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JU. (4)

Prime Minister

Treasury Chambers, Parliament Street, SW1P 3AG MES 3/11
01-233 3000

3 November 1981

J R Ibbs Esq.
Central Policy Review Staff
Cabinet Office
LONDON
SW1

Dear Robin

THE HEALTH OF INDUSTRY

Thank you for your letter of 16 October.

I have some sympathy with the case you and others are making for a reduction in the National Insurance surcharge next year, as you will have seen from my recent reply to Patrick Jenkin, and as you know from our discussion last Friday.

But as you recognise, and as I have to stress, my room for manoeuvre is very strictly limited by the fiscal prospect generally for next year, and the public expenditure prospect in particular. It may well be, as you suggest, that I shall not be in a position to pledge myself to cut the rate next April when decisions have to be taken next month.

For that reason I was interested to see your idea for keeping the options open. Since the responsibility for collecting NIS along with National Insurance contributions rests with the DHSS it must be for Norman Fowler to consider your suggestion for preparing alternative sets of tables for employers, and I am, therefore, copying our correspondence to him. But I am bound to say that, on my and my officials understanding of the logistics of a change, the need to issue the new tables to employers as early as January so that they can prepare for the new contribution year, coupled with the prior need for legislation, seems to rule it out as a practical possibility.

Nevertheless, you should not conclude that if I have to leave the rate as it is next April, there is no possibility of a lower NIS until April 1983. Arrangements have been explored in the past for making a mid-year change in the rate following

/an announcement

an announcement in the Budget, and though these are not without practical problems and inconvenience for DHSS, I hope Norman Fowler will be able to confirm that we could proceed that way if the need arose.

As well as Norman Fowler, I am sending copies of this letter to the Prime Minister, Patrick Jenkin and Sir Robert Armstrong.

GEOFFREY HOWE

J. Vereker
A Duguid
A Walters

CONFIDENTIAL

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Prime Minister

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Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

16 October 1981

The Rt Hon Patrick Jenkin MP
Secretary of State for Industry
Department of Industry
Ashdown House
123 Victoria Street
LONDON SW1E 6RB

Dear Patrick

Thank you for your letter of 12 October. As I said when we met on Monday, with P.M. (Blackpool), there is a good deal in it with which I am in sympathy.

There are, of course, other views, even in industry, about the best form of fiscal relief - if any were to become possible. Even so, the case for an early cut in the national insurance surcharge, to ease the strain on costs and prices, and to help stimulate greater output and more jobs, is explicitly acknowledged in the paper Leon Brittan and I have circulated to colleagues for next week's public expenditure Cabinet.

So too is the case for realism in setting public expenditure levels if we are ever to be in a position to move in the direction you would wish. We are suggesting that the maximum public expenditure we can afford falls well short of the bids that colleagues have made. Even so, because the levels are well above our White Paper plans, they are likely on present indications to use up the room I hoped would be available for tax cuts next year - and indeed the risk is that taxes may have to rise even higher. As you know, we shall be reviewing the rates and levels of NICs next month.

Leon has written to you about your proposal to reduce the deferment of RDGs. I have to look at this in the context of your public expenditure programme and of expenditure programmes as a whole. Much as I would like to reduce - indeed abolish - the deferment of RDGs there is no room for the additional expenditure in 1982-83. As Leon has said, not only are he and I bound to reject your bid, but we must ask for further cuts in your programme beyond what you have offered.

/The public expenditure

The public expenditure situation is thus crucial. Of course, your programme alone could not conceivably produce the sort of savings that would be necessary to finance a significant cut in the NIS. That is why I hope for your full support in pressing in Cabinet for the lowest possible public expenditure totals consistent with our political requirements. If we can successfully press our colleagues to make savings of the same severity as those being sought from the Industry programme, leading to lower overall figures than Leon and I have put forward, the prospects for taxation, and industry generally, will be that much improved.

As far as electricity price reductions are concerned, I understand that some proposals have been put to Nigel Lawson. No doubt he will be discussing them with you soon, if indeed he has not already done so.

I am sending copies of this letter to the Prime Minister, Sir Robert Armstrong and Robin Ibbs.

GEOFFREY HOWE

Mr. Scholar.

CABINET OFFICE

Central Policy Review Staff

From: J. R. Ibbs

70 Whitehall, London SW1A 2AS

Telephone 01-233 7765

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(2)

Prime Minister

MLS 16/10

2

CABINET OFFICE
Central Policy Review Staff
70 Whitehall, London SW1A 2AS Telephone 01-233 7765

From: J. R. Ibbs

Qa 05703

16 October 1981

Dear Chancellor,

The Health of Industry

The Secretary of State for Industry sent me a copy of his letter to you dated 12 October.

As you know I too have major worries about the possible long term damage which the current recession may inflict on British manufacturers. The forcing out of inefficiencies is an important benefit and I have ample evidence from my own contacts that managements are effectively tackling fundamental long standing problems and that unions are accepting some much needed changes. However, a persistent climate of low profitability undoubtedly inhibits development and investment in many established businesses and can wipe out the efficiency gains. This brings a heavy penalty in terms of international competitiveness if companies overseas are meanwhile making technological advances. The whole area is one where generalisation is extremely difficult because the balance of the relevant factors varies widely between sectors and between companies. However, a central problem is the morale of management and owners; prolonged retrenchment stifles enterprise and willingness to take risks. The problem is one of preserving faith in the future rather than of creating an immediately easier environment. Against the background of continuing difficulties, of which the most recent is the increases in interest rates, an acknowledgement of the need for some encouragement would be extremely valuable.

It is in this context that I am attracted to the Secretary of State's suggestion of reducing the National Insurance Surcharge (NIS). I am pleased

The Rt Hon Sir Geoffrey Howe QC MP
H M Treasury
S W 1

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to see in your paper on Economic Policy and Public Spending that you too attach considerable importance to it. Once implemented, such a cut would have a direct and immediate impact on employers' cash flow. By reducing labour costs it would help to improve cost competitiveness and/or enable companies to re-build profits and invest and/or reduce borrowings. It would be a valuable boost to business morale.

I am well aware of the problems associated with reducing NIS. First, within a predetermined national cash limit, easement of NIS must mean greater economies or additional taxation elsewhere. Personally I would not wish to urge a cut if this merely led to other greater difficulties, but this is a matter of priorities and I doubt whether NIS and the morale of industry should come bottom of the list. Second, there is a fear that a reduction of NIS might weaken the resolve of some employers on pay, although I believe it may be possible to reduce this risk by suitable timing as I indicate below.

All these problems are made worse by the inflexibility of NIS and the need to make preparations for a change six months before it is put into effect. I am told there are also severe administrative difficulties if the change occurs at other than the beginning of a tax year. This inflexibility, which calls for a decision now if it is to take effect in April 1982, may understandably mean that, because of uncertainties in the budget arithmetic and doubts about the pay round, you feel you have to rule it out.

One solution you may like to consider would be to put in hand now arrangements that would make possible a cut in NIS by a given percentage in April 1982, but to postpone the actual decision to next Spring. There would still be some administrative problems because DHSS would have to prepare two sets of tables but these difficulties would be less serious than a mid year change. The merit of the proposal is that you would retain freedom to take the final decision when the overall macro-situation in 1982 is clearer and when there is a fair indication of the outturn of the pay round.

There is of course the risk that knowledge of your creating such an option would leak. This might not be a bad thing because it would be interpreted as concern for industry and it could be pointed out that the final decision depended, among other things, upon a satisfactory outcome on pay settlements.

I am sending a copy of this letter to the Prime Minister, the Secretary of State for Industry and to Sir Robert Armstrong.

Yours sincerely,

J R Ibbs

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f A. Duguid

cc A Walters

TOTAL COPIES 20

COPY No. 2

SECRET

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

Secretary of State for Industry

1

12 October 1981

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1P 3HE

Prime Minister

MLS 13/10

Dear Geoffrey,

THE HEALTH OF INDUSTRY

One of the central tenets of our policies is that we must create conditions in which industry can prosper. Of course the control of inflation is central to these policies, and will bring huge benefits to industry as to the rest of the country. The fact remains, however, that while we are in the process of containing inflation we are also maintaining conditions which are damaging to the long term health of industry to an important extent as a result of unintended and unexpected consequences of our broader policies.

Costs in industry are too high. This has reduced profits and also competitiveness in domestic and overseas markets. Industrial profitability has been falling progressively over the last two decades. In 1980 it was down to an average real return in manufacturing of 2 per cent. The consequences of this on the willingness and ability of industry to invest both in fixed assets and in advanced technology and, perhaps even more important, to undertake new ventures, develop new products and open up new businesses, are extremely worrying. Moreover, the lack of profit has made it impossible in many cases for firms to take advantage of the capital allowances for investment, to which they are entitled under the present tax regime. Company liquidity, while less strained than last year because of the sharp physical cutbacks by industry, is still weak, and is likely to be put under further strain once stockbuilding becomes positive again.

So far as the events under our own administration are concerned, in 1980 the exchange rate rose far more strongly than we had foreseen. While the rise brought great benefits to us in the battle against inflation it imposed great strains on our export industries. The recent fall in the rate will relieve those pressures to some degree, but in its place the sharp rise in interest rates - the need for which I appreciate - has created a new and damaging strain. The pressures on nationalised industries to reduce their deficits, again a policy I strongly support, have resulted in input prices to industry rising faster than warranted by world conditions.

I believe that we should act promptly to reduce the strain on industry. The first priority of the CBI is a cut in the National Insurance Surcharge (NIS). I am in full agreement with them. It happens that the political and economic circumstances are particularly favourable for such action. On the political level NIS is a tax introduced by Labour as a short-term emergency measure. We strongly criticised its introduction and by retaining it we are acting in economic terms against our own policies. As it is a tax which adds directly to industry's costs any cut in it should feed through into extra profits or into a reduction in price rises and inflation and also into overseas competitiveness. Previous discussion of the case for a reduction drew attention to the danger of such action feeding through into an increase in wages. I believe that it is one of the real benefits of our overall policies that that risk is now much less and that the recognition amongst wage bargainers, in manufacturing especially, of the relation between wage increases, the competitive position of their firm and job prospects is now markedly greater.

There are two other measures which could usefully be considered alongside so as to constitute a worthwhile package for industry. The first, which I believe is both necessary and urgent, is to press ahead with a scheme to reduce electricity prices to the largest consumers, as was agreed in principle in the summer. This proposal has been with us now for many months. I hope it can now be quickly brought to finality.

The second relates to expenditure by my own Department. The position on this was set out in my letter to you of 5 October. In that I referred to the possibility of a reduction in the period of deferment for RDGs. The points I have set out above emphasise the desirability of that step.

I recognise of course the scale of cost of the actions I am suggesting, especially in relation to the NIS. In the last resort it must be for you to advise the Cabinet how large a cut can be afforded and how it should be financed. I am, however, clear that early and substantial action is needed and that an announcement of a cut should be made forthwith, for implementation at the earliest practicable date*. A cut of $1\frac{1}{2}$ per cent is what I would like; anything less than 1 per cent would be derisory.

* presumably 1.4.82

What I am suggesting would of course have very direct implications for many colleagues, but at this stage I am copying this letter only to the Prime Minister, Sir Robert Armstrong and Robin Ibbs.

Yours ever

Patrick

1. Chancellor
2. Prime Minister
3. Sir Robert Armstrong
4. Robin Ibbs
5. PS/KB
6. PS/NL
7. PS/JW
8. PS/JM
9. PS/Sec
10. Mr Gill
11. Mr Mauzee
12. Miss Mueller
13. Mr Croft
14. Mr Liesner
15. Mr Berman
16. Mr Treadgold
17. Mr Farrow
18. Mr Oulen
19. Mr Michell (on file)
20. Masters