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Telephone 01-379 7400
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From
Sir Campbell Fraser
President

(2)

CBI CONFEDERATION OF BRITISH INDUSTRY

Prime ~~Minister~~

They want a £9 billion PSBR, and ~~additional~~ a £2½b ~~bn~~ fiscal adjustment - including abolition of NIS, lower business rates, and nothing more than indexation of personal allowances. MLS 25/1

24 January 1983

Dear Prime Minister,

I have today sent to the Chancellor of the Exchequer a copy of the CBI's Budget Representations which are to be published on 26 January, with copies to the members of the Cabinet.

I am conscious of the many proposals that the Chancellor receives at this time, and of the need to weigh many factors in the balance before conclusions are reached. The CBI proposals have the unanimous approval of its Council in the belief that they not only meet the needs of business but would be helpful to the nation as a whole. I commend them to you.

Yours sincerely,
Campbell Fraser

The Rt. Hon. Margaret Thatcher, MP,
Prime Minister,
10 Downing Street,
London, SW 1.

INSTITUTE OF DIRECTORS WITH COMPLIMENTS

Mr Scholar

R20/1

Director General
Walter Goldsmith

We thought that you might be interested to see the Institute's 1983 Budget Submission to the Chancellor of the Exchequer.

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Head of Policy Unit

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INSTITUTE OF DIRECTORS

BUSINESS RECOVERY THROUGH TAX CUTS FOR CUSTOMERS

JANUARY 1983

BUSINESS RECOVERY
THROUGH
TAX CUTS
FOR
CUSTOMERS

Submission to the Chancellor of the Exchequer
for the 1983 Budget and Finance Bill

CONTENTS

INSTITUTE OF DIRECTORS
116 Pall Mall
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INSTITUTE OF DIRECTORS

1983 BUDGET REPRESENTATIONS - SUMMARY OF PROPOSALS

Paragraphs	Item	Proposal	Cost (£M) (See Note) 1983-84	Full Year	Reasons
3-5	The economy	1. Do not reflate (ie keep to Medium-Term Financial Strategy & PSBR of £8.5b)			1. Keep interest rates down 2. Keep inflation falling 3. Steady sterling
7-12, 18		2. Use scope within MTFS for £2b tax cuts. Fiscal adjustment of £2b assumed in IOD package.			Aid business recovery
11, 49-52	Creating jobs	Promote self-employment by: 1. Extension of enterprise allowances	NM	NM	1. Success of pilot project 2. Ease transition to self-employment 3. Harness black economy energies
		2. £5,000 tax allowance incentive for new small businesses	NM	NM	1. Ease transition to self-employment 2. Harness black economy energies
		3. Suspension of Class 4 National Insurance	Nil	240	Reduce tax on self-employment
55	Freeports	Establish	NM	NM	Improve Britain's world trade position
13-15	Government spending	1. No let-up in retrenchment even where underspending	Saving	Saving	Continue transfer of resources to private sector
		2. Carry through privatisation program, including financing of capital projects	Saving	Saving	

Paragraphs	Item	Proposal	Cost (£M) 1983-84	Full Year	Reasons
16-17	Local authority rates	1. Statutory right to tender	Saving	Saving	1. Opportunities for local business 2. Reduce rates burden
		2. Abolish GLC metropolitan counties	Saving	Saving	1. Reduce rates burden 2. Eliminate wasteful duplication
19-24, 27	Income tax thresholds	Raise allowances and thresholds 6½% more than inflation	900	1,300	1. Ease poverty trap 2. Increase consumer spending to aid business
19-24,28-29	Income tax rates	Reduce basic & higher rates by 1p at least	905	1,005	1. Manifesto commitment 2. Increase incentives 3. Increase consumer spending to aid business 4. Taxpayer morale 5. Reduce pressure on wage awards 6. Directly help companies incurring unrecoverable ACT on dividends
29-32	Investment income surcharge	Abolish	15	240	1. Cost-effective stimulus to saving & investment 2. Investment income now more at risk than employment income
57	Mortgage interest relief	Raise limit above £25,000	*	*	1. Stimulate home buying 2. Help construction industry 3. Boost consumer spending

Paragraphs	Item	Proposal	Cost (£M) 1983-84	Cost (£M) Full Year	Reasons
58	Stock options	Tax as capital gains not as income	NM	NM	Incentive for business leadership
19-24,29	National Insurance surcharge	Further reduce in longer-term only	No change	No change	1. Limited results from significant cuts already made 2. Income tax cuts more cost-effective as aid to business 3. Fears of import surge largely unfounded
29,33-35	Capital transfer tax	Increase business & agriculture reliefs to 100%	25	100	1. Capital taxes promote one-generation high-spending society 2. Capital taxes are counter-productive in reducing inequality 3. Reduce burden on family businesses 4. Complement start-up incentives 5. CTT cuts cheap by comparison with industrial or employment subsidies
		Reduce rates (top rate by 10%)	25		
36-40	Capital gains tax	Improve indexation rules	Nil	?200?	
		Cut off after 7 years	Nil		
		Reduce rate to 25%	Nil		
26,41-44	Corporation tax	Reduce rate to 50%	130	250	1. Help companies paying mainstream corporation tax 2. Encourage investment
		Improve marginal relief**	35	75	Encourage small companies to expand
		Liberalise use of tax losses	NM	*	1. Help tax-exhausted co's 2. Stimulate surge of investment
		Remove 6-year cut off of stock relief	Nil	*	

Paragraphs	Item	Proposal	Cost (£M) 1983-84	Full Year	Reasons
53	Capital allowances	Extend to new commercial building	NM	See reason 4	1. Help construction industry 2. Reduce anomaly disproportionately harming service industry 3. All business expenditure should be allowable 4. Full-year cost not reached for very long time
54	Value added tax	1. Remove zero-rating anomaly between new buildings and repairs**	*	*	Help construction industry
16		2. Same treatment for private contractors as for public authorities providing same service	*	*	Remove discrimination against private sector
59-60	Directors and other in multiple employment	1. Remove anomalies on travel expenses and National insurance	NM	NM	Encourage appointment of more non-executive directors
		2. Allow Schedule D directors to join superannuation schemes	NM	NM	

Note:

1. In addition to the above costs there would be a net cost of £300M from indexing tax thresholds and excise duties for inflation on the assumptions in the Chancellor's autumn statement.

2. For more detailed explanation of the costing of the IOD proposals, see Appendix to the submission.

3. NM = Not material
   *= Insufficient information on which to base an estimate
   ** = only if more than £2b fiscal adjustment available (Appendix paragraph 17)

4. The costs stated relate to each measure taken separately. The actual first round cost of the package will be lower to the extent that, for instance, tax relief from increased allowances and from reduced rates overlap. The second round effects cannot reasonably be estimated, but it is reasonable to suppose that the stimulus to the economy would result in higher incomes and spending and therefore higher tax revenues, and would reduce spending on benefits for the unemployed. Again this reduces the real cost of the IOD package.

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Director-General
Sir Terence Beckett CBE

Secretary
Denis Jackson

CBI CONFEDERATION OF BRITISH INDUSTRY

26 January 1983

F E R Butler Esq
Prime Minister's Office
10 Downing Street
London SW1

Dear Robin,

I enclose a copy of the CBI's Budget Representations to the Chancellor which have been approved by CBI Council.

Yours ever,

John

J T Caff
Economic Director

Econ Pol

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CBI CONFEDERATION OF BRITISH INDUSTRY

26 January 1983

Michael Scholar Esq
Prime Minister's Office
10 Downing Street
London SW1

Dear Michael,

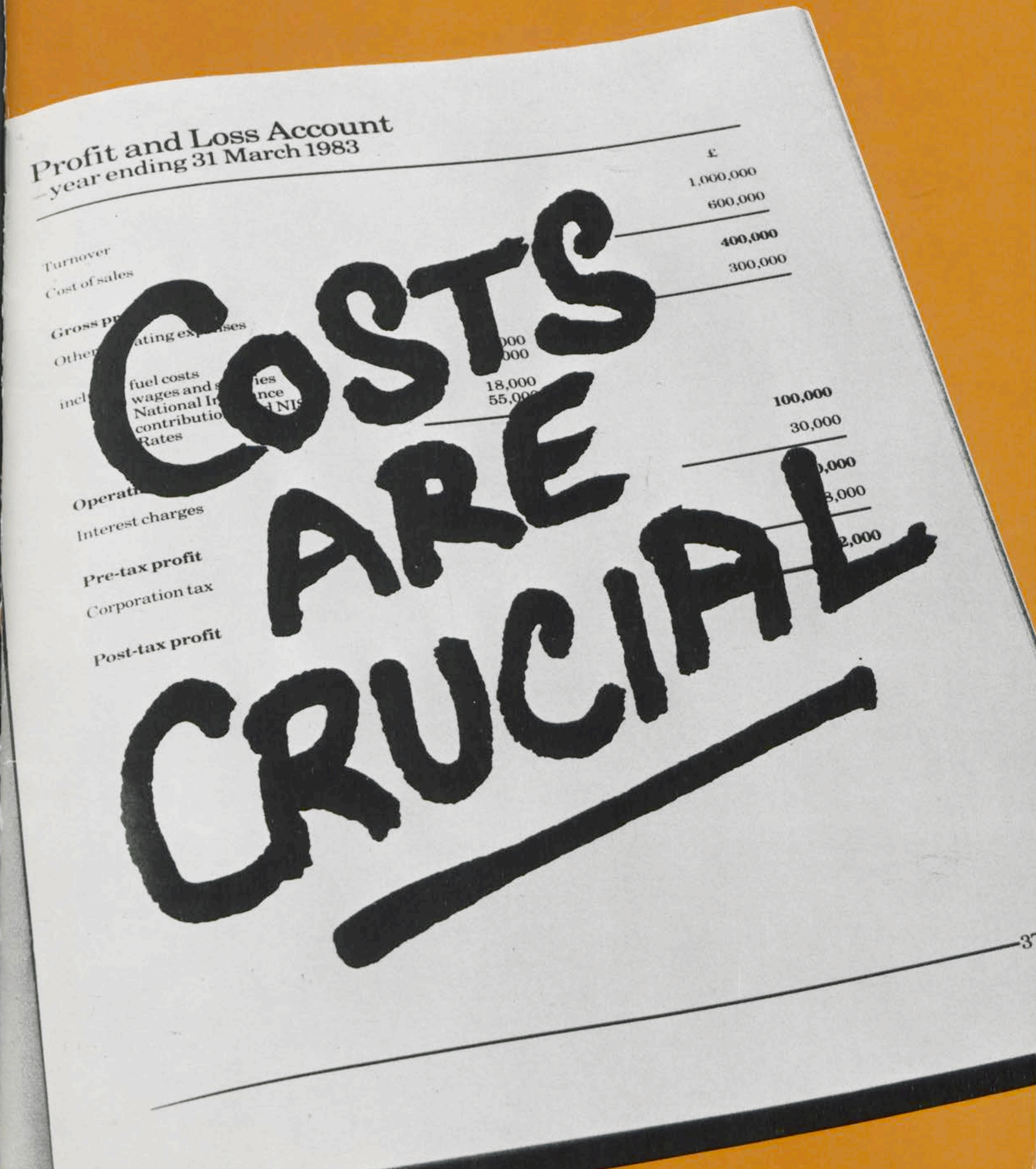
I enclose a copy of the CBI's Budget Representations to the Chancellor which have been approved by CBI Council.

Yours ever,
Jon

J T Caff
Economic Director

Budget Representations to the Chancellor January 1983

CBI



BUDGET REPRESENTATIONS
TO THE CHANCELLOR
JANUARY 1983

CBI

Confederation of British Industry
Centre Point
103 New Oxford Street
London WC1A 1DU

January 1983

£3.00

CONTENTS

I MAIN REPRESENTATIONS

This year's Budget must make Britain more competitive. The emphasis therefore must be on reducing business costs to ensure that a larger share of demand is satisfied from home output.

The world outlook is uncertain and no more than a modest recovery seems likely. We are still some 20% less competitive than in 1975, despite the helpful measures announced in the 1982 Budget and Autumn Statement. In depressed world markets, Britain faces intense pressure from overseas competitors.

Profitability is essential for investment. With competitiveness it holds the key to our ability to satisfy future demand and create jobs. Industry's profitability has fallen sharply in the last decade, and to stay in business firms have been forced to cut investment, stocks and manpower. The CBI proposals are aimed at reversing this process as quickly as possible.

I.1 The Proposed Budget

Our main recommendations for the 1983 Budget are:

* **ABOLITION OF THE NATIONAL INSURANCE SURCHARGE (Section III.2).**

* **LOWER BUSINESS RATES (Section V): a 15% derating of business premises, the abolition of empty property rating, and 'mothball' relief for rates on parts of properties temporarily unused, financed initially by central government grant. In addition, a ceiling should be imposed on business rate increases.**

* **ADDITIONAL CAPITAL EXPENDITURE: increased provision for investment and reduced underspending on capital projects in the public sector (Section IV.2); and, for the private sector, the reintroduction of the Small Engineering Firms Investment Scheme (SEFIS) (Section IV.3), improvements in Corporation Tax (Section III.7) and measures to encourage research and development (Section IV.3).**

* **MORE COMPETITIVE FUEL AND ENERGY COSTS FOR BUSINESS (Section IV.4).**

* **INDEXATION OF PERSONAL TAX ALLOWANCES AND BANDS (Section III.3).**

Other important recommendations but with relatively lower costs include: tax changes to encourage equity investment in smaller firms, for example through Small Firms Investment Companies (SFICs) (Section III.12); measures to reduce the disincentive effects of capital taxation (Section III.5); and certain special measures to reduce unemployment (Section IV.5).

I.2 Financing the Recommendations

The costs of our proposals and ways of financing them are set out in Table I.1.

* **We reject the option of financing our proposals by raising taxation elsewhere as inconsistent with our objectives of raising output, improving incentives and reducing inflation.**

TABLE I.1

EXCHEQUER COST OF THE RECOMMENDATIONS

	£ billion 1983/84 prices 1983/84	1984/85
Abolition of National Insurance Surcharge	1.3	1.5
Lower Business Rates	1.0	1.2
Public Sector Capital Expenditure	0.5	1.5
Other Measures to raise Investment[1]	0.2	0.6
Reductions in Fuel and Energy Costs	0.2	0.2
Indexation of Personal Tax Allowances and Bands[2]	0.9	1.2
Special Employment Measures[3]	0.1	0.2
Other Tax Changes[4]	0.1	0.3
Government Expenditure Economies[5]	-0.6	-1.6
Feedback Effects[6]	-0.8	-2.4
Effect on Public Sector Borrowing Requirement[7]	2.9	2.7
Effect on Public Sector Borrowing Requirement on Treasury Definition[8]	2.6	2.2

1 Changes in Corporation Tax, Reintroduction of the Small Engineering Firms Investment Scheme, R & D measures.

2 Costing assumes indexation by 6% to compensate for 1982 inflation. The additional cost of indexation to restore real value of allowances in 1983/84 to 1978/79 levels would be £0.5 billion in 1983/84 and £0.7 billion in 1984/85.

3 The costings allow for direct savings from reduced benefit payments. Effects on PSBR from higher activity, for example through increased tax receipts, are included in the feedback effect.

4 Mainly Small Firms Investment Companies, Capital Transfer Tax and Capital Gains Tax changes.

5 See Table IV.1: manpower cost economies and reduced contingency reserve.

6 Feedback effects reflect the estimated impact of these recommendations on activity levels. Their impact is mainly to reduce the PSBR as higher activity generates more tax revenue and reduces the number receiving unemployment benefit in comparison with what otherwise would have happened.

7 In comparison with a definition of unchanged policies that assumes no indexation of tax allowances etc.

8 In comparison with a definition of unchanged policies that assumes indexation of tax allowances etc and revalorisation of excise duties.

* **We see scope for reducing government current expenditure and recommend that our proposals be financed partly from this source (Section IV).**

We anticipate a substantial undershoot in the Public Sector Borrowing Requirement (PSBR) for 1982/83. Even on unchanged policies, after taking account of the measures announced in the Autumn Statement, an undershoot in 1983/84 seems likely. We therefore believe that the scope for fiscal adjustment will be greater than the £1 billion tentatively assumed in the Autumn Statement.

The CBI welcomed the Chancellor's statement on the operation of monetary policy: "Flexibility is essential. But flexibility has to be achieved without a drift into laxity"[1]. We estimate that our recommendations would lead to a PSBR of about £9 billion, 3% of GDP. We believe that this would be consistent with monetary restraint and, provided that external circumstances permit, with further falls in interest rates (Section II) while encouraging a recovery in activity.

In our income tax recommendations we have assumed indexation to compensate for the erosion of allowances and bands through inflation during 1982. Should scope remain after the implementation of the other recommendations, we would support a further modest increase in these allowances to compensate for falls in their real value through inflation in earlier years.

I.3 The Effects of the Recommendations

Our measures are designed to improve competitiveness, profitability and to raise investment. They would:[2]

* **Assist exports and hold back imports;**
* **Help achieve lower inflation;**
* **Boost activity; and thus**
* **Generate more jobs.**

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1 Speech by the Chancellor of the Exchequer at the Lord Mayor's Banquet for the Bankers and Merchants of the City of London, October 1982.

2 Annex 2 shows these effects in more detail.

II THE ECONOMIC BACKGROUND

This section shows the need for action by Government to support the progress made by business in improving competitiveness and looks at the financial scope for doing so. The reasoning draws on the analysis of the economic situation and prospects in Annex 2.

The rate of inflation has fallen significantly in the past year. But output and employment remain depressed, with profitability, a key to future growth, at historically low levels. This points to the need for measures to raise activity without risking the resurgence of inflation.

II.1 The World Economy

Our proposals need to be set in the context of a sluggish world economy. Both world trade and, probably, output in the industrialised countries fell in 1982. We forecast only a slow recovery in 1983 but this is still at risk.[1] The weakness of the international economy in 1982 has contributed to two further problems; the growth of protectionism and the debt problems of certain developing countries.

* **As a major trading economy the UK has a direct interest in international action to deal with these problems as well as agreement by the governments of the major industrial nations on co-ordinated policies for economic recovery without exacerbating inflation.**

II.2 Competitiveness

Given the international prospects, UK producers face intense competition. Our recommendations are therefore designed to increase demand in areas where it is likely to be met from domestic production and to improve UK producers' shares of domestic and overseas markets.

* **We believe that the best way of raising domestic activity while minimising the risk of a resurgence of inflation is to improve competitiveness by reducing business costs.**

This is highlighted by the experience of British business in domestic and overseas markets.

Imports of manufactures have risen from roughly 17% of the home market for manufactures in 1970 to 25% in 1980 and over 28% in the first half of 1982; while British manufacturers selling abroad have seen their share of the exports of the main industrial nations fall from over 10% in 1970 and in 1980 to 8-8½% in the first three quarters of 1982. These developments have resulted in a serious loss of business and jobs.

Other indicators of competitiveness show a similar picture. UK relative unit labour costs arestill around 20% higher than in 1975, a typical post-war year for competitiveness. Again, in 1982, the CBI Industrial Trends Surveys showed on average nearly 70% of manufacturing exporters citing price

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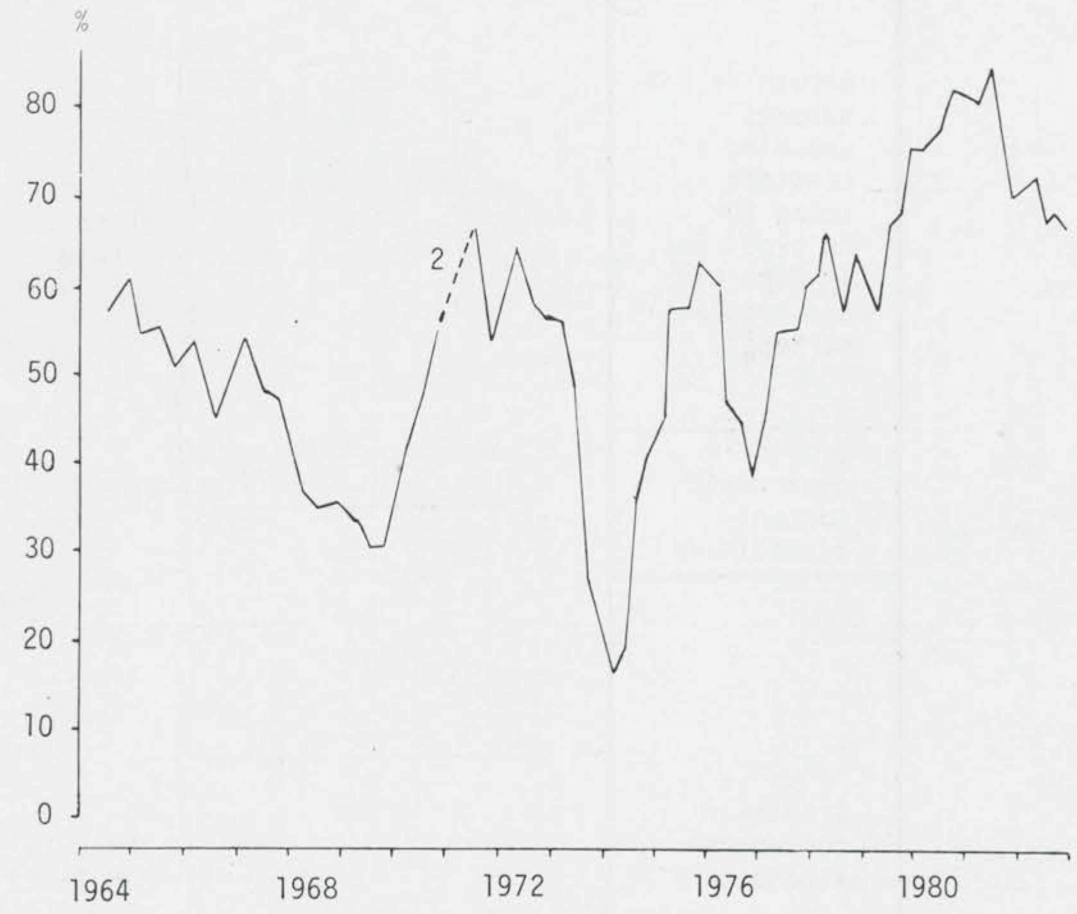
1 For a detailed discussion, see CBI Economic Situation Report, November 1982, pp 36-42.

competition as an important factor restricting their exports. Chart II.1 shows how high this proportion is in comparison with previous years.

CHART II.1

MANUFACTURERS' PRICE COMPETITIVENESS[1]



1. Percentage of respondents to CBI Industrial Trends Survey who consider that their export prices (compared with those of overseas competitors) limit their ability to obtain export orders over the next four months.

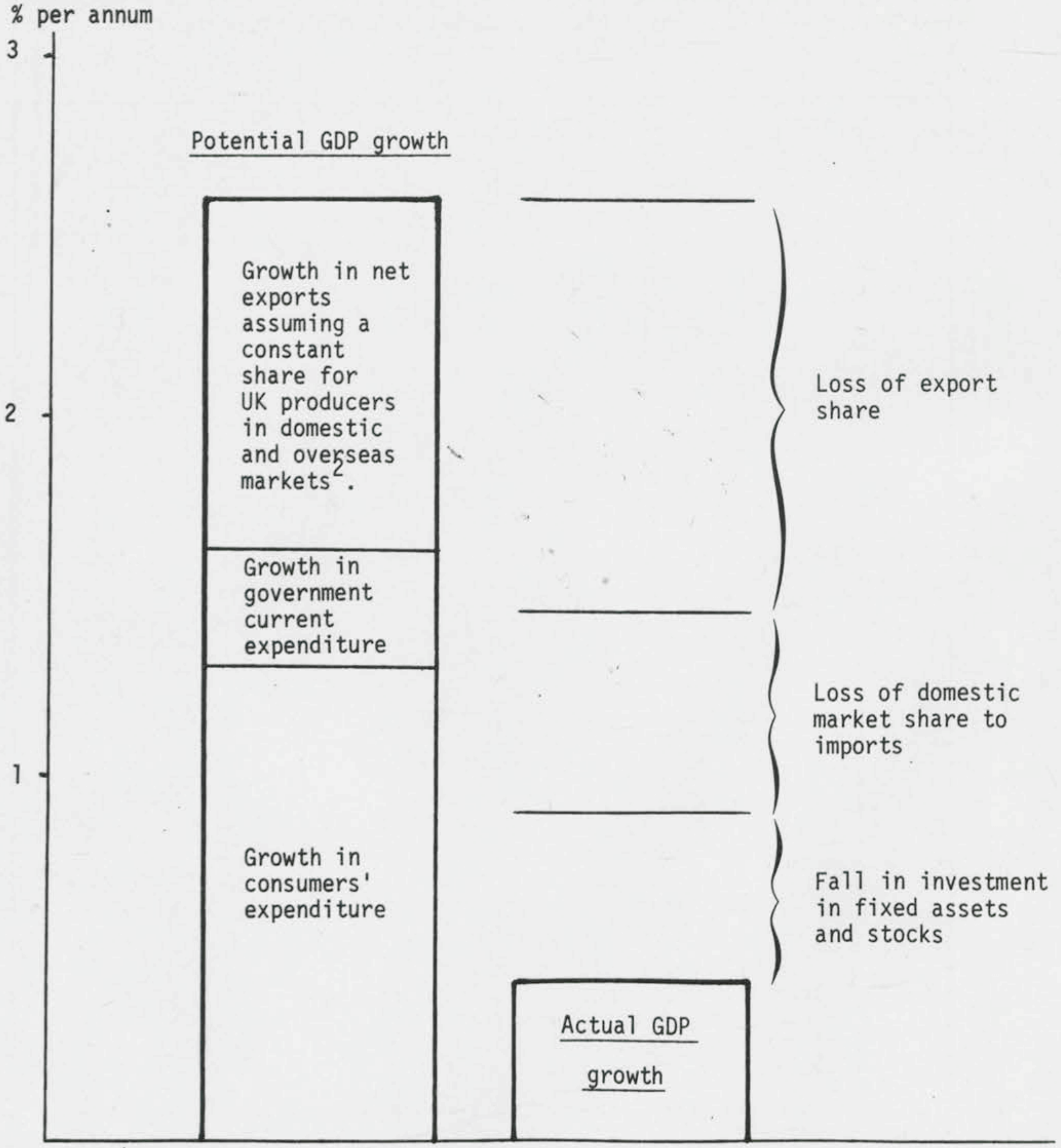
2 Survey 40 (February 1971) abandoned because of the postal strike.

Source: CBI Industrial Trends Survey

Chart II.2 shows, in a different way, the need for improved competitiveness to raise activity levels. The left hand column shows that between 1977 and 1982, the sum of the rises in UK consumers' demand, government current expenditure and demand in our export markets provided a stimulus to GDP growth worth 2½% per annum. However, because of our loss of share of both export and domestic markets, both directly related to declining competitiveness, and to a lesser extent, because of cuts in investment in

CHART II.2

POTENTIAL AND ACTUAL GDP GROWTH 1977-82[1]



1. Potential growth is annual percentage rise in GDP at 1975 prices that would have occurred had the UK held its share of domestic and overseas markets and maintained its levels of investment over the period 1977-82. Actual growth is measured on the expenditure basis at market prices for statistical consistency. GDP growth over this period measured on an output basis and at factor cost was about 0.1% per annum.
2. For constant export share, UK exports of goods and services are assumed to grow in line with OECD exports. For constant import share, imports of goods and services are assumed to grow in line with UK final expenditure.

Sources: OECD exports: OECD Economic Outlook, December 1982
Other figures: CSO, CBI estimates

both fixed assets and stocks, the actual growth in GDP over the period was only ½% per annum (and excluding North Sea Oil, GDP fell by nearly ½% per annum). This is shown in the right hand column.

To succeed in holding and, where possible, regaining market shares, it is particularly important that UK firms are competitive in their products, marketing and costs. Much of this must be the responsibility of businesses themselves but the government can help or hinder. Our proposals for the Budget show the best way of backing the efforts of businesses to become more competitive, by reducing those costs which are beyond their control. At the same time, action is also necessary to improve the prospects for pay and productivity.

Pay and Productivity

An encouraging feature of the last two years of pay bargaining has been the much more realistic level of settlements. In the 1980/81 and 1981/82 pay rounds the underlying rates of increase of earnings were 11% and 9% respectively, after running at 20% in 1979/80. There have been a number of factors responsible for this fall. One has been the growing realisation that a continuation of the excessive settlement levels that characterised pay bargaining in 1979/80 would be catastrophic.

However, in the current pay bargaining context, there is no cause for complacency. In most of our major competitor countries the average level of settlements has been falling too. With income from employment representing four-fifths of UK domestic incomes, failure to moderate settlements would lead to uncompetitive price increases or a renewed collapse of profit margins or both.

* **It is therefore essential that in the public sector wage costs are held down. Private sector pay negotiators for their part must scale down their earnings expectations to ensure improved competitiveness, bearing in mind the lower underlying rate of inflation.**

Real incomes of those in work have held up well in the present recession. Thus the costs of recession have been borne almost entirely by business, in reduced profitability and bankruptcies, and by those becoming unemployed. A greater measure of restraint in the pay demands of those in work would make it correspondingly easier to 'price back into jobs' those out of work.

The gains in productivity of 1981 and 1982 have been impressive although two qualifications are needed. First, a considerable part of the rise has been merely a recovery from the previous sharp fall in 1979 and 1980. Second, distinguishing cyclical movements of productivity from changes in long run trend rates is especially difficult with the economy still in deep recession. It seems that some of the spectacular gains in productivity recorded in 1981 and 1982 reflect only the shutting down of the least productive plants and processes rather than improved efficiency in the remaining operations. Given the special factors that have applied in the past two years it is essential that industry renews its drive for higher efficiency if the rate of productivity growth is to be maintained. It is worth noting, however, that many industrialists believe that they could achieve considerably better levels of productivity if activity levels were higher, permitting fuller use of capacity.[1]

II.3 Monetary Policy, Public Borrowing and Interest Rates

The previous section has shown the need for measures to improve competitiveness. This section looks at the financial scope for Government action.

The Chancellor has indicated recently that monetary policy will continue on the lines set out in the Medium Term Financial Strategy.[1] At the same time he pointed out that the targets covered more than one monetary variable and that firmness was not inconsistent with a flexible interpretation of the individual targets, using other relevant information, such as movements in asset prices and exchange rates, to assess the position.

We have indicated that our proposals would lead to a modest increase in public borrowing in comparison with what would otherwise have occurred. In assessing the interest rate consequences of this additional borrowing in the context of the monetary targets we note:

Firstly, the overall level of activity in the economy, both actual and forecast, needs to be taken into account. Although the Medium Term Financial Strategy set out in the 1982 Budget Statement shows the PSBR falling as a percentage of money GDP by ¾% each year the text points out that 'decisions about the appropriate size of the PSBR in any particular year will be taken in the normal way at Budget time'.[2] In previous Budgets, consistent with the Medium Term Financial Strategy, PSBR targets have been raised, when necessary, to take account of greater than expected falls in output. Demand, real profitability and employment can now be seen to be substantially worse than expected at the time of the 1982 Budget. Conversely the inflation performance has been substantially better. As a result, the growth of money GDP has been significantly lower than was expected at the time of last year's Budget. This relatively slower growth is expected to continue into 1983 and should leave room within the overall thrust of firm monetary policy for measures to boost activity.

Moreover much of the Government's present need to borrow reflects the impact of the continuing recession on tax revenues and benefits payments. The 'high employment' PSBR, adjusted to exclude this impact, would on any such estimate of its size for 1982/83 be very greatly reduced.

These factors would be enough on their own for a PSBR outturn for 1983/84 that was somewhat higher than that envisaged at the time of the 1982 Budget yet remaining consistent with the overall aims of the Government's anti-inflation strategy.

Secondly, the proposed level of public sector borrowing as a percentage of GDP would still remain low in comparison both with the recent past in the UK and with other industrialised countries.

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1 Survey evidence supporting the anecdotal information received by the CBI is contained in National Institute Economic Review, August 1982.

2 Speech at the Lord Mayor's Banquet, October 1982.

Chart II.3 shows how public sector borrowing as a proportion of GDP has fallen sharply from the excessive levels of the mid-1970s. For 1983/84 the PSBR of about £9 billion or 3% of GDP implied by our proposals would remain far below these levels. In addition 1981/82 was characterised by undershooting, with the actual PSBR being £2 billion below projected levels. It is likely that this may again be the case in 1982/83 with the PSBR outturn being perhaps as much as £2 billion below the £9½ billion projected in the March 1982 Budget.

CHART II.3

PSBR AS PERCENTAGE OF GDP[1]

1. PSBR as percentage of GDP at market prices.

Sources: 1973/74 to 1981/82, Financial Statistics and CSO; 1982/83 CBI estimate, assuming PSBR as announced in 1982 Budget; 1983/84 CBI forecasts, assuming implementation of CBI proposals.

Meanwhile, the OECD figures in Chart II.4 show public borrowing in the UK lower in 1982 than in any other major industrialised country[1].

Thirdly, in assessing the financial consequences of a given level of government borrowing not only the absolute size but also its composition is relevant.

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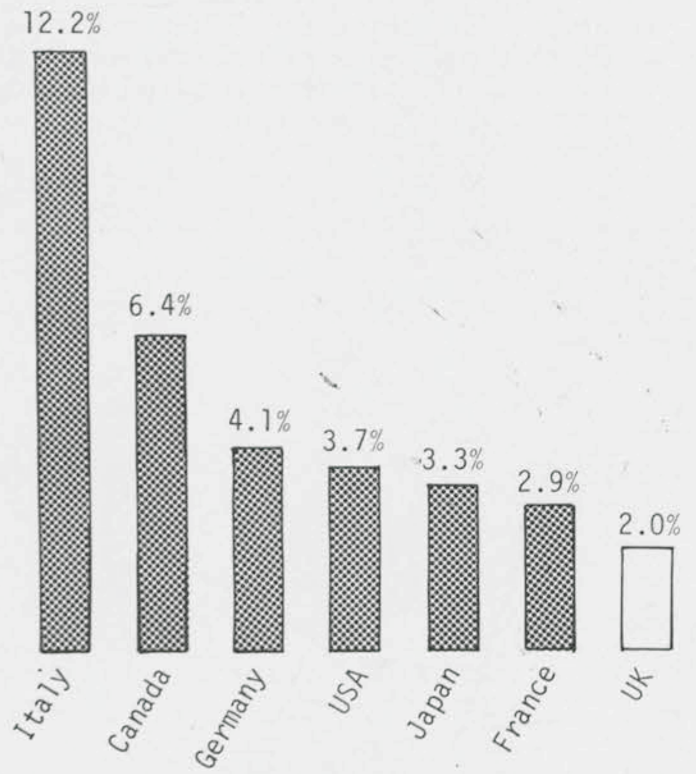
1 The figures refer to a somewhat narrower concept of public borrowing than our PSBR, but are on a comparable basis; and indeed they are more meaningful than would be a comparison of PSBRs, partly because of the differing degree of nationalisation in the various countries.

CHART II.4

INTERNATIONAL COMPARISON OF GOVERNMENT BORROWING[1]



1. General Government Deficit as percentage of GDP/GNP at market prices, 1982.

Source: OECD Economic Outlook, December 1982

The effect of a change in the level of public borrowing on interest rates and/or the money supply will depend on the effects on 'real' and 'financial' variables with which it is associated and on whether or not it is combined with economic policies encouraging financial confidence. For example a rise in public borrowing which reduces the need for companies to borrow from the banks might have little net effect on interest rates or on the money supply. Equally, a given PSBR resulting from measures to improve competitiveness might, through the effect on financial confidence of a potentially better balance of payments, be expected to permit lower interest rates than a PSBR of the same size generated through measures boosting consumers' expenditure and hence imports.

The proposals which we have put forward would, if implemented, improve the quality of the PSBR through their beneficial effects on competitivness and hence the balance of payments, their effect in reducing inflationary expectations, and their effect in reducing, at least in the short term, company borrowing from the banks. In turn they would reinforce the confidence of the financial markets in the Government's determination to deal with the fundamental problem of competitiveness.

Fourthly, we believe that our PSBR proposals are not inconsistent with further reductions in interest rates, as explained below.

The balance of risks

Deciding on the appropriate target to be aimed at for public borrowing involves a judgement about the relative risks from PSBR levels that are too high or too low. Too restrictive a PSBR would involve undue risks, given the weak state of the domestic economy and the depressed outlook for international trade, of further cuts in capacity and increases in unemployment. Too high a level of borrowing might lead to an inflationary relaxation of monetary control or higher interest rates. A level of borrowing that was so high as to lead to a loss of financial confidence in the Government's fiscal stance could lead to particularly adverse consequences for interest rates.

We judge that the level of borrowing implied by our proposals, especially when account is taken of the nature of these proposals, would involve little risk of generating a loss of financial confidence, while a lower PSBR would be too restrictive.

Interest Rates

Bank base rates fell from 14½% at the beginning of 1982 to a low point of 9% in early November. Around the turn of the year, some of this fall was reversed in response to pressure on the exchange rate, leaving base rates at 11% in mid-January. Each 1% point fall in UK interest rates is worth £270 million a year to industrial and commercial companies.

* **It is therefore important that we see a return to falling interest rates as soon as possible.**

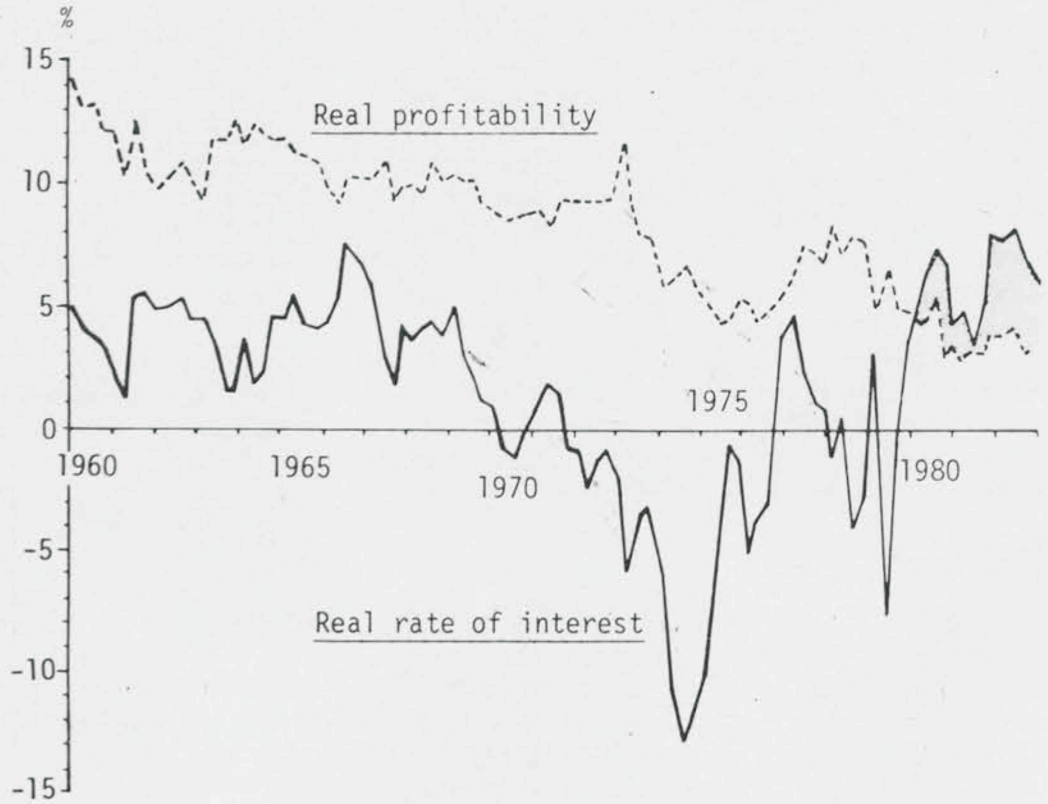
In real terms and in relation to profitability these rates are still very high (see chart II.5) imposing a heavy burden on business.

In the first 10 months covered by the 1982/83 monetary targets, monetary growth was within the 8 to 12% annual growth range set as a target in the Medium Term Financial Strategy. The effects of rapid growth in bank lending have been compensated for by 'overfunding' the PSBR. On a seasonally adjusted basis, public sector debt sales exceeded the public sector borrowing requirement by £2.7 billion in the first 10 months of the monetary target period.

In 1983/84 bank lending to the private sector is likely to fall as banks cut their mortgage lending and in response to the falls in inflation that have taken place. The CBI proposals would, in addition, reduce company borrowing from banks both as a direct result of higher profitability and through the effects of higher profitability on share issues. The level of public borrowing implied by our proposals should, therefore, be compatible with continued monetary restraint and falling interest rates. However, the prospects for interest rates will depend not only on domestic monetary influences but also on international factors, particularly US interest rates.

CHART II.5

REAL RATE OF INTEREST[1] & REAL RATE OF PROFITABILITY[2]



1. Base rate + 2% less inflation rate (RPI) over subsequent 12 months.
2. Gross trading profits plus rent minus stock appreciation and capital consumption for industrial and commercial companies excluding North Sea activities as a percentage of capital employed.

Source: CBI estimates based on Bank of England and CSO figures.

III TAXATION

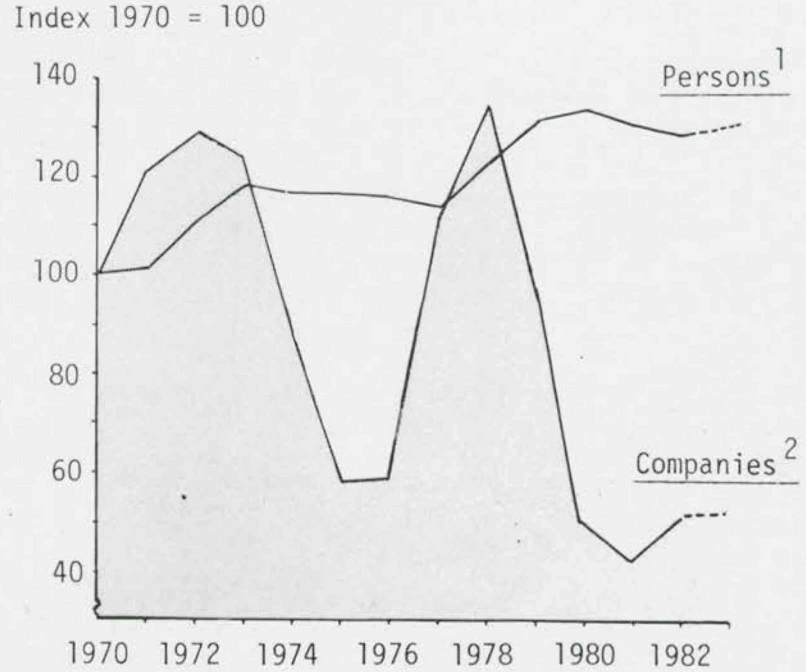
This section sets out our overall taxation objectives and specific recommendations for the 1983 Budget.

It is important to shift towards a balance between business and personal taxation which will increase our competitiveness in world markets and reduce import penetration.

Chart III.1 shows how post-tax real incomes of businesses have fallen dramatically and are likely to remain low in 1983, while total real income of persons has held up remarkably well, despite the recession and rise in unemployment, and is forecast to remain buoyant this year.

CHART III.1

PERSONS' AND COMPANIES' REAL INCOME



1. Real personal disposable income.
2. Undistributed income plus dividends on ordinary shares after providing for depreciation, stock appreciation and additions to tax reserves. Deflated by Total Final Expenditure Deflator.

Sources: CSO and CBI estimates.

III.1 Personal and Business Taxation

Our forecast on unchanged policies shows consumers' expenditure continuing the strong growth started in the second half of 1982. But increased import penetration and sluggish world demand for UK exports result in a continued depressed forecast for business activity as a whole (see Annex 2).

The forthcoming Budget can best help activity by improving competitiveness. Excessive reductions in personal taxation, resulting in increased consumer purchasing power, would draw in further large amounts of imports so long as British industry remains so highly uncompetitive, whereas cuts in business costs would help to keep imports out, as well as encouraging production for export by British firms.

An improvement in business profitability from the present extremely low level (see chart A.3) is also essential, along with improved competitiveness, for recovery and prosperity in the future.

- Higher profits are needed to increase investment - particularly if we are to keep pace with technological advances in Germany, Japan and elsewhere. If we do not, still more jobs will be lost to foreign competitors.
- If the economy is to recover significantly, higher profits will be needed to help finance higher stocks and work in progress, particularly after the drastic de-stocking of the past three years.
- Higher profits are also needed to fund research, development and investment in marketing at home and abroad, and indeed provision for the future generally, on which so many firms have had to cut back during the past couple of years or so simply to ensure their financial survival.

It has been argued that cuts in business costs would be used to finance higher pay settlements and that reductions in personal income tax would be reflected in lower pay settlements. Evidence from periods of income tax and National Insurance Surcharge changes does not in any way support either contention. In present circumstances, and at present levels of demand, it is most unlikely that UK companies would use reductions in costs to raise pay settlements. They are more likely to use them to stay in markets at home and abroad where they have been barely covering prime costs, to raise their market shares where possible, to increase investment and other provision for the future in the ways just described, and to hold down prices.

The CBI nevertheless recognises the importance of incentives for the personal sector and the need to prevent these from being eroded by inflation, but doubts whether much, if anything, can be done in the forthcoming Budget to reduce the burden of personal taxation in real terms given the relatively limited scope for reducing the PSBR, and above all the over-riding need to improve competitiveness and business profitability.

In addition to the abolition of the National Insurance Surcharge (discussed below), our other main recommendations for reducing business costs are discussed in other chapters: business rates (Chapter V); energy costs (IV.4); need to keep interest rates as low as possible (II.5).

III.2 National Insurance Surcharge

Cuts in the National Insurance Surcharge (NIS) were announced by the Chancellor in his 1982 Budget and in the Autumn Statement.

The clear cut advantages of reducing or abolishing NIS were set out in our previous representations. Abolition would improve competitiveness, reduce costs, boost profitability and encourage employment. To maintain a special tax on jobs, hindering exports and boosting imports, with unemployment at its present high level, is perverse.

This year, with growing real personal disposable incomes expected to boost consumer demand and depressed world trade likely to hold down exports, the case for giving priority to reducing UK labour costs through abolishing the Surcharge is especially strong.

The National Insurance Contribution rates which employers will be paying from April will be 0.25 percentage points higher in respect of employees contracted into the State Pension Scheme and 0.65 percentage points higher in respect of those contracted out.

* **It is therefore crucial that the 'Jobs Tax' should be abolished from April. This would have a direct cost of £1.3 billion in 1983/84 and £1.5 billion in 1984/85.**

The Chancellor has shown in his imaginative move announced in the Autumn Statement that the administrative problems surrounding the early implementation of changes in the tax can be surmounted and we have therefore assumed the abolition of the Surcharge from the beginning of the financial year. We have also assumed that the savings from the abolition of the tax will be recovered from the Government sector. For Nationalised Industries we have assumed that the benefit from abolition will be reflected in increased investment and/or lower prices (in addition to the proposals set out in Sections IV.2 and IV.4).

III.3 Income Tax

Our long-term objective remains a reduction in income tax rates so that the basic rate of income tax does not exceed 25% and the top rate 50%.

In the CBI's view we need to differentiate between action on thresholds and personal allowances on the one hand and rates of tax on the other. We believe there is a difference between the need for incentives to work at all which particularly involves the thresholds, and the incentive to work harder. We look forward to further consideration of the issues involved, when the Sub-Committee of the Treasury and Civil Service Committee reports on its enquiry into the Structure of Personal Income Taxation and Income Support. Of particular concern is the high effective marginal rate of tax resulting from income tax and national insurance contributions combined with benefit withdrawal.

Given the economic prospects, our emphasis on cutting business costs and the need to hold down import penetration, we believe changes in income tax this year should be concentrated on indexation. Increases in line with inflation in the personal tax allowances, basic rate limit, higher rate bands and investment income surcharge threshold are required in order simply to stand still in terms of the income tax burden on individuals. Failure to index these for 1982 inflation would mean an extra £0.9 billion tax revenue in 1983/84 and an extra £1.2 billion in a full year. We recommend that:

* **Indexation to allow for inflation over the last year should be the main income tax priority for this year. If resources permit after our other proposals are implemented, we would recommend further modest increases in these allowances, bands and thresholds to compensate for the erosion of their real value in earlier years.**

III.4 Indirect Taxes

We are not asking for a change in the rate of VAT this year. However we propose some adjustments to the VAT system.

* **We urge that the threshold for VAT registration should continue to move upwards. Not only will this help some smaller firms but also it should reduce the administrative burden. At the same time the facility of voluntary VAT registration should remain freely available in appropriate cases.**

Our Budget calculations are based on the assumption that there will be no increase in excise duties. Increases in these duties have a disproportionate effect on the Retail Price Index compared with their extra yield and the level of indirect taxation on the items subject to excise duties is high relative to that on other goods and services. Taxes on alcohol, tobacco products and oil products need to be considered in this light.

Our latest calculations on fuel costs show that the UK tax on DERV, the bulk of which is bought by business, is considerably higher on average than in other EEC countries. As part of the campaign to reduce business costs this differential should be phased out over a period of time. Although some reduction might be made this year, in our view the timing of later moves should take account of the motor industry's ability to meet shifts in demand.

An important constraint on this industry is the special car tax. This discriminates against a major industry and there is a strong case for planning to eliminate it.

III.5 Capital Taxes

Given the wide belief that smaller firms will play an important role over the next few years in providing new jobs and developing new technology, consideration of the tax problems that confront them and their proprietors is important.

We wholeheartedly agree with the statement by the Chancellor in the 1982 Budget that: "there is no case whatever for maintaining a system of capital taxes which, by holding back business success and penalising personal endeavour, does serious economic and social damage".[1]

1 Budget Statement, Hansard, 9 March 1982, Col 754.

We set out our position on these taxes in full in our submission to him in 1979,[1] and we have welcomed the steps which have been taken in line with our recommendations to reduce their burden.

However, there remain areas where there is a need to continue to improve the capital tax system, some of which are shown below. Costings of changes to capital taxes are difficult to produce but we estimate that the overall revenue cost of our recommendations would be unlikely to exceed £100 million in 1983/84 and £300 million in 1984/85.

Capital Gains Tax

Particularly gratifying, in view of our repeated representations on the topic, was the introduction last year of relief designed to alleviate the taxation of the inflation element in capital gains. For future gains this will ultimately do much to reduce the damage caused by this tax.

We note the reasons why the Government felt unable to give relief for inflation occurring within the first year of ownership of assets or on losses. However the length of the Finance Bill debates on these subjects is indicative of the complexities in the new rules caused by the accommodation of these two restrictions.

* **We urge that the treatment of losses and assets not held for twelve months should be kept under constant review.**

We also believe that fair treatment of those who have continued to hold assets over the longer term, which covers an era of high inflation, requires that they too should obtain relief for the inflationary element in the value of their assets. One rough and ready but administratively simple solution to the problem of past inflation which also encompasses our view that gains on assets held over the longer term ought not to be taxable is that:

* **Assets held at April 1982 which have been in continuous ownership for seven years should fall out of the capital gains tax net.**

There remain a number of other points which we raised in our 1979 submission where the Government has not yet met our requests but which we believe merit action. These include:

* **Rationalisation of the retirement relief provisions.**

* **Action to relieve the double charge on capital gains where assets are held through a company.**

Capital Transfer Tax

As with capital gains tax we welcomed the introduction last year of an element of indexation relief into capital transfer tax. However with the latter as well as the former, a number of points we registered in 1979 remain outstanding.

1 Capital Taxation: CBI Submission to the Chancellor of the Exchequer, 1979.

Especially important is the need to avoid the damaging effects of this tax on small and family businesses. This point is recognised in most other EEC countries where gifts within a family are taxed at reduced rates.

Whilst not repeating all of the outstanding points from our previous submission to the Chancellor[1] we do wish to emphasise certain points where early action would be particularly beneficial:

* **The relief for business assets should be improved by amalgamating all the existing classes of qualifying assets and giving them relief at 75%.**
* **Consanguinity relief for lineal descendants and analogous relief for full time employees of a business owned by the transferor should be introduced to reduce the burden of CTT by not less than half that otherwise payable.**
* **Lifetime rates of CTT should be half those on death throughout the scale.**
* **Consideration should be given to the possibility of holding over CTT liability arising on death in relation to business assets.**
* **The period of payment by instalments of CTT and CGT should be extended from eight to twelve years.**
* **The £250,000 limit on interest free payments for CGT should be abolished and henceforth the provisions for instalment payments and interest should be the same for CGT and CTT.**

III.6 Share Options and Incentives

Ten years have elapsed since the Conservative Government of 1972 encouraged companies to stimulate management enterprise and participation by the use of share option and incentive schemes.

Since that time there has been a host of changes in the relevant law which have led to considerable complication. We suggest that Government should now review the whole area with a view to rationalisation and simplification. We urge that schemes such as those set up in response to the 1972 initiative should be encouraged by removing the charge to income tax.

III.7 Corporation Tax

We have recently submitted our initial response to the Government's Green Paper on Corporation Tax[2] and it is not necessary for us to repeat here all the points made in that context.

In our paper we emphasised the need for stability but we coupled this with suggestions for improvements to the operation of Corporation Tax. We do not

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1 Capital Taxation: CBI Submission to the Chancellor of the Exchequer, 1979

2 CBI Submission on the Green Paper on Corporation Tax, October 1982.

believe that the open ended debate on the Green Paper which may follow from the submission of the various representations should be used as an excuse for not taking early action to correct specific anomalies. We shall continue therefore to mention in our annual Budget and Technical Budget Representations those items to which we give current priority within our overall economic policy.

One theme of our suggestions for evolutionary improvements to the present Corporation Tax is the need for modernisation to make the tax more closely reflect current commercial realities.

The main items which we wish to emphasise for inclusion in this year's Finance Bill are set out below. In total we estimate that their Exchequer cost would be £90 million in 1983/84, £500 million in 1984/85 and £650 million after 4 years.

Capital Allowances

One aspect of business taxation about which we have repeatedly regretted the lack of action by Government is in the field of capital allowances for commercial buildings. At present, relief is only for buildings in the hotel and catering industry, although the initial allowance is even there only 20% in comparison with 75% for industrial buildings.

In our Green Paper response referred to above we have pointed out that all our major international competitors have allowances for commercial buildings. The Green Paper itself accepts the argument for giving capital allowances for all capital that is consumed in earning income. We therefore once again urge the Chancellor to recognise the principle. As well as correcting an existing anomaly this would give a boost to the construction industry and so to employment and provide a welcome recognition of the role of commercial business in the vitality of the economy.

* **We recommend that straight line writing down allowances should be introduced for new commercial buildings at 2% per annum.**

The cost of our proposals is negligible in the first year and small for a good many years thereafter as shown below[1].

In our 1980 Budget Representations we drew attention to the case for modernisation and improvement of mining capital allowances. We regret that no action on this front has yet been taken.

Advance Corporation Tax

Many companies are faced with regular bills for Advance Corporation Tax (ACT) despite the fact that they have insufficient profits to be liable to mainstream corporation tax and cannot fully utilise corporation tax reliefs and allowances to which they have earned an entitlement.

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1 Assuming companies have sufficient profits fully to absorb the allowances estimated costs are: first year - negligible; second year £20 million; third year £45 million; fourth year £70 million; fifth year £100 million; sixth year £130 million - eventually £1500 million a year.

In our representations in previous years and in our response to the Corporation Tax Green Paper we have drawn attention to various difficulties concerning the treatment of ACT. Given that ACT is advance corporation tax we feel that early action should be taken on at least some of these problems. This could go some way to reducing the build up of unrelieved allowances to which reference is made in the Green Paper.

Ever since the 1971 debates on the imputation system we have drawn attention to the particular problems faced by companies with a large proportion of their income derived from overseas. The problem of their inability fully to utilise double taxation relief can be acute.

* **We recommend, therefore, that double taxation relief should be available for offset against ACT.**

Companies which have taken steps to incur expenditure in ways which capital allowances are designed to encourage should be able to get timely relief.

* **The offset of capital allowances against ACT should be permitted.**

Other amendments to ACT to which we are giving priority this year are:

* **The setting of ACT payments against companies' next mainstream corporation tax liability.**

* **Removal of the restriction of ACT set off to 30% of income.**

Corporate Financing

A fresh approach is needed to the taxation aspects of corporate financing. This should recognise the role of flexibility in funding for example in the use of new forms of financing as they emerge in the market to obtain capital at the lowest available rates. Two topics to which we have drawn specific attention in our Technical Budget Representations are:

* **Acceptance credits**

* **Convertible loan stock.**

Recently the authorities have indicated a desire to see a revival in the corporate bond market to secure a spread of debt maturities and to reduce the present level of bank borrowing. We believe that such a revival will be held back without more favourable tax treatment.

We regret that the consultative document of 12 January on the tax treatment of deep discounted stock suggests that the Government is not yet convinced of the case for asymmetrical treatment of lenders and borrowers. However, we shall continue to press for this question to be examined further and urge that the debate should not be foreclosed before relevant issues of practice, as well as principle have been fully aired.

Losses on Foreign Currency Transactions

Tied in with the review of corporate financing is the question of transactions involving conversions between sterling and foreign currencies.

* **We propose that action should be initiated by providing tax relief for all losses on foreign currency borrowings.**

This should improve competitiveness by bringing the UK more into line with other countries and by reducing the cost of such borrowings.

Reduced Rate of Corporation Tax

Although we are concentrating our business tax representations on cost cutting measures rather than reductions in the rate of corporation tax itself, we propose relatively cheap measures in relation to the lower rate:

* **The lower rate of corporation tax should apply to the first tranche of all companies' profits.**

* **The thresholds for the lower rate should continue to be moved upwards at least in line with inflation.**

III.8 Development Land Tax

This tax raises very little revenue, estimated to be £40 million in 1982/83, but does affect commercial decisions for example by discouraging businesses from disposing of assets they no longer require. This is of particular concern at present when a large amount of business property is out of use.

* **We therefore urge the abolition of development land tax or, failing which, suspension of its operation for at least two years to provide an incentive to proceed with relevant development projects as soon as possible.**

III.9 International Taxation

Last year we urged the Chancellor not to take precipitate action on certain international taxation proposals which had been the subject of consultative papers. We are grateful that he decided that these matters needed more time for further consideration.

We shall be responding separately and in detail on the further consultative document issued on 20 December 1982. Its length (125 pages) and the nature of the complex issues involved leave us still concerned as to whether the time available for consultation is adequate to ensure full consideration of all relevant matters before attempting legislation in this year's Finance Bill.

We echo the Chancellor's sentiment that in contemplating action in this field "we must be very careful not to prejudice legitimate business particularly because of the importance of London as a financial centre"[1]. We therefore strongly recommend that:

* **Legislation should not be introduced on international taxation which could prejudice legitimate business.**

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1 Hansard, 9 March 1982, Col. 748.

III.10 Technical Budget Representations

We have already submitted the full text of our Technical Budget Representations to the Government[2].

Last year we referred to the desirability of a Technical Taxation Bill to begin to tidy up the numerous technical anomalies that have crept into the taxation system. Changes are necessary to the legislative process if there is to be early progress on correcting these anomalies and beginning the evolutionary programme of improvements to which we refer in our response to the Corporation Tax Green Paper. We suggest that:

* **Urgent consideration should be given to methods whereby early and effective Parliamentary action on taxation reforms can be taken.**

III.11 Purchase of Own Shares

We welcome the taxation relief provided last year for companies repurchasing their own shares. However we are keeping the operation of the legislation under review particularly in relation to the requirement that the repurchase must be for the benefit of the trade of the company.

* **We recommend in addition that relief be extended to unquoted shares of quoted companies.**

III.12 Smaller Firms

The CBI recognises the vital role that smaller firms must play in generating new jobs and new wealth in the future. It has therefore welcomed the measures taken by the present Government to encourage the development of new firms and the expansion of existing smaller firms.

However, this sector will be able to fulfil its true potential only when overall economic conditions improve. The priorities for smaller firms in the next Budget are therefore identical to the priorities for business as a whole - reduction in business costs, improved competitiveness and restored profitability. The CBI's main economic policy and tax recommendations cover these concerns.

Within this section we deal with two specific recommendations which are of exclusive concern to smaller firms. Other matters, which are of particular concern to smaller firms are dealt with within the main tax recommendations, or in the case of the Small Engineering Firms Investment Scheme (SEFIS) in Section IV.3.

Small Firms Investment Companies (SFICs)

One of the CBI's current objectives is to increase the amount of equity investment in the smaller company sector. The Government has already introduced several helpful measures in this respect notably the Business Start Up Scheme (1981 Finance Act), the Venture Capital Scheme (1980 Finance Act) and the new rules relating to unquoted trading companies repurchasing their own shares (1982 Finance Act). We believe that the Government now has

2 Copies are available from the Taxation Department, CBI Economic Directorate.

an opportunity to build on these foundations and stimulate a radically improved climate for investment in smaller firms.

The CBI has already sent proposals to the Government suggesting a framework through which the investment by individuals in private companies could be stimulated. It has, however, been made clear in submitting these proposals to Government that it is the objectives rather than the vehicle with which the CBI is primarily concerned.

These objectives are:

i Extension of existing incentives for investment in start up companies to established smaller companies in order to stimulate investment in the smaller company sector as a whole.

ii The encouragement of individuals and large financial institutions - such as banks and pension funds - to invest in smaller companies by giving them a spread of risk through a single investment.

iii Improvement of the marketability of investment in smaller companies by making it easier for individuals and institutions to realise their investment at an appropriate time. Investing in smaller companies would therefore be a more attractive proposition than it is at present.

iv The identification of willing investors and the matching of them to smaller companies in need of finance. This would make it easier for both individuals and institutions to invest in smaller companies and encourage a wider cross section of society to participate in the ownership of business.

The proposals for SFICs put forward by the CBI would enable funds to be attracted from both individuals and institutional investors and for this money to be invested in defined smaller companies. Rules would govern the nature, size and spread of the investment, but these should be sufficiently flexible to enable financial packages to be specifically geared to the needs of smaller companies. It should also be possible for the investment to be supported by the contribution of managerial and other technical assistance.

The objective of encouraging equity investment in smaller companies could be secured, in part, through the extension of the Business Start-Up Scheme but some other changes will be necessary if the objectives the CBI has identified are to be achieved. How best this might be done we would be pleased to discuss with Government but in order that these discussions may take place from a constructive base, we have developed our SFICs proposals, the main points of which are:

i Individuals subscribing for shares in a SFIC, or directly in a qualifying company, should receive the same tax advantage as is currently available under the Business Start Up Scheme.

ii Financial institutions, and other corporate bodies, should be permitted to buy shares in a SFIC.

iii Qualifying companies should, in general terms, be defined as smaller unquoted trading companies. There should be no requirements for a qualifying company to be "new" or to be carrying on a "new" trade.

iv SFICs would be permited to lend to their portfolio companies but only as part of a financial package which involved a substantial equity investment. The possibility of a SFIC borrowing money on terms which would allow it to on-lend to its portfolio companies at market rates should be investigated.

v A SFIC should comply with strict rules concerning the nature, size and spread of its investments. However, these rules would allow it sufficient flexibility to derive some income to use for management fees, or to repurchase its own shares. Approval would be required from the Inland Revenue before a SFIC could operate.

vi SFICs themselves would have a tax status similar to some existing investment institutions. They would, therefore, be exempt from capital gains tax on most transactions.

Disincorporation

For some businesses the price of incorporation with all that it involves in terms of compliance with various company law requirements is proving excessive.

It is important to facilitate the continuation of previously incorporated businesses as partnerships or sole proprietorships. We therefore recommend that:

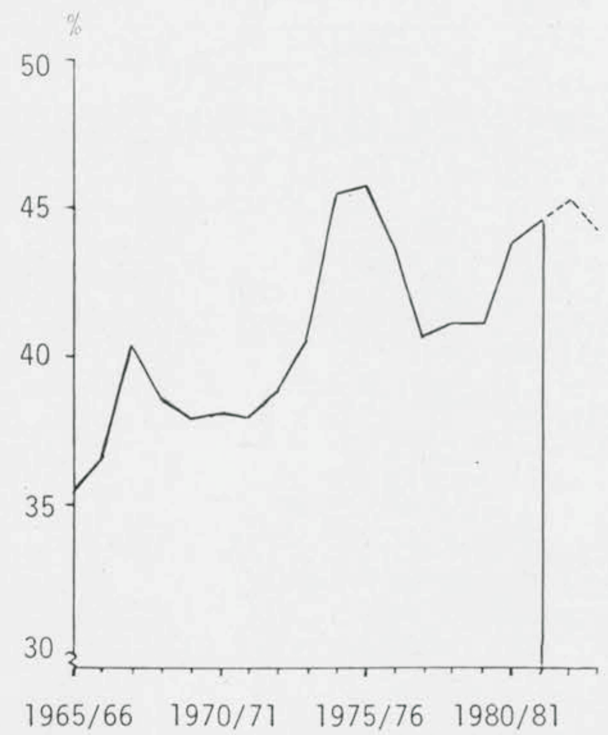
* **Government should examine the various tax and other measures which apply on disincorporation with a view to simplification and amelioration of any tax burdens where the transactions are carried out for genuine business purposes.**

IV GOVERNMENT EXPENDITURE

CBI policy on government expenditure has been described in a number of documents including the Report of the CBI Working Party on Government Expenditure[1], and most recently in a detailed paper submitted to the Chief Secretary to the Treasury[2]. We have argued that there is a need to restrain total levels of public expenditure, to facilitate a reduction in the cost burden on business within a given fiscal stance. The CBI has also argued that within a reduced expenditure total, there should be a shift in favour of capital expenditure in order to redress the imbalance which has arisen in recent years. Both measures would assist in restoring the cost competitiveness of British industry.

CHART IV.1

SHARE OF GOVERNMENT EXPENDITURE IN GDP



Definition: Planning total of government expenditure as percentage of expenditure estimate of GDP at market prices.

Source: The Government Expenditure Plans 1982-83 to 1984-85 (Cmnd 8494 Table 1.1); CSO; CBI forecasts for 1982-83 and 1983-84.

1 'Report of the CBI Working Party on Government Expenditure', September 1981.

2 'Government Current and Capital Expenditure', paper submitted to the Chief Secretary to the Treasury, July 1982.

This section updates CBI policy in the light of more recent information.[1]

IV.1 Planned Levels of Spending

The latest Government announcement shows that total expenditure in 1983/84 is planned to be £120.06 billion (excluding debt interest) which is some £600 million lower than the planning total of £120.7 billion[2] for 1983/84 announced in the 1982 Budget. Whilst the CBI welcomes the Government's achievement in avoiding an increase in planned expenditure for 1983/84, this represents only a marginal reduction in total public expenditure in both cost terms, and as a percentage of GDP, over the likely outcome in 1982/83. It is clear that in certain areas, particularly the current expenditure of local authorities, there are persistent problems in controlling expenditure levels. Moreover, the revised planning total for 1983/84 was only held within previously announced totals after taking account of:

i A reduction in cash limits equivalent to the savings from reductions in NIS.

TABLE IV.1

MAIN CBI RECOMMENDATIONS ON GOVERNMENT EXPENDITURE[1]

	£ million, 1983/84 prices	
	1983/84	1984/85
Extra capital expenditure	500	1500
SEFIS and industrial support	85	100
Extra expenditure on reducing energy costs	200	200
Special employment measures	100	200
Offset by:		
Savings from manpower cost economies[2]	-350	-700
Savings from a reduced contingency reserve	-200	-900
Savings from lower unemployment levels and other demand effects of CBI package[3]	-350	-800
TOTAL EFFECT ON GOVERNMENT EXPENDITURE	-15	-400

1 In comparison with totals announced on 8 November 1982 for 1983/84, and in comparison with totals given in the March 1982 White Paper for 1984/85 (adjusted for subsequent policy changes).

2 Excluding savings which would arise from the abolition of NIS, which are already taken into account in the costing of this proposal.

3 See footnote 6 to Table I.1.

3 In particular the Chancellor's statement on 8 November 1982 in respect of government expenditure for 1983/84.

2 Planning total in Cmnd 8494 adjusted for Budget changes. Figures expressed in cash terms.

ii A forecast increase in public sector costs which is lower than that foreseen in March 1982.

iii A substantial reallocation from the contingency reserve to spending programmes (see Section IV.6).

Table IV.1 summarises our main recommendations in respect of government expenditure. We urge the Government to announce changes in favour of enhanced efficiency in the provision of public services as soon as possible, although we recognise that the full savings from these measures may not accrue until 1984/85.

IV.2 Extra Capital Expenditure

The need to redress the imbalance in government expenditure in favour of greater public investment has been a consistent feature of CBI policy in recent years. Attempts to curtail the total level of government expenditure and its share of national output have been largely unsuccessful because of difficulty in containing current costs. Public sector capital expenditure, part of our investment in the future, with direct implications for industrial competitiveness, has shown a consistent decline in real terms since the mid 1970s and in 1981/82 was some 25% lower than in 1976/77[1].

* **We believe there should be a revival in public sector investment, in part to correct the substantial underspending of recent years, but also to improve both the standard of our national infrastructure and the efficiency of publicly owned industry.**

Such a revival would benefit the construction industry in particular, where output is now running at 16% below its 1975 level. The low import content of construction activity, and its high labour intensity, imply that any increase in construction output would have direct benefits for UK employment. A fuller discussion of these issues is contained in the First Report of the CBI Steering Group on Unemployment, November 1982, which also considers the case for more emphasis on tourism.

* **We recommend that the Government directs its attention to three particular categories of public sector investment:**

i Infrastructure

Investment in motorways, by-passes, link roads to the East and South coast ports, and roads designed to assist inner city regeneration, would yield attractive economic and social returns and contribute, via lower transport costs, to a more competitive economy. We also urge the Government to speed up infrastructural improvement in other areas including the water and sewerage system which is, in many places, in need of urgent repair. Whilst we recognise that some infrastructure investment schemes do not lend themselves well to private sector financing, we would urge the Government to consider seriously such

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1 See 'Government Current and Capital Expenditure', CBI submission to the Chief Secretary to the Treasury, July 1982. Figure adjusted for effect of council house sales.

proposals as have been put forward, for example the financing of roads by royalty payments.

ii <u>Nationalised Industries</u>

Certain of the nationalised industries feel that their ability to invest in projects which would enhance efficiency, and thus reduce costs, are hampered by a lack of finance. Some of these schemes also fall into the infrastructure category, for example rail electrification. Wherever possible, the Government should consider the introduction of private finance into profitable schemes, as suggested in the Ryrie Report.

iii <u>Local Authority Underspending</u>

We applaud the recent attempts by Government to correct the underspending of capital cash limits which has been evident in local authorities for a number of years. However, underspending of £1.5 billion in one year is difficult to rectify in the last few months of a financial year. It has been argued that short run changes in capital expenditure policy have contributed to this underspending, together with the fear that investment projects incur future current costs. It is misleading to believe that capital expenditure in general incurs the latter in that some projects may, for example, save on energy or labour costs. In addition, road maintenance is now a capital item. It is clear however, that problems may be caused by debt financing. We would therefore urge the Government to consider how debt charges could be treated in calculations of the Rate Support Grant in order to overcome this problem.

Our recommended increase in capital expenditure of £500 million in 1983/84 and £1500 million in 1984/85 will assist in eliminating the cumulative underspending of recent years. We also propose:

* **That Government assists in the <u>long-term planning</u> of local authority investment in essential local road construction, housebuilding and urban renewal schemes. A welcome step away from one year planning is the recent announcement that at least 80% of the 1983/84 housebuilding budget will be available in 1984/85.**

* **That the Government extend the practice of allowing a limited carry over of capital allocation from one financial year to the next.**

* **In addition we recommend that those activities which can be contracted out or privatised be transferred to the private sector, where investment can take place with fewer arbitrary constraints.**

IV.3 <u>Industrial Investment</u>

We believe that two particular industrial support programmes should receive additional resources in 1983/84 and 1984/85.

a <u>Small Engineering Firms Investment Scheme (SEFIS)</u>

* **We propose that SEFIS, first introduced in March 1982, be reintroduced with a ceiling of £50 million allocated to it in 1983/84.**

This would allow for some relaxation of the original rules which restricted eligibility to firms covered by Standard Industrial Classification 3 and to metal-working machinery. We believe that SEFIS has, and would continue to encourage productive investment, and increase competitiveness in a sector of the economy which has been badly hit by recession.

b <u>Innovation Support</u>

In view of the importance to the economy of the development of new products and processes, we recommend that the Government does more to help industry to maintain or increase its investment in this area. We estimate that it would be reasonable to allow for additional expenditure of £30-40 million in 1983/84 to finance these changes, increasing to £50 million in 1984/85.

This money could usefully be spent in the following ways:

* **Continuation of the maximum rate of grant payable on new projects of 33 1/3% throughout 1983/84.**

* **Grants for the later stages of innovation should be more widely available than at present.**

* **Relaxation of the 'additionality' criterion in order to facilitate the take up of funds.**

In addition we recommend that while the support for computer and associated industries proposed in the 'Alvey Report' is welcome, this should be additional to existing support programmes.

IV.4 <u>Energy Costs</u>

The CBI and individual sectoral organisations have made consistent representations over the last two years about the level of UK energy prices and the threat they pose to international competitiveness. In certain respects there has been some relief and we welcome the £250 million assistance given to industry in the 1981 and 1982 Budgets. We also welcome the gas price freeze and the standstill of average electricity prices envisaged for 1983.

However, problem areas remain, particularly for the electricity intensive industries.

* **We seek further relief from the severe burden borne by these industries and also continue to drive for competitive UK energy prices.**

* **In line with our overall statement on energy policy we would like to see greater financial assistance by the Government to encourage investment in energy efficient plant, equipment and processes.**

In the present economic climate industry is unable to take advantage of apparently attractive energy saving investment because of lack of funds. Further assistance, possibly through low interest loans with deferred repayments until the projects start to show a financial return, would accelerate the realisation of potential energy savings. Additional funding should also be made available to encourage replication in the Energy Conservation Demonstration Project Scheme.

Gas

British Gas announced in November 1982 that the freeze on industrial contract prices would be maintained until October 1983. We welcomed this move. With exchange rate movements and price increases on the Continent it is likely that during 1983 UK prices will be within the range of those applying elsewhere, although the situation will need to be monitored closely to ensure significant disparities do not reappear.

Heavy fuel oil

The duty on heavy fuel oil is largely responsible for the disparities between UK product prices and those in competitor EEC countries. We acknowledge the difficulties involved in lowering this duty but urge that it be kept continually under review. The existence of this duty adds strength to the case for taking alternative actions to reduce industry's energy costs.

Coal

We are requesting the extension of the Department of Industry Coal Firing Scheme for another year.

Electricity

We welcomed the limited help for electricity intensive industries in the last two Budgets but pointed out that considerable price disparities remained in comparison with certain European countries. Although we welcome the electricity price standstill in 1983, the review of the Bulk Supply Tariff by the Department of Energy which made such a standstill possible does nothing for the particular group of industries on whose behalf we have been campaigning.

* **We therefore strongly urge the Government to take further action to reduce the costs for these consumers to bring them closer to those of their continental competitors. We estimate that this would involve a cost of approximately £200 million.**

It is worth noting that while the Government argues that it cannot reduce electricity prices further because of the high costs of production, it does not apply the corresponding argument to gas where we have relatively low costs of production.

IV.5 Special Employment Measures

* **Moderate additional resources should be made available to develop special employment measures.**

The first of the measures described below, the continuation in an adapted form of the Temporary Short Time Working Compensatory Scheme (TSTWCS), has been agreed as CBI policy, and is being discussed with the Secretary of State for Employment. Consultations are continuing on the remaining three proposals. For 1983/84 a sum of £100 million has been included for these measures (the cost for 1984/85 is estimated at £200 million). These figures are in addition to the funds already allocated by government to the Youth Training Scheme. This will be implemented in September 1983 and the CBI is formally committed to its support.

The TSTWCS is due to end in March 1984. This scheme has kept a significant number off the unemployment register by allowing employers to maintain their workforces during difficult periods. The CBI now believes that a permanent scheme for short time working compensation should be introduced.

The Job Release Scheme (JRS) encourages early retirement and the CBI believes that the scheme could be extended by reducing the age at which people become eligible to join.

The CBI fully supports the Government's announced job-splitting scheme (to take effect from January 1983) and believes that it could be developed by incorporating a system for encouraging phased retirement. This is estimated to involve no net additional cost to the Exchequer once the scheme is fully operational. Such a scheme would keep the Government grant to an employer for splitting a job but would, in addition, encourage those nearing retirement to split their job by giving them part of the payment made under the JRS.

Finally, the Community Programme Scheme which provides temporary work for the long-term unemployed could be given additional funds so as to improve the quality of projects undertaken through the scheme. This improvement in quality is a necessary first step towards increasing the number of places provided by it.

IV.6 Controlling Government Expenditure

General Efficiency

The CBI welcomes a number of steps which have been taken in the course of 1982, designed to improve the efficiency of both central and local government. We welcome in particular the establishment of an Audit Commission for local authorities - a measure we have pressed for strongly in recent years. We urge that this Commission undertakes value for money and comparable performance studies. This would improve efficiency, and also the accountability of local authorities to their electorates. In similar vein we also welcome the positive response by Government to the recommendations of the Treasury and Civil Service Select Committee in favour of improved financial management in the Civil Service[1].

The CBI has argued strongly that comparative studies of the cost of Regional and District Health Authorities would be of great benefit in enhancing the efficiency of what is in effect a loose federal structure. We support the recommendation of the House of Commons Public Accounts Committee that the Department of Health and Social Security should take much stricter financial control of the NHS.

We urge the Government to consider how management expertise can be harnessed to improve the efficiency with which public services are provided. In this respect we welcome the announcement by the Secretary of State for Health and Social Security of private sector involvement in an efficiency scrutiny of the National Health Service.

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1 Efficiency and Effectiveness in the Civil Service - Government Observations on the Third Report of the Treasury and Civil Service Select Committee. Cmnd 8616.

Use of Contingency Reserve

We pointed out in July 1982 that the very large contingency reserves built into the 1982 White Paper for expenditure in 1983/84 and 1984/85 (£4 and £6 billion respectively) were likely to encourage a slackness in expenditure control. Whilst we welcome the fact that Government has been able to contain the planning total for 1983/84 within the level previously planned, it is clear that substantial increases in, for example, local authority current expenditure were contained within a marginally reduced total only by drawing on the contingency reserve.

* **The £6 billion figure contained in the existing 1984/85 plans should be substantially reduced, particularly in view of the more favourable prospects for cost inflation. This would also improve financial control in next year's public expenditure review.**

TABLE IV.2

GENERAL GOVERNMENT MANPOWER (GB): THOUSANDS, FULL TIME EQUIVALENT

	1980/81	1982/83	% change 80/81-82/83	Government target for* 1983/84	% change 80/81-83/84
Armed Forces	334	323	-3.3	334	no change
Civil Service	697	655(1)	-6.0	639	-8.3
Local Authorities					
Teaching	620	2242(2)	-3.2	561	-6.7
Education Support	442			369	
Protective & Social	480			496	
Other	775			736	
NHS					
front line	582	625	+7.4	606	+4.1
support staff	369	369(3)	-	379	+2.7
TOTAL	4299	4214	-2.0	4120	-4.2

Sources: (1) Treasury Press Release, July 1982

(2) Joint Manpower Watch, England, September 1982
Joint Manpower Watch for Scotland, Scottish Office, September 1982
Joint Manpower Watch for Wales, September 1982

(3) Question asked by Mr Ralph Howell of the Chancellor of the Exchequer, Hansard Col 290, 12 November 1982

* See Table IV.8, CBI Working Party report on Government Expenditure.

IV.7 Manpower Reductions

The CBI's report on Government Expenditure identified significant scope for cuts in public service manpower which are consistent with maintaining the existing level of services. Overall, allowing for all employment associated costs, we identified savings of at least £2 billion at 1981/82 prices by 1984/85. We argued that these savings should obtain in 'non front line' areas, particularly in the local authorities and NHS. Our evidence of significant regional disparities in manning levels for both local authorities and the NHS has been supported by other bodies.[1]

Table IV.2 outlines where reductions in public sector manpower have been achieved. These figures illustrate that there is still substantial scope for rationalisation in levels of public service manpower. We note that the Government has been more successful in controlling levels of manpower in the Civil Service (saving £124 million in 1981/82)[2] than have the local or health authorities. We welcome the establishment of manpower targets for each regional health authority as a preliminary step towards achieving reductions in overall NHS manning. We would urge the Government to consider how it might exert pressure on local authorities to act likewise (for instance, through the use of a cash limit for wages and salaries). We believe that the tightening of financial management throughout the public services, and the introduction of a MINIS-type system wherever possible will aid these objectives.

* **We recommend manpower cost savings of £350 million in 1983/84 and £700 million in 1984/85.**

IV.8 Public Sector Pay

The CBI Working Party Report showed that public sector pay relative to private sector pay had improved for all categories of public sector workers during the 1970s.

Chart IV.2 gives the most recent figures, indicating that there was some reversal in the post-Clegg public sector advantage in 1981/82. Relative pay does however remain high by historical standards for manual workers in the public services.

* **We urge the Government to adhere firmly to its 3½% guideline for public sector pay increases in 1982/83.**

IV.9 Pensions

* **In evidence to the Scott Committee of Inquiry in 1981 into the value of Pensions we recommended that fully inflation-proofed pensions in the public service sector be discontinued.**

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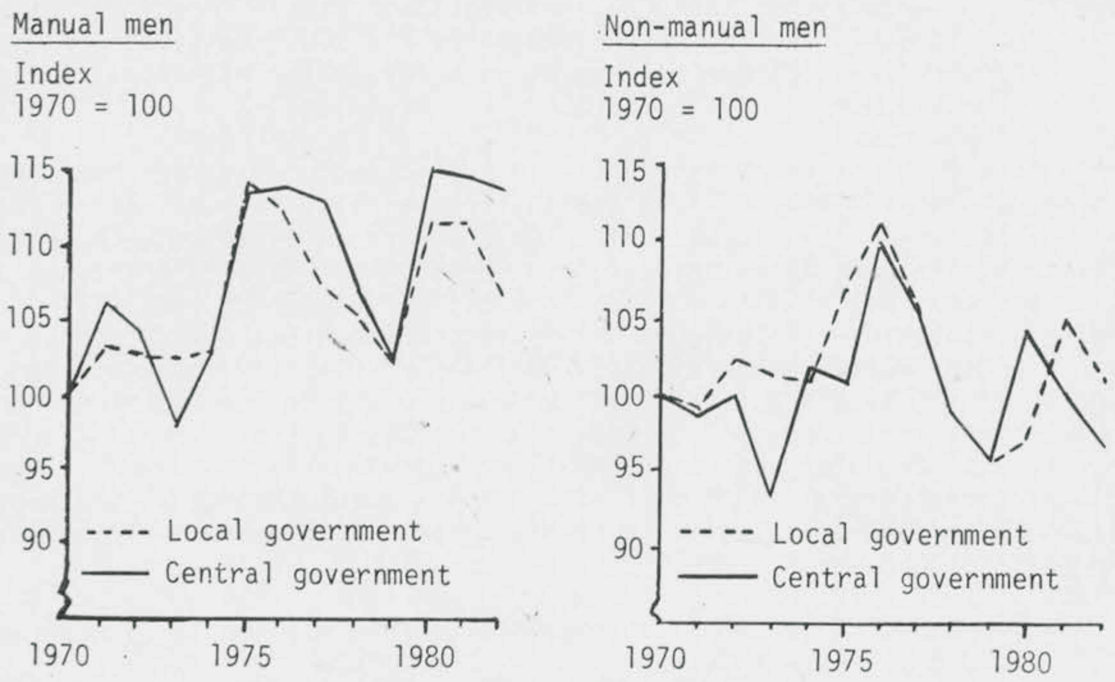
1 See page 28 of 'A Winning Budget'.

2 Source - Treasury memorandum to Treasury and Civil Service Select Committee on Civil Service Manpower, 7 December 1982.

CHART IV.2

INDEX OF PUBLIC SECTOR EARNINGS AS A PERCENTAGE OF PRIVATE SECTOR EARNINGS



Notes: The figures relate to men working full-time. Comparisons for females have been affected by moves to equal pay and have not been included.
The earnings figures (from which the percentages are calculated) include all gross pay but do not take account of pension arrangements, fringe benefits, or other conditions of service.
No allowance is made for the differences in the nature of the work done or the qualifications of the employees concerned.
The 1982 figure for local authority non-manuals has been adjusted to include the teachers' 1982 settlement.

Source: New Earnings Survey 1982 and CBI estimates.

* **We have also recommended that in the interim all public sector pension contributions be increased to the notional 8-8½% paid by the civil service. We welcome the recent increase in contribution rates for the police force, and recommend that similar action is taken in respect of local authority workers, teachers and employees of the NHS.**

IV.10 Competitive Tendering

As we have highlighted in Section IV.1, one area where there has been a persistent problem of control is local authority current expenditure. This is of particular concern to CBI members in view of its implication for rates.

In our response to the Government's Green Paper 'Alternatives to Domestic Rates'[1] we argued that local authority current spending should be reduced by:

* **Leaving the provision of some services to the market and voluntary sectors.**

* **Increasing efficiency, in part by using private contractors where appropriate.**

* **Tailoring levels of provision more closely to real consumer need.**

It is in the second area that we believe real manpower cost savings may be achieved, particularly in local authority services but also in parts of the NHS (such as catering and cleaning). We recognise that areas of the civil service such as the PSA and the Department of the Environment have already taken this course of action. We believe that opening a range of public services to competitive tendering or contracting out will encourage efficiency, even if the service continues to be provided by direct labour.

We are at present considering a recommendation that there should be an extension of the existing legislation in respect of Direct Labour Organisations which would open up a wider range of local authority services to competition.

1 CBI Submission on the Green Paper 'Alternatives to Domestic Rates' (Cmnd 8849), March 1982.

V: LOCAL AUTHORITY FINANCE

We have repeatedly stressed in these Representations that a reduction in business costs is an essential part of the strategy for improving our competitiveness so fundamental to our recovery from the recession.

Last year's Budget Representations emphasised the concern of business ratepayers about large increases in rate bills over which they had no control. Since then the rate burden on business has become an even more prominent issue. In the four years 1978/79 to 1982/83 business rates have risen by more than one and a half times as much as the level of retail prices as illustrated in Chart V.1.

CHART V.1

BUSINESS RATES[1] INCREASES COMPARED WITH INFLATION

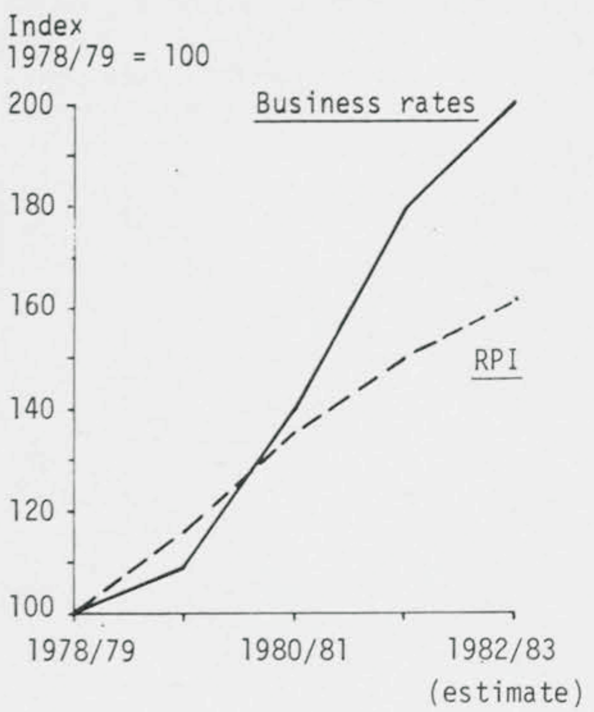
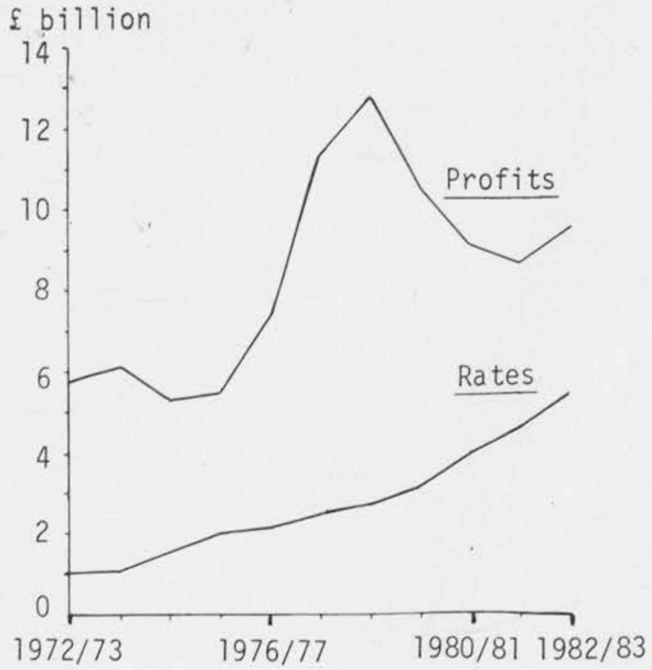


CHART V.2

BUSINESS RATES[1] AND PROFITS[2]



1. Business rates exclude North Sea activities and financial institutions.
2. Profits are gross trading profits for industrial and commercial companies less stock appreciation and capital consumption, excluding North Sea activities.

Sources: Rates - CBI estimates for Great Britain based on Department of Environment and Scottish Office data.
Profits - CBI estimates based on CSO data.
RPI - Department of Employment. Financial year averages.

First indications for 1983/84 suggest that, despite the falls in inflation, many authorities are contemplating rate rises in double figures. In some cases increases of six or more times the likely rate of inflation are being considered.

These increased costs reduce profitability, and this in turn will influence the regional location and investment of industry.

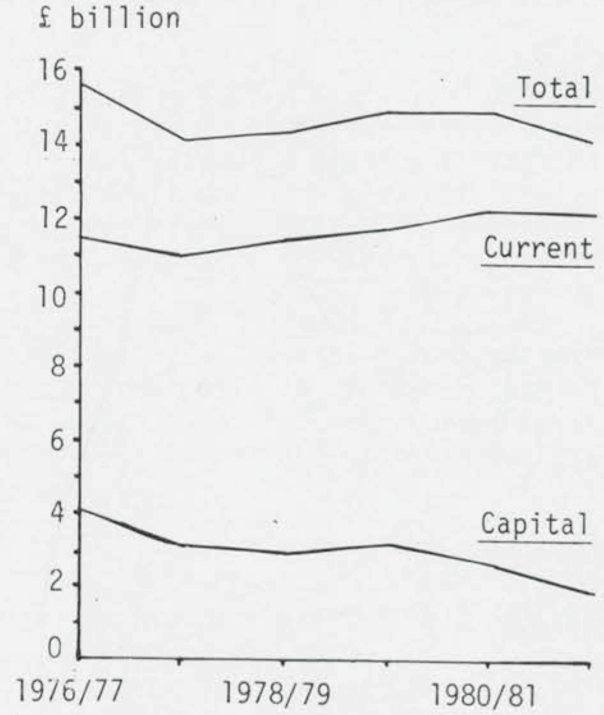
Relatively large prospective increases in rates are taking place at a time when profits are particularly depressed. Chart V.2 compares the movements in profits of industrial and commercial companies, excluding North Sea activities and financial institutions, with the rise in those companies' rate bills.

V.1 Local Authority Expenditure and Rate Levels

The main determinant of the level of rates is the level of local authority current expenditure. It has been suggested that as total local government expenditure has fallen by 10% in real terms over the last 5 years it is unreasonable to suggest that local councils have not made an important contribution to the cutting back of government expenditure. However, Chart V.3 shows that the fall in expenditure has been entirely due to cuts in capital spending whilst current expenditure remains relatively buoyant.

CHART V.3

LEVELS OF LOCAL AUTHORITY EXPENDITURE[1]



1. Great Britain only, at 1976/77 outturn prices.

Source: The Government's Expenditure Plans 1982-83 to 1984-85 (Cmnd 8494, Table 4.3).

The Government has published details of the total for the Rate Support Grant (RSG) for 1983/84. Government support for local authority spending in England will drop again in percentage terms from 56.1% in 1982/83 to 52.8% in 1983/84, though the effect of this reduction in grant will be offset to some extent by the increase in relevant expenditure from £20.5 billion to £22.3 billion. Government has also set expenditure targets for individual authorities designed to achieve a cutback of 1% in the real average level of spending.

From our calculations for 1983/84, we estimate that provided councils keep to the Government's guidelines, the national average rate level would be approximately the same as in 1982/83 and on average rates would not need to rise. Indeed, within that average, some councils could even reduce their poundages. This was also our contention last year when we calculated that, even taking account of the drop in RSG, local authorities on average could have balanced their budgets with a zero rate rise or even, in some cases, with a drop of one or two points. Yet rates increased by an average of nearly 13%. In order to achieve the target expenditures in 1983/84, authorities which have budgeted to overspend in 1982/83 will be expected to make significant real cuts - as much as 7% in a few cases - whereas councils which have kept within the guidelines will be required to make a real cut in spending of up to 2%. The CBI regrets that many local authorities still appear unwilling to accept the need for restraint in local government current spending and the practicability of cuts, and are set to raise their rates again by amounts which in some cases will far exceed the rate of inflation.

We recognise, however, that in some cases short-term increases in current spending may be justified in the interests of increasing efficiency and reducing expenditure in the long term. The CBI is concerned that local authorities should not be penalised through the grant system for expenditure of this nature.

The CBI strongly backs the Government's policy of making gradual reductions in the RSG in order to encourage restraint in local authority current expenditure and to increase the local accountability of councils to their electorates. The problem with this approach is that it has not been accompanied by measures to protect the business ratepayer who, unlike his domestic counterpart, has no formal way of influencing local authority decisions through the ballot box.

It is a matter of priority that this vital missing link in the Government's strategy is forged by measures aimed at safeguarding the business ratepayer from high spending local authorities. Rates are now the heaviest tax on business and in 1982/83 we estimate business will have paid £5.7 billion in rates.

V.2 Specific recommendations

*** A ceiling on business rate increases should be introduced**

This measure, which we had hoped to see incorporated in the Local Government Finance Act 1982, is necessary in order to protect business from its vulnerable position in relation to the rating authorities.

Such a ceiling would:

i reduce the uncertainty which businesses face;

ii restrain local authority spending;
iii limit overall taxation levels;
iv help to increase local accountability;
v impose no real constraint on local democracy;
vi involve no Exchequer cost to central government; and
vii contribute towards improving our competitiveness by restraining the growth of business costs.

Therefore we urge the Government as a matter of the highest priority to introduce legislation to impose a ceiling on business rate increases. The ceiling should aim to prevent business rates rising by more than the rate of inflation or the rate of increase in domestic rates, whichever is the lower.

*** Partial business derating should be introduced**

The CBI does not oppose rates as a tax in principle, and in general business ratepayers are prepared to pay their fair share for local authority services from which they benefit directly. But at a time when most businesses are struggling against the depressing effects of the recession, they feel strongly that they should not be taxed at a higher level than the domestic sector which enjoys rate relief granted by central government.

In the inter-war depression and up to 1963 industrial derating was granted at a time when there was no rate relief for the domestic sector. Since 1967, when domestic rate relief was introduced, the situation has been reversed. Given the budgetary constraints, our recommendation is for 15% derating to be enacted for all business (with a comparable extension of the current industrial derating in Scotland and Northern Ireland). The case for partial derating being introduced is particularly strong for industrial concerns.

The proposal for 15% derating should be financed by central government grant in the first year. In subsequent years, this grant could be phased out as the local authorities increased both their efficiency and their income from charges.

It is recognised that the introduction of partial business derating will require legislation separate from the Finance Act. We are convinced that, given sufficient political will, such legislation could be enacted in the present session and that the administrative problems for both central government and local authorities could be overcome without much difficulty.

We estimate that the cost for 1983/84 would be approximately £950 million at 1983/84 prices, representing less than 4% of total rate- and grant-borne expenditure for that year.

This measure would have an immediate effect in reducing business costs.

*** Empty business property rate should be abolished and relief for "mothballed" premises and plant should be implemented**

In principle, rates are a tax on beneficial occupation of property, so in our view the levy of rates on empty property is illogical and undesirable. Although some relief is given both through the initial 3-month 'free' period and the statutory maximum levy of 50% of the full rate, at a time of recession when profits are so depressed the taxation of empty property is viewed by business as being particularly harsh.

Because of depressed trading conditions it is becoming even more difficult to sell or let empty business property, especially industrial property. In fact there are widely publicised reports of companies rendering empty buildings derelict, for example by removing the roofs, so that they are not liable for rates.

The CBI considers that the existence of a tax which encourages the reduction of our capital base is unacceptable. The CBI has done all it can to persuade those local authorities who levy empty property rates to exercise their discretion to waive them but, though some have responded, many others have not. It is time for the Government to step in and abolish the rating of empty business premises. The power to prevent this type of rating already exists and primary legislation is not required.

We estimate the loss of annual revenue to local authorities arising from the abolition of empty property rate for business premises would be in the order of £30-35 million.

The arguments put forward for abolishing empty property rate for business apply equally to the rating of partially empty premises where companies cannot use the empty part because of the recession but which they wish to maintain for re-use when the economic situation improves.

We do not accept the argument that this 'mothballing' relief would be too complex to administer and too difficult to police. The CBI has put forward practical proposals for the implementation of such a measure, and for its policing, in our response to the Green Paper on 'Alternatives to Domestic Rates' (Cmnd 8449).

Help could also be given in this area by making the discretionary apportionment of rateable value between occupied and temporarily unoccupied parts of business properties mandatory, so that the overall rate bill on these properties would be lower.

We recommend that legislation is introduced to permit 'mothballing' relief for business in 1984/85. We propose that £150 million of annual relief at 1983/84 prices is given.

ANNEX 1

Government Measures to Encourage Business in 1982

In the CBI Budget Representations submitted to the Chancellor in early 1982 various recommendations were made aimed at reducing the disproportionate burden on the business sector. The table below sets out the main recommendations together with details of actual measures introduced during 1982.

	CBI 1982 Budget recommendations	1982 Budget	Autumn Statement
National Insurance Surcharge	2% immediate reduction as first step to abolition	Reduced from 3½% to 2½%	Reduced to 1½% for 1983/84 plus backdating of extra ½% reduction for 1982/83.
Income tax allowances and bands	Index by rate of inflation	Indexed by 14% (2% above inflation)	
Business derating	15% derating		
Aid for Small Firms	Extensions of Business Start-Up Scheme to encourage the development of SFICs and to help already existing small firms	Some improvements to Business Start-Up and Loan Guarantee Schemes.	
	Capital tax indexation	Capital taxes partially indexed	
Energy	Reduction of industrial users electricity prices.	Gas freeze April to December 1982. Special tariff introduced for heavy users.	Gas price freeze extended to October 1983. Standstill of average electricity prices.
Investment	Increase in planned public capital expenditure of £250m in 1982/83 and £1b in 1983/84.	Small package of measures to encourage house building	Further small package of increased expenditure on urban development and housing.

ANNEX 2

THE ECONOMIC SITUATION AND PROSPECTS

INTRODUCTION AND SUMMARY

In this annex we consider first the current economic situation; secondly the outlook on unchanged policies for the next two years; and thirdly the effects of our recommendations.

A year ago our central forecast on unchanged policies was a sluggish recovery in output, insufficiently fast to reduce unemployment. We estimated that our recommendations would improve the prospects for growth and employment but, even if implemented in full, our central forecast would still have been only modest growth. We also drew attention to three elements of the forecast where the prospects were particularly uncertain - consumers' expenditure, stockbuilding and the world economy - and constructed optimistic and pessimistic scenarios to indicate the margins of error.

In the event, although consumers' expenditure has been more buoyant than in our central forecast, the unexpected weakness of the world economy has more than offset this. The outcome for output, growth and unemployment in 1982 has therefore, been close to the pessimistic scenario which we prepared a year ago.

Meanwhile, partly because the world economy has depressed commodity prices, but also because of a number of other factors described below, (some of which might not be repeated), the fall in inflation has been in line with our optimistic scenario.

Looking ahead, we must emphasise the margins of uncertainty surrounding our forecasts as illustrated in the charts that follow.

Our central forecast on unchanged policies over the next two years is, again, one of slow growth, with inflation remaining close to the 5% level in the first half of this year.

We estimate that our recommendations would improve the prospects for output, profitability, unemployment and inflation. To the extent that any strategy carries risks, we believe our proposals would considerably reduce the danger of further widespread losses of industrial capacity, and rising unemployment, with little risk of encouraging inflation.

SITUATION, AND PROSPECTS ON UNCHANGED POLICIES

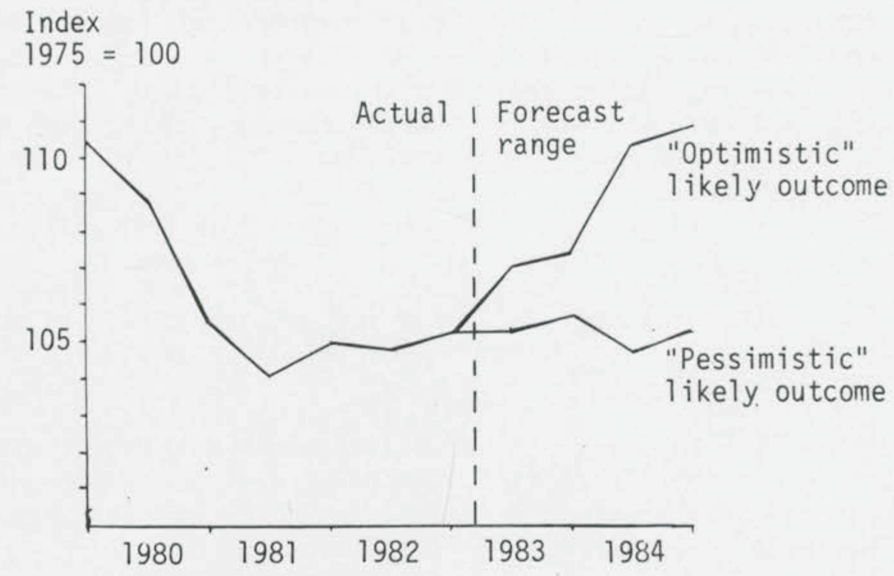
Demand and Output

The sharp fall in output in 1980 continued into early 1981 before starting to stabilise, or possibly rise slightly, from the middle of the year. Output fell sharply by historical standards in the economy as a whole and the fall was particularly great in the manufacturing sector.

During 1982 GDP has remained more or less flat. Between the two halves of 1982, consumers' expenditure grew by about 3% at an annual rate, accompanied by some growth in government current and capital expenditure. The effect on output of the growth in these demand components was however, offset by continuing destocking, growth of imports and a small fall in exports. As a

CHART A.1

GDP[1] - FORECAST ON UNCHANGED POLICIES[2]



1. Output estimate of GDP at 1975 prices, half-yearly figures.
2. See text for definition of 'unchanged policies'.

Source: CSO and CBI forecasts

consequence, we estimate that GDP was less than ½% higher than in 1981 (see Chart A1).

On the Treasury's definition of unchanged policies[1] GDP is forecast to rise by about 1% in 1983 and about 1½% in 1984. This assessment is in line with the official Treasury forecast. Chart A.1 shows the CBI staff projections for GDP on optimistic and pessimistic paths[2] and indicates how, even on optimistic assumptions, on present policies it is likely to take until the end of 1984 for production to recover to the 1979 level. Our pessimistic path shows a slight decline in output over the next 2 years.

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1 Indexation of tax allowances and revalorisation of specific duties, no change in direct tax rates and the Government's published spending plans.

2 We have increased our central GDP projections by the average error in past London Business School forecasts between February 1977 and February 1981 to give the "optimistic likely outcome" shown in Chart A.1. The "pessimistic likely outcome" shown in Chart A.1 was obtained by subtracting the average error from our central forecasts. There is about a 3 in 5 chance of the outturn falling within the range of one average error above or below the central forecast if the forecast errors are normally distributed. The Charts showing RPI, unemployment and real rate of return were derived in the same way using data on average errors in London Business School or CBI staff forecasts.

Our central forecast suggests that in 1983 and 1984 the main upward influences on demand are likely to be an increase in consumers' expenditure, a return to modest stock rebuilding and growth in public current and capital expenditure. We see imports continuing to rise strongly with only a gradual recovery of exports. We should stress that our forecast for the UK is critically dependent on our views of the world economy over this period. We forecast world trade in manufactures to rise by about 2% in 1983 and by a little under 4% in 1984. The danger of world recovery being even weaker than this is one of the factors most likely to cause the forecast to be below the central path.

Inflation

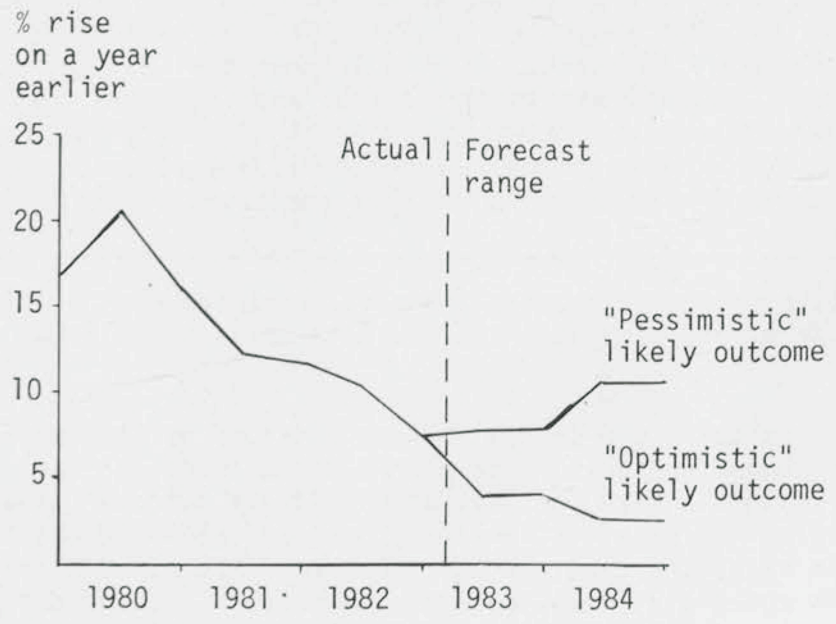
1982 witnessed a continuing decline in the rate of inflation, as measured, for example, by the percentage change in the Retail Prices Index over the previous twelve months.

By the end of the year this measure of inflation was running at 6%. The decline reflected a number of factors, including weak world commodity prices, favourable seasonal food prices and reductions in the mortgage rate, as well as lower unit labour cost increases working through.

On our central forecast some slight increase in inflation could occur from mid-1983. To a large extent this would reflect the ending of the impact of a series of recent temporary influences which have been favourable to inflation. In particular, seasonal food prices are unlikely to exert the same downward effect on prices, commodity and oil prices are unlikely to be

CHART A.2

RETAIL PRICE INFLATION - FORECAST ON UNCHANGED POLICIES



Source: Department of Employment, and CBI forecasts.
See text for definition of 'unchanged policies'.

so weak (unless the world economy proves even more sluggish than expected) and mortgage interest rates are not likely to decline so rapidly. However, if retail price inflation does pick up somewhat, this should not necessarily be regarded as a return to higher inflation but more as a return to the underlying rate. By the middle of 1984, the central estimate suggests that the downward trend in inflation will again be apparent.

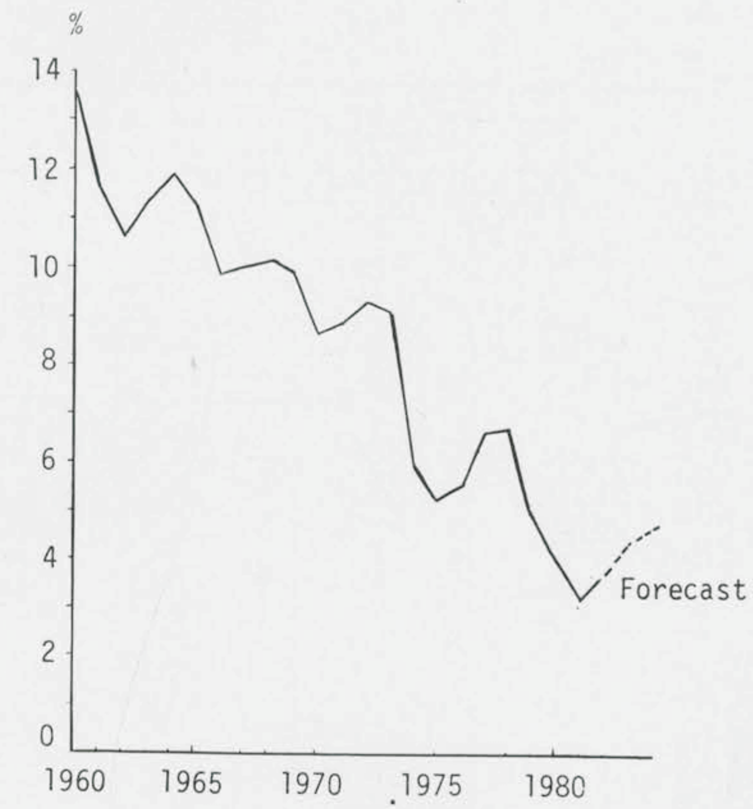
Chart A.2 shows that on optimistic assumptions, inflation could come down to 2-3% by 1984, while on pessimistic assumptions it could rise again to 10%.

Company Profitability and Investment

We estimate that in 1982, the real pre-tax rate of return for industrial and commercial companies was about 4%, excluding North Sea activities. This is some improvement over 1981, but is still very low by historical and international standards.

CHART A.3

REAL PROFITABILITY[1]



1. Gross trading profits plus rent minus stock appreciation and capital consumption for industrial and commercial companies, excluding North Sea activities, as a percentage of capital employed.

Source: Bank of England, and CBI forecasts assuming no action in 1983 Budget.

As a result of low profitability, investment and other provisions for the future have been cut sharply in the past three years by businesses. Manufacturing industry investment (even after adjusting for leasing) is estimated to have fallen by around 25% between 1979 and 1982, although investment outside manufacturing has remained relatively strong.

For 1983 and 1984 some improvement in real profitability is expected - to around 4½% on our central estimates. Chart A.3 shows that this would still be very low compared with past levels. Manufacturing investment is expected to fall by some 4½% in 1983 and private investment to rise by a modest 1% in 1983 compared with a year earlier. The outlook for 1984 is a little, although not significantly better.

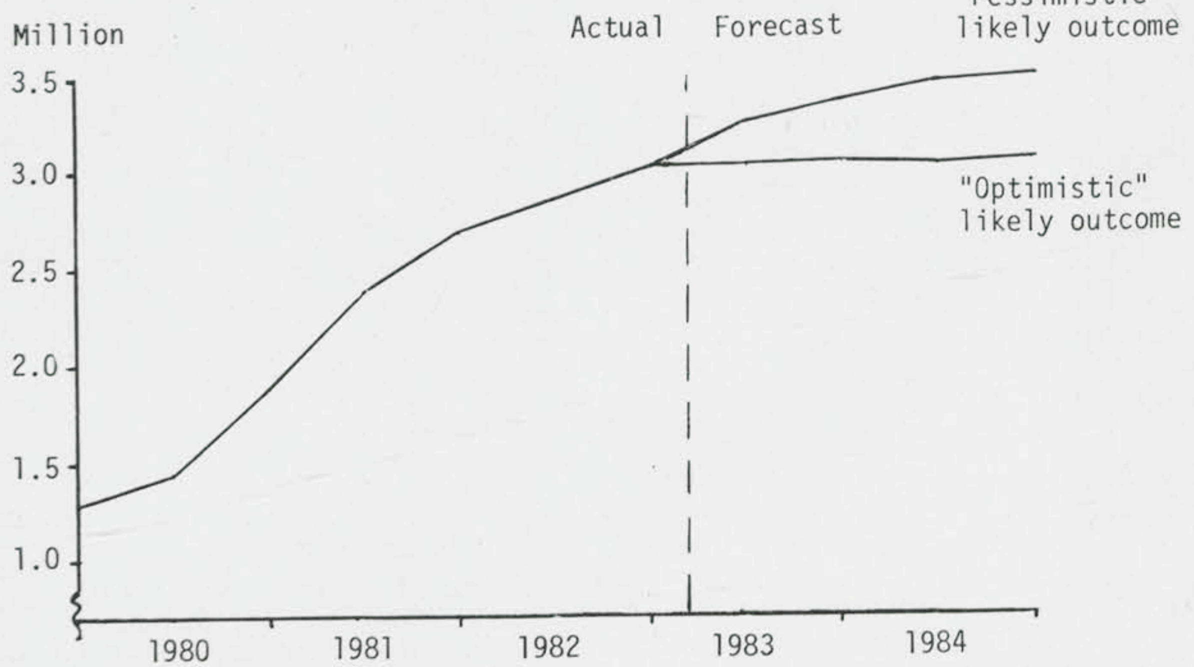
Unemployment

Chart A.4 shows the very rapid rise in unemployment from the end of 1979 and throughout 1980. Unemployment continued to rise throughout 1981 and 1982, but at a lower, though still historically high rate. By the end of 1982, the number unemployed (seasonally adjusted and excluding school leavers) was 2.95 million on the voluntary registrations method of counting. The figure on the old method of counting would have been about 3.2 million.

Unemployment on the old basis is forecast to reach a little over 3.2 million by the end of 1983. Thereafter unemployment could stabilise at around this level (see Chart A.4).

CHART A.4

UNEMPLOYMENT[1] - FORECAST ON UNCHANGED POLICIES



1. For consistency with earlier data, figures from November 1982 onwards are adjusted to include estimates of those not claiming benefit who had previously registered as unemployed.

Sources: Department of Employment, and CBI forecasts. See text for definition of 'unchanged policies'.

Monetary Situation and Public Sector Borrowing Requirement

Our central estimate, still subject to a large margin of error, is that the outturn of the public sector borrowing requirement for 1982/83 will be around £7½ billion. This compares with the Treasury's £9½ billion estimate in March 1982. The growth of Sterling M3 is likely to remain within, but probably at the top end of, its 8-12% range, and broadly in line with the growth of M1 and PSL2.

Preliminary forecasts suggest that, in the 1983/84 financial year, the PSBR will be around £6 billion, assuming unchanged policies.

Monetary forecasts are particularly uncertain, but it is likely that monetary growth, assuming some fall in interest rates, will be close to the top of the 7-11% target range for 1983/84.

HOW THE PROSPECTS WOULD BE IMPROVED BY IMPLEMENTATION OF CBI POLICIES

We described above our forecasts for GDP assuming unchanged policies. In this section we consider the likely outlook if the CBI recommendations set out in this document were implemented in the 1983 Budget. The formal assumption is made that there is no further change in fiscal stance in the 1984 Budget. In "The Will to Win" and "Agenda for Recovery" the CBI put forward medium-term proposals that would imply a fiscal expansion in the 1984 Budget. Our estimates are based on our own econometric model but we also checked them with the London Business School model and obtained essentially similar results.

HOW CBI POLICIES AFFECT OUTPUT

CHART A.5

"PESSIMISTIC" LIKELY OUTCOME

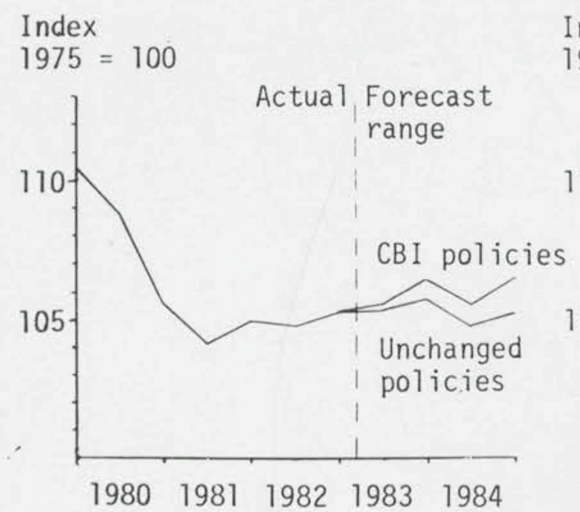
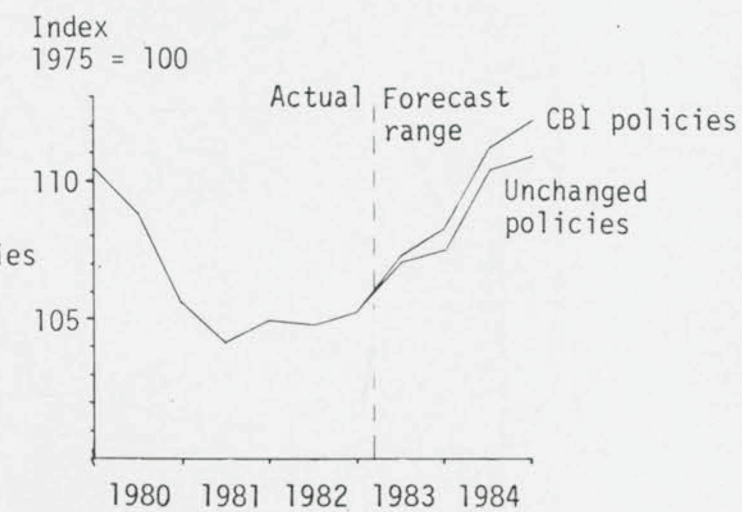


CHART A.6

"OPTIMISTIC" LIKELY OUTCOME



Notes: Sources and definitions as for Chart A.1
See text for definitions of 'unchanged policies' and 'CBI policies'.

i Effect on Output

Our proposals would increase output compared with unchanged policies through two main routes. First, competitiveness would be improved by the reductions in business costs that we are proposing. This improvement in competitiveness should lead to higher exports and lower import penetration, thus increasing GDP. Second, our measures represent an increase in the overall level of demand because of the increase in the difference between government expenditure and revenue.

Chart A.5 shows that on present policies, if developments were at the pessimistic end of the range of likely possibilities, output by the end of 1984 would be lower than at the end of 1982. This would destroy the present hopes that unemployment could more or less stabilise in the second half of next year and it would eliminate the small recovery in profitability that we are currently hoping for. We would regard such an outcome as extremely unsatisfactory. If, on the other hand, our policies were implemented, output would rise, though only slowly. This would still be far from satisfactory but markedly better than a decline in output.

Chart A.6 shows that if the outcome were at the optimistic end of the likely range then even on present policies output would grow at a significant rate. If our policies were implemented, there would be growth of 6-7% over the next 2 years (3-3½% a year). Even this, however, would leave output only a little higher than in 1979. Because of the large margin of spare capacity existing at present, growth at this rate would be unlikely to lead to significant shortages.

HOW CBI POLICIES AFFECT UNEMPLOYMENT

CHART A.7

"PESSIMISTIC" LIKELY OUTCOME

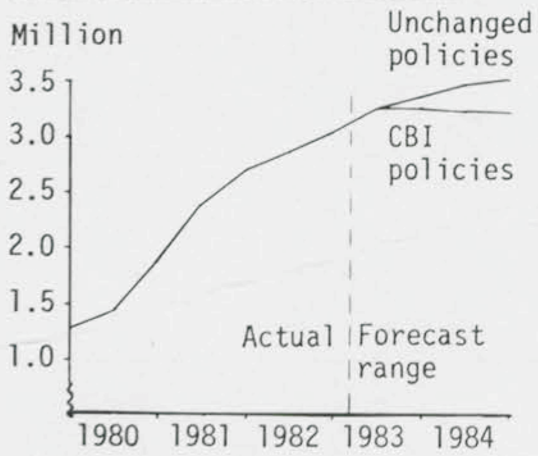
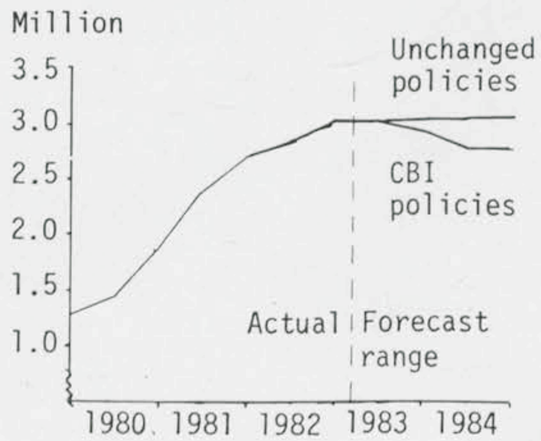


CHART A.8

"OPTIMISTIC" LIKELY OUTCOME



Notes: Sources and definitions as for Chart A.4.
See text for definitions of 'unchanged policies' and 'CBI policies'.

ii Effect on unemployment

Charts A.7 and A.8 show the likely impact of our policies on unemployment. If unemployment turned out to be at the pessimistic end of the likely range suggested by our forecasts, then on current policies it would continue rising fairly markedly throughout the period to the end of 1984, while on our policies it would turn down slightly. At the optimistic end of the likely range, unemployment would decline slightly on current policies but on CBI policies it would fall - to around 2½ million (excluding school leavers, seasonally adjusted on the old basis).

iii Effect on Profitability

Chart A.9 shows that on current policies real profitability would fall back from the expected level in the first half of 1983 if developments turned out at the pessimistic end of the likely range of outcomes, while if CBI policies were implemented, there would be little change from present levels. If events turned out at the optimistic end of probable forecasts, profitability on present policies would rise to around 5% by the second half of 1984 - still very low by historical standards - whereas on our policies it could reach 6%.

HOW CBI POLICIES AFFECT PROFITABILITY

CHART A.9

"PESSIMISTIC" LIKELY OUTCOME

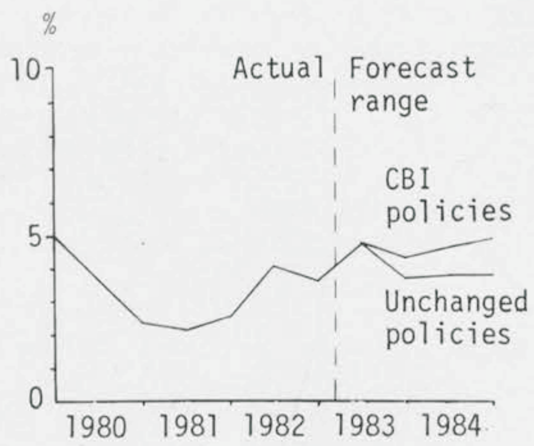
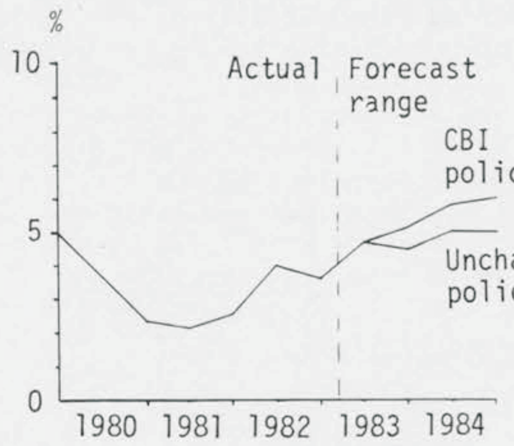


CHART A.10

"OPTIMISTIC" LIKELY OUTCOME



Notes: Sources and definitions as for Chart A.3
See text for definitions of 'unchanged policies' and 'CBI policies'.

iv Effect on inflation

We described above our central projection for inflation, which showed a slight slowdown from the present rate, assuming unchanged policies.

Charts A.11 and A.12 show that, if anything, our proposals would be likely to reduce inflation, because of the reduction in business costs that they imply.

HOW CBI POLICIES AFFECT INFLATION

CHART A.11

"PESSIMISTIC" LIKELY OUTCOME

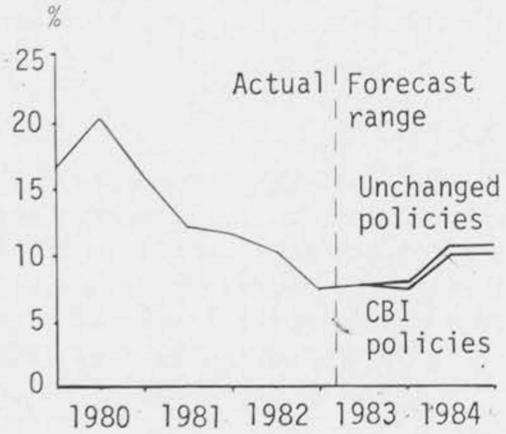
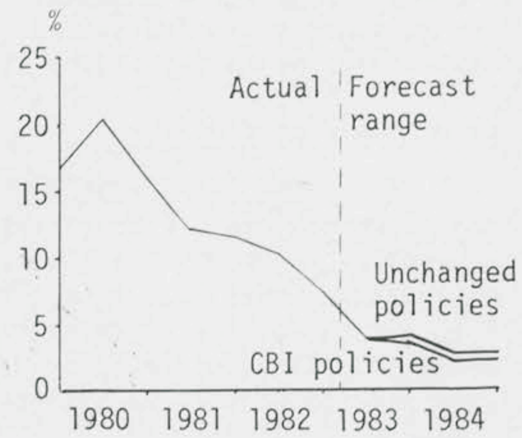


CHART A.12

"OPTIMISTIC" LIKELY OUTCOME



Notes: Sources and definitions as for Chart A.2.
See text for definitions of 'unchanged policies' and 'CBI policies.

v **Effect on PSBR**

The higher output generated by our measures would, after a while, boost government tax revenue and reduce unemployment payments compared with present policies. This would partially offset the direct effects on the PSBR of the measures we are proposing, although the initial effect would probably be small. Table I.1 summarises our estimates of these "feedback" effects. The PSBR would be increased by about £3 billion in 1983/84 from the £6 billion figure we expect on current policies. In 1984/85 the PSBR would be increased by about £2 billion at 1983/84 prices by our recommendations, compared with what it would otherwise have been.

vi **Balance of risks**

The charts above give an indication of the balance of risks affecting the economy. They show that CBI policies are likely, if anything, to reduce prices compared with what they would otherwise have been by reducing business costs and increasing volume; and that even on optimistic assumptions about growth, our policies would be unlikely to lead to inflationary shortages. In any case, any risk of higher inflation has to be balanced against the risk of lower output and higher unemployment. Our pessimistic assumptions, assuming no change in policies, show output stagnant or even declining, and unemployment in the second half of 1984 some half a million higher than in the second half of last year.

Given the range of possibilities, we judge that the risk of implementing the proposals contained in this document are relatively small, whereas the dangers involved in following unchanged policies, or policies substantially more modest than those we propose, would be unacceptably great.