Percentage Figures

CBI Monthly Trends Enquiry: Time Series of results from August 1986 to July 1987

In the intervening months between the main quarterly Industrial Trends Surveys the CBI carries out a much abbreviated monthly Trends Enquiry. In the latter participants are only asked to answer five questions. These five questions are also included in the main quarterly Survey and the table below sets out the time series of results for the past year.

		Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	
1a Total Order Book	(Q.5a)*	-20	-21	-23	- 9	-10	-15	+ 2	+ 4	+ 1	+10	+ 3	+ 6	+10
1b Export Order Book	(Q.5b)	-25	-23	-22	-10	- 7	-13	- 2	0	- 6	0	+ 9	+10	+1
2 Stocks	(Q.5c)	+15	+12	+10	+11	+ 5	+10	+ 6	+ 7	+ 5	0	- 1	+ 1	-7
3 Volume of Output	(Q.8)	+ 7	+11	+13	+13	+10	+15	+29	+34	+25	+31	+37	+23	+25
4 Average Prices	(Q.12a)	+10	+10	+14	+19	+26	+30	+34	+25	+26	+28	+19	+19	+23

* question number in quarterly survey

* The 'balance' is the difference between those replying 'more', 'up', 'above normal' or 'more than adequate' and those replying 'less', 'down', 'below normal' or 'less than adequate'.

TABLE 1

RECENT TRENDS IN CBI SURVEY QUESTIONS
(CSO seasonally adjusted figures in brackets)

	Oct 85	Jan 86	April 86	July 86	Oct 1986	Jan 1987	April 1987	July 1987	Oct
Business Optimism	-6 (+3)	-1 (-3)	+8 (-6)	-9 (-2)	0 (+9)	+12 (+10)	+29 (+15)	+25 (+32)	+23 (+32)
Export Optimism	-7 (-2)	0 (-3)	+12 (+3)	-10 (-2)	+11 (+15)	+20 (+17)	+24 (+15)	+24 (+32)	+14 (+18)
Changes in new orders past 4 months	+11 (+18)	-2 (-1)	0 (-9)	-6 (-4)	0 (+6)	+14 (+15)	+26 (+17)	+24 (+26)	+25 (+31)
Expected volume of output in next four months	+17 (+19)	+4 (+6)	+14 (+9)	+5 (+10)	+13 (+14)	+15 (+17)	+25 (+20)	+23 (+28)	+25 (+26)
Volume of output in past four months	+10 (+14)	+6 (+6)	0 (-5)	-2 (-2)	-1 (+3)	+9 (+10)	+24 (+19)	+23 (+23)	+19 (+23)
Volume of order book above normal	-13 (-7)	-19 (-14)	-24 (-21)	-25 (-22)	-23 (-17)	-15 (-10)	+1 (+4)	+6 (+9)	+10 (+14)
Volume of export order book above normal	-16 (-10)	-19 (-16)	-20 (-21)	-25 (-21)	-22 (-16)	-13 (-10)	-6 (-6)	+10 (+14)	+1 (+7)
Prices (domestic) - next 4 months	+17 (+19)	+25 (+17)	+19 (+15)	+11 (+15)	+14 (+17)	+30 (+22)	+26 (+22)	+19 (+23)	+23 (+26)

CBI TRENDS

3/31

CONFIDENTIAL
until 11.30am Tuesday 27 Octo
then UNCLASSIFIED

FROM: **PETER CURWEN**
DATE: 26 October 1987

Nigel

1. MISS ~~O'MARA~~
2. CHANCELLOR

The survey was undertaken before the stock market fall. Generally, good news again, though some critics may draw attention to the slight deterioration in the picture on output constraints.

MOM 26/10

Thanks.

cc
Chief Secretary	Mr Gray
Financial Secretary	Mr Hibbard
Paymaster General	Mr Pickford
Economic Secretary	Mr Allum
Sir Peter Middleton	Mr Brooks
Sir Terence Burns	Mr Hudson
Mr Cassell	Mr Mills
Mr Monck	Mr Price
Mr Odling-Smee	Mr Owen
Mr Scholar	Mr Dyer (+1 for No. 10)
Mr Sedgwick	Mr Cropper
Mr Bottrill	Mr Tyrie
Mr R I G Allen	Mr Call
Mr S J Davies	HB/03

CBI QUARTERLY INDUSTRIAL TRENDS SURVEY - OCTOBER 1987

The CBI's latest survey of manufacturing industry will be released at 11.30am on Tuesday 27 October. The survey was conducted between 25 September and 14 October - before the recent fall in the stock market. During the survey period, sterling averaged \$1.639 and DM2.994 compared with \$1.615 and DM2.96 over the July survey period. Sterling's effective exchange rate rose by 0.4 per cent between the two survey periods.

2. The survey shows that business confidence continues at a high level and that prospects for growth remain good. The CBI note that "demand growth, while strong, is no longer accelerating, and manufacturers remain able to increase output in response". They also note "there are few signs of overheating". However, the proportion of firms working below capacity is at its lowest level since 1973 and the proportion viewing capacity as a constraint on output (excluding the marginally higher April 1987 result) is at its highest level since 1973. The survey notes the downward trend in manufacturing employment "may have been reversed". Export optimism remains high.

3. The results of the survey, and seasonally adjusted series produced by the CSO (but not published), are attached. Some points to note are:

- Business confidence has improved for the fourth survey in succession. The balance of businesses reporting an increase in optimism is at +23 per cent. This compares with a balance of +25 per cent in July. The seasonally adjusted figure has remained unchanged at +32.

- A balance of +10 per cent report total order books above normal. This is equal to the balance recorded in the May 1987 monthly enquiry and is the best result since the question was first asked in April 1977.

- The balance on the volume of output over the past four months, has fallen back from its highest ever level in July but at +19 per cent it has been bettered on only four occasions since the question was first asked in 1977Q3.

- A shortage of orders or sales has, historically, been the major constraint on output and although this continues to be the case, the percentage of firms citing this factor, at 65 per cent, is the lowest since October 1974. The proportion of firms mentioning a shortage of skilled labour was up slightly from 18 per cent to 19 per cent between the two survey periods. These levels are still well below those recorded in the cyclical upswing of 1973-74 but the CBI note that the overall picture conceals a worsening situation for small firms and for fast growing industries such as 'office equipment and data processing' and 'electric industrial goods'. Capacity as a factor likely to limit output was cited by 22 per cent of firms in July but 24 per cent in October; excluding the 25 per cent figure in April 1987, this is the highest recorded level since October 1973. Industries particularly affected include 'chemicals', 'metal products', 'paper, printing and publishing' and 'motor vehicles and other transport equipment'. The percentage of firms working below capacity has fallen for the third survey running and at 41 per cent in October is at the lowest level since July 1973.

- Investment intentions in plant and manufacturing have fallen back from July. However the balance of +17 per cent now reporting an intention to increase capital expenditure over the next 12 months is high by the standards of the 1980s.

- The CBI note that the fall in manufacturing employment has "at least for the present, been reversed". A balance of +4 per cent of firms reporting an upward trend in employment over the past 4 months is the first positive balance since January 1977. This improved outlook is spread across all sectors of industry.

- The rise in average unit costs reported by firms seems to have picked up again with the balance of firms reporting increased costs over the past four months rising from +10 per cent in July to +22 per cent in October. The upward trend is expected to continue with, on balance, +19 per cent of firms now expecting an increase in unit costs in the next four months, compared with +11 per cent in July.

- The export optimism series has improved for the fifth survey running, although the balance of firms reporting an increase in optimism has been reduced from +24 per cent in each of the previous two surveys to +14 per cent. However, there is a mixed response across industry sectors with 'food, drink and tobacco' and 'motor vehicles and other transport equipment' reporting improved confidence whilst 'metal manufacture' and 'paper, printing and publishing' are now less confident.

- Export order books remain above normal. Although the balance at +1 per cent of firms is below the record level of July (+10 per cent) it has only been bettered on six other occasions (both monthly enquiries and quarterly surveys).

- Responses to the export prices series showed the rate of increase in the average prices at which export orders are booked slowing down further in the third quarter, with the upward trend falling from +9 per cent in the July survey to +6 per cent now. The CBI note that the slowdown, although expected, was more marked than had been anticipated. The survey suggests a substantial acceleration in the next four months.

Forecasts for manufacturing industry

4. The results of this survey are used by the CBI to forecast short term trends in manufacturing industry. On this basis, the CBI expect the following:

- manufacturing output to grow at annual rate of 5½ per cent in Q4.

- manufacturing investment to be nearly 6½ per cent higher in 1987H2 than in 1986H2. (NOT FOR USE: This implies lower growth in 1987 than our own forecasts.)

- a levelling off in manufacturing employment with little change in the total between 1987Q3 and 1988Q1.

- the twelve month increase in producer prices to "accelerate slightly" to 4.3 per cent in Q4.

Peter. S. Curwen

PETER S CURWEN

TABLE 1

RECENT TRENDS IN CBI SURVEY QUESTIONS
(CSO seasonally adjusted figures in brackets)

	Jan 86	April 86	July 86	Oct 1986	Jan 1987	April 1987	July 1987	Oct 87
Business Optimism	-1 (-3)	+8 (-6)	-9 (-2)	0 (+9)	+12 (+10)	+29 (+15)	+25 (+32)	+23 (+31)
Export Optimism	0 (-3)	+12 (+3)	-10 (-2)	+11 (+15)	+20 (+17)	+24 (+15)	+24 (+32)	+14 (+18)
Changes in new orders past 4 months	-2 (-1)	0 (-9)	-6 (-4)	0 (+6)	+14 (+15)	+26 (+17)	+24 (+26)	+25 (+31)
Expected volume of output in next four months	+4 (+6)	+14 (+9)	+5 (+10)	+13 (+14)	+15 (+17)	+25 (+20)	+23 (+28)	+25 (+26)
Volume of output in past four months	+6 (+6)	0 (-5)	-2 (-2)	-1 (+3)	+9 (+10)	+24 (+19)	+23 (+23)	+19 (+23)
Volume of order book above normal	-19 (-14)	-24 (-21)	-25 (-22)	-23 (-17)	-15 (-10)	+1 (+4)	+6 (+9)	+10 (+16)
Volume of export order book above normal	-19 (-16)	-20 (-21)	-25 (-21)	-22 (-16)	-13 (-10)	-6 (-6)	+10 (+14)	+1 (+7)
Prices (domestic) - next 4 months	+25 (+17)	+19 (+15)	+11 (+15)	+14 (+17)	+30 (+22)	+26 (+22)	+19 (+23)	+23 (+26)

CBI INDUSTRIAL TRENDS SURVEY

Summary of results from July 1986 to October 1987

TOTAL TRADE		Jul 86	Oct 86	Jan 87	Apr 87	Jul 87	Oct 87
1 Optimism re business situation		- 9	0	+12	+29	+25	+23
3 12 month forecast of capital expenditure authorisations compared with previous 12 months on:							
a buildings		-15	-13	-10	- 3	+ 1	- 3
b plant and machinery		+ 5	+ 8	+10	+13	+20	+17
4 Firms working below capacity[1]		48	49	50	49	45	41
6 Numbers employed	- past 4 months	-20	-17	-16	-10	- 7	+ 4
	- next 4 months	-21	-19	- 9	- 4	- 3	+ 2
7 Volume of new orders	- past 4 months	- 6	0	+14	+26	+24	+25
	- next 4 months	+ 4	+18	+20	+25	+25	+25
8 Volume of output	- past 4 months	- 2	- 1	+ 9	+19	+23	+19
	- next 4 months	+ 5	+13	+15	+25	+23	+25
10a Stocks of raw materials	- past 4 months	- 7	- 4	- 8	- 6	+ 3	0
	- next 4 months	-17	-19	- 6	- 6	- 3	- 8
b Stocks of work in progress	- past 4 months	- 8	- 2	- 8	- 5	+ 6	+ 7
	- next 4 months	-13	-12	- 5	- 6	+ 1	+ 1
c Stocks of finished goods	- past 4 months	- 2	- 7	- 6	- 7	- 4	- 7
	- next 4 months	-16	-14	- 5	- 8	- 5	- 8
11 Average unit costs	- past 4 months	+11	+ 6	+15	+25	+10	+22
	- next 4 months	+ 8	+11	+29	+18	+11	+19
12a Average domestic prices	- past 4 months	+ 6	+ 3	+13	+20	+16	+18
	- next 4 months	+11	+14	+30	+26	+19	+23
14 Four month forecast of factors likely to limit output[1]							
Orders or sales		81	75	82	72	69	65
Skilled labour		12	12	9	12	18	19
Other labour		1	1	1	2	3	5
Plant capacity		14	13	15	25	22	24
Credit or finance		4	4	3	4	3	3
Materials/components		7	6	5	4	6	8
Other		3	3	2	2	4	2

EXPORT TRADE		July 86	Oct 86	Jan 87	Apr 87	Jul 87	Oct 87
2 Optimism re export prospects		-10	+11	+20	+24	+24	+14
7b Volume of new export orders	- past 4 months	-10	-11	+ 7	+15	+23	+ 9
	- next 4 months	- 3	+15	+21	+20	+17	+17
9b Volume of export deliveries	- past 4 months	- 7	- 5	+ 7	+15	+23	+13
	- next 4 months	- 1	+11	+21	+22	+21	+21
12b Average export prices	- past 4 months	- 3	0	+ 9	+18	+ 9	+ 6
	- next 4 months	- 1	+20	+29	+15	+13	+21
15 Four month forecast of factors likely to limit export orders[1]							
Prices		60	61	61	59	60	56
Delivery dates		8	13	13	15	12	15
Credit or finance		9	12	9	9	13	6
Quota and licence		11	13	11	10	13	11
Political/economic conditions abroad		31	29	26	25	28	28
Other		11	11	10	10	9	13

1 Percentage Figures

CBI Monthly Trends Enquiry: Time Series of results from November 1986 to October 1987

In the intervening months between the main quarterly Industrial Trends Surveys the CBI carries out a much abbreviated monthly Trends Enquiry. In the latter participants are only asked to answer five questions. These five questions are also included in the main quarterly Survey and the table below sets out the time series of results for the past year.

		Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct
1a Total Order Book	(Q.5a)*	- 9	-10	-15	+ 2	+ 4	+ 1	+10	+ 3	+ 6	+11	+ 9	+10
1b Export Order Book	(Q.5b)	-10	- 7	-13	- 2	0	- 6	0	+ 9	+10	+ 5	+ 3	+ 1
2 Stocks	(Q.5c)	+11	+ 5	+10	+ 6	+ 7	+ 5	0	- 1	+ 1	- 1	+ 3	- 7
3 Volume of Output	(Q.8)	+13	+10	+15	+29	+34	+25	+31	+37	+23	+38	+30	+25
4 Average Prices	(Q.12a)	+19	+26	+30	+34	+25	+26	+28	+19	+19	+21	+20	+23

* question number in quarterly survey

* The 'balance' is the difference between those replying 'more', 'up', 'above normal' or 'more than adequate' and those replying 'less', 'down', 'below normal' or 'less than adequate'.

UNCLASSIFIED

Rup

FROM: N G FRAY

DATE: 26 October 1987

MR S D KING

CBI QUARTERLY INDUSTRIAL TRENDS SURVEY - OCTOBER

The Chancellor has seen and was grateful for your minute of 23 October, the contents of which he has noted.

Nigel Fray

N G FRAY

1807/19

Papes
PLe

CONFIDENTIAL

FROM: R FELLGETT

DATE: 26 October 1987

1. MR HAWTIN

2. CHANCELLOR

C/Letter to issue?

CR 26/10

cc PS/Chief Secretary
Sir P Middleton
Mr F E R Butler
Mr Anson
Mr Monck
Mr Hawtin
Mr R I G Allen
Mr P R C Gray
Mr Potter o/r
Mr Cropper
Mr Tyrie

RATE REFORM: THE CBI PROPOSALS

Mr Banham wrote to you on 14 October, enclosing a summary memorandum of the CBI's latest thinking. You will recall that Mr Nickson discussed this with you recently, and I attach Mr Potter's briefing note for that meeting.

2. The CBI memorandum is broadly as predicted in Mr Potter's note. However, although it covers a number of topics, most emphasis is on the CBI proposal (earlier played down) for a 25% reduction in business rates. The link between this and the other aspects of Mr Banham's ideas is not always clear; the fact that they are presented as a package may reflect the internal debate about the CBI's stance which Mr Potter reported to you.

3. The memorandum contains four main proposals:

(i) a large shift from unhypothecated block grant to specific grant in support of particular services;

(ii) closer links between business and local authorities, associated with the idea that business in each locality should pay through business rates for only (part of) the services that directly benefit business;

41/496

(iii) the 25% cut in business rates;

(iv) a per-household Community Charge, rather than a per-adult poll tax (and possibly the retention of domestic rates).

4. We have generally opposed <u>specific grants</u>, in place of block grant, because they encourage spending on the services supported, without an equally good offsetting pressure to reduce spending elsewhere; they discourage the efficient allocation of resources by local authorities by distorting local decision-making; and they leave neither central nor local government clearly responsible for the efficient delivery of the service involved. They also complicate local government finance (as indeed do Mr Banham's proposals as a whole) when there is much to be said for simplicity. The proposal to increase specific grants is not necessarily related to the other ideas in the memorandum, except to the extent that it reflects the idea that there are broad categories of local authority services - national, property and business, community, and marketed services - which require different hypothecated sources of revenue.

5. The memorandum opposes a <u>Uniform Business Rate</u> (UBR), in part because it "unhooks local authorities from business". In fact, local authorities already have no financial incentive to attract business or take business interests into account, because business rate income is offset by reduced RSG through resource-equalisation. (However, this may not be widely understood.) The CBI proposal that business should pay three-quarters of property and business related local authority services would provide such an incentive.

6. However, it would also perpetuate different rates bills for businesses in different areas for reasons which should not all affect decisions on the location of industry; a Uniform Business Rate throughout the country (or even separately in England and Wales, as the Government intends) would be fairer. It is a pity that the CBI is coming down in favour of varying business rates in different parts of the country. This may reflect no

more than a tactic to make business rates look arbitrary, so that if the Government is seen to be controlling them through its indexation within the RPI, business can more easily lobby for levelling-down.

7. There is incidentally an apparent inconsistency between the proposals to levy business rates sufficient to meet 75% of related services, and the proposal to index them within the RPI, unless local authority expenditure in these areas rises no faster than the RPI.

8. The CBI memorandum also refers to their fear that a UBR could be increased by some future administration to increase the overhead burden on business. You could reassure Mr Banham about the Government's intentions.

9. As to the 25% reduction in business rates, the CBI propose, in effect, to pay for this by increased fees and charges on the domestic sector, particularly through higher council house rents. We are of course generally supportive of higher fees and charges, and Mr Banham is presumably now aware of the Government's housing policy. But it is not obvious that the extra burden on the domestic sector (albeit through fees and charges rather than taxation) should all go to benefit business. Unless there was scope for a reduction in the overall burden of business taxation, any reduction in rates that could be afforded would imply that other business taxes should be higher, notwithstanding any effect on incentives.

10. You will not wish to concede any prospective reduction in business rates, although you could remind Mr Banham of the commitment to index rates within the RPI; the option to increase them by less if that should be justified in any year; and mention the transition period of 5 years which will moderate the impact on the highest losers, at the expense of business generally during the transition period rather than of the worst losers.

11. Alternatives to the Community Charge are mentioned only briefly. There is a good deal of force in the CBI argument that

collection and other costs would be lower if the Charge was levied on each household, rather than on each adult, although the Government would argue that there would be a substantial loss of accountability.

12. The memorandum has a section on financial implications. We recognise few of the figures, although none look so obviously wrong that they invalidate the CBI points. (However, the table on patterns of net funding does not add up, even taking account of the qualification in the following paragraph.)

13. The table on non-domestic rates payable by region shows, in part, lower business rates due to the 25% reduction assumed by the CBI. It also shows that redistribution between regions would be less under the CBI proposals, presumably because losers from revaluation in London, the South East and East Anglia would not face the full increase in bills implied by the revaluation, even if that was economically justified. Conversely, winners in the North and elsewhere would not see their full gains. This seems inconsistent with the emphasis on helping the inner cities elsewhere in the memorandum.

14. On changes in household taxation, the CBI proposals are presumably more helpful in deprived areas because, on average, there are more adults per household in such areas than in more prosperous ones.

Conclusion

15. If you see Mr Banham you might like to:

(i) discourage his enthusiasm for specific grants;

(ii) sympathise with the view that local authorities should be responsive to business, but query whether financial incentives (which do not exist at present) are needed and whether the complicated hypothecation of revenue to service categories that he proposes is necessary;

(iii) discourage any hope of a 25% reduction in business rates, while emphasising the benefits to business of the Government's plans;

(iv) acknowledge that a household Community Charge would be easier to collect than a poll tax, while reiterating that the Government is embarked on a different course because of the benefits it believes will come in accountability.

16. Only a short formal reply is necessary to the letter. I attach a draft.

Robin Fellgett

R FELLGETT

~~DRAFT~~ **LETTER FOR THE CHANCELLOR'S SIGNATURE TO:**

John M M Banham Esq
Confederation of British Industry
Centre Point
103 New Oxford Street
LONDON WC1A 2DU

RATE REFORM

Thank you for your letter of 14 October, enclosing an interesting memorandum about the CBI's latest thinking on rate reform. I am grateful for your general support for the Government's objectives. As you know, rate reform is primarily a matter for Environment Ministers and no doubt Nick Ridley will be happy to provide a detailed response to your ideas.

[N.L]

MEETING NOTE FOR MEETING WITH CBI PRESIDENT ON BUSINESS RATES

Background

1. The CBI at first supported the "Paying for Local Government" proposals. But this support was made conditional upon a 25% reduction in the proposed uniform business rate, relative to average business rate bills.

2. This line was held until the CBI budget representation this year, but never pursued strongly. The CBI were somewhat reassured by:

(i) the proposed power in the Bill to limit the increase in the UBR each year to the annual increase in the RPI; and

(ii) the decision that the Chancellor would have the powers to determine the level of the UBR.

CBI revised proposals

3. Following John Banham's appointment as the Director General, there was a thorough review of the CBI's line. The proposals which emerged are by no means new: John Banham put them forward in a personal capacity when he was at the Audit Commission.

4. The CBI's revised plans are based on distinctions between the following types of local authority service:

(a) "National" services - eg schools and personal social services; these would be run by central government; it follows that they would be paid for from central taxation;

(b) Business related services - eg refuse collection and planning permissions; these would be paid for by a local business rate;

(c) Marketable services - eg services like housing that are currently subsidised, would be put on a full cost recovery basis; costs would be met from rents, fees and charges;

(d) Other services - eg street lighting would be paid for through a small Community Charge.

5. These proposals are by no means universally supported within the CBI. Several members of the policy-making Economic and Financial Committee are opposed to them and concerned about the implied attack on Government policy. (There is also another strand within the CBI that would prefer freezing present business rates and uplifting them in line with the RPI (the scheme in Scotland). We are not certain of the CBI President's stance. But DOE think he may be more minded to support the original CBI line, ie broad support of Government policy, than the revised proposals.

6. Mr Banham was told by Mr Howard about a month ago that Ministers could not be expected to change track now on the reform of local government finance. We also understand that Mr Ridley has conveyed the same message to Mr Banham. (You should also be aware that Mr Nickson is due to meet Mr Ridley at a separate meeting tomorrow.)

<u>Line to Take</u>

7. You will first wish to probe Mr Nickson's appreciation of the CBI's stance on these revised proposals. What is the strength of support for the new line? It would be helpful to find out Mr Nickson's own position.

8. If Mr Nickson presses the new CBI package you will wish to reinforce the message that there can be no substantive change in the Government's plans for introducing the Community Charge and the NNDR in 1990. You may like to remind Mr Nickson that the NNDR (and the revaluation) are to be phased in over a period of 5 years. This should avoid excessive increases in business rate bills.

9. You could also indicate that many elements in the CBI's revised proposals are consistent with Government policy. The Government favours more fees and charges being set for marketable LA services. The Government is also committed to reducing excessive subsidies to services like housing; and the Local Government Bill will encourage further contracting out of services to industry. The objectives underlying the CBI's and Government proposals are the same: to keep down business rates and the Community Charges.

MAINTAINING THE MOMENTUM

Confederation of British Industry
Centre Point
103 New Oxford Street
London WC1A 1DU
Telephone 01-379 7400
Telex 21332
Facsimile 01-240 1578

From
John M M Banham
Director-General

CBI

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London
SW1P 3AG

27 October 1987

Para 14 gives policy prescriptions

Dear Chancellor

With this letter I am enclosing a copy of Maintaining The Momentum Of The Economic Recovery. This summarizes the CBI's views on the priorities for the coming round of tax and public expenditure decisions. It has been produced after extensive consultation within our membership; and it was approved at the October meeting of the CBI Council on 21 October - in full knowledge of the events on Wall Street and in the City. Indeed, the nervousness of the markets simply underlined the importance of getting the fundamentals right, as our paper suggests.

If the momentum of the economic recovery is to be maintained over the medium-term, the CBI believes that British industry now needs to embark on an era of investment, in training and in innovation, as well as fixed capital. And, as our strategy made clear, we are determined to play our part in the vital initiatives that are now underway in education, management development, inner cities and in preparing for the completion of the Internal Market in 1992.

The ability of business to contribute to these latter problems will depend, in large measure, on its continued ability to compete successfully - which in turn requires a substantial increase in investment. The paper addresses the central dilemma: how can business be encouraged to invest for the longer-term when it is relatively unprofitable by international standards and the high cost of money (relative to our main competitors, at least) requires management to set very demanding pay-back targets which themselves militate against longer-term investment?

I hope that we will be able to meet to discuss the issues involved later in the year, when the impact on consumer and business confidence of recent events can be assessed more surely.

With best wishes

Yours sincerely

John M M Banham

JMMB/AB

CH/EXCHEQUER
REC. 28 OCT 1987 28/10
ACTION MR FLANAGAN WITH ATTACHMENT.
COPIES TO C ST FST PMG EST
SIR P. MIDDLETON
MR FERBOLER
MR CASSELL
MR MONCK MR BURGNER
MR GRAY
MR CROPPER

Confederation of British Industry
Centre Point
103 New Oxford Street
London WC1A 1DU
Telephone 01-379 7400
Telex 21332
Facsimile 01-240 1578

Director-General
John M M Banham

Secretary
Maurice Hunt

CBI

MAINTAINING THE MOMENTUM OF THE ECONOMIC RECOVERY:

TAX AND PUBLIC EXPENDITURE PRIORITIES

October 1987

MAINTAINING THE MOMENTUM OF THE ECONOMIC RECOVERY

CBI TAX AND PUBLIC EXPENDITURE PRIORITIES

1 In September 1987, CBI Council agreed a strategy to meet the challenges of a new era. Having passed through the era of the Corporate State and the era of industrial restructuring, the UK now needs to embark on an era of investment if the improvements in productivity and performance of recent years are to be sustained.

2 Since the summer of 1981 UK gross domestic product has increased at an average annual rate of almost 3%; real rates of return on capital are currently at their highest level since 1973 as productivity is rising rapidly; inflation is under control and real pre-tax profits are more than twice as high as they were in 1981. In 1987, the UK is set to lead the world in economic growth.

3 But as recent events in the Stock Market have underlined, complacency at this stage could be dangerous. CBI forecasts point to a slowdown of growth in 1988, particularly reflecting uncertainty over world trade. The momentum of recent years will not be sustained without much higher levels of investment, in research and development and training, as well as fixed capital. Despite the recent progress of manufacturing industry, average productivity and profitability still lag behind our main competitors. Britain remains, relatively, a low pay, low productivity and low profit economy.

4 The momentum behind the recent recovery needs to be sustained. To achieve this will require:

a Further gains in business productivity;

b Investment in people and innovation, as well as plant and equipment;

c Reductions in the cost burden on business.

5 Though business must shoulder the prime responsibility for the investment and productivity improvements that are needed, the Government has an important role to play. This paper, which was agreed by CBI Council on 21 October 1987, sets out the rationale for these proposals and develops them in more detail. It discusses, in turn, the nature of the investment gap and the steps that, in the CBI's view, are needed to maintain the momentum of the economic recovery.

THE INVESTMENT GAP

6 Until recently, international growth rate comparisons made depressing reading in the UK. Table 1 compares the UK's growth rate since 1960 to the OECD average and some of our main competitor countries. (To eliminate differences due to growth of the labour force, this is shown in terms of GDP per capita.) In every period the UK has been below the OECD average and often substantially below some of our main competitors. This has been reflected in the fall in our living standards relative to other countries. By 1985, GDP per head in the UK was 5 per cent below France, 8 per cent below Japan and 11 per cent below West Germany[1].

TABLE 1: GROWTH RATES OF GDP PER CAPITA, 1960-86
% a year

	UK	W Germany	Japan	USA	OECD
1960-68	2.4	3.3	9.4	3.1	3.9
1968-73	2.9	4.1	7.3	2.2	3.7
1973-79	1.4	2.6	2.5	1.6	1.9
1979-83	0.3	0.6	2.8	-0.3	0.5
1983-86	2.7	2.8	3.6	3.3	2.9

Source: OECD Historical Statistics and National Accounts

7 Considerable progress has been made over recent years in improving business performance, not least in manufacturing industry, which is reaping the benefits of the painful adjustment during the early 1980s. Table 2 provides some of the evidence. Improved productivity performance has led to slower growth of unit labour costs, which in turn has contributed to higher profitability. The declining trend in Britain's share of world trade has been halted and is beginning to be reversed, albeit from a low base.

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1 OECD National Accounts 1987, special supplement. Purchasing power parity exchange rates are used in this comparison.

TABLE 2: IMPROVING UK MANUFACTURING PERFORMANCE

	1970's	1979-83	Per Cent 1983-87
Productivity Growth (annual average)	2.6	4.1	4.3
Annual Increases in Unit Labour Costs	12.8	9.1	3.6
Profitability* (end of period)	5.6	5.8	8.0
Share of World Trade (end of period)	9.1	7.9	8.4

*Gross operating profits as a percentage of gross capital stock

8 Yet despite this turnaround there remains a sizeable gap between the UK and its major OECD competitors in manufacturing productivity and profitability. The contrast with West Germany is instructive. Average pre-tax returns in manufacturing are still almost double those in the UK (17% compared to 8% in 1986)[1] and, according to one recent estimate, average manufacturing productivity is also around twice British levels[2]. This is not to say that the best British companies are not competitive with their German counterparts; but the average standard needs to be raised considerably.

9 While the CBI is concerned to promote the competitiveness of the business sector as a whole, a competitive manufacturing base is a particularly vital ingredient of our future prosperity. This is because:

a UK consumers wish to buy more manufactured goods as they grow more prosperous and if we cannot produce them ourselves, we must trade other goods or services for them. Yet manufactures themselves are the most easily traded products, accounting for close on 60 per cent of all UK trade. Manufacturing production must also help to fill the trade gap left by falling oil production in the 1990's.

b UK manufacturing output has fallen over the past decade, while elsewhere it has increased (Table 3).

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1 Gross operating surplus, expressed as a percentage of capital stock. OECD.

2 G F Ray Labour Costs in Manufacturing <u>National Institute Economic Review</u>, May 1987.

TABLE 3: CHANGE IN MANUFACTURING PRODUCTION 1976-1986

	%
Japan	+ 56
USA	+ 34
Italy	+ 15
Netherlands	+ 20
West Germany	+ 18
France	+ 5
UK	- 2

Source: OECD Main Economic Indicators

c Without an internationally competitive manufacturing base, the prospects for reducing unemployment outside the South-East are remote.

d The manufacturing and service sectors are interdependent, to the extent that the distinction between them is meaningful at all. Consulting without clients is not a particularly rewarding pastime and whole industries have grown up providing services which were previously undertaken in-house by manufacturers (eg catering, workwear).

10 Investment is a prerequisite for sustained productivity growth, not only in manufacturing but in the economy as a whole, and the UK's performance in this direction has historically been poor relative to other countries. Over the period 1960-1985 the UK devoted only 14½ per cent of national output (GDP) to fixed capital formation (excluding housing): less than our major competitors (with the exception of the US) and consistently below the average for the OECD (16½ per cent). Though the position has improved relative to our competitors recently, this is because they have been investing less, rather than the UK investing more (Table 4). Our poor performance has left a considerable investment gap which remains to be filled. Britain's failure to match West Germany's rate of fixed investment as a percentage of GDP has been responsible for a cumulative investment shortfall of £25 billion since 1980 alone.

TABLE 4: THE INVESTMENT RECORD

	% of GDP	
	R & D* (1985)	Fixed Investment# (1980-85 ave.)
Japan	2.5	23.8
Germany	2.5	14.7
USA	1.9	13.9
France	1.8	14.2
UK	1.5	13.7

* Excluding proportion spent on defence

\# Excluding residential construction

Source: OECD

11 This poor record of fixed investment is mirrored in R&D (Table 4). Though R&D is only one element of the innovation process, the UK again spends less than its competitors. More worrying, perhaps, is the fact that since 1981, expenditure has fallen as a percentage of GDP while in competitor countries (particularly Germany and Japan) it has increased. In absolute terms, West Germany is currently spending more than twice as much as the UK on research and development.

12 Training is another cause for concern - particularly of young people. In West Germany, a country of comparable population size, 1.7 million people are currently engaged in three-year apprenticeships. Britain's closest counterpart, our two-year YTS, will only cater for only 400,000 youngsters this year. This must be set alongside CBI Industrial Trends Surveys which show the number of firms whose output is constrained by shortages of labour is at its highest level this decade. Demographic factors will reduce the number of young people coming into the labour market in the 1990s, which emphasises the need to make more effective use of scarce resources.

MEASURES REQUIRED

13 In general, it is business that must undertake the investment that is required. Well-managed businesses recognise the importance of planning and investing for the future, given the resources and the incentives to do so. They do, however, require a stable economic framework in which to plan for the future and externally imposed cost burdens - notably interest rates and exchange rate uncertainties - that are no greater than those faced by international competitors.

14 Specifically, the Government is urged to:

(i) Seek to maintain a competitive and stable exchange rate and continued control of inflation;

(ii) Allow businesses to retain a higher share of the surplus they earn, to provide both the incentive for investment and the resources to do so;

(iii) Order public expenditure decisions so as to secure a higher level of public sector capital expenditure;

(iv) Continue to foster enterprise, both by individuals and by Britain's smaller firms.

Maintaining the present economic framework

15 For industry to invest more the macro-economic framework must engender business confidence. The key aspects of the framework should be a stable and competitive exchange rate and continued control of inflation.

(i) The exchange rate

16 There is no absolute "right" exchange rate and, in any event, the Government must contend with factors outside its control in the international money markets. But manufacturing industry, in particular, needs sterling at a level at which it can reasonably be expected to compete. Misalignment can be very costly. The CBI's monetary policy report[1] showed that one in five of the firms surveyed had reduced export commitment or withdrawn from a specific export market because of the high value of sterling in the early 1980s. Three in five said the level of sterling was very important to their operations.

17 Chart 1 illustrates the impact of the exchange rate on business competitiveness, in this case relative to Germany. Though changes in the UK's price competitiveness depend also on the control companies establish over their unit costs, hard won achievements in controlling costs can be rapidly eroded by a sharp appreciation of the exchange rate.

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1 Survey of UK monetary policy's impact on business, CBI, August 1987.

18 Now that sterling has reached a more competitive level, maintaining stability is vital, particularly for manufacturing, where the lead times can be long. A number of CBI members competing in export markets have already registered concern over the strengthening of the pound during 1987, fearing that, if continued, this will jeopardise the recovery of manufacturing industry. The resources necessary to develop export markets will not be forthcoming if business lacks confidence in the exchange rate. Entering the Exchange Rate Mechanism of the EMS would add certainty to the policy of preserving stability against European currencies, particularly the DM.

19 UK interest rates remain high relative to other countries (see Table 5) in both nominal and real terms. At present, the high cost of money requires businesses to set very demanding payback targets for captial investments - generally three years or less. Almost by definition these will only be met by projects which produce cost reductions rather than value improvements. And, in the long run, it is simply not possible to secure a competitive future by cost reduction alone.

20 This suggests that the scope provided by any increase in international confidence in sterling should be used to reduce interest rates rather than allowing sterling to strengthen. Lower interest rates would also improve the incentive for investment. With slower growth expected as we move into 1988, there is a strong case for a lower interest rate (and hence a more competitive value of sterling) in any case.

(ii) **Inflation**

21 Business also needs low inflation if it is to approach the future with confidence. Much of the responsibility falls on industry, in controlling its own costs, but the Government must provide financial discipline and itself avoid adding to costs.

TABLE 5: INTEREST RATES, SEPTEMBER 1987

% per annum

	3 month inter-bank lending rate	Real Rate
Japan	3.8	3.7
US	7.4	3.1
Germany	4.1	3.3
France	7.9	4.4
UK	10.0	5.6

Source: National Sources

Note: The real interest rate is measured as the short-term interest rate less the rate of increase in the consumer price index over the past year.

22 Relying on the exchange rate and interest rates to "squeeze out" inflation puts at risk investment and exports in the manufacturing sector. The burden of ensuring financial prudence at the macro-economic level must therefore fall on fiscal policy. This means keeping down public expenditure and borrowing so that demand does not outstrip the economy's capacity to supply.

23 The CBI's main concern is that excessive consumption will weaken the balance of payments, force up the interest rate and raise the cost of borrowing to business. This points to caution over borrowing in the coming years as the current account of the balance of payments will deteriorate anyway into 1988 and 1989, while industry re-equips itself for the 21st Century. However, this need for fiscal prudence cannot be translated into a rigid target for the Public Sector Borrowing Requirement (PSBR). The impact of Government spending and taxation policies on the PSBR depends on changes in oil prices, asset sales and the level of economic activity. Indeed, such factors have assisted in reducing public borrowing in recent years, and have tended to exaggerate the degree of control which has been achieved over public finances.

Reducing the burden on business

24 Since 1980/1, there has been a real increase of almost £5bn in the take from the main taxes on the corporate sector. Though there has been an offset from reduced national insurance contributions, both corporation tax payments and local authority rates have increased substantially. Table 6 shows the main changes in the source and application of public sector funds over the past six years.

25 There are two ways of allowing the business sector to deploy more of its resources for investment. The first is to provide specific grants and incentives for investment - in R&D, training and investment. The incentives may be costly, as investment which would have taken place anyway can also attract the tax subsidy or grant. They may also distort economic behaviour in that businesses are encouraged to arrange their affairs so as to attract the lowest possible tax burden.

26 The second approach is to reduce the overall tax burden on business activity, allowing companies to allocate their surpluses as they see fit. This also carries a risk - that companies will not deploy their resources for investment, but increase the returns to employees or shareholders. However, as the net rate of return on business activity has increased, this should feed through into business investment in the long run. Moreover, as the tax burden is reduced the need for tax allowances and incentives is also reduced. Businesses will be encouraged to invest for business reasons, rather than for tax reasons.

TABLE 6: CHANGES IN TAXES AND PUBLIC EXPENDITURE, 1980/1 - 1986/7

£ billion, at 1986/87 prices

Changes in Government Outlays		
Public Expenditure:		+ 18.8
- Transfer payments	+ 7.2	
- Services (including defence)	+ 10.3	
- Capital (infrastructure)*	- 0.6	
- Net debt interest etc	+ 1.9	
Reduction in New Public Borrowing		+ 13.5
		32.3
Changes in Government Income		
Taxes on Business:		+ 4.7
- Corporation Tax (excluding North Sea)	+ 5.4	
- Employers' National Insurance Contributions	- 2.5	
- Business Rates	+ 1.8	
Income tax, employees' NIC		+ 9.2
VAT and Excise Duties		+ 13.3
Privatisation proceeds and Council House Sales		+ 4.9
Adjustments (including North Sea)		+ 0.2
		32.3

Source: CSO Financial Statistics, Financial Statement and Budget Reports and Public Expenditure White Paper 1987

* excluding defence and public corporations.

27 In general, the CBI favours this second approach. The most obvious route would be to lower the corporation tax rate, further reducing the gap between the standard rates of personal and corporate taxation. This would also compensate companies more fully for the increase in their tax payments which has resulted from the change to the system of capital allowances in 1984. Eliminating the cross-subsidy of the domestic sector within local authority rates or reducing employers national insurance contributions would reduce the tax burden on unincorporated business as well as companies. Both these taxes add directly to business costs and - unlike corporation tax - are unrelated to profitability and business's ability to pay. Reducing capital taxes would also be of benefit to smaller firms.

28 The scope for reducing business taxation could also be used to simplify and rationalise the tax system, for example by implementing the changes proposed in the CBI's Technical Budget Representations. CBI members have also indicated a preference for a 25 per cent straight line depreciation allowance, as opposed to the current reducing balance system. This would not only represent a simplication, but would also allow a more rapid write off, helping to offset the inability of firms to write off the full value of their investments in real terms because of non-indexation.

29 However it is accomplished, the CBI believes that business must be allowed to deploy more of the surplus it generates if it is to undertake the investment in plant and equipment, training and innovation on the substantial scale which is so evidently needed. This is particularly true if the Government wishes to see more private sector initiatives in areas where traditionally the public sector has taken the lead (eg education, urban renewal, sponsorship of the arts).

30 Other burdens on business which are outside individual companies' control must also be minimised. These include:

a Energy prices, which are regulated directly (coal and electricity) or by levies and excise duties (oil and gas), must be internationally competitive and the financial framework for energy utilities needs to allow investment to secure future supplies. As industries are transferred to the private sector, these priorities must be reflected in the new regulatory structure;

b Obstacles to the mobility of goods and resources, including high transport costs, which reflect inadequacies in the infrastructure. To tackle these problems, public expenditure must be rebalanced to reflect the importance of public infrastructure investment.

Rebalancing Public Expenditure

31 The scope for reducing the tax burden depends on public expenditure falling as a share of GDP. The CBI therefore supports the Government's commitment to this goal and its current targets for achieving it. However, within the total, resources need to be switched from current to capital expenditure if Britain is not to be shackled with an out of date infrastructure which adds to business costs.

32 The public sector's past performance on capital expenditure leaves much to be desired. When pressure is put on spending totals, capital expenditure can appear the easiest to cut: few sewers will collapse if replacement is put off for 2 years; buildings will not fall down; and roads will remain, albeit with growing potholes. But the steady fall in capital expenditure, both in real terms and as a proportion of GDP, since 1984/5 will eventually have an impact on business competitiveness. This decline is planned to continue (Table 7). It has occurred despite the high priority accorded by business to an infrastructure which helps reduce business costs, and the decline in the quality of the Nation's fabric. The deterioration in the condition of Britain's roads, sewerage system and public housing stock are examples of this.

TABLE 7: GOVERNMENT CAPITAL SPENDING*

	% of GDP		£bn (1986/7 prices)	
	Civil Government Expenditure	Capital Grants	Civil Government Expenditure	Capital Grants
Outturn				
1984/85	2.7	1.0	9.8	3.5
1985/86	2.4	0.7	8.8	2.8
1986/87	2.4	0.8	9.0	2.9
Plans				
1987/88	2.2	0.7	8.7	2.6
1988/89	2.1	0.6	8.4	2.3
1989/90	2.0	0.5	8.3	2.3

* Excluding defence and nationalised industries.

33 To restore non-defence government capital spending to its 1986/87 level in real terms would require an addition of £0.6 bn in 1988/89 to direct expenditure and a similar increase in capital grants. However, to keep pace with the growing demands on the nation's infrastructure, it is not sufficient to hold public investment constant in real terms. It needs to be increased as national output grows. If capital spending was restored to the same proportion of national output as in 1986/87, an addition of over £1 bn in 1988/89 would be needed in direct expenditure alone.

34 To finance this, resources need to be switched from current to capital spending. Substantial potential economies within the public sector have been identified by the National Audit Office and the Audit Commission, as well as by the CBI's own Government Expenditure Working Party (see "Financing the Future", CBI, 1985). The scope for value improvements in local Government alone is probably over £2 billion a year; but implementation has been disappointingly slow.

35 A number of other changes to the system of planning capital spending would also help to remove the bias against capital in the allocation of funds:

a a clearer distinction between current and capital spending within the public sector;

b a longer time horizon, both for planning investments and in the allocation of funds;

c greater flexibility in the treatment of joint projects with the private sector, so that private resources can be attracted into infrastructure investment;

d allowing public sector bodies to sell off surplus capital assets and apply the proceeds to their capital expenditure programmes.

36 However, an improvement in the "mix" of public spending in favour of capital should not be achieved at the expense of control over the public expenditure total. This must fall as a proportion of national output so the burden of taxation on business - and indeed the community at large - can be reduced.

<u>Promoting enterprise and the growth of smaller firms</u>

37 Providing an environment in which small firms can grow is essential to the development of an enterprise economy. British manufacturing industry is still one of the most concentrated of the developed economies. 64 per cent of all manufacturing employment is in establishments of over 500 employees; in Japan the proportion is 33 per cent and in France and Italy even lower. The CBI Smaller Firms Council will be making specific recommendations on measures needed to remove some of the barriers to small firms' growth. These will cover:

a The structure of capital taxes and, in particular, inheritance tax. Also, the UK rate of tax on long-term capital gains is the highest among the major developed economies (Table 8).

b The incentives for individuals to build up a personal equity stake in their enterprise.

c The tax treatment of corporate venturing, which could substantially increase the financial resources available to rapidly growing companies. An extension to companies of the incentives available under the Business Expansion Scheme, with suitable safeguards, might be considered.

TABLE 8: CAPITAL GAINS TAX ON SHARE INVESTMENTS, 1987

	Max. short-term	Max. long-term	Long-term qualifying period
UK	30	30	-
US	38.5	28	6 months
Germany	53	exempt	6 months
France	16	16	-
Japan	exempt	exempt	-

Source: Arthur Anderson

Note: excludes local taxes

38 In the CBI view, investment for the 21st Century is the priority for business. This is unlikely to be possible on the scale required unless business has less of its surplus pre-empted by public expenditure, directly or otherwise.

39 In general, the CBI favours the taxation of consumption rather than the creation of wealth. We are, of course, aware of the more general stimulus to enterprise and endeavour which is achieved by reducing marginal rates of personal taxation and allowing individuals to retain a greater part of any increase in earnings for themselves. The CBI has for many years, supported a reduction in the top rate of personal income tax to at least 50%. The cost to the Exchequer of such a move would be around £400 million in a full year, but the net cost may be lower, as incentive for avoidance is reduced.

40 At the same time, a comprehensive review of the impact of taxation and benefits at the lower end of the income spectrum is urgently required. Individuals become liable for tax and national insurance at relatively low income levels (for a single person, 24% and 20% of average earnings, respectively), and benefits (particularly housing benefit) are withdrawn rapidly as income rises. This produces a disincentive to taking up employment which is particularly serious for industries where pay levels are still relatively low.

41 This combination of factors means that some lower paid individuals will retain as little as 6 per cent of any increase in income, even after the changes introduced by the 1986 Social Security Act are fully implemented in 1988. The tax, national insurance and benefits systems must be more closely integrated, to ensure there are incentives throughout the income spectrum. As the problems associated with the "unemployment trap" and the "poverty trap" stem primarily from the operation of the benefit system, it is here that reforms are needed most urgently.

42 For most people, the marginal rate of tax is the basic rate of income tax. The Government has repeatedly stated its aim of reducing this rate to 25 pence, when it is prudent to do so. The CBI supports this basic approach. But it is business which must undertake the investment that is needed to sustain the momentum of the recovery and ensure future prosperity. Reductions in taxes on personal incomes should not come at the expense of the long run competitiveness of British business, which faces a massive investment backlog while remaining - on average - relatively unprofitable by international standards, despite the improvements of recent years.

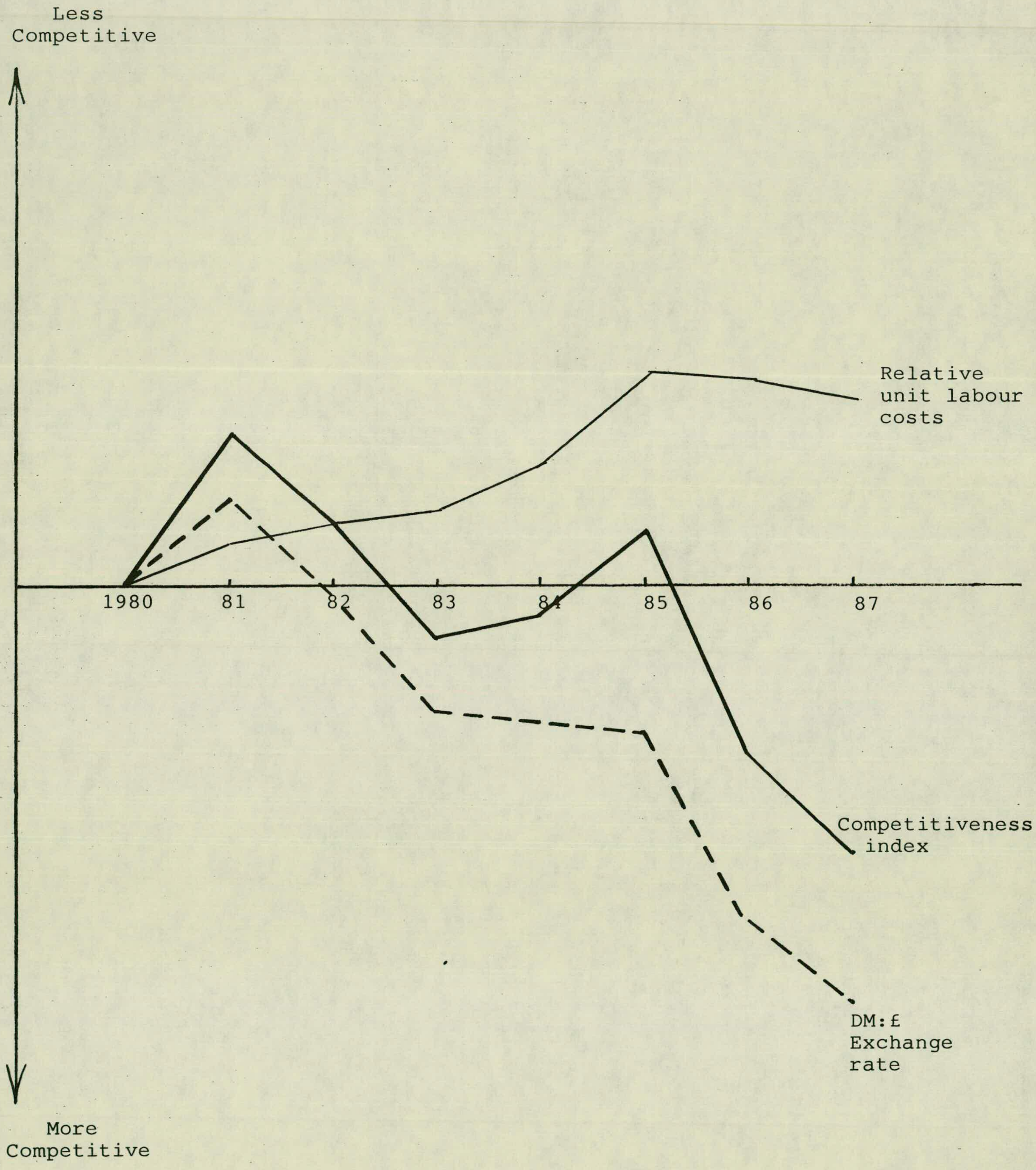
* * *

43 The commitment to a higher wage/higher productivity economy implies an internationally competitive business sector. The Government cannot make businesses competitive. But, by creating an economic climate conducive to competitiveness and by reducing the burden on business, Government has the opportunity within the next round of public expenditure and tax decisions to signal the importance it attaches to promoting the investment necessary to further improve business competitiveness as we move towards the 21st Century.

Centre Point
London WC1
October 1987

CHART 1

UK MANUFACTURING COMPETITIVENESS
RELATIVE TO GERMANY



ps2/75R

cc PS/Chief Secretary
Sir P Middleton
Mr F E R Butler
Mr Anson
Mr Monck
Mr Hawtin
Mr R I G Allen
Mr P R C Gray
Mr Potter
Mr Fellgett
Mr Cropper
Mr Tyrie

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

27 October 1987

John M M Banham Esq
Confederation of British Industry
Centre Point
103 New Oxford Street
LONDON WC1A 2DU

Dear John

RATE REFORM

Thank you for your letter of 14 October, enclosing an interesting memorandum about the CBI's latest thinking on rate reform. I am grateful for your general support for the Government's objectives. As you know, rate reform is primarily a matter for Environment Ministers and no doubt Nick Ridley will be happy to provide a detailed response to your ideas.

Yours ever
Nigel

NIGEL LAWSON

4308/015

FROM: S J FLANAGAN

DATE: 27 October 1987

/ Rwo 27/10

1. MR WYNN OWEN

2. CHANCELLOR

C/letter to issue?

CR 27/10

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
PS/Sir P Middleton
Mr Monck
Mr Burgner
Mr P Gray
Mr Cropper

CBI REPORT: "INVESTING FOR BRITAIN'S FUTURE"

Sir David Nickson sent you a copy of the CBI City Industry Task Force report on 13 October. He also sent copies to the Chief Secretary and the Financial Secretary. The final report is much as the draft Mr Monck sent you with his minute of 11 September. The report concludes that there is a problem of short-termism in UK industry, but that the City is not to blame.

2. The report contains no recommendations for Government. When you saw the draft you commented that it was "something of a mouse" (Mr Taylor's minute of 15 September to Mr Monck). However, on 26 January, when the Task Force was being set up, you wrote personally to David Nickson warmly welcoming the initiative. Given that, it would seem best if you were to write to Sir David Nickson yourself thanking him for the final report. A draft is attached.

Steven Flanagan

S J FLANAGAN

4308/015c2

~~DRAFT~~ LETTER FROM THE CHANCELLOR TO: Pl. type for C's sig.

Sir David Nickson, KBE DL,
President,
Confederation of British Industry,
Centre Point,
103 New Oxford Street,
LONDON WC1A 1DU

Thank you for sending ~~John Major, Norman Lamont and~~ me ~~copies of~~ the CBI City/Industry Task Force report "Investing for Britain's Future". // ~~I was interested to see the conclusions reached, and hope that the CBI will continue to pay close attention to the important issue of relations between the financial and industrial sectors.~~

[N L]

As you well know, I ~~attach great importance to the work issues it covers, and I~~ have warmly welcomed the attention which the CBI is giving to relations between industry and the City, and the publication of the Task Force report is an important step forward. I touched on some of its conclusions in my speech to the Stock Exchange last week (copy attached, in case you have not seen it). //

~~In the curr~~

It is vital that the recent turmoil in the stock market does not lead to a loss of confidence and a ~~retreat~~ retreat into "short-termism", and I am sure the CBI will be working to avoid that in the months to come.

N — L —

Reference ....

Alex – Did we know this?

CR

PMP

1. Mr Ward [handwritten initials]
2. PS/Secretary of State

cc at 2: PS/Mr Howard
PS/Mr Chope
Mr Brearley
Mr Fellgett HMT
Mr Dunabin
Mrs Ramsay

SECRETARY OF STATE'S MEETING WITH CBI REPRESENTATIVES, 14 OCTOBER 1987

1. On Wednesday 14 October the Secretary of State and Mr Howard met Sir David Nickson and Mr John Banham of the CBI to discuss the government's plans for rating reform and to receive the CBI Memorandum "Lifting the Burden on Business: An Alternative Approach to Paying the Local Government".

2. I attach the note of this meeting.

Sally Hawkins

MRS S HAWKINS
FLT(A)
N6/04
Ext 5593

28 October 1987

Mr Potter o/r

cc PS/CX (Mrs Ryding)
PS/Sir P. Middleton
Mr Monck
Mr Hawtin o/r
Mr Scholar
Mr Dickson
RF

According to this DoE note of Mr Ridley's meeting with the CBI, Sir David Nickson and Mr Banham would drop Mr Banham's ideas for the reform of local authority finance and support the Government in exchange for a 25% cut in business rates. (I.e. back to their first response to "Paying for Local Government".)

Robin Fellgett

30/10

DOC1307PS

CODE 18-77

NOTE OF THE SECRETARY OF STATE'S MEETING WITH CBI REPRESENTATIVES ON 14 OCTOBER 1987.

Those present:

Mr Nicholas Ridley	Secretary of State
Mr Michael Howard	Minister of Local Government
Mr C J S Brearley	LGFP
Mr P D Ward	FLT(A)
Mr R U Young	PS/Secretary of State
Mrs S C Hawkins	FLT(A)
Sir David Nickson	Chairman, CBI
Mr John Banham	Director-General, CBI

1. The CBI wished to warn Ministers of the strength of opposition to both the NNDR and the Community Charge amongst their members, to present their revised "alternative" proposals for local government finance reform and to receive assurances that their private discussion with the government were to continue.

2. Sir David summarised the history of the CBI's reaction to the government's proposals since their 1985 conference. The CBI's desire to support rather than criticise the government if possible, which had determined their stance in the pre-election period, had to be set against the need they felt to warn the government of the dangers - as they saw them - of the current proposals.

3. The Secretary of State stressed that the Bill was already being drafted and that - although transitional provisions were still to be finalised - most major decisions had been taken. The relations of local government and business were a legitiate CBI concern and ground for discussion with government; their members' worries about community charge, however, must be dealt with through the wider arena of public debate.

4. The CBI report "Lifting the Burden on Business: an Alternative Approach to Paying for Local Government" was presented to Ministers:

- Mr Howard's argument that the proposals put to the CBI Council in September 1987 were inconsistent with government commitments had been accepted by the CBI Council and the proposals had been revised; in particular, the new proposals had no reference to the retention of domestic rates;

- The revised proposals were backed up by exemplifications and case studies of the relative effects of CBI and government proposals;

- The CBI memorandum was accompanied by a summary paper headed "Lifting the Burden on Business: a Possible Compromise," suggesting that their business rate proposals could be considered in isolation from the other proposals; it was likely that CBImembers would be prepared to accept such a compromise if the 'full alternative' was not available.

- The report would be sent also to the Chancellor of the Exchequer and to the Secretary of State for Trade and Industry.

CBI concerns and government response

5. The principle concerns underlying the CBI alternative were put to Ministers:

(a) The CBI was particularly concerned with the overall rates burden on business; they might prefer to see more of the burden carried by, for example, corporation tax. At present £2 billion per year was being paid by businesses for services which they did not receive, which could be spent instead on training or investment in the inner cities, and had also to be paid whether or not a business was profitable;

(b) The benefit of future savings made by local authorities should flow to businesses as well as to community charge payers;

(c) Consultation between local authorities and business was vital; under the government's new system, local authorities were free to be concerned only about the community charge payers to whom they were accountable and would have no incentive to improve or maintain services to business;

(d) The extension of user charges was vital.

6. The Secretary of State responded to these concerns:

(a) The level of the overall tax burden on business was a matter for the CBI to pursue with the Chancellor rather than with him but the distribution of the rates burden itself was his concern. He did not accept that it was appropriate to compare the level of rates as against services received; rates were a tax which was not specific but was levied as a source of money for the funding of local government;

(b) It was desirable that local authorities should make savings and the options under current government proposals of an uprating of the NNDR poundage by less than RPI was one way in which such savings could be passed on in part to business; the CBI thought this proposal - which was new - was a helpful one.

(c) The Secretary of State, while sympathetic to the CBI's concern about the future of consultation, did not feel that the solution was clear; officials would be examining possibilities;

(d) The Government was also in favour of the extension of user charges for certain services, although it may not be realistic to expect certain local authority services to be funded by this method in their entirety.

7. It was agreed that Ministers and officials would study the revised CBI proposals and a further private meeting would be arranged at which they could be discussed. The assurance that discussions were continuing would be offered to the CBI conference, but the substance of these discussions would remain in confidence.

DOC1272PS

MR 4/24

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

2 November 1987

Sir David Nickson KBE DL
President
Confederation of British Industry
Centre Point
103 New Oxford Street
LONDON
WC1A 1DU

Dear David

Thank you for sending the CBI City/Industry Task Force report "Investing for Britain's Future".

As you well know, I have warmly welcomed the attention which the CBI is giving to relations between industry and the City, and the publication of the Task Force report is an important step forward. I touched on some of its conclusions in my speech to the Stock Exchange last week (copy attached, in case you have not seen it).

It is vital that the recent turmoil in the stock market does not lead to a loss of confidence and a retreat into "short-termism", and I am sure the CBI will be working to avoid that in the months to come.

NIGEL LAWSON

[illegible]

30/11

CH/EXCHEQUER

REC.	11 NOV 1987
ACTION	Mr P. Gray
COPIES TO	Sir P Middleton Mr Monck Mr Scholar Mr Burgner Miss O'Mara Mr M Williams Mr B Potter Mr WynnOwen

11/11

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

10 November 1987

Ch
You are going to this
- see papers below

Dear Alex,

DINNER FOR THE CBI

The Prime Minister is giving a dinner for Sir David Nickson and other members of the CBI on Monday 30 November, as you know, and I attach a copy of the guest list. It would be helpful please to have a brief by close of business on Thursday 26 November which should set out recent concerns expressed by the CBI and suggested lines to take. This need not be long. It would also be helpful to have a note on what Sir David Nickson would regard as the main achievements of his Presidency for the Prime Minister to draw on if she decides to give a short speech to mark his approaching retirement.

I am copying this letter to Tim Walker (Department of Trade and Industry) and Peter Smith (Chancellor of the Duchy of Lancaster's Office).

Yours,

David

DAVID NORGROVE

Alex Allan, Esq.,
H. M. Treasury

LIST OF GUESTS ATTENDING THE DINNER TO BE GIVEN BY THE PRIME MINISTER AND MR. DENIS THATCHER FOR THE CBI ON MONDAY, 30 NOVEMBER 1987 AT 7.30 PM FOR 8.00 PM LOUNGE SUIT

The Prime Minister and Mr. Denis Thatcher	
Rt. Hon. Nigel Lawson, MP	
Rt. Hon. Lord Young of Graffham	
Rt. Hon. Kenneth Clarke, MP	
Sir David Nickson	President, CBI. Chairman, Scottish & Newcastle Breweries plc
Mr. John Banham	Director General, CBI
Sir Trevor Holdsworth	Deputy President, CBI Chairman, GKN plc
Mr. Ian Butler	Chairman, CBI Companies Committee. Chairman, Cookson Group plc
Mr. Denys Henderson	Member, CBI President's Committee Chairman, ICI
Sir Peter Walters	Member, CBI President's Committee. Chairman, BP
Mr. David Norgrove	

pwp.

SECRETARY OF STATE FOR THE ENVIRONMENT

2 MARSHAM STREET
LONDON SW1P 3EB

01-212 3434

My ref:

Your ref:

The Rt Hon The Lord Young of Graffham
Secretary of State
Department of Trade and Industry
1 Victoria Street
LONDON
SW1H QET

11 November 1987

Dear Secretary of State,

MEETING WITH THE CBI

I understand that you are to see Sir David Nickson and Mr Banham of the CBI on Thursday. I imagine they will want to try to elicit your support for their alternative proposals on business rates. You may therefore find it helpful to see the attached critique which my officials have prepared. I would advise against using this much at this stage, as I have yet to put these points to them myself.

You will see that we do not think much of the substance of the proposals and would not do so even if there were time at this stage to reconsider our plans. I am sure that the basic message must be that they have missed the boat. But we must also make it clear that we do not see that their proposals meet our requirements at all.

I am copying this to Nigel Lawson, Kenneth Baker and John Cope who I understand have also been approached by the CBI.

Yours sincerely,

R... J

pp NICHOLAS RIDLEY
(Approved in draft by the Secretary of State and signed in his absence.)

CBI ALTERNATIVE PROPOSALS: BULL POINTS

1. The CBI proposals would require substantial recasting of the Government's proposals. They are therefore too late. They are also inconsistent with the Government's manifesto. which set out the proposals for the uniform business rate and for authorities to be made fully accountable through the community charge.

2. The CBI had every opportunity to enter their reservations before the Green Paper was published and during the consultation period. (See Annex for history of CBI views.)

CBI Criticisms

3. Business rates are £2bn too high. Everyone would like to pay less. It will be up to the Government to set the starting level for UBR for 1990. The assumption is that it will be at the then average level. Any lower level would have to be made up from other taxpayers.

4. UBR breaks local links. Only breaks the link which allows local councils to charge any level of rate regardless of the views of local businesses. Local authorities will have every incentive they have now to encourage industry for its contribution to the wealth of the area. Business location should not be influenced by differences in local spending decisions but by market considerations.

5. UBR could be misused by a different government. Statutory indexation will only be amendable by new primary legislation. A hostile government could do anything it wished by primary legislation. The British constitution does not allow for greater protection.

6. Current rate levels are too high and business will get no benefit from any later "value improvements" (ie. efficiency savings) by local authorities. Historically local spending has moved ahead faster than the rate of inflation. Statutory indexation to the RPI is therefore likely to be more valuable than industry's share of any value improvements.

Government anyway taking a reserve power to increase UBR by less than the rate of inflation. Efficiency savings could be a consideration in how to exercise that power.

7. Combined with revaluation there will be large increases in rate bills. UBR will increase rates by more than 15% for only 1 business in 7. It is not unknown for rates to increase by more than this in a single year. Revaluation will also increase some rates. But revaluation is inescapable - indeed the CBI asked for one - if the incidence of rates is to be fair. Revaluation will only follow the markets judgement. Of course turbulence is undesirable. That is why there will be a 5 year transition.

8. Accountability will be confused if 75% of income comes from the centre. Services to business will bear no relation to their contribution. Under our proposals there will be a standard community charge for a standard level of service and every £1 variation in spending will lead to an equivalent charge in community charge. Nothing could be clearer - certainly not the CBI alternative.

9. Grant proposals inconsistent with education proposals and inner city objectives. Government's education proposals do not require centralisation of education spending. UBR will benefit inner city areas by £380m pa. If community charges in inner city areas are high, it is because spending is high in relation to need. Wasteful expenditure and disorganisation by local authorities is part of the inner city problem. CBI proposals do not substantially reduce community charges in inner cities. But they do make them arbitrary (eg. £648 in Sheffield but only £164 in Liverpool).

The CBI Alternatives

The CBI alternative is to split local spending into 4 categories.

(a) National Services Locally Administered (eg secondary education and child care). It is proposed that these services should be funded by specific grant (presumably at 100%).

Comment. Funding at 100% is appropriate only where local authorities have no discretion about whether to provide a service or its standard. Although education and child care must be provided. they can clearly be provided more or less efficiently (residential child care is much more expensive than foster care). and more or less lavishly. Specific grants would have to be limited to what the government thought should be spent. This simply separates financial and management responsibilities and allows local authorities to blame government for their shortcomings. It does not foster accountability.

(b) Property and Business Services (eg Fire. Police. NAFE). These services would be funded 75% by business rates. with the rest met by "community charge" and block grant.

Comment. There is no particular rationale for business paying for these services and for no others. nor for the chosen level of support. The 75% figures is an average and varies from authority to authority reflecting the present split of domestic and non-domestic rateable value. This has a very odd impact on the levels of business rates and community charges (see below). CBI also propose a minimum poundage of 114p (the current minimum) and a cap on increases limited to the annual increase in the RPI. They do not appear to explain what would happen to the surplus revenue accruing to authorities which do not need the income from 114p. Nor what would happen if Police and Fire expenditure were to increase faster than the increase in RPI - which it tends to.

(c) Community Services (eg primary and nursery schooling, care of the elderly) to be financed by community charge and block grant.

Comment. The CBI's preferred community charge is different from the Government's in being a household rather than an individual charge (though they would allow a discount for single pensioners). This would not bring all adults into the local tax net and would not extend accountability. It is not clear how they have chosen the services to be funded by community charge, nor how they propose to compensate the areas of high need.

(d) Marketed Services (eg housing and leisure services). The CBI proposes that these services should be funded entirely by user charges.

Comment. The Government is currently considering the financing arrangements for local authority housing in order to bring them onto a more business like footing. The CBI proposal is not satisfactory but a system in which the community charge is isolated from the housing revenue account is a possibility. It is not, however, clear that all "marketed services" can be self sufficient, eg. swimming pools. It would certainly be very controversial to have full cost pricing for leisure services, particularly for the unemployed, and it would be too bureaucratic to arrange social security compensation. The Government supports the extension of direct user charges and regular reviews of charges - but not full cost recovery.

Results of the CBI's proposals

The CBI's exemplifications are very difficult to compare with the Government's because they reduce the business contribution by £1.8bn. This is achieved by increased charging of £1.2bn and a 'saving' compared with government plans of £450m as their estimate of the extra cost of collecting community charges from every adult.

Comment. The increased level of charging implied is implausible (certainly in the short term). The additional cost of billing individuals separately for their community charge compared with the cost of household bills should not be as high as £450m. (£200m might be closer to the truth). Comparing the CBI proposals with the Government proposals, the following is true:

(1) It has not been possible to replicate - even remotely the CBI figures. This throws doubt on those figures.

(2) The CBI figures show a preponderance of gainers but this is entirely because they have reduced the yield by £1.8m.

(3) If the yield were the same as that for the UBR, the CBI proposals would bring more big losers (17 authorities would have increases over 20% under UBR: 65 would do so under CBI proposals).

(4) The CBI proposals radically change the incidence of gains and losses. Under government proposals the North and Midlands are the main gainers from UBR. Under the CBI proposals the biggest gains are in the South East.

(5) Some of the individual results are bizarre. In Greater Manchester the rate poundage in Manchester on CBI proposals would be 189p, in Rochdale 287p: in Tameside 270p. In Islington it would be 114p in Wandsworth 132p. In Liverpool 229p, in the Wirral 246p. The CBI would increase rates in Derwentside (Consett) by 49p: Government proposals would reduce them by 35p.

(6) There are equally bizarre results in relation to the community charge. High spending Manchester would have a 'community charge' of £420. Low spending Salford £480. Low spending Birmingham would charge £370 and Liverpool only £164.

Conclusion

The CBI proposals do not meet the Govenment's specification for a clear comprehensible system of local finance. They would not extend the numbers paying local taxes nor would they provide any coherent relationship between spending and local tax rates. Technical weaknesses in the specification mean that it does not amount to a full system only a collection of proposals. And - especially but not only the household-based "community charge" - they are inconsistent with the manifesto. The package does not offer a way forward for the Government.

HISTORY OF THE CBI INVOLVEMENT IN DEVELOPING GOVERNMENT PROPOSALS

1. Part of the CBI case for speaking out now against the Government's proposals is that they did not wish to speak out before the election. This claim is not really justified. Discussions were held with the CBI before the Green Paper was ever published. Sir James Clemison (President) and Sir Terence Beckett (Director General) met Mr Baker and Mr Waldegrave on 17 July 1985 and 25 November 1985 to discuss the Government proposals. They were given a clear indication of the Government's thinking on UBR. They indicated then that they would accept it subject to:

(i) it being simultaneous with a revaluation:

(ii) a 5-year phasing-in period:

(iii) partial business derating or alternative safeguard for business ratepayers:

(iv) increases in poundage to be held down to rate of inflation in primary legislation:

(v) 5-yearly revaluations thereafter.

In addition the CBI Taxation Committee and their Rating and Valuation Committee both supported UBR. The former as a prelude to abolition of business rates: the latter on the conditions put to the Department. Before the issue of the Green Paper the CBI proposal was for a 10% derating.

2. After the Green Paper, the CBI's formal response to it accepted the UBR subject to the following conditions:

- poundage should be set 25% below the current average:

- poundage should be set at the same level throughout Great Britain:

- it should be linked to the RPI by primary legislation:

- revaluation should take place before the NNDR is introduced:

- phasing-in should ensure that no business faces an increase of more than 10% a year:

Also:

- CBI rejected proposal for 5% local discretionary poundage:

Councils should continue to have a duty to consult business ratepayers:

- there should be statutory minimum standards for the provision of local services to business:

- non-domestic rate poundages should be frozen between now and the introduction of the NNDR.

After despatching the response to the Green Paper. the CBI did not pursue the issue of 25% derating before using it as the basis on which to back out from acceptance of the UBR.

PW687

I'm no deadbeat, and you can quote me

Being misquoted is a vital part of a politician's learning process, particularly if the misquote is more headline-grabbing than the original, accurate version. The re-ordering of one or two vowels and consonants can have a startling effect. Thus, my innocuous statement last weekend that certain facts hadn't "penetrated the debates of the CBI" became vitriolic overkill when described as "hadn't penetrated the deadbeats of the CBI" in a morning newspaper – not *The Times*.

The question is, what should be done by way of damage limitation? Answer: absolutely nothing – just be thankful you hadn't issued a press release complaining about the excessive number of parliamentary debates. A morning walk around a House populated with parliamentary deadbeats would be a harrowing experience for the perpetrator.

Misquotes can be positive, negative, amusing or terrifying. They are an under-utilised journalistic resource, and should be exploited by politicians who wish, for example, to hedge their bets according to the editorial standpoint of the newspaper. On that basis, press releases could state:

- "British plastics should be nationalized/rationalized" (delete whichever is appropriate).
- "The Radical Party's defence is appalling to the majority", *or*
- "The Radical Party's defiance is appealing to the majority".

The possibilities are endless, and I'm surprised that so far sub-editors have behaved with impeccable restraint. *Hansard* editors even err on the side of kindness, often tidying up loose English or bad language. Thus "The honourable member should be castrated" (uproar) would become "The honourable member should be castigated" (hear hear).

Society columnists would be less benign. Lady So-and-so recently divorced by Lord So-and-so would have a hard time proving that she wasn't recently debauched by his Lordship. "Sorry, Rosanna, my informant was on a bad line".

The trouble with misquotes is that they pass into the accepted folklore of history. At Fulton, Missouri, the straight-talking Churchill, who didn't much like Stalin, might well have said: "An Iron Cretin has descended on Europe". Wellington probably said the Battle of Waterloo was won on the playing fields of Acton, but the Eton-educated war correspondents would have none of it.

And what about the misquotes/mistakes that never saw the light of day? In 1964 a young shorthand minute-taker for Alec Douglas-Home's cabinet transcribed all references to "departmental approach" as "deeper mental approach". Martin Redmayne, the then Chief Whip, hit the roof, but in those leak-free days it didn't hit the press. In the middle of a contribution to a Council of Ministers meeting in Brussels, an official slipped me a badly handwritten note; in the event, I managed to avoid referring to the internal market as the infernal market.

A mistyped speech for a similar occasion in Brussels invited a colleague to declare the British position as follows: "Our objective is increased bureaucracy and increased expenditure." I'm sure his Secretary of State was relieved to hear that his junior had, just in time, substituted "objection" for "objective".

All misquotes have one thing in common: they stick out like sore thumbs in the newspaper cutting files and no power on earth can get them changed. Henceforth, I will have to learn to enjoy my introduction on radio panel shows as the man who called the CBI a bunch of deadbeats.

John Butcher

The author is Parliamentary Under-Secretary for Trade and Industry.

DEADBEATS

CX PV

This was in Nicholson/Baxter tapes - did you see ?!

14 NOV 1987 THE TIMES

see below.

Monday November 9 1987

THE DAILY TELEGRAPH, MONDAY, NOVEMBER 9, 19[illegible]

CBI 'deadbeats' face attack by ministers

By Nigel Dudley and Roland Gribben

SENIOR MINISTERS are planning a full-scale assault on the Confederation of British Industry as their anger rises over the organisation's continued attacks on Government policy.

The final straw has been the CBI's criticism of the electricity price increases, announced last week to pay for new power stations, and the proposal for a unified business rate.

Mr John Butcher, a junior Trade and Industry minister, yesterday described the CBI as "deadbeats" and dismissed as "bizarre" their criticism of the unified business rate, which is to be set by central Government and distributed to councils.

Today, Mr Parkinson, Energy Secretary, who has been stung by CBI criticism of the price increases, will meet Mr John Banham, its director-general.

He is particularly angered by claims from trade bodies that the new financial set-up would undermine existing discount schemes and result in big firms facing increases of up to 15 per cent next year and up to 10 per cent in the following year.

'Big boys' club'

Some ministers, including Lord Young, Trade and Industry Secretary, think the CBI has "become a club for the big boys" and ignores small companies.

Mr Butcher said yesterday that the uniform business rate "met the CBI's long-held wish for discrimination in favour of manufacturing industry."

He said it would also meet the CBI's complaints of a drift in economic activity to the South-East and benefit the Midlands to the tune of £700 million.

"There will be reductions of 30-40 per cent for the long-suffering businessmen in high spending authorities like Manchester and Newcastle. Much of this does not seem to have penetrated the deadbeats of the CBI," he said.

Mr Parkinson said yesterday it was ridiculous to suggest some electricity bills could rise by up to 25 per cent over the two-year period. The average increase for industry and the domestic consumer would work out at eight per cent to nine per cent in the first year and substantially less in the second.

But Mr Alan Marriott of the British Paper and Board Industry Federation, said on the same programme, that preliminary indications suggested there could be rises of up to 25 per cent for some firms.

Rates policy

CBI leaders deny they are at odds with the Government over broad economic aims but want business tax reductions, including cheaper energy, and extra spending on public sector works without increasing overall state spending.

The CBI will shortly release a policy document setting out its proposals for rating reform changes based on companies paying only for the services they use and cutting the business rates bill by £2 billion to £6 billion a year.

This would mean firms opting out of contributions to social services and council housing. The CBI says companies would be willing to pay more than their share for services they need such as roads, public services, including police and fire, and parts of education and possibly the arts.

FINANCIAL TIMES

5

CBI backed over electricity prices

BY DAVID THOMAS

THE Confederation of British Industry is likely to tell Mr Cecil Parkinson, Energy Secretary, at a meeting today that it has the backing of the electricity supply industry for its plea for the scrapping of the electricity price rises announced by the Government last week.

There was considerable agreement at a meeting between the CBI and electricity supply leaders last week that the argument advanced by the Government that the increases were necessary to fund a new generation of power stations could not be justified.

However, Mr Parkinson, who yesterday strongly restated the Government's defence of the 15 per cent increase over two years, with 8 per cent to 9 per cent coming next April, appears unlikely to accept the CBI's case, thereby ensuring that the row will rumble on.

Mr John Banham, CBI director-general, will tell the Energy Secretary that there is no need for an increase in the price paid by industry for electricity.

Mr Parkinson, speaking yesterday on BBC Radio, reiterated the Government's argument that the increases were needed to replace old power stations. "There has been no provision made for their replacement," he said.

However, Lord Marshall, chairman of the Central Electricity Generating Board, and Sir Philip Jones, chairman of the Electricity Council, agreed at a meeting with Mr Banham and Sir David Nickson, CBI president, last Thursday that the new power station programme did not require price increases on the scale proposed.

The Electricity Council recently received a report from consultants at Price Waterhouse, which is understood to conclude that electricity prices would have to increase by about 20 per cent over five years to meet the industry's needs, including building its new stations.

Mr Parkinson insisted yesterday that it was the industry's responsibility to decide how the planned increases, which are averages across the country, should fall on individual groups of consumers.

Mr Parkinson, who said yesterday that the increases would add only one sixth of 1 per cent to industry's average costs, argued there was no reason why electricity prices for industry should go up next year by more than the average of 8 per cent to 9 per cent.

However, some people within the industry, while discounting speculation that industry's electricity prices could go up by as much as 20 per cent next year, believe that industry will have to bear an above-average increase.

At today's meeting with Mr Parkinson, the CBI will also revive an argument which has flared up several times in recent years about whether British industry pays more than its competitors abroad for energy.

5h

Confederation of British Industry
Centre Point
103 New Oxford Street
London WC1A 1DU
Telephone 01-379 7400
Telex 21332
Facsimile 01-240 1578

From
Sir David Nickson KBE DL
President

CBI

CH/EXCHEQUER
REC. 17 NOV 1987 17/11
CST WITH ATTACHMENTS

16th November 1987

Dear Nigel.

I am enclosing a copy of a report which we are publishing tomorrow on the whole question of paying for Local Government.

As you may know, the issue involved has been very widely debated within the CBI and, most recently, at our National Conference in Glasgow.

We have been discussing our ideas with the Secretary of State for the Environment, who has had the opportunity to consider our proposals over the past few weeks. John Banham and I had a very constructive meeting today with Nicholas Ridley and Michael Howard. They made it clear that, whilst it was now too late to change the plan for a uniform business rate across the country, they shared our concern to see effective local accountability for services for business, reasonable transitional arrangements following revaluation and the business rate set at levels which did not consolidate existing waste and inefficiency within Local Government.

We will certainly stress the positive nature of the Government's response to our concerns. And we will make it clear that the CBI supports the Government's view that the present domestic rating system must be replaced. We will, moreover, make it clear that we regard the present proposals as a distinct advance. However, our members do not agree that business should be paying £2 billion a year for services it is not receiving; and they are uncomfortable at the loss of local accountability that the uniform business rate will involve.

Our report is being published as a contribution to the debate about a very important subject for business and a constructive move.

Yours ever
David

The Rt. Hon. Nigel Lawson MP
Chancellor of the Exchequer
H M Treasury
Treasury Chambers
Parliament Street
London SW1P 3AG