CONFIDENTIAL

SECRETARY OF STATE FOR THE ENVIRONMENT

Mr Duguid
Mr Walters
Mr Wolfson

2 MARSHAM STREET
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My ref:

Your ref:

16 February 1981

Dear Geoffrey

1981 BUDGET

I have thought further about the letters you have received from Keith Joseph. Jim has reinforced for me even more strongly how critical it is that your forthcoming Budget should be - and be seen to be - designed to advance our long-term objective of a vigorously growing private sector, generating new investment and jobs that have a commercial future. And yet it must not conflict with the need to keep up the attack on inflation and on easy money. But all our gains on that crucial front will be lost if by the time of the election it cannot be seen that the positive growth policies have been working.

Our industrial base is desperately weak. Not only is this an economic problem but far more serious are the social and political consequences. Here down in the South we are partly shielded from the grim truth - although even here in Inner London and still more in the Black Country, the evidence is there in decaying manufacturing, its associated infrastructure and the disappearing jobs.

After 2 years, you can rightly claim that our hard message about the link between inflation and monetary laxness is getting home. Inflation is falling and wage settlements in private industry and public service are becoming more responsible. But not surprisingly the link between that and rebuilding our industrial base is neither understood nor credible at a time when the main indicator of industrial performance - the output of manufacturing industry - has fallen nearly 10% in one year - and the profits to invest in new growth have evaporated.

As we pull out of the present recession, profits will recover, probably in 1982. But the recovery of investment will be slower - on past performance we cannot expect any significant upsurge in manufacturing investment much before 1983, for investment will only be widely undertaken (on any past analysis of which I am aware) if and after prospects for sales and profits are good. Is it right that we should wait that long? Is there in fact any need to do so?

The public is rightly concerned about the annual £4 billion tax receipts from North Sea Oil. I share the general view that we ought to have been using them to invest in the future. But the truth is that they have been used to shield private consumption and the public services from economic reality. Between 1977 and 1979 our predecessors' decisions allowed post-tax incomes to rise by 14% while output rose by less than 5% - as well as leaving us with plans for larger public programmes and the Clegg time-bomb. Somehow we must reverse these priorities - and start using our North Sea revenue for rebuilding our industrial base.

I have no doubts about public expenditure. It is still much more than we can afford. But what distrubs me most is the way the distribution of our cuts has hurt the private sector so disproportionately. We all know this. We know the damage that is taking place and I believe we have got to find a means of changing the balance now. It is not sufficient to believe that the balance will be restored simply by us holding down public expenditure as the recovery proceeds. That is too slow.

Capital expenditure - in spite of our condemnation of our predecessors for just that fault - has been cut much harder than current - with especial damage to the private construction industry. And even in current expenditure, preference has in practice gone to preserving jobs and real pay levels in the service with purchases from outside suffering.

I fully realise that you have virtually no scope for general relaxation (especially as that could, by keeping interest rates and the exchange rate up, damage industry even more). But any switch to help industry and investment can come only by curbing consumption, public and private. The increase in employees' national insurance contributions has pointed the way. But I would urge you now to go further to achieve the positive response from industry whose absence could so easily undermine our strategy for beating inflation. I believe that we should ask those in work to contribute more by suspending entirely for one year (at a revenue gain of over £2 billion) the Rooker-Wise provisions for the indexation of tax allowances. I would also look wider for similar contributions from other inflation-protected groups not at the bottom of the income scale. There will be protest. But, if the burden is spread fairly from top to bottom, and is seen as a genuine attempt to shift resources to the underlying problems of rebuilding our industry base, I believe that there is very widespread support available both from a political as well as an economic standpoint.

I do not believe we should use such money to give across-the-board budgetary relief to industry and commerce's current costs (whether by reducing the NIS or non-domestic rates). The relief you can bring by creating the monetary conditions in which interest rates can fall is more valuable. Such unselective help will not capture the imagination of the public as an adequate response to industry's recovery needs nor offer reason enough to forego their personal living standards. Nor would it stimulate industry to whom it would be very much a case of too little too late. But certainly a determined programme of incentives to the successful companies could be devised and existing programmes with the right ingredients expanded.

It is much more a question for Keith than me to advise how the money could be spent to secure increasing investment. Within my own sphere of responsibilities I can see several areas where added investment, some in industry, some in the infrastructure, would help to create the climate for successful new business especially in the industrial and economically deprived areas where the inherited environment is such a drag on the spirit of enterprise.

Much of the industrial area of Britain looks derelict. At the heart is the despoiled land which is not going to be cleared up and used because it is cheaper to use new unspoiled land. We should act to remove this negative value of this derelict land on an increased scale. It is right in every way and particularly as it is job creating in areas of high unemployment.

We could act to restore and convert declining industrial buildings into premises for new small businesses on a large scale.

Schemes exist on the continent to provide grants for companies improving their effluent discharge. The companies get modern equipment, the community gets cleaner air, less noise or fresher water.

We have a range of ideas for cheap starter homes either fully owned or partly owned that could be advanced, where for each pound of public expenditure 3 or 4 times as much private finance could be forthcoming with direct benefit not only to the construction industry, but to both the building materials and home fitments and furnishings industries also.

I am not aiming to press my Departmental ideas at the expense of other colleagues. They too will have good candidates for consideration once one has decided that a drive of this kind will take priority over more regular types of public expenditure and that we will not flinch from the sacrifices needed to provide the funds without resorting to extra public borrowing. Presentationally, the sort of programmes you could offer would be most exciting - and could galvanise the private sector into action. And you would have the political initiative back firmly in our hands. Is it worth considering?

I have mentioned to you the next step that I think follows from what I have said. Jim makes it clear that we are facing the prospect of sustained unemployment of 2½ to 3 million. I know what your personal attitude will be to this. And just as these appalling figures are emerging we shall be anguishing over the cash limits for the next pay round.

May I ask you to consider a package that deals with the central set of problems we face? I set it out only in its most basic form. In essence you should present for the next pay round a challenge incorporating the items I have outlined above. You set a near nil pay factor for cash limits. You say that for the next year extra North Sea Oil revenue will also be set aside for investing in the future. And you put on the table investment programmes, some private, some public, that you would be prepared to back in return for such a manifestation of national sanity. It would not mean no wage increases - but only increases that genuinely arose from efficiency and productivity. We all know they are available if the will is there.

I am copying this as before.

Yours ever

Michael

MICHAEL HESELTINE

Rt Hon Sir Geoffrey Howe MP

Econ Pol

PRIME MINISTER

Next Tuesday's Cabinet

Mr. Whitelaw and Mr. Edwards will be absent from Cabinet. Lord Carrington will be back.

Attached is a letter from Mr. Heseltine to the Chancellor giving his views on the Budget. He suggests we should do the maximum for industry by not raising the tax allowances at all and thus bringing down the PSBR and reducing interest rates.

N.P.G. Mitchell
Duty Clerk
(For TPL)

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17 February 1981