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Secretary of State for Industry

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R 4/7

Dear John.

GOVERNMENT STRATEGY

In my minute of 25 June to the Prime Minister, I said that I should be letting you have some ideas set out in more detail to help our recovery programme. These I now attach in the form of two papers, the first on the acceleration of enterprise and the second on the acceleration of de-manning.

Both papers involve many difficult issues, and officials have not been able to examine them in any depth either within the Department or more widely with experts in other Departments. But I believe that it is important for us to draw together as many realistic ideas as we can so that we can decide which ones we want officials to pursue positively and energetically.

I am sending a copy of this minute to the Prime Minister, the Chancellor of the Exchequer and the Secretaries of State for Trade, Energy, Employment and the Environment, the Lord President, Sir John Hunt, and Sir Kenneth Berrill.

Yours.

Keith.

ACCELERATION OF ENTERPRISE

Note by the Secretary of State for Industry

This note puts forward five proposals for measures to help accelerate enterprise. I recognise that they involve difficult issues, but I think that it should be possible to overcome these if the will is there. I would hope that these proposals might be supplemented later by a comprehensive package of measures to help small firms.

KJ

29 June 1979

TAX HOLIDAYS FOR SMALL FIRMS

Under the existing system of taxation of business profits, a new small firm which invests in capital equipment and holds growing quantities of stock may be able to limit the amount of tax it pays in the early years to very low levels. However, this system, while it has been very helpful for small manufacturing companies and has attracted some inward investment is less attractive for many non manufacturing companies. Moreover, many firms, having grown quickly in their first few years, enter a period of consolidation in which they attempt to secure financial stability by retaining profits for the next stage of growth; such firms enter a period under the present tax system where they have to pay tax at that stage.

2. There is a case, which is worth careful examination, for a more overt incentive to new small firms in the form of tax exemption or business profits for (say) the first ten years - a "tax holiday". This would be readily understood by potential entrepreneurs, would remove uncertainty about the incidence of tax liability, and would extend to non manufacturing firms the advantages already conferred by investment allowances and stock relief. It would also be seen as firm evidence of the Government's commitment to creating conditions within which small firms can flourish.

3. Such a proposal would need to be looked at in the EEC context, but it is not felt that this would obstruct the proposal. There would be legislative and administrative problems to be overcome (including, for example, how to ensure that the "holiday" applied only to genuinely new business and not old ones re-incorporated to take advantage of the tax position). Moreover, it might be necessary to limit the relief to incorporated businesses. On the other hand, complete exemption from tax liability for a period of years could reduce the cost of tax administration in the small firm field to some extent.

"LOI MONORY" FOR THE UK?

Over recent years, UK financial markets have become increasingly "institutionalised" for a variety of reasons: one reason has been the series of tax advantages in routing savings through the savings institutions rather than into direct personal investment on the Stock Exchange. Because of the tendency of large institutions to concentrate their investments on a small range of major firms, this has led to a polarisation of the stock market between the 200 or so largest firms in which the institutions regularly invest, and the vastly larger number of smaller firms in which institutional investment is less frequent, and whose shares therefore are relatively lower priced so that the cost of capital to them is higher than to the large firms.

2. For this and for more general reasons, there is a strong case for seeking to encourage personal investment direct rather than through the institutions. There are compelling reasons against doing this by the withdrawal of existing tax concessions for institutional investment (eg for pensions) in particular the disruption to capital markets which this would cause. An alternative approach would be to extend similar advantages to personal investment which might not merely make it more attractive to invest direct where the individual has an option to do so but might also increase the actual volume of investment in company securities.

3. A year or two ago, the French Government introduced a tax concession to small investors (the Loi Monory) under which investors will pay no income tax on income devoted to new net purchases of French shares up to a limit of fr5,000 (£600) per household, with extra allowances in respect of children. It was hoped that, for a revenue loss of fr 1.2 billion, this measure could lead to the availability of an additional £5 billion per annum for investment in French industry. The immediate effect on the French Stock Exchange was substantial, though it is believed that a substantial part of that effect led to an increase in the price of existing shares rather than an increase in new issues. However, the scope for such a step in the UK is well worth examining in detail, taking account of the likely take-up of such a relief, its cost in revenue foregone, and the additional funds which might be made available for industrial investment. This initiative should apply to all incorporated businesses, whether quoted or unquoted, although small businesses, for which provision is made in Annex III, would not be included.

TAX RELIEF FOR DIRECT INVESTMENT IN SMALL FIRMS

It is generally recognised that the private investor has declined in importance as a source of finance for small firms. The reasons are complex, but they include the bias in the tax system in favour of routing investment through savings institutions. The recent budget measures will increase the attractions of investment generally, but a strong case still exists for introducing specific tax advantages for individuals investing in the equity of small firms.

2. There are various possible approaches to this. The most direct, and the most likely to have a substantial effect, would be to allow an individual to deduct from his taxable income the amount (subject perhaps to a specified limit) of any new investment in the share capital of a small company (which would have to be defined). Such a measure could have a major effect in encouraging the subscription of new equity in small firms, not only by existing proprietors but by other individuals.

3. Another, less direct, approach would be to allow realised losses from individuals' investment in small firms to be offset against personal income tax liability (instead of against capital gains tax) and to charge realised gains from small firms investment at a lower capital gains tax rate.

4. Both these approaches would entail considerable administrative difficulties and opportunity for avoidance. However, the potential benefits particularly of the first approach could outweigh these disadvantages.

INVESTMENT IN SMALL FIRMS: AN EQUITY GUARANTEE SCHEMES

The decline of the individual investor and the rise of the savings institution havemade it increasingly hard for small firms to obtain external equity finance. Nevertheless, one of the main objectives in the small firms field must be to increase the supply of risk capital to small innovative firms, preferably in the form of equity. So far as individuals are concerned, this is best approached by tax changes, including specific incentives to invest in small firms. However, for structural market reasons, the institutions are now overwhelmingly the main source of investment finance in the economy, and looking for profitable investment outlets. They are at present inhibited from playing a larger part in the small firms field for two reasons: the relatively high risk of such investment, and the high cost of portfolio management of such investment for an institution handling extremely large sums of money.

2. With the economy needing an expansion of the small firms sector as a source of enterprise, innovation and employment, there is an argument therefore that the state would be justified in providing modest incentives to the institutions to play a bigger part in small firms' finance. Such incentives would be, in effect, to offset existing distortions in market mechanisms which militate against the small firm. Since tax measures are unlikely to help in the institutional field, a possible approach would be an equity guarantee scheme under which the Government would accept a proportion of the risk, possibly linked with a small subsidy for administrative costs. Such a system would have negligible public expenditure costs, at least initially (it would operate by guarantee rather than direct participation); and it would preserve the plurality of decision making and avoid direct Government involvement in investment decisions. It is for consideration whether a small premium might be charged to cover all or part of the cost of meeting guarantees.

ACCELERATION OF DEMANNING IN INDUSTRY

1. This note discusses how the necessary process of demanning in industry could be accelerated.

2. A definition of 'overmanning' and an analysis of its causes is necessary. The concept is not simple, and there is no single solution.

3. It is possible to define overmanning as 'inefficiency in the use of labour'. The concept comprehends:

i) reluctance of management to shed labour when demand falls from its peak;

ii) restrictive labour practices;

but the concept is closely allied with other factors relating to low productivity:

iii) low rates of output (arising from factors as slow workpace, poor maintenance, poor quality control), shortages of materials because of external labour disputes or inefficient internal management, and poor management control;

iv) under-investment in machinery and adaptation of new techniques.

RELUCTANCE TO SHED LABOUR

4. Employers' reluctance to shed surplus labour appears

/ to have

to have increased in recent years following the 1973/74 oil price crisis. The relationship between employment levels and GDP has certainly widened. When GDP fell in 1974, the combination of an increasing labour force would, on past modest productivity trends, have increased unemployment to over 2 million by 1977. In fact it peaked at 'only' 1.4 million because productivity was allowed to fall - at varying speeds in different industries - as the price for retaining labour. A subsequent pick up in GDP had comparatively little effect on employment / unemployment levels because there was more than enough slack available to take it up. There are grounds for believing that this reluctance to shed labour can mainly be attributed to political pressures to preserve jobs, particularly in the public sector.

RESTRICTIVE LABOUR PRACTICES

5. The most relevant factor affecting overmanning (as distinct from other productivity factors) is the demarcation of jobs. This appears to be an underlying weakness in British organisation of industry, at manager level as well as shop floor level. The TUC claim that the shop floor problem, which they recognise, is being brought under control. We cannot readily measure such alleged improvements, but the CPRS report in 1975 on 'The Future of the British Car Industry' gives a snapshot of the problem in that sector (which will not be typical of all sectors). Comparing a Mini plant in Britain with one in Belgium it showed (as a particularly bad example) higher British manning levels in plant maintenance of between 69% and 78%. This was partly attributed to trade demarcation: in Belgium one mechanical and one electrical would repair a multiweld machine, in Britain it required an electrician, a jig fitter, a pipe fitter, a mechanical fitter, a tool man and a repair man to do the same job.

/ LOW PRODUCTIVITY

LOW PRODUCTIVITY

6. The same CPRS report makes it clear that overmanning (in the strict use of the term) is not the sole reason for low productivity. Even given competitive manning levels (on paper) the British output was less than half its continental counterpart, on account of the slow work pace. Additionally, British car output suffered because it then had twice the incidence of quality faults; and, despite the 50-70% additional manning required on maintenance work because of the demarcation problem, twice the number of production hours were lost in Britain than the continent because of plant breakdowns. Low productivity is also attributed to factors not directly connected with manning. A survey of a broad range of industries indicated an even higher differential in productivity between Britain and the USA than between Britain and West Germany and France respectively, partly due to the higher scale of production in the USA.

SOLUTIONS

7. There is no single solution to the interrelated problem of overmanning and under-productivity. The range of Government policies aimed at increasing incentives should be allowed to work their way through, so that the market will suck unproductive labour into productive occupations.

8. The Government's aim is to dismantle the obstacles to the market. Any proposal to sort out the specific overmanning problem by an across-the-board market distortion (e.g. by increasing artificially the cost of labour) would be contrary to that broad objective.

9. The analysis in paragraphs 4 - 6 above suggests that:

i) a public presentation of the realities of the market would at least reverse the political pressures exerted by the previous Government in favour of preserving jobs irrespective of demand. The difficulties of such a presentation should not be underrated, bearing in mind the immediate economic prospects. Against that background Ministers would need plausibly to argue on the one hand that excessive wage settlement would mean lost jobs, and at the same time that increased productivity would not mean the same thing. Both management and unions will be reluctant to come out from their defensive attitude in a period of low demand. Yet the message needs to be conveyed that the maintenance of manning at levels not even justified by peak demand will lessen a company's competitiveness possibly beyond the point of recovery. Ministers should give point to the lesson by giving moral support to management during disputes, and by making it clear that the cost of an unjustified pay settlement will not be picked up by the taxpayer or the ratepayer.

ii) progress must be made on eliminating restrictive labour practices, but again the time is unpropitious. Such practices thrive in conditions of job insecurity and there are cultural attitudes to be overcome. For example in Sweden employers have a clear prerogative for establishing manning levels, whereas in the UK it is a matter for negotiation (and therefore compromise) between employee and employer. A number of ideas have been put forward:

/ a)

a) a coordinated campaign to improve the public awareness of the cost of restrictive labour practices;

b) persuasion of the AUEW to abandon apprenticeship as the sole route for union membership with craft status, e.g. by acceptance of certification;

c) encourage discussion at plant level between employers and unions of problems of 'job utilization, resistance to dilutee labour, demarcation etc.

d) finding an independent body to report on restrictive labour practices and their economic effect.

10. Beyond these measures, we do not believe that there is much room for direct Government intervention. But the following ideas deserve consideration:

i) in the public sector, the process of demanning in the nationalised industries is closely linked with the process of instilling greater efficiency by means of cash limits, financial targets and performance targets, currently under consideration by Ministers. Excess labour should be shed by such means. There may not be much scope for creating new statutory redundancy schemes (e.g. steel, shipbuilding, coal already have them) but, subject to overriding PSBR considerations, Ministers could encourage the Corporations to give greater emphasis, if it is needed, to redundancies, e.g. by extending 'the step by step' approach adopted by British Steel in negotiating redundancy payments as each plant closes, and topping up as the situation demands.

/ ii)

ii) in the private sector, it could be counterproductive to assist demanning by any <u>wholesale</u> changes to redundancy payments, even on a temporary basis. First, some firms would be unable to afford a higher statutory level and secondly too high a level of redundancy payments (which are based on length of service) would encourage the best skills to leave and put the emphasis in industry on getting <u>out</u> of work and not <u>on</u> with it. But there may be scope for adjusting redundancy payments on a selective basis. At present, industry recoups 41% of its statutory payments from a Redundancy Fund held by the Government. One possibility relates to the defunct Employment Development Scheme, about which the Secretary of State has written to Mr Prior. If that scheme, or something like it, were resurrected, it could include a provision to increase the level of rebate to firms which satisfied the Government that they were undertaking structural or other changes which would increase productivity. If the rebate differential were sufficiently attractive, firms could thereby be encouraged to 'top up' redundancy payments beyond the statutory level, providing an incentive for union acceptance. An increase in redundancy rebate in approved schemes leading to higher productivity could be seen as a useful means of discarding without pain that proportion of the workforce that would be redundant after the restructuring has taken place. The skilled workers should be encouraged to remain by the prospect of stretching differentials made possible by the productivity scheme.

IC Division
29 June 1979