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Qa 05796

To: PRIME MINISTER

27 January 1982

From: J R IBBS

Economic Strategy - C(82)1

1. The second half of the Chancellor's paper invites views on where a possible tax cut might best be directed.
2. In my view the economic arguments are strongly in favour of a cut in National Insurance Surcharge (NIS). Annex 3 reminds us that the average real rate of return for all non-North Sea companies, let alone manufacturing, has come down to an appallingly low level (Table 4), while the tax burden has not fallen (Table 5). If they are to win their share of expanding markets companies will have to increase investment in new products and processes. Before they can expand investment they need a recovery in their profitability, and some reassurance to stimulate their confidence in future prospects. A cut in NIS would reduce the tax burden on companies and directly help their profits. Without better profits and more investment in the UK, an undue proportion of greater demand in home and overseas markets will be met by our competitors and will not help UK output or employment. On the other hand experience suggests that cuts in personal taxation may have limited helpful effect because of an increase in demand for imports.
3. The Chancellor refers to a risk of leakage into wages. I accept that there is some risk. But hard pressed companies themselves know all too well how necessary it is to use any profit improvement on investment to keep up with their competitors. Increasingly they are getting this message across to their workforce. There is obviously a timing point here. Fear of leakage to wages cannot be allowed indefinitely to restrict recovery of profits; this would ensure continued industrial decline.
4. There is a separate and equally strong case for cutting NIS, namely as an aid to employment. The immediate cause of unemployment is that companies cannot afford the costs of employing more people or are



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uncompetitive because of employment costs. NIS is part of these costs and hence any cut (like a cut in real wages) will help to create more jobs. In this context because a cut in NIS would also help service industries it would be more helpful than a change limited to the manufacturing sector.

5. I am sending a copy of this minute to Sir Robert Armstrong only.