2 MARSHAM STREET
LONDON SW1P 3EB

My ref:

Your ref:

25 February 1982

Mr Culpin
PPS FST EST
MST(C) MST(L)
Sir D Wass
Sir A Rawlinson
Mr Ryrie
Mr Middleton
Mr Bassett
Mr Wilding
Mr Battishill
Mr Kemp
Mr Kitcatt
Mr Mountfield
Mr Kelly
MH Case
Mr Griffiths

Econ Pol
Budget

Dear Leon

NATIONAL INSURANCE SURCHARGE

I was concerned to see from your letter of 16 February that you and Geoffrey Howe are still considering a reduction in the National Insurance Surcharge. As you know, I am strongly opposed to what I believe would be an indiscriminate tax reduction. I will not repeat the arguments, with which you are familiar.

However, I have gone fully into the implications for local authorities. First, the examination illustrates the way in which the incidence of the surcharge is widely spread over a large number of employers, with a relatively small effect on any one of them. I assume that you are proposing an offsetting adjustment not only in the cash provision for local government but also in that for similar public sector non-trading bodies such as the National Health Service.

I do not know, of course, the scale of the reduction which you have in mind. It would technically be possible to amend the rate support grant settlement as you propose, but for the following reasons I would be most reluctant to do so. The total cost of the surcharge for local authorities in England is about £450 million. I imagine that you envisage a reduction of only some part of this. In the context of the £20 billion of relevant expenditure allowed for in the settlement, the prospective reduction may be quite small. We would have to change relevant expenditure, aggregate Exchequer Grant, specific grants, individual GRE's, and individual block grant entitlements, and lay a Supplementary Report before Parliament. Moreover I think it is impossible to achieve your proper proposal that no authority should be better or worse off as a result of this change. While this should be possible as a whole, there is no way in which we can ensure it for individual authorities. To make even a small adjustment would lay us open to the challenge that we have once again changed the rules after the game has started.

I share your concern for the PSBR. It would however be wrong to assume that authorities would necessarily spend all of the extra cash accruing to them from a reduction in the surcharge if it were not clawed back through a reduction in grant. In so far as the cash is not spent, external borrowing by local authorities would be reduced, thus dampening the upward effect on PSBR of the reduction in the surcharge.

In normal circumstances, we now expect local authorities to take the rough with the smooth in terms of RSG and cash limit assumptions. With cash limit factors over the years underestimating actual inflation,

they have taken much of the rough. This is an occasion when they could justifiably argue that they should benefit from one of the rare changes in their favour. Even so, the benefit from a small reduction in the surcharge is unlikely to compensate for the amount by which inflation exceeds the pay and price assumptions on which the settlement was based. If by allowing local authorities to retain the benefit of any reduction on the surcharge we can reduce the aggregate overspend it will have proved a worthwhile concession.

Nor am I convinced that your proposal is consistent with the principles of cash planning. We have determined a cash provision for local authorities in aggregate and individually. We have said that if pay and prices diverge from our assumptions, local authorities must bear the consequences. The surcharge is a cost of manpower, and to validate a change in it would implay that the cash provision was made up of 2 components, volume and price. This might have been an acceptable procedure last year - but not in a cash planning regime.

My conclusion, therefore, has to be that your proposal would create very significant problems and should not be proceeded with.

I am sending copies of this letter to George Younger, Nicholas Edwards and Jim Prior.

MICHAEL HESELTINE

Rt Hon Leon Brittan QC MP