FENTIMAN ROAD: DRAWING THE CONSERVATIVE FISCAL POLICY THREADS TOGETHER IN 1978

DUNCAN NEEDHAM
Trinity Hall, Cambridge

This paper draws upon previously unexplored archive material to explain the evolution of Conservative Party fiscal policy in the lead-up to the 1979 General Election. In his first Budget, Sir Geoffrey Howe fundamentally altered the balance between direct and indirect taxation, lowering the rates of income tax and increasing Value Added Tax. The broad outlines of strategy were laid down within the various policy groups set up following Mrs Thatcher's victory in the 1975 leadership election. However, the details of these fiscal policy changes were drawn out at a series of 'summits' held over the summer of 1978 at the Vauxhall home of Sir Geoffrey and Lady Howe, 71 Fentiman Road. At these summits, Shadow Cabinet members 'drew the threads together', aided by Conservative Research Department advisers such as Adam (later Sir Adam) Ridley. This paper draws upon Sir Adam Ridley's archive to shed light on a radical and long-lasting change in British economic policy.

Following Margaret Thatcher's 1975 leadership election victory, Sir Keith Joseph was charged with creating a broad network of groups to formulate policy in readiness for the next election.[1] Fiscal policy fell within three different groups: the Economic Reconstruction Group under the chairmanship of Shadow Chancellor Sir Geoffrey Howe; John Nott's Public Sector Policy Group; and David Howell's Taxation Group. Two principles guided the formulation of Conservative fiscal policy while in opposition. The first was a straightforward desire to reduce the overall burden of taxation in order to 'restore incentives'. The second was a deep-rooted preference for indirect as opposed to direct taxation. In practice this meant a shift to a higher (single) rate of Value Added Tax (VAT).[2] This two-pronged approach was very much in line with longstanding Conservative taxation policy. Anthony Barber had

[1] In all, 95 different policy groups covered such diverse areas as 'Inland Waterways' and 'the Arts', 'Progress report of policy groups', 12 December 1975, Cambridge, Churchill Archives Centre, Churchill College, (hereafter 'Churchill'), HWLL 2/4/1/1.
[2] Prior to the 1979 Budget, the standard rate of VAT was 8 per cent, with a 12.5 per cent rate applied to petrol and certain luxury goods.

reduced the basic rate of income tax by 6d (2.5p) in his first (1971) Budget before introducing VAT two years later in place of Purchase Tax. Both of these measures fulfilled manifesto commitments made ahead of the 1970 election. They were also very popular with the national party. As Howe recalls, 'pay as you spend, not pay as you earn' was a 'sure-fire applause line' at Conference.[3] This approach commanded broad assent within the three major economic policy groups. In its July 1975 interim report, the Taxation Group pointed to 'our readiness to move to a standard rate of VAT' as '(giving) us some fiscal leeway elsewhere'.[4] Indeed, such was the consensus on income tax and VAT, that the Taxation Group was able to spend most of its time looking at how taxes on capital and savings such as the Capital Transfer Tax and the Investment Income Surcharge might be reduced. As Lawson explains:

> on the tax side, in which I was also involved, rather less preparation was done, the principal difficulty was not so much identifying the course we wished to steer but securing the public expenditure savings which would enable us to embark upon it.[5]

The Economic Reconstruction Group had a wider remit, to conduct a 'more general analysis at a fairly aggregate level'.[6] This high level of generality was necessary because individual members held very different views on how the economy should be run. Howe touches upon this, referring to the 'passionate debates', often on the merits of incomes policy, and usually between Sir Keith Joseph and Jim Prior.[7] As Ridley points out, 'the importance of the Group lay in the consensus it built into its meetings rather than in papers and formal conclusions reached'.[8] The Group's conclusions were laid out in the October 1977 pamphlet *The Right Approach to the Economy*. It is testament to Howe's ability gradually to draw the group towards consensus that the pamphlet could be presented as the work of both Joseph *and* Prior.[9]

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[3] R.E.G. Howe, *Conflict of loyalty*, (London, 1994), p. 102. Howe was particularly enthusiastic about the switch to indirect taxation: 'central to our tax strategy was my determination to switch the tax burden from taxes on income, investment and enterprise to taxes on consumption and expenditure', Howe, 1994, p. 99.
[4] 'Policy group on taxation: Chairman's interim report to the Shadow Cabinet', 23 July 1975, Churchill, HWLL 2/4/1/2.
[5] N. Lawson, *The view from No. 11: memoirs of a Tory radical*, (London, 1992), p. 17.
[6] 'Programme of work', Economic Reconstruction Group (PG/10/75/14), 21 October 1975, p.2, Churchill, HWLL 2/4/1/2.
[7] Howe, 1994, pp. 100-101.
[8] Private email correspondence, 3 June 2010.
[9] The pamphlet's authors were listed as Howe, Joseph, Prior and Howell.

The *Right Approach to the Economy* announced, *inter alia*, the four main elements of Conservative tax strategy:

i) Lower personal taxation to restore work incentives.
ii) An enterprise package of measures to stimulate business growth.
iii) Stronger encouragement to personal savings and capital building on the widest possible scale.
iv) Simplification of the system.[10]

When returned the government, Ministers would proceed on four fronts:

i) We shall reduce the basic rate of income tax.
ii) We shall raise the thresholds.
iii) We shall widen the higher tax bands.
iv) We shall reduce the higher rates.[11]

Clearly, this would all come at a cost to government revenue. The authors conceded that 'it may be necessary in part to pay for cuts in income tax by higher indirect taxes' before making a virtue of necessity:

> 'given the need for revenue, VAT is an efficient tax. The Conservative Government introduced it in 1973, and we stand by it'.[12]

After an initially cool response to the pamphlet, Mrs Thatcher publicly adopted the proposals 'as her own'.[13] What remained was to 'draw all the threads together' in time for the forthcoming election which, at that stage, was expected to be in late 1978.[14] This was done at a series of 'summits' at the Vauxhall home of Sir Geoffrey and Lady Howe, 71 Fentiman Road, over the summer of 1978. At these three meetings the tax proposals that emerged from Howell's group were married up with the public expenditure cuts envisaged by Nott's group and the macroeconomic assumptions of the Economic Reconstruction Group.

The existing policy groups were primarily comprised of Shadow Ministers and backbench MPs, leavened by a handful of outside 'experts', such as the City University economist Brian Griffiths and the former union official, Sir Leonard Neal. Research Department staff had been involved in providing papers and acting as group

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[10] *The Right Approach to the Economy*, p. 24.
[11] ibid., pp. 26-7.
[12] ibid. p. 33.
[13] Howe, 1994, p. 101. Mrs Thatcher's major concerns centred on the proposal elsewhere in the pamphlet for a tripartite approach to industrial strategy based on the German notion of 'Collective Action'.
[14] ibid. p. 112.

secretaries. However, as Howe points out, ‘these Fentiman Road meetings were the settings in which our Research Department advisers played a central part in drawing all the threads together’.[15] Continuity was provided with the active participation of Economic Reconstruction Group secretary Adam Ridley and Barber’s former tax adviser, Lord Cockfield. They were joined from the Research Department by Douglas French and Christopher Mockler. Finally, from Westminster, as well as senior Shadow Cabinet Ministers Sir Keith Joseph, Patrick Jenkin and Howe himself, there were two additional frontbench Treasury spokesmen, the former tax barrister Peter Rees and the ex-journalist, Nigel Lawson.

The first Fentiman Road meeting was held on Sunday, 11 June 1978.[16] The participants had been given a comprehensive reading list, composed mainly of papers by Cockfield, a number of which he had drawn up before the April Budget. This was significant as Healey’s introduction, in April, of a new starting rate of income tax at 25 percent necessitated a substantial reworking of the calculations done by the Taxation Group. Based on Ridley’s assumption of 3.8 percent growth in GDP in 1978-79 and Cockfield’s tax calculations, there would be sufficient revenue to increase the basic tax allowance by 50 per cent, reduce the basic rate to 30 per cent and reduce the top rate from 83 per cent to 60 per cent while completely restructuring the various tax ‘bands’, all in the incoming Chancellor’s first Budget.[17] This would be funded by the increase in VAT to a standard rate of 15 percent, with further contributions coming from increased excise duties on alcohol, tobacco and fuel. The increase in the basic allowance would have two beneficial effects. It would take ‘around four or five million people’ out of income tax altogether while further reducing the effects of the ‘poverty trap’ wherein those drawing (untaxed) benefits often found it uneconomical to take up (taxed) employment because of the net reduction in their final income.[18] Reducing the basic rate of income tax to 30 per cent might only be ‘a start’ towards the ultimate objective of applying the new 25 per cent

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[15] ibid.

[16] There was an ‘all-day discussion’ on economic policy at Fentiman Road on 18 May 1975 involving Howe, Howell, Nott, Michael Niblock and Anne Bulloch. However, this meeting predated the Economic Reconstruction Group and, as Howe pointed out in his subsequent note to Mrs Thatcher, produced only ‘a modest output’ and should be considered separately. Please see: ‘Fentiman Road seminar (principles of economic policy)’, http://www.margaretthatcher.org/document/109968, last accessed 5 June 2011.

[17] ‘Record of meeting held on Sunday 11 June 1978’, Churchill, RDLY 2/1/4/1.

[18] ibid.

rate to the whole of the first tax band. However, it fulfilled a very important *political* objective. The group was very aware of the criticism that had been directed at Barber's 1971 'rich man's Budget'. As the Taxation Group pointed out in its progress report this was an ongoing problem:

> the main difficulty is that by inclination, outside pressure and even a measure of objective assessment, the group is driven to put significant emphasis on changes, particularly in capital taxation, which can be presented as 'tax cuts for the rich'.[19]

Howe reveals the ordering of priorities while showing himself to be keenly aware of the political requirement that the tax changes must be viewed as 'fair':

> the level of income tax payable by the average taxpayer had to be reduced substantially. Not just because his or her income was more highly taxed that that of most of our overseas competitors. Not just because he or she felt demotivated. But, most important of all, because it would be politically impossible to make the large cuts in top rates that were necessary without achieving some comparable reduction in the direct tax burden of the average citizen.[20]

Having rejected increases in National Insurance and commissioned further work on domestic rates, child benefits and pensioner tax credits, the meeting agreed to compromise positions on both the Investment Income Surcharge (IIS) and Capital Gains Tax (CGT). Howe and Cockfield were in favour of abolishing the IIS, Jenkin feared this would be contentious if brought in at the same time as the higher tax rate cuts. They agreed to reduce the rate and increase the threshold for both the IIS and CGT. However, amidst all the optimism, a note of caution was sounded:

> the Group inclined towards a more cautious set of economic growth assumptions, and a more ambitious target for reduction of the PSBR than (Ridley) had built into his figures. Not all of this would be available for tax reduction: there was an urgent need to reduce the PSBR as well.[21]

At the second 'summit' on 21 July, the group was even more cautious. Since the previous meeting, the London Business School had revised its growth estimate for 1978-79 down from 3.8 percent to 2.5 percent. This would push the deficit up by

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[19] 'Progress report of policy groups', Churchill, HWLL 2/4/1/1.

[20] Howe, 1994, p. 129. At Fentiman Road, Sir Keith Joseph and Lord Cockfield were particularly vocal in their view that the tax changes must be perceived by the public as 'fair'.

[21] 'Record of meeting held on Sunday 11 June 1978', Churchill, RDLY 2/1/4/1. The PSBR is the Public Sector Borrowing Requirement.

£1.5 billion (1.1 percent) providing much less for the new Chancellor to 'give away' in his first Budget.[22] The conclusion drawn from the 'very uncertain' estimates was that it was 'vitally important to achieve the maximum by way of expenditure reductions early on' since this was an essential precondition for rebuilding market confidence in UK economic management.[23] With lower growth crimping revenue, Sir Keith Joseph provided a list of 'big things which could be sold quickly'.[24] These included council houses, state-owned shares and government offices. There also appears to have been some unease about the effects on the Retail Price Index (RPI) of the large increase in VAT to 15 percent. Howe responded to a request that Ridley present an alternative scenario in which VAT was raised to just 12.5 percent by reminding the group that:

> the vital thing in our whole programme was the cutting back of Income Tax. If we became fearful of the RPI effects we might as well give up. (Ridley) reminded (the group) that one of the present Government's budgets had a projected 4.5% RPI implication. Colleagues would have to be exhorted to take an aggressive stance on Income Tax; the process of persuasion should open out in increasing circles.[25]

The increasingly uncertain economic forecasts presaged a further retreat from the confident predictions of the first meeting when the group convened for a third (and final time at Fentiman Road) on 30 July. It was now 'impossible to crystalise proposals on expenditure in detail and anything said in public would need to be directed more to general objectives and things we would like to do, rather than as commitments'.[26] There was also a practical problem with the switch from direct to indirect taxation. While raising VAT would have an immediate effect on the cost of living, the income tax cuts would take several months to feed through. The gap might have to be bridged with a 'midsummer payment' to the more vulnerable sections of society. Cockfield was also reining back from the original proposal of a 50 percent rise in the basic rate allowance. A number of scenarios were analysed with Howe favouring the 'blockbuster' approach of a 25 percent basic rate with a 25 percent increase in the allowance. The meeting was unable to reach a firm conclusion albeit 'the argument had veered towards concentration on the basic rate reduction in Year 1

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[22] 'Record of a meeting held on Friday 21 July 1978', Churchill, RDLY 2/1/4/1.
[23] ibid.
[24] ibid.
[25] ibid.
[26] 'Record of a meeting held on Sunday 30 July 1978', Churchill, RDLY, 2/1/4/1.

subject to the need to do enough on the thresholds to cope with the lift in indirect tax'.[27] However, a 'basic Fentiman proposal' had emerged.

The 'central assumption' presented in *The Tax Programme* to Mrs Thatcher in late September 1978 was as follows:

> i) An overall reduction in taxation of £1 to £2 billion.
> ii) Reductions in income tax of £5 to £5.5 billion plus up to a further billion reduction in higher tax rates and investment income surcharge making a total direct tax reduction of £6 to £6.5 billion.
> iii) This would entail increasing indirect taxation by something like £4.5 billion.[28]

In case the leader's resolve should falter on the VAT increase, the paper argued forcefully that:

> the crux of the matter, however, is the increase in VAT to 15%. This would add 3.5% to the cost of living index. An increase to 12.5% would yield only £2.1 billion which is insufficient for our purpose. If the increase is not made on this occasion, it never will be made and we will have lost for good any opportunity of seriously redressing the balance between direct and indirect taxation.[29]

Mrs Thatcher gave permission for further work to proceed on the basis of the Fentiman proposals at the end of September 1978.[30] However, there is uncertainty over exactly what this meant. Howe suggests that the move to 15 per cent 'had always looked the most plausible of the options set out in our pre-election planning documents' and that Mrs Thatcher had 'long accepted our central tax theme: the switch from income to expenditure taxes'.[31] However, 'when the time came to move from the level of high principle and evangelism to practical politics', she wavered.[32] By her own account, it took a series of meetings ahead of the 1979 Budget before Howe was able to demonstrate that the entire package would require a unified VAT rate of 15 per cent.[33] This is borne out in the minutes of the pre-Budget meetings:

> As for indirect taxes, she was extremely perturbed at the prospect of having to increase VAT to 15%. This would mean a sudden jump in the RPI of at least 3%. The result could be catastrophic for the next pay round, and she would

[27] ibid. In the event, the 'central assumption' contained two scenarios i) allowances up 50% and the basic rate down to 30% and ii) allowances up 25% and the basic rate down to 25%.
[28] 'The tax programme', (C/TAX 100), 29 September 1978, Churchill, RDLY 2/1/4/5.
[29] ibid.
[30] 'Background to the tax meeting, 5th February 1979', Churchill, RDLY 2/1/4/1.
[31] Howe, 1994, p. 130.
[32] ibid.
[33] M.H. Thatcher, *The Downing Street years*, (London, 1993)

> far rather find the necessary savings for the direct cuts with a smaller increase in indirect taxes and larger public expenditure cuts'.[34]

Be that as it may, Howe stuck doggedly to the 'central assumption' of the Fentiman proposals, securing Mrs Thatcher's reluctant agreement for the tax package on 24 May 1979.[35]

The Tax Programme anticipated that the central assumptions might have to be modified in the light of changing economic circumstances. By 1st February 1979, the Research Department was reporting that the Winter of Discontent ("the public sector wage revolt etc") had added £2-3 billion to the PSBR in 1979-80.[36] Given the critical importance attached to reducing the deficit, this meant that the £1-2 billion earmarked for tax cuts would now have to be diverted to reducing the PSBR, unless they could find further cuts. Another shortlist was drawn up on 5th February which included delaying government contracts, reducing the central contingency reserve and lower nationalised industry borrowing.[37] Despite these proposals, Howe reluctantly concluded that they would be unable to reduce the PSBR from the £8.5 billion recently announced by Healey for 1978-79 to an intended £6 - 6.5 billion in the first year of the new Conservative administration.[38] Another fundamental problem was the impact of the election date on the switch from direct to indirect taxation. Changes in direct tax rates would be backdated to the start of the financial year i.e. April 1979. The increase in VAT could only take effect from the day of the Budget. However, the Spring Bank holiday and the European elections meant that the earliest practical date for a Budget was 12 June. This would create a significant funding gap for the year as a whole. By 10 April, Cockfield was arguing for a cut in the basic rate to 28 percent in the first year, with the remaining 3 percent drop delayed until the 1980 Budget. Any major uplift in the allowances would also have to wait until the following Budget.[39]

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[34] 'Note for the record', 16 May 1979, London, The National Archives (hereafter 'TNA'), PREM 19/29.

[35] 'Lankester to Battishill', 24 May 1979, TNA, PREM 19/29.

[36] 'Background to the tax meeting, 5th February 1979', Churchill, RDLY 2/1/4/1.

[37] 'Record of a meeting held on 5th February 1979', Churchill, RDLY 2/1/4/1.

[38] ibid. In the event, Howe announced a forecast PSBR of £8.5 billion for 1979-80 in the 1979 Budget.

[39] Consideration of increased allowances was much complicated by the 'Rooker-Wise' amendment to the 1977 Finance Act which automatically increased the allowances by the rate of inflation, unless the Chancellor was able to convince Parliament of the merits of doing otherwise.

After the election victory of May 1979, the new Treasury team under Howe was able to harness the vastly greater resources of Great George Street and the Bank of England in the preparation of its first Budget. The highest rate of income tax was lowered from 83 to 60 percent. The basic rate was lowered to 30 percent with the promise that 'our long-term aim should surely be to reduce the basic rate of income tax to no more than 25 percent'.[40] The single persons allowance was raised by £180 (18 percent). This only just covered the indexation required by the 1977 Finance Act and the effect of removing the initial 25 percent introduced in the previous Budget. VAT was raised to a single rate of 15 percent and the PSBR for the forthcoming financial year was estimated at £8.5 billion, fractionally down on the outturn for 1978-79 although some way ahead of the £6 - 6.5 billion hoped for at the early Fentiman meetings.[41] However, while the package might have fallen short of the aspirations of the first Fentiman Road summit, it did represent a sea-change in UK fiscal policy. Howe refers to 'the fairly haphazard process of Opposition policy making'.[42] Yet through his own determination to draw the Economic Reconstruction Group to the consensus of *The Right Approach to the Economy* and the doggedness of the various Research Department staff, he was able, within 'forty days and forty nights' of the election to introduce one of the most radical Budgets in post-war British history

[40] < http://hansard.millbanksystems.com/commons/1979/jun/12/income-tax>, last accessed 25 January 2011. In the event, it took nine years and a different Chancellor, Nigel Lawson, before this particular aspiration was realised.
[41] The 1979 pre-Budget forecast estimated a £9.227 billion PSBR for financial year 1978-79. The outturn for 1979-80 was £9.789 billion. Sources: Hansard and *Financial Statistics*.
[42] Howe, 1994, p. 98.