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SECRET

Secretary of State for Industry

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SWIE 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

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The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
SW1

Prime Minister

Sir Keith's budget representations - see final page for summary.

Dear Chancellor

THE 1981 BUDGET

Your Budget will be a critical one for industry, and particularly for the tradeables sector. I think it will also be important for the future relationship between ourselves as a Government and industry. Until recently I have found considerable support in industry for our policies and a willingness to accept sacrifices. But there is now a growing mood of resentment that other sectors have not suffered proportionately; and growing criticism that, while our policies are reducing inflation, they are not yet providing a basis for the restoration of industrial growth and profitability.

2 You are of course familiar with the events underlying this change of attitude, and with the forecasts for the period ahead. 1980 was a very difficult year for industry, coming on top of the problems of 1979. Labour costs rose rapidly for much of the year. The exchange rate rose sharply. Output fell, particularly in manufacturing. Profitability at home was further squeezed, and our international competitiveness suffered a further deterioration.

3 The fall in output was due to a large extent to de-stocking, which should broadly come to an end this year. But great uncertainty surrounds the future trend of exports, investment, and consumer expenditure. On balance, it seems unlikely that output will rise significantly in the course of 1981 and it could well decline further. Meanwhile, the squeeze on company profitability and liquidity is expected to continue.

The Danger to Industry

4 In my letter to you of 23 December, I described the risks as I saw them then. Continued low output, combined with low profitability and cumulative financial deficits, may increasingly during 1981 lead companies to cut potentially viable capacity.

/Companies ...

Companies will initially try to avoid closures by cutting back on discretionary expenditure - investment, R&D, product development, marketing, "seed-corn" expenditure generally. The Department's investment intentions survey, for example, is indicating a fall in 1981 for manufacturing industry of between 11 and 16%, even after taking account of the effect of leasing. We should not over-emphasise the seriousness of this - what really matters is that existing and new investment should be used efficiently and profitably - but the trend is worrying for the future ability of companies to take advantage of the improvement in demand when it comes. Our overseas rivals, less constrained than we are by low profitability and liquidity, will be in a better position to maintain their expenditure.

5 Companies which are forced to close plants are in most cases unlikely to be able to re-open them as soon as the upturn comes. Productive capacity will have been lost for a significant period, and in many cases permanently. My concern is that from now on an increasing proportion of closures are likely to be of good capacity; industrial "muscle" as I have previously called it.

The Objective of the Budget

6 Against this background I would like to suggest that the objectives of your Budget, so far as industry is concerned, might be:

a) to give relief to corporate liquidity pressures imposed by Government, both to avoid closures of potentially viable capacity and to avoid damaging reductions in discretionary expenditure;

b) to supplement this by giving positive encouragement to discretionary expenditure e.g investment; and

c) to continue to stimulate enterprise in the economy in the hope of speeding up the climb out of recession.

7 In relation to the first objective relief must be fairly quick-acting to affect decisions taken by companies in 1981 (i.e before the upturn comes when special measures would not only be too late but would possibly add to inflationary pressures); it should be on a substantial scale; and it should be directed mainly towards the tradeables sector, especially manufacturing.

8 In relation to the second objective, I would not propose new measures, but rather an increased and more vigorous use of existing instruments. The aim would be to supplement any steps to improve corporate liquidity by encouraging companies to bring forward or maintain discretionary expenditure which might otherwise be deferred or cut. This would also give a much-needed psychological boost to industry by the explicit recognition of the importance of the supply side.

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9 The third objective, stimulation of enterprise, has always been fundamental to our strategy. We must continue to support it vigorously.

10 I would hope that the position on the monetary front would enable you to consider a further reduction in MLR. A reduction in interest rates would bring direct financial help to industry, and would also help indirectly by the stimulus to activity it should bring.

11 However, I believe there is a strong case for going further than this. I fully support, as you know, the maintenance of the existing Medium Term financial Strategy. But I believe we must think in terms of a switch of resources in favour of the corporate sector at the expense of the personal sector, which has done relatively well.

12 I wish I could think that, despite the arguments in your letter of 16 January, you could make it one of your budget objectives to take direct action to influence the value of sterling. We must all acknowledge that the rise in sterling has done us proud in terms of inflation. But there is no doubt that the treadeables sector has been faced with great difficulty in adjusting to the rapid and steep rise. It would be highly desirable if the average level of sterling over the year as a whole could be a shade lower - 5 to 10% would be ideal.

Measures to Improve Company Liquidity

13 I believe the principal measures should be aimed at reducing industry's costs. Certain measures are already under consideration:-

a) Energy Prices. These are being studied as a whole by NEDO. In addition, I understand that officials have concluded that my proposals for abolishing or rebating the Heavy Fuel Oil Duty would be an expensive way of providing relief to industry. If you accept this, I hope you would agree to provide an equivalent measure of relief to high load factor electricity users, whose competitive disadvantages I described in my letter to David Howell of 27 November 1980.

b) Stock Relief. Your consultative proposals would bring extra relief to industry, at least in the short term. I believe certain aspects of your proposals (particularly the credit restriction and the single index) are causing widespread concern and I hope you will consider carefully the representations you receive. Subject to this, I hope you will be able to institute a permanent scheme in place of the present temporary arrangements.

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14 Important though these are, I believe we need to go further, and I should like to recommend the following for your consideration:-

a) Regional Development Grants (RDG)

The 4 month deferment of payment of RDG was introduced in your 1979 Budget. It is widely resented by industry which, while recognising the need for it in 1979, now feels that its continuation leaves the private sector bearing the cost of the Government's public expenditure savings which resulted from it. Abolition of the deferment in 1981/2 would bring forward around £100m of RDG expenditure which would otherwise fall into 1982/83. (This figure would be greater if the decision on the eligibility of the Sullom Voe project resulted in its RDG being brought forward into 1981/82). The relief would be concentrated on manufacturing industry in the areas where the recession has caused the greatest problems and it would be felt quickly.

b) The National Insurance Surcharge (NIS)

We have of course already considered and rejected a reduction of the NIS. Nevertheless, I think it right to ask you to consider the position again in the circumstances we now face. A reduction in the NIS is perhaps the most effective available way of channelling substantial relief to industry fairly rapidly (not as rapid as the RDG route, but more substantial). It would relieve industry of an impost by the Government which represents a considerable burden. A reduction would be consistent with the widely-held view that the present industrial problems are due to real wages that are too high in terms of domestic prices (i.e low profitability) and international prices/costs (i.e poor competitiveness).

A reduction would bring down labour costs and should (though this may depend on how it is financed) stimulate activity through lower prices and/or higher profits. Manufacturing should benefit more than proportionately. All companies benefit, including the tax-exhausted, which mades this option more attractive than any reduction in Corporation Tax. In international terms, a reduction in the NIS would help towards offsetting the effects of the high exchange rate on UK exporters. Having re-read your letter to me of 15 January, I am more than ever convinced that we must think in such terms if there is no way of shading down the exchange rate itself.

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In the past, I know you have thought that a reduction of the NIS would benefit too many companies who did not really need help. While this may have been true in 1979 or even 1980, I think it is a proposition that must be seriously re-examined today.

Less than 8% of the benefit of any reduction would go to oil companies, banks and financial institutions (and, so far as banks are concerned, I understand you may be considering special measures). It is true that only a third would go to manufacturing. But the construction, distribution and transport sectors are now all in serious difficulty and should I believe be seen as deserving. In any case, the benefit to prices and output should accrue whoever in the private sector is the immediate beneficiary.

I should perhaps add that I do not favour a selective reduction of the NIS (effectively a return to the Selective Employment Tax). I understand that in addition to political and analytical arguments against, it would take time to implement, and require considerable numbers of new staff.

Another previous worry about the NIS was that a reduction would feed through into wages. I believe this risk has now lessened. An announcement in the Budget could not significantly affect the 1981 pay round. In any case the labour market is so depressed, especially in manufacturing, that a NIS reduction this year should leak much less than it might have done in 1979 or 1980.

I should like to think we could abolish the NIS; it was a "crisis" tax introduced by Labour in an ill-considered way. If this is impossible, I believe we should go for a reduction of 1½ points.

c) Industrial Rates

The very substantial and rapid increases in rates that have occurred in recent years have placed a considerable and uncontrollable burden on industrial costs. I welcome your willingness to explore this area, and I am very willing that Department of Industry officials should participate in the exercise you propose in your 15 January letter.

d) Nationalised Industry Investment Programmes

The squeeze on the nationalised industry investment programmes (especially, in my own field, British Telecommunications) has caused great difficulty for private industry. It is vital that we should find

/a way ...

a way of maintaining the viable investment programmes of the nationalised industries (especially BT), on which the future of many private sector high technology companies depends. These would benefit directly from any easement.

Discretionary Expenditure

15 I turn now to ways in which we can encourage industry to maintain or increase the discretionary expenditure that is so vital to our future. I was grateful for your decision to include in your 24 November measures an "industrial support" package. However, you will remember that I wrote on 8 August last year recommending a package of some £50 million in 1981/82, £70 million in 1982/83 and £90 million in 1983/84. In the event you recommended to the Cabinet a package of some £25 million in 1981/82, £43 million in 1982/83 and £40 million in 1983/84. This is helpful but the prospects are now worse than in August. The case for additional funds is therefore even stronger than when I last wrote to you and I should now like to propose that the shortfall of approximately £100 million, between what I requested last year and what you felt able to recommend, be made good. This sum might be spread £25 million in 1981/82, £40 million in 1982/83 and £35 million in 1983/84. Although the rate at which money can actually be spent dictates this kind of spread, planning and ordering would begin to take place at once and that would be the objective. I should apply these additional funds as follows:-

a) Investment

I believe we need to make more positive use of the powers that already exist in the Industry Act. This would involve publicising our readiness to consider applications, relaxing some of the guidelines for a limited period (but keeping the main criteria intact), and announcing a specific allocation of money. If you are attracted by this idea in principle, Department of Industry officials would be ready to discuss the details with Treasury officials.

b) R&D

Large firms are now turning to Government support to enable them to carry out R&D, whereas previously they had relied on their own resources. Many smaller firms are withdrawing from R&D projects because our "normal" grant level of 25 per cent is insufficient inducement in present economic circumstances. I would like to have the flexibility to increase the level of assistance to 35 per cent of qualifying costs particularly for the development aspects of R&D and to offer 50 per cent shared

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cost contracts more frequently. Steps are also in hand to publicise our support measures. These changes would increase our total support costs but they do appear necessary if industrial R&D is not to decline further.

c) Departmental "Wedge"

There are strong arguments for rebuilding our Departmental "Wedge" for future industrial needs. In earlier years this Wedge has stood at over £50 million but in 1981/82 it stands at about £5 million and in 1982/83 calls such as the Laker Airways deal have reduced the unallocated Wedge to under £3 million. Such low levels leave us with little scope to cover year-by-year fluctuations in the opportunities and imperatives which emerge.

Stimulus to Enterprise

16 Subject to the consultative process, I very much hope you will be able to implement a scheme on the lines of the current proposals for tax relief on equity investment in start-ups. I also hope the pilot loan guarantee scheme will be in a sufficiently advanced state of preparation for you to announce it in the Budget.

17 In addition to these, I attach importance to stimulating the growth of Small Firms Investment Clubs. I am glad to know that the FASE group are now examining the tax aspects and I look forward to seeing the result of their work well before the Budget.

18 My letter of 19 December 1980 contained a number of proposals to help new and expanding businesses. I hope you will consider all of them, but I would single out particularly my proposals on the taxation of share options. I think this would give a considerable boost to the expanding, innovative type of business where risks may be high and enterprise needs to be rewarded.

Housing

19 Finally, I should like to return to the theme of my letter to you on housing of 31 December. A revival of housebuilding has in the past led industry out of recession and could on this occasion also give a much needed stimulus. I hope you will consider all possible measures in this direction.

Priorities

20 I suggest that we should be thinking of an "industrial package" for 1981/82 totalling at least £1 billion. This would be in addition to the benefit to industry from any reduction in interest rates and in addition to the benefits of the new stock relief schemes and the measures to encourage enterprise (the Aunt Agatha and loan guarantee schemes). My order of priorities would be:

/ a ...

	Benefit to Industry 1981/82 £m approx
a) 1½ point reduction in NIS	800
b) Assistance to maintain discretionary expenditure	25
c) Abolition of Heavy Fuel Oil Duty or measure to give equivalent relief	85
d) Abolition of RDG Deferment	100
	£1 billion

21 If you are unable to accept my recommendation for a significant reduction in NIS, I urge you to consider what other way can be found to improve corporate liquidity to an equal extent. One possibility might be allowances exceeding 100% for capital investment and R&D; but I consider a change in NIS far preferable.

Financing the Package

22 A switch of resources on the scale I suggest will clearly require a substantial increase in the burden on the personal sector. In deciding how to impose this burden, I hope you will bear in mind the importance of limiting the adverse effect on industry (either through the dampening of demand or through pressure for higher wage settlements, for example). I think we must consider the whole Budget this year from this point of view.

23 I am copying this letter to the Prime Minister, the Secretaries of State for Employment, the Environment, Scotland, Wales, the Social Services and Trade, and to Sir Robert Armstrong.

Yours sincerely

Ian Ellison

KEITH JOSEPH

(approved by the Secretary of State and signed in his absence)