C. & J. PATTEN, M.P.

PRIME MINISTER

National Insurance Surcharge

1. Chris and John Patten have sent to me an advance copy of an article which they have written, jointly, for The Guardian, and which is due to appear this week.

2. Although you will remember that this point was raised by Denis Fahey at the small meeting after the Party Reception in Stoke-on-Trent on Friday, the prospect of increasing the P.S.B.R. by one billion pounds is the reverse of attractive.

3. Nevertheless, I think that the two Pattens have argued their case very well.

4. The article appeared in to-days Guardian.

9th June, 1980

Ian Gow

9th June, 1980

National Insurance Surcharge

Thank you so much for your letter of 5th June, and for letting me see an advance copy of the article which you and John have written for The Guardian.

I much appreciate your having written as you did about this, and I have shown your article to the Prime Minister.

If I may say so, I think that you argue your case most persuasively, although I take the view that even a P.S.B.R. of £8,500 million (however uncertain that estimate may be) is too high.

I am sure that you will have sent a copy of your article to Geoffrey, and that you will have a talk with him, if you would like to do so.

I cannot help noting the agreeable contrast between the style of your advice to the Chancellor, on the one hand, and the style of the advice which is given by Labour backbenchers to the Shadow Cabinet, particularly when it is the Labour Party which is proclaiming the universal brotherhood of man.

IAN GOW

Chris Patten, Esq. M.P.
House of Commons,
Westminster, London SW1

c.c. John Patten, Esq. M.P.

JOHN PATTEN, M.P.

HOUSE OF COMMONS
LONDON SWIA OAA

5th June, 1980

Ian Gow, Esq., MP.,
The Prime Minister's Office,
10 Downing Street,
LONDON S.W.1

Dear Ian,

We thought that you might be interested to see a copy of an article which we have written on the subject of National Insurance Surcharge. It is to appear, we understand, in The Guardian next week.

Yours sincerely,

Chris

Chris Patten, MP

John Patten

John Patten, MP

HOUSE OF COMMONS
LONDON SWIA OAA

Whether you are a monetarist, a Keynesian or a card-carrying agnostic on the economy, there is no painless way of abating inflation. One of the paradoxes of the present political scene is that while the Government's intention is to strengthen British industry in the medium and long term, its attack on inflation is bound to mean ~~a period of~~ some "hard pounding" over the next year or two for what Walter Eltis would call the marketable sector of the economy. High interest rates, a high exchange rate and pay settlements which are still in some parts of the private sector (as well as the public sector) unsustainably high, are together bound to put a vice-like squeeze on many firms this winter. Add falling world demand to a sharp drop in the level of economic activity at home and the immediate outlook, even for some of our averagely successful companies, is not likely to give many boards of directors or sensible shop-stewards much to be sanguine about.

Last September, the Bank of England was forecasting that "industrial companies may be faced with a financial squeeze as severe, if not as abrupt, as in 1974-75". The Treasury Select Committee has more recently expressed similar anxieties, as for example in their question and answer session with the Governor. "The Guardian's" own Frances Cairncross has argued that the squeeze this time round ma not be as tight as it was in 1974 but that it could last longer. Others still have been more apocalyptic, going so far as to express the over-blown fear that in a few years' time we may finish up with the Government's books beautifully balanced but with large sections of industry in the hands of the Receiver. According to the far left, the end of capitalism is nigh.

It is very easy to over-do the gloom. Nevertheless, the evidence of cuts in stocks, investment and the work-force is visible week-by-week in most constituencies where there is any manufacturing industry.

Some argue that the only thing we can do in these circumstances is to grit our teeth, hold on tight and hope that the industrial casualties are not too heavy. This seems an unnecessarily high risk strategy. Without compromising any of the Government's laudable objectives, there are other policy options ~~which are~~ to hand.

One idea which has received increasing attention is that there should be a substantial cut in the National Insurance surcharge which employers have to pay. This proposal should appeal to the Cabinet when they gather for their economic summit next month, not only because of the political history of this tax but more particularly because of the immediate and future economic effects of cutting it.

The surcharge was first introduced by Denis Healey in the summer of 1976 at the rate of 2 per cent. Faced by his customary July crisis, and faced by the equally customary refusal of his colleagues to concede sufficiently large public spending reductions, Mr. Healey brought in what was accurately described as his "Job Destruction Scheme" in order to help lower the Public Sector Borrowing Requirement. The surcharge was vigorously attacked by the Conservative Opposition. As John Nott said at the time, it was "a tax involving smaller profits for industry, less investment, higher prices and fewer jobs". He could have added a point which was made implicitly by Sir Geoffrey Howe in his first Budget Statement last year that (unlike VAT) it

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penalised exports but not imports.

Undeterred by all the criticism, Mr. Healey slapped a further 1½ per cent on the surcharge in June 1978, and it has remained at 3½ per cent ever since.

Unfortunately, even if time does not increase the attraction of particular taxes, it does increase their yield! So when we pressed the Chancellor for a cut in the surcharge during the Budget debate this year, his answer was, understandably enough, fairly predictable. "I recognise," he said, "that a claim can be made for a reduction of the surcharge, but it is a very expensive tax to reduce." He went on, "A reduction of 1 per cent in the tax would cost £1,000 million . . . To achieve such a reduction would be at the expense of a higher PSBR and, therefore, at the expense of high interest rates."

Nevertheless, the arguments for reducing the surcharge looked more sensible the more one examined them. In the critically important task of helping efficient manufacturing industry to come through the recession in something like one piece, it was difficult to think of any better ideas which were compatible with the Government's overall strategy. Those to whom we spoke in industry usually appeared to share our view. As one prominent industrialist said, it could be just as useful as a cut in M.L.R. becuase it would give an immediate boost to a firm's cash flow and thus help it to weather the recession.

We decided, therefore, to take advantage of the availablility of the Treasury model to see what would be the effects of halving the surcharge without making any compensating fiscal adjustments. The results - on plausible

assumptions about the economy - were more encouraging than we had dared to hope, modest perhaps in the extent to which a cut would alleviate industry's inevitable difficulties but helpful nonetheless.

First, there would be a small boost to the economy with about 85,000 more people employed at the beginning of 1982 than would otherwise be the case. Industry's competitiveness and our export performance would improve slightly and this, taken with the effect on companies' cash flow, would help investment. At the same time, this reduction ~~does~~ would not suck in imports like other sorts of tax cut.

Not necessarily not

Second, because of the increase in economic activity, the rise in the PSBR (about £1 billion) would be less than the cost of the reduction in revenue (about £1½ billion). Even if one does not share the view of the monetarist London Business School that it is reasonable for the borrowing requirement to rise slightly in money terms in a recession, this small increase is hardly larger than the last minute borrowing by local authorities which lifted the final PSBR figure for 1979-80 by £660 million within weeks of the Chancellor's April Budget estimate. A £1 billion increase in the PSBR is well within the margins of error usually associated with this somewhat over-rated yardstick of economic virtue.

Third, the monetary effects shown by the simulation are negligible. The improvement in firms' cash flow reduces the demand for credit which they would otherwise place on the banks. It was possible to retain the same path of monetary growth without raising short term interest rates and with only a minute increase in long rates.

We are not suggesting that having fed this single proposal into the Treasury model, we have hit the jack-pot. But at worst the result isn't a lemon, and at best it seems to give the Chancellor a little more room for manoeuvre in protecting industry from the most damaging side-effects of the over-ridingly important fight against inflation. Jobs and output are bound to be lost temporarily in that struggle. That is not in question. But what _is_ still in question is how many jobs and how much output. Cutting the National Insurance surcharge is one of the non-inflationary ways of keeping these figures within acceptable bounds.

By Chris Patten and John Patten
(The Conservative MPs for Bath and Oxford)

The simulation referred to above was undertaken on the Treasury Macroeconomic Model (including the experimental monetary sector) through the scheme operated by the House of Commons Library with the help of the Economist Intelligence Unit. It is not a Treasury forecast and incorporates assumptions which do not necessarily correspond to Treasury thinking.