8

10 DOWNING STREET

From the Private Secretary

5 July 1983

Dear John,

STRATEGY FOR UNEMPLOYMENT

The Prime Minister plans to hold meetings at Chequers on Tuesday 6 and Wednesday 7 September, to consider what the next steps should be in Government strategy for creating a more enterprising and prosperous British economy, and thus reversing the growth of unemployment.

The Prime Minister would be grateful if the Chancellor would provide papers for the discussion at Chequers under the following headings:

1. What changes should be made to the taxation system, to tax rates, thresholds, allowances and other aspects of tax legislation or administration to reduce costs for industry and to stimulate the creation and expansion of new enterprises and to reduce unemployment?

2. Can the resources currently devoted to regional policy be better deployed to encourage the growth of lasting jobs?

3. What further progress can be made in the lifetime of this Parliament in privatisation, contracting out, and, generally, the opening up of the public sector to market forces?

4. Could public expenditure policies be altered to bring more to the fore the improvement of employment prospects?

5. Can an affordable scheme for portable pensions be devised? As an input to a paper on the subject, I am sending you, under separate cover, a paper produced by the CPRS.

6. Passport for a Job (minute by the Chancellor of the Duchy of 1 July).

Mrs. Thatcher particularly hopes that each paper will avoid generality and will concentrate on the specific decisions which need to be taken.

I would be grateful if you would ensure that these papers are sent to the Prime Minister by Friday 26 August at the latest.

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The Prime Minister has asked that these papers be produced by the Treasury's own resources, without any consultation outside the Treasury. She has also asked that the fact of the Chequers meetings be closely guarded, that this letter be seen by no-one except the Chancellor and yourself, and that in commissioning the above papers you do not disclose their occasion.

I enclose two notes by Alan Walters about recent academic work on unemployment, supplementary benefit and relative wages, to which reference was made at last week's Ministerial discussion; and a wide-ranging note which the Prime Minister believes will also form a useful background to the Chequers discussions.

Yours sincerely,

Michael Scholar

John Kerr, Esq.,
HM Treasury.

FLW SH

for MCS (or) with a set of papers JH 31/8

COPY NO. 12
OF ..12 COPIES

10 DOWNING STREET

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From the Private Secretary

30 August, 1983

I attach the papers that have so far been prepared for the meeting at Chequers on 6 and 7 September.

I will let you have copies of the other papers as soon as they arrive.

I should stress the absolute confidentiality of these papers. They are for the personal use of those attending the meeting, and they should not be copied. They should only be shown to others if the Minister concerned feels their advice is essential, rather than just desirable. The purpose of these papers, and knowledge of the meeting, should be confined to those attending the meeting and their Principal Private Secretaries.

I am sending a similar letter to the Principal Private Secretaries of all those attending the meeting.

W.F.S. RICKETT

John Kerr, Esq.,
H.M. Treasury

SECRET AND PERSONAL

10 AA.

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

26 August 1983

W F S Rickett Esq
10 Downing Street

Dear Willie,

STRATEGY FOR UNEMPLOYMENT

I am enclosing papers on the six topics listed in Michael Scholar's letter to John Kerr of 5 July, as background to the Chequers discussion on 6 and 7 September.

I am also enclosing two further papers which the Chancellor thought the Prime Minister might be interested to read. The first covers the private rented sector and the second discusses the increase in employment in the service-producing sector in the USA.

Yours sincerely,

Margaret O'Mara

MISS M O'MARA
Private Secretary

cc P. Gregson ✓

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SECRET AND PERSONAL

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

30 August 1983

W F S Rickett Esq
10 Downing Street

Dear Willie,

STRATEGY FOR UNEMPLOYMENT

I sent to you on Friday a number of papers which we had prepared as background to the Chequers discussion on 6 and 7 September. I am now enclosing one further paper on Professor Minford's proposal to impose a cap on benefits for the unemployed. This was not on Michael Scholar's original list of topics but the Chancellor nevertheless thinks it very relevant to the discussion.

Yours sincerely,

Margaret O'Mara

MISS M O'MARA
Private Secretary

21 PAPER 21

BY HM TREASURY

CAPPING BENEFITS TO THE UNEMPLOYED

Economic Aspects

The proposal to impose an earnings-related limit on benefits for the unemployed rests on the view that, because benefits under the present system are unrelated to income when in work, they set a floor level to wages throughout the economy. Hence wages cannot adjust downwards to market-clearing levels, and this is a major cause of unemployment.

2. If maximum benefits were set at some fraction of previous earnings, as they are in a number of other EC countries (including the Federal Republic of Germany), this would allow real wages to adjust downwards and therefore increase employment. Capping benefits is a way of preserving a margin between income in and out of work where it matters: ie where the existing system provides benefits so close to earnings in work that people may decide to be unemployed almost indefinitely.

3. Professor Minford believes that the response to benefit changes will be very high in this critical region. His estimate is that capping benefits at 70 per cent will reduce unemployment by 700,000 in 5 years and will by then save some £4 billion annually on the PSBR (about a third of this in benefit savings).

4. The calculation depends both on the number caught by the cap and on the size of response to the change in benefit. Minford estimates that 45 per cent of people have "replacement ratios" of 70 per cent or more ie they have total incomes out of work equal to or exceeding 70 per cent of their in-work income. These figures relate to the working population as a whole - not just the unemployed. Comparable calculations by the Institute of Fiscal Studies give lower figures. Estimates of the replacement ratios faced by the unemployed based on the DHSS cohort study suggest that perhaps 30 per cent may be affected. There are formidable complexities in the calculations and concepts, but it does look as though the 45 per cent figure is on the high side.

5. We calculate that direct benefit savings clawed back from the unemployed in excess of the 70 per cent level might amount to about £300m (which would accrue immediately). Minford's estimate of a benefit saving of £1.2 bn at the end of 5 years appears to be largely due to the estimated reduction of 700,000 in the numbers unemployed.

6. This estimate of the effect on numbers unemployed is, as Minford acknowledges, much higher than other research on the effect of benefit changes would suggest, and is almost certainly too high. (The relevant elasticities are some 10 times as large as those found in recent studies by Nickell and others.) But it is not in dispute that capping would help the downward adjustment of wages - indeed it could radically change perceptions of the 'why work?' syndrome.

7. One problem with the proposal is that it would reduce the incomes of family men with dependent children who have the highest replacement ratios. Many of these will be receiving S.B. top ups to maintain their income at officially recognised poverty levels. Capping their benefits would thus take them below the poverty line if they remained unemployed, and in some cases if they took a job at a lower wage than before. On the other hand the cap would not affect young unemployed who had never had a job, which is why Minford recommends a "workfare" scheme for them.

Structure of the scheme

8. The proposal is to take account not only of net earned income (which could be ascertained from pay records) but also benefits available to those in work. These include FIS, rent rebate, rate rebate, child benefit and FIS-passported benefits, eg school meals.

9. Because these benefits vary with individual circumstances, a precise calculation of them would be very complicated administratively (as was the old 'wage stop'). The scheme would therefore only be workable by constructing tables to reflect average levels of in-work benefits and tax. Because this would not precisely match an individual's circumstances there would be complaints about unfairness, and probably a need to provide for hardship cases and appeals procedures. There are

number of points which would need further consideration, including the interaction of housing benefit (now administered by local authorities) with unemployment and supplementary benefit.

Administrative costs

10. It is extremely difficult to estimate costs. It would be necessary to check each of the 350,000 new claims made each month; and to recalculate each time a claimant's entitlement changed (eg because of a change in family circumstances) and probably annually, when the tax/benefit table would be recalculated in the light of changes in tax rates and thresholds and benefit upratings. A scheme might well require perhaps 500 or more additional staff. These staff would need to be taken on in advance of the operational date, in order to check the in-work income and benefit entitlement of all current claimants (unless some phasing were acceptable; but this would discriminate among claimants).

Conclusion

11. Officials concluded in 1980 that a workable scheme to cap benefits to the unemployed could be devised. Main legislation would be required. Some considerable work would also be needed in order to establish the details of the scheme. Only DHSS could advise on the present costs of the scheme. But subject to that, we see no reason to differ from the 1980 conclusion that such a scheme would be feasible.

HM Treasury
30 August 1983

THE GERMAN SCHEME

The scheme provides for the payment of an unemployment allowance for the first year of unemployment of 68 per cent of net earned income up to a maximum of DM60,000. This gives maximum benefit of around DM42,000 (around £10,000 a year or £200 a week) which broadly equates to average industrial earnings in Germany. There is currently a proposal to reduce the percentage for single people and childless married couples from 68 per cent to 63 per cent. Family allowances are payable in addition.

2. When unemployment allowance runs out, unemployment assistance is paid on a means-tested basis. It is also payable as a proportion of earned income, but at a lower level - 58 per cent. The cap is hence also lower - around DM35,000 (£8,600 a year). Again, family allowances are payable in addition.

3. In comparing the German system and the proposed cap in the UK, it is necessary to bear in mind the different role of child support. In Germany this is a far less significant proportion of out of work benefits - at maximum it adds around £24 a week for a three child family - and is paid at the same level whether in or out of work for the same level of income. In comparison in the UK child support plays a far more significant role for the unemployed. The basic benefits paid to the unemployed are around £25 a week for a single person and £40 for a married couple, while child support for a three child family on supplementary benefit may be as high as £40 a week, in comparison with around £20 paid as child benefit to the earner.

4. In the UK the highest replacement ratios are faced by families with 2 or more children; and this is a reflection of differential child support in and out of work. But to increase child benefit (paid universally) up to supplementary benefit scale rates would cost billions of pounds. The alternative is to reduce out of work child support, either by acting directly on the child scale rates or by an overall cap on benefits.

REGIONAL ECONOMIC POLICY: RE-DEPLOYMENT OF RESOURCES

The White Paper provision for regional economic policy (REP) spending for 1983-84 is £674m; this includes £474m for regional development grants (RDGs), though the outturn may be nearer £450m (Table 1). RDGs are paid automatically on qualifying investment, essentially capital spending on new machinery and plant in manufacturing industry and the buildings in which the plant and machinery are housed. The rates of grant are 22 per cent in Special Development Areas and 15 per cent in Development Areas. Selective assistance may be paid on top of RDGs up to the EC limit (normally 30 per cent) and in principle it is available to other industries and the service sector, although in practice only to a limited extent. In the Intermediate Areas, only selective assistance is available. The regional map was last revised in 1974 when the proportion of the working population in the Assisted Areas (AAs) was reduced from 44 per cent to 27 per cent (Table 2).

The case for abolishing REP

2. AAs were first designated in 1934. Now, as then, unemployment is highest in areas hit by the decline of traditional heavy industries It is estimated that since 1960 half a million jobs have been created directly and indirectly in the regions, and that over the 1970s investment in the AAs was 5 per cent higher than without REP. But this has largely represented a shift of jobs and investment from the non-assisted areas to the AAs. The first Report on REP concluded that the strength of the case for these policies in net national economic terms might be debatable, but that the social and political arguments were powerful.

3. Between 1971 and 1981 the Exchequer cost per job was around £34,000. However, the annual cost depends on how long the job lasts.

4. REP may improve the supply side of industry by encouraging new investment and innovation. But:

- This is a national rather than a regional objective.

- REP distorts location decisions which in time may weaken competitiveness, as at Linwood and Halewood.

5. At periods of high unemployment, REP was claimed to reduce overall pressures on labour demand and wage rates by encouraging new jobs in areas of labour surplus. This argument clearly no longer applies as unemployment is now high over the country (Table 3).

6. Much of current REP goes on projects which would have taken place anyway and thus creates no extra jobs ("deadweight"). RDGs are paid on replacement investment and on highly capital intensive projects of limited mobility (Sullom Voe).

A more cost effective REP

7. Total abolition may well not be a practicable option for political and social reasons. Moreover, some element of REP is needed:

- To trigger assistance from the European Regional Development Fund (ERDF). The Fund could produce some £300m for the UK this year.

- To help the UK compete with other EC countries for inward investment projects. EC rules limit the use of financial assistance outside the AAs.

8. The second Regional Policy Report, which Ministers are to consider in September, recommends policy changes designed to make REP more cost-effective and related to jobs; the changes would also help to improve the prospects of money from the ERDF.

9. The main features would be to eliminate replacement investment and to impose a cost-per-job ceiling. This would help to deal with the deadweight problem, although it cannot be eliminated completely. A straight labour subsidy like the regional employment premium is not allowed by the EC rules but a job-related grant option is proposed. The report also proposes to extend the coverage of

 but see para 1

qualifying investment for RDGs to include a range of services, which can be assumed to be mobile rather than attached to a specific location, (ie technical and administrative services but not retail trade). These measures would also help to reduce the current bias towards capital-intensive projects.

10. The total expenditure will depend on grant levels and the AA map. There could be savings of up to £200m (Table 4), if the present map remains unchanged, although there will be pressure to include the West Midlands - at a cost of £50m or so. Some of the savings could be channelled into increased spending on R&D and innovation in the regions at a cost of, say, £60-£70 million, as the DTI propose. (The current national provision for these activities is £350m.)

11. But there is a strong case for using the savings on REP to help reduce taxation. In this way, the savings would contribute to the improvement in work incentives and to the reduction in the tax burden on companies, which we need to achieve to encourage the creation of new, lasting jobs in the private sector.

HM Treasury
26 August 1983

TABLE 1
EXPENDITURE ON REGIONAL ASSISTANCE : £m

	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84
REGIONAL DEVELOPMENT GRANT	406	312	474	598	600	474
REGIONAL SELECTIVE ASSISTANCE	80	70	67	75	87	90
OTHER*	84	99	140	169	132	110
TOTAL	570	481	681	842	819	674

* Mainly advance factory provision

TABLE 3

UNEMPLOYMENT RATES BY REGION   PLUS SCOTLAND AND WALES

REGIONS	(JUNE) 1976 %	(JUNE) 1983 %
North	7.4	16.8
Wales	6.7	15.4
West Midlands	5.2	15.4
North West	6.7	15.2
Scotland	6.2	14.5
Yorkshire/Humberside	5.3	13.6
East Midlands	4.5	11.3
South West	5.8	10.5
East Anglia	4.6	10.0
South East	3.8	9.0
Great Britain	5.2	12.3

All figures are claimant based and seasonally unadjusted.

TABLE 4

POSSIBLE SAVINGS ARISING FROM CHANGES TO RDG SCHEME

Option	Capital grant rate	Cost-per-job ceiling	Job grant	Estimated expenditure (£m) Automatic grant	additional expenditure on selective aid	Total	Savings (£m)
CPRS proposal	10%	£7000	£3000	140	80-105	220-245	205-230
A	15%	£10,000	£2,500	200	70-95	270-295	155-180
B	20%	£12,500	£3000	260	60-85	320-345	105-130
C	25%	£12,500	£3000	320	50-75	370-395	55-80
D upper	15%	£10,000	£3000	170	75-100	245-270	180-205
lower	10%	£7000	£2000				
E upper	20%	£12,500	£3000	230	65-90	295-320	130-155
lower	15%	£10,000	£2500				
Present RDG scheme upper	22%	-	-	450	-	450	-
lower	15%	-	-				

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* Mainly advance factory provision

TABLE 2

PROPORTION OF WORKING POPULATION* WITHIN ASSISTED AREAS

	May 1979		1983	
	%	million	%	million
Within SDAS	13.2	3.1	13.4	3.1
Within DAS	10.9	2.5	8.6	2.0
Within IAS	19.3	4.6	5.5	1.3
Assisted Areas	43.4	10.2	27.5	6.4
Non-assisted Areas	56.6	13.3	72.5	17.1
TOTAL	100.0	23.5	100.0	23.5

*based on working population as at 1977.

BLE 3

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lower	15%	£10,000	£2500				
Present RDG scheme upper	22%	-	-				
lower	15%	-	-	450	-	450	-

cc Chief Secretary
Financial Secretary
Economic Secretary
Mr Middleton
Mr Bailey
Mr Battishill
Mr Christie
Mr Rickard
Mr Ridley
Mr Chivers
Mr Anson
Mr Lovell
Miss Low

Treasury Chambers, Parliament Street, SW1P
01-233 3000

Rt Hon Cecil Parkinson MP
Secretary of State for Trade & Industry

[27] July 1983

Dear Cecil

The Prime Minister's decision to defer consideration of the second Report on Regional Policy until September gives us more time to develop our thoughts on these important issues. But this has implications for the proposal in your letter of 1 July to Willie Whitelaw that Clauses governing possible changes in the Regional Development Grants system should be prepared for incorporation in the Co-operative Development Agency Bill, which QL has recommended for inclusion in the 1983-84 legislative programme. Normally drafting of the necessary clauses would not be put in hand until the underlying policy has been decided.

2. You mentioned to me your concern that the postponement of the policy discussion might inadvertently result in closing the option of legislation in this Session which we might subsequently decide was desirable. As you pointed out in your letter, there are substantial public expenditure savings in prospect, and it would be a pity to deter these because of lack of legislative cover, assuming our colleagues agree on the Report's general recommendations for changing the grant system.

3. I think it is generally accepted that the current system is very cost-ineffective - we want no more Sullom Voes, for example - and the sooner we can move to a more cost-effective system and so fulfil our Manifesto commitment, the better. Nor should we lose sight of the possible benefits to be derived from the European Regional Development Fund by changing the RDG system in the direction proposed in the Report. I hope therefore that you will be able to secure agreement that, exceptionally, contingency drafting should be put in hand so as to keep the 1983-84 legislative option open.

4. I should also like to comment on some of the points made in John Sparrow's letter to me of 19 July. I have a great deal of sympathy with the general thrust of John's comments.

In my view, the economic benefits of regional economic policy are questionable as the first report on Regional Policy recognises. Indeed, from the point of view of the national economy, it is arguable that the policy may well be counter-productive.

5. This gives further strength to the social and political case for modifying the system to make it as effective as possible in generating employment, and for securing substantial savings which can be put to better use elsewhere. In your 1 July letter you suggested a possible potential saving of £100 - £150m. In my view, we should aim a little higher than this. I believe we should set our sights for net savings of at least £200m and I can see scope for achieving still more. However, these possibilities will depend on the outcome of our future discussions. Once the general principles of the revised grant system have been established, much will depend on the levels of grant as well as on the shape and size of the revised Assisted Area map. When we come to these issues, we ought to give serious consideration, along with the other options, to John Sparrow's suggestion for a package which would combine a job grant set as high as possible (within EC constraints) with a low capital grant and a low cost per-job ceiling. This would reduce the bias in the system towards capital-intensive investment, and would be better geared to the creation of jobs.

5. I am sending copies of this letter to the Prime Minister, the Lord President and the Lord Privy Seal, to the Secretaries of State for Scotland, Wales, Northern Ireland, Environment and Employment, and to Sir Robert Armstrong and John Sparrow.

Yours
Nigel

NIGEL LAWSON

PUBLIC EXPENDITURE AND EMPLOYMENT

The Government already spends substantial sums (£1800m in 1983/84) on "special employment measures" designed mainly to promote increased employment and youth training. The various incentives and subsidies are subject to diminishing returns, and the effects of some are hard to quantify; but in general, decisions on the scale of each are taken on the basis of judgments on how far they are cost-effective in the light of Government objectives. Given the Manifesto commitment that "as long as unemployment remains high we shall maintain special measures of this kind", it seems inevitable that such measures will continue for some time to come. But to keep overall public expenditure under control, we shall need to go on looking very critically at individual bids in this as in other areas.

2. It can be argued that there is more scope for schemes designed to reduce wages to market-clearing levels. The Young Workers Scheme, introduced in 1982, already has the aim of encouraging employers to take on more young people at realistic wage rates (reflecting their lack of training and experience) by paying £15 a week to employers of young full-time workers with wages below £42 a week (£7.50 for wages between £42 and £47). The number of workers covered is at present about 100,000, at an estimated annual cost of £75m. It might be worth considering whether the scheme could be extended to cover adult full-time workers on low wages. But there would be increased problems in fixing an appropriate wage rate, in relation to Wages Council minimum rates and to social security benefits. There could also be difficulties in preventing collusion between employers and workers in small firms (ie ensuring that there were no separate cash payments above the limit eg for 'overtime'). And it would remain uncertain how much real effect ('additionality') the subsidy would have, particularly in traditionally low-wage service industries like catering; the Young Workers Scheme is thought to have a high deadweight cost and therefore a high net cost (£3000) per person off the register.

3. There are pressures to distort public expenditure priorities, in various directions, in the hope of promoting increased employment - for example, by

encouraging contractors to use labour-intensive methods, or by increasing numbers employed in the public sector. But all such schemes have the overriding drawbacks that they promote less efficient methods of working and ignore the offsetting job-destroying effects of increased taxation and government borrowing.

4. Therefore the contribution of public expenditure has to be less direct. At present, there are a number of cases where structural distortions in the economy, depressing the level of sustainable employment in the longer term, are deliberately supported by public spending:

i. The support given to uneconomic activities in the public sector is the prime example. As the following table shows, very large sums are spent annually to maintain state-subsidised industries on a scale which could not be justified on commercial criteria unless costs and efficiency could be drastically improved to eliminate the subsidy element:

	£m(1983/84)
Coal	1430
Steel	321
Shipbuilding	210
Rail	891
Other transport	853
	3705

ii. In the private sector, market decisions as between capital-intensive and labour-intensive activities or methods of production are subject to a whole range of fiscal distortions. The £700m a year of regional assistance, mainly to promote capital expenditure by firms in the regions, is discussed in the paper on regional policy. There are also "tax expenditures" in the form of 100% capital allowances on plant and machinery for corporation tax. On the other side, labour is taxed by NIS. These tax aspects are discussed in the separate paper on taxation.

iii. Similarly in agriculture, the operation of the market is heavily distorted by fiscal intervention both via UK public expenditure (at least £500m this year) and through the CAP.

iv. The effect of social security expenditure on incentives is considered in other papers.

5. Much of the expenditure under i. and ii. is designed either to maintain employment in the short term (in the loss-making industries) or to distribute employment more equally (to the regions). But there is a trade off between short-term palliatives and sustainable long-term jobs. For the longer term, adopting an employment-oriented approach to public expenditure would mean pursuing consistently over a long period a policy of eliminating or reducing distortions of these kinds.

HM Treasury
25 August 1983

OPENING UP THE PUBLIC SECTOR TO MARKET FORCES

The key to improved efficiency in the activities currently in the public sector is to increase competition wherever possible. Privatisation and contracting-out are both means to this end.

Privatisation

2. There are two main approaches:

   a. wholesale privatisation of public-sector activities;

   b. exposure of such activities to increased competition.

3. Up to now, most attention has been focussed on selling profitable companies operating in competitive environments. But as these are disposed of, ways will need to be found of dealing with less profitable companies, and with the large utilities where at present there is little or no private-sector competition.

Competitive/unprofitable

4. Before privatisation, such companies will usually need to be in a position where they can show a reasonable prospect of profit. Options include bringing in more effective management, increasing efficiency and closing loss-making capacity.

5. Some companies have profitable parts which could be privatised earlier. Splitting up and selling off profitable parts is the right course, provided that economies of scale are not such that it would be significantly more difficult after a split to bring the loss-making parts back to profitability.

Non-competitive

6. Some of the utilities, though generally protected by their cost structure from competition ('natural monopoly', eg domestic distribution of electricity or gas),

have parts of their business where there is or could be private-sector competition. These need to be reorganised into separate companies and privatised.

7. In some cases (eg mail services, coal mining) the present monopoly is artificial, being created or reinforced by legislation. Wherever possible such artificial barriers should be removed (as has been done for electricity generation).

8. Even where there is a degree of natural monopoly, it may be possible to re-structure the industry so that the scope for competition is increased - for example by tightly defining the residual 'common carrier' role in gas or electricity distribution to prevent discriminatory pricing. It then needs to be considered whether this non-competitive element would operate more efficiently if sold into private ownership and subjected to a licensing/regulatory regime.

9. Another option is to arrange for licensing of franchises to provide a specified service, perhaps in a limited geographical area - so that although competition within that area is technically impossible, different firms can still compete for the right to provide the service for a limited period.

10. For some services, social objectives are important (eg rural rail and postal services). Uncontrolled cross-subsidisation by the monopoly provider is likely to lead to wasteful overprovision. A restructured service, with an explicit, cash-limited subsidy, is likely to be more efficient; and franchising might in some cases provide an element of competition.

Progress in this Parliament

11. The Chancellor's minute of 25 July to the Prime Minister emphasised that more attention must be given to the structure of the enterprises which are in the privatisation programme, and that the privatisation programme must be considered as a whole to avoid potential legislative and capital market bottlenecks. The Economic Secretary will be conducting a series of bilaterals after the recess with sponsor Ministers and will then be reporting on the programme as a whole.

12. The timing and content of the programme of asset sales in this Parliament cannot therefore be decided yet. Some of the uncertainties should be clarified by the Economic Secretary's review in the autumn. Any figures for sale proceeds must be highly speculative at this stage, and in some cases must await decisions on the form of privatisation to be adopted. The present presumption is that the overall receipts are likely to be of the following order:

1982-83	1983-84	1984-85	1985-86	1986-87
£488m	£1,250m	£1,500m	£2,000m	£2,000m

These totals are heavily influenced by the proposed sale of British Telecom, whose magnitude and timing remain uncertain.

Contracting Out

13. Where services remain in the public sector, there is still scope for increasing competition by allowing private-sector firms to tender for contracts to provide all or part of the work. This brings market forces into play both directly, by giving competitive opportunities to the managements and workers of private firms, and indirectly, by stimulating in-house staff to perform more competitively.

14. In central government, Ministers and departments have made modest but useful progress (saving nearly 15,000 staff) and further opportunities are being examined. Firm central control of cash and manpower numbers can increase the pressure to take these opportunities where they are cost-effective.

15. In the National Health Service, though some work is contracted out, there is undoubtedly considerable scope for further progress (eg only £17m out of the £400m total spent on domestic services is contracted out). The Secretary of State for Social Services is about to send out a circular requiring health authorities to seek tenders for cleaning, catering and laundry services, and urging them to seek opportunities for contracting out other services.

16. Local authority direct labour organisations are being required to compete for an increasing proportion of their work, and as a result numbers have already fallen by some 17,000. Progress in other areas of local authority activity has, however, been slower. 16 local authorities have decided to contract out refuse collection and street cleaning; to require this more widely would need fresh legislation.

17. Cabinet considered the scope for further progress on contracting out on 21 July, and invited the Chief Secretary to pursue this in discussions with Ministers concerned with local authority services.

HM Treasury
24 August 1983

3.33

CONFIDENTIAL

cc PS/CST
PS/EST
PS/MST
Mr Middleton
Mr Bailey
Mr Byatt
Sir T Burns
Mr Anson
Mr Cassell
Mr Christie
Mr R H Wilson
Mr Morgan - o.r.
Mr Turnbull
Mr Grimstone
Mr Burgner

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

14

PRIME MINISTER

COMPETITION AND PRIVATISATION

Privatisation, combined with increased competition, is one of the main planks of our economic policy. It is designed to improve our national economic performance by increasing the role of market forces and by reducing the size of the public sector. We made a good start during the last period of Government. But experience shows that much preparation and discussion are needed to prepare State industries and trading bodies for sale to the private sector. And after 3-4 years, an approaching General Election casts a forward shadow that makes further sales difficult. So we need to use the time we have available as fully and constructively as possible.

2. The programme we have put forward is a full one. The Manifesto speaks of selling 51 per cent of shares in British Telecom, Rolls-Royce, British Airways and substantial parts of British Steel, British Shipbuilding and British Leyland; privatising as many as possible of Britain's airports; introducing substantial private capital into National Bus; the transfer to the private sector of the British Gas Corporation's offshore oil interests; and increasing competition and attracting private capital into the gas and electricity industries. The Queen's Speech added the Royal Ordnance Factories. And there are other candidates also, as the papers circulated to E(DL) shortly before the Election showed.

3. Two aspects of the programme will become much more prominent in the next phase of our drive for privatisation.

4. First, the need to promote competition to the maximum extent means that we must give much more attention to the structure of the bodies which are on the privatisation programme. Hitherto the companies we have sold have mainly been profitable and operating in competitive environments. Preparing them for privatisation, although time-consuming in terms of legislation and preparations for flotation, has involved relatively little change to their structure. But from

now on we are increasingly working in the heartland of the public trading sector, where we shall have to deal both with the giant utilities and unprofitable companies. Questions of whether and how to separate the profitable parts from the unprofitable; how to separate the potentially competitive parts from the natural monopolies; and how to deal with the irreducible elements of monopoly will increasingly dominate the debate. We shall increasingly have to devote time and effort to these issues - well in advance of the mechanics of privatisation itself - if we are to reap the maximum benefit from a transfer to the private sector.

5. I recognise that in some cases the costs - in terms of the delay and upheaval involved in restructuring - of pursuing the best solution may be excessive, running the risk of putting off privatisation into the remote future. This is a price which in political terms we may not be prepared to pay. In particular cases it may be better to go for a quicker solution. For British Telecom we are following a route which combines rapid liberalisation with privatisation (accompanied by a degree of regulation). We shall want to see how this works out in practice when considering our approach to other monopoly utilities.

6. Early consideration is therefore essential. It must be done case-by-case. Most of the detailed work on individual industries can only be carried out in the sponsor Departments using their knowledge of these industries, although Treasury officials will need to be closely involved. I am attaching a paper by Treasury officials which sets out some thinking about questions of competition and structure and illustrates how this could be applied in certain of the larger public sector industries, not all of which currently figure in the privatisation programme. Treasury officials will be glad to discuss these matters further with the individual sponsor Departments concerned.

7. Second, and following from this, there is now a much greater need to consider the privatisation programme <u>as a whole</u>. This is essential if we are to avoid potential bottlenecks in bringing a range of industries and companies to market. Bottlenecks can arise in the legislative programme, as we have seen in the plans for 1983-84 where there have been difficulties about the inclusion of

legislation relevant to privatising National Bus and British Airways. They can also arise in the capital market, where the sheer size of the bodies to be privatised can create difficulties both for other Government sales or for the private sector. This problem is raised in an early and acute form by the proposed sale of British Telecom.

8. Both these aspects point to a need to strengthen our existing procedures. We shall certainly want to have periodic reviews of progress. But we need to do this on a more systematic basis than hitherto. We need to produce for each major privatisation candidate a programme and a time-table which will map out the various issues needing to be resolved, e.g. what structural changes (if any) are to be considered; how and when this is to be done; the approximate time-scale for making such changes; the target date for privatisation; and the likely scale of the equity to be sold. I recognise that there will be uncertainties at the outset particularly about some of the later stages along the route. But in this way we can best ensure that while maintaining a worthwhile programme of asset sales we put the emphasis on maximising competition, and at the same time avoid as far as possible any potential bottlenecks in implementing the agreed programme.

9. I am therefore asking all colleagues with privatisation responsibilities to let me have by end-September a time-table of this kind for each of their candidates. John Moore, who has been given particular responsibility for privatisation within the Treasury, will then discuss these replies with sponsor Ministers in each case and subsequently report on the programme as a whole.

10. I am copying this minute to all our Cabinet colleagues and to Sir Robert Armstrong.

NL

(N.L.)

25 July 1983

CONFIDENTIAL

"PASSPORT FOR A JOB" AND HELP FOR THOSE STARTING UP IN SELF-EMPLOYMENT

This note discusses two schemes. The first is designed to ease the problem of youth unemployment; the second, to help those who wish to set up in business on their own.

"Passport for a job"

2. This scheme would apply to those under 18, earning no more than £45 a week. A worker falling within this category would be issued with a "passport" which he would lodge with his employer. The employer would hold the document as his authority to employ the worker, without deducting income tax or national insurance contributions and would be exempt from employee protection requirements in this respect. The date of expiry would be printed prominently on the "passport" and if the employer wished to retain the worker's services thereafter, he would be obliged to put him back into the system.

3. The essence of the proposal appears to be that under-18s would be willing to accept jobs at lower levels of pay and employers would be more willing to take them on, if they could be relieved of some of the administrative burden and, in relation to national insurance, perhaps some of the cost too. (It is worth noting in passing that employee protection already only applies to workers under the age of 18 in a very limited way. The redundancy and most of the major maternity provisions do not apply to them at all. The unfair dismissal provision requires a qualifying period of one year's employment and it has been proposed that this should be raised to two years - it is already two years in small firms.)

4. The arrangements for the scheme as outlined above raise a number of technical difficulties:-

(i) if under-18s were exempted from employees' NIC, their employers could be exempted from payment of employers' NIC and NIS. NIC exemptions would, however, give rise to special difficulty since the contributions buy entitlement to benefits. It would be possible to exclude the employees from this entitlement. But it would not be easy and would provoke requests for similar treatment from others who would be willing to give up benefit entitlement if they were exempt from NIC.

(ii) If income tax and NIC became payable in full as soon as the £45 limit was passed, a very high marginal rate would be created at that point.

(iii) It is not clear whether self-employment would be covered.

(iv) The scheme might actually make PAYE compliance more complicated for employers if they had to give special treatment to part of their workforce.

However, none of these problems is likely to be insuperable.

5. There are also more powerful arguments against the proposal. The first is one of equity. It is by no means clear that under-18s should receive specially favourable treatment, particularly through discrimination in the tax system, which is usually expected to be equitable between taxpayers. Indeed, it could be argued that those under 18 are unlikely to have dependents; that because of their low expenses, they get better value out of the single personal allowance than other taxpayers; and that the poverty trap and unemployment trap are less important for them.

6. Second, there must be some doubt about the cost-effectiveness of the scheme. Some of the extra jobs for the under-18s would be created by displacing over-18s, although it is impossible to assess what proportion would be affected. Moreover, part of the subsidy would also go to under-18s who would in any event have been in work. In the case of the Young Worker's Scheme which shares a very similar objective, it has been estimated that only about 20 per cent of the jobs receiving subsidy were new ones. (It would, incidentally be for decision whether

the Young Worker's Scheme should be withdrawn if this proposal were implemented.)

7. Finally, there is the risk that an employer will hire a succession of young people who will each lose their job on reaching the age of 18. This is not, however, a conclusive argument. Even a short-lived job would have the big advantage of introducing the young people to habits of work and putting them in contact with the labour market.

8. The direct cost of the scheme would be about £60m a year, if only income tax and employers' NIC were involved. If employers' NIC and NIS were brought in also, the cost could be £120m. But these are only the direct taxation effects. To the extent that those receiving the subsidy were in newly created jobs, the PSBR cost would be less because of the benefit savings. But to the extent that they displaced over-18s, the cost would be more. And the upside risk is greater because over-18s pay more tax and receive higher benefits than under-18s.

Help for those starting up in self employment

9. Under this scheme, those self-employed who had completed an appropriate training course would be exempted from income tax, VAT and national insurance contributions for a three-year period, provided turnover did not exceed £10,000. (An individual whose turnover is less than £10,000 does, of course, already fall well below the current £18,000 registration threshold for VAT.)

10. This proposal poses problems on national insurance and the cut-off point for relief similar to those set out in paragraph 4 above. In addition, it can be argued that any test based on turnover is not appropriate for income tax. The profit of a self-employed person with few expenses, (eg a window cleaner) will be little less than his turnover. By contrast, if a business with substantial inputs (eg a retailer) or considerable expenses on tools or materials (eg a repair shop) has a similar turnover, the owner's income will be very much less.

11. These difficulties could be overcome by redesigning the scheme so that a self-employed person who had completed an appropriate training course would be exempt from income tax on the first £10,000 of his income. This would remove any disincentive to expand beyond the cut-off point.

H & W - £20,000 without any tasks.

12. The cost of the proposal would depend on which training courses qualified for the scheme and the extent of the take-up. But based on recent experience of TOPS courses, if around 60,000 adults were to enter MSC courses next year and, say, 7 per cent were to become self-employed soon after, the cost of the scheme could build up to about £8m a year.

13. Although restricting the scheme to those self-employed who had completed some form of training would limit the Exchequer cost, it would also necessarily imply discrimination between one new business and another. It would be argued that relief from tax should not depend on whether those entering self employment needed, or had the benefit of, a training scheme and however the qualifying schemes were defined, there would be those who would fall on the wrong side of the line and would complain they had been arbitrarily excluded. Indeed, it might be suggested that those who had enjoyed the benefit of a training scheme (and had probably paid no fees, if the scheme were provided by the MSC) were the last people to deserve further help through a selective tax relief.

14. Second, there is a case for saying that a much clearer dividing line should be drawn between the areas of employment and self-employment before exposing it to further pressure by increasing the relative attraction of Schedule D (Self-employment). Indeed, the scheme would give an added incentive to represent employment as self-employment through such devices as labour only sub-contracting arrangements.

[illegible]. Finally, there must be some doubt as to whether the scheme would achieve its purpose. The most critical period in the survival of a small business typically comes after about 18 months. At that time, a business will often not even have been assessed to tax for its first year. And, even if it has been assessed in its first year's results, the tax bill will often be fairly small. The extra expenses of setting up a business and getting it off the ground, the likelihood of capital expenditure which will attract tax allowances, and the fact that turnover is generally only starting to build up in the first year, mean that a new business' taxable profits may often be quite small or non-existent. Moreover, because of the way the profits of a new business are assessed to tax (the first year's results form the basis of tax assessments for, in general, about 2½ years' liabilities), the existing rules already have the effect of minimising liabilities in the early years.

Enterprise allowance

16. Given these objections, a different proposal to encourage the unemployed to set up in business could be considered. An enterprise allowance has been introduced nation-wide this year, under which a grant of £40 a week is paid for a year to unemployed people going into business. (subject to a maximum of 25,000 places). The future of the allowance is to be decided as part of this year's public expenditure review. If the allowance is continued, then there could be a case for making it non-taxable in order to increase the benefit to the successful. This would, however, point up the taxability of unemployment benefit.

HM Treasury
19 August 1983

5

PAPER 5

by HM Treasury

PORTABLE PENSIONS

The problem

Occupational pension schemes treat early leavers badly by comparison with stayers, and this is a disincentive to labour mobility. An increase in mobility would help to reduce unemployment.

2. Occupational pensions are generally based on years of service and final salary. For an "early leaver" who spends 20 years with one employer and 20 with another, only his last 20 years of work will count towards a pension geared to his salary at retirement. The pension attributable to the first 20 years of his career will be geared only to the final salary level he has reached by mid-career when he switches his job. This will usually be much lower than his salary at retirement because of the likelihood of inflation, growth in real earnings and promotion over the last 20 years of his career. This loss will occur whether he freezes his rights with his old employer, or transfers them to his new one (assuming that he moves to a new employer with a pension scheme). If he leaves early to start a business, he has no alternative to keeping his rights frozen with his former employer - which is particularly hard if he wants to invest his savings in the business. The loss of pension rights by early leavers is a direct, substantial and arbitrary subsidy to the stayers. The loss in typical cases can be shown to be worth at least a year's salary (in present value terms).

3. 11½ million employees (over half the UK total) are members of occupational schemes. About 10% are early leavers each year. Three quarters of these have less than 5 years' service and are entitled only to a refund of their contributions. The rest - perhaps 250,000 a year - normally have their accrued rights preserved in their old scheme.

4. Evidence about the effect of this loss of pension rights on mobility is sparse. But what there is confirms the presumption that it acts as a disincentive. Increasing awareness of the problem is likely to accentuate it.

5. As it grows to maturity in 1998, the State Earnings Related Pension Scheme (SERPS) will make an increasing contribution to solving the early leaver problem for the bulk of the working population. For those earning up to the upper earnings limit (UEL) of about 1½ times average earnings, their statutory earnings related pension will be the same however many times they change jobs. Those earning above the UEL will be protected in relation to their earnings up to the UEL. However, it is far from clear that the massive public expenditure cost of SERPS is affordable - nor is it in any event apparent why pension provision over and above the basic State pension should be a public sector rather than a private sector activity.

6. For the 5½ million public sector occupational scheme members (almost half the total) the potential loss is a good deal less, whether they move within the public sector or into the private sector. This is because their preserved rights are revalued by prices up to retirement.

7. But a problem remains, particularly up to 1998, for all private sector scheme members; and in perpetuity for those earning above the UEL, whose rights in excess of this have no statutory protection. This latter group includes middle managers, technologists etc., who (unlike top managers) will not usually be able to negotiate an individual pension package with their new employer.

The considerations

8. Early leavers subsidise stayers. To improve their position therefore involves costs. These could be borne by a reduction in stayers' benefits, or an increase in employers' and/or employees' contributions. To the extent that extra employer contributions were not offset by lower wages, or that employees gained higher wages to compensate for higher employee contributions, there would be a short term addition to industrial costs. Some reduction in promised benefits for stayers may be more feasible, if the Government makes clear that this is the desired outcome. But employers are likely to be quicker to perceive the risk of extra costs to them than the potential benefits in terms of enhanced mobility; indeed some employers may see advantage in keeping some disincentive to labour mobility, to minimise disruption and re-training costs.

9. Government has so far taken the view that improvements for early leavers, while highly desirable, should be left to voluntary action by employers; but has threatened legislation if there is no noticeable improvement.

10. Ministers could take the more radical position that the resources devoted to pension provision in this country are excessive (and hardly conducive to enterprise), and that reducing the benefits to stayers, in order to remove the discrimination against the early leaver, would be a step towards correcting this. It would make pension provision less of a bargain for the employer, and in particular, it would remove one of the main purposes of "generous" pension schemes, if they could no longer be used to impose a penalty on anyone moving to another employer. A still more drastic step would be to start reducing the tax advantages enjoyed by pension schemes; these have distorted the flow of savings by giving the institutions a premium over direct investment by individuals. But there are clearly problems in reducing pension benefits and the rest of this paper discusses the alternatives for improving the treatment of early leavers.

Solutions

(i) Revaluation

11. For existing final salary schemes, the straightforward solution would be to revalue preserved rights by average earnings or by average prices. Given economic growth, prices revaluation would do less to equalise treatment than would earnings revaluation, particularly for the younger mobile worker.

12. The cost would depend on the rate of increase in the index. If the index rose by, say, 5%, the estimated cost of revaluation would be about £500m a year, or roughly ½% of the private sector's payroll. This cost could in principle be absorbed (see para 8 above). It would increase the pressure on employers to guarantee revaluation of pensions in payment, at additional cost; again this might be dealt with by a reduction in promised levels of benefits.

13. Part of the problem with this cost is its open-endedness; if inflation were to rise sharply, it could become unsustainable. This risk could be limited by not requiring revaluation beyond a stated rate of inflation. But by the same token, the protection to early leavers would be reduced.

(ii) Portable pensions (POPs)

14. The CPRS and others have proposed that employers should allow their employees to opt out of pooled occupational schemes and choose an individualised, money purchase, portable scheme. (But under the CPRS scheme employers would

not be forced to provide this option). Both employer and employee would contribute. The level of contribution would be variable; benefits would depend not on final salary but on the value of the accumulated fund. New entrants bringing a POP with them could keep it, but employers would be allowed to charge to reflect the additional administrative cost. The range of providers would be widened to include other financial institutions as well as insurance companies. There might need to be some increase in the limits for tax relief on contributions, especially for older employees.

15. POPs, if they became widespread, would improve the position of early leavers by eliminating the worst cross-subsidisation within schemes. They would widen individual choice and responsibility and, it is argued, enhance individuals' interest in the performance of the investments on which their pensions depend.

16. POPs are not expected to replace final salary schemes in the short term. Most scheme members are likely to prefer the security of employer schemes, particularly given recent experience of the havoc which inflation can wreak on money purchase schemes. POPs may become popular in due course but their contribution to the early leaver problem is therefore likely to be small initially:

(a) They will only operate for future service. CPRS argued against 'unitising' existing schemes, on the grounds of the impossibility of ensuring an equitable share-out, reflecting members' legitimate rights and expectations;

(b) they will not guarantee a final salary-related pension. In conditions of high inflation employers might not be willing to make the necessary increases in contributions for older employees; and employees might anyway not be willing to risk this possibility;

(c) they are likely to be administratively expensive for employers (and for Inland Revenue); existing pooled schemes are very cheap to run and the difference would be reflected in lower benefits (or higher contributions);

(d) it would not be compulsory for employers to provide them, at least until it was clear that there was a general unmet desire for them.

17. CPRS therefore endorsed compulsory revaluation of preserved rights for the generality of early leavers (para 12), and some POPs as a long term evolution towards more individual choices.

Conclusions

18. The problem of early leavers is a serious one in mobility terms and legislative action may well be required. The most obvious remedy would be revaluation of preserved rights, whatever is done about POPs. Further work needs to be done on POPs, including the question of whether to go further than the CPRS proposal and compel employers to provide POPs for their workers.

Next Steps

19. The Secretary of State for Social Services is holding a conference with the pension industry on early leavers on 14 September. If he then judges that it has not made sufficient progress on a voluntary basis, he will want to propose legislation in 1984-85. This would be a suitable point at which to take action on POPs, if that were considered desirable.

HM Treasury

24 August 1983

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HM Treasury

24 August 1983

EMPLOYMENT IN THE USA

During the 1970s the number of people in employment in the USA grew steadily, broadly keeping pace with the growth in the labour force. More recently, employment has lagged behind but it is now increasing.

2. The main reason for the buoyancy of the US employment figures is the continued growth in the service-producing area. This has to some extent offset the decline in the goods-producing industries during the recession. (The number of people employed in the service-producing sector is almost three times that in the goods-producing sectors, excluding agriculture).

3. The major reason for the greater mobility of labour in the US is the capacity of its service sector to create jobs. There are various reasons for the increase in employment in the service-producing sector. First, no action was taken by the Federal Government to try to discourage the growth of employment in the service sector, as it was in Britain at the end of the 1960s through the introduction of the Selective Employment Tax. Second, the status of employment in service industries is, by and large, higher in the United States than it is in Britain. Many jobs in this sector are therefore attractive to native Americans and not just to disadvantaged immigrants. Finally, the standard of service offered to the consumer is generally higher in the US than in Britain. For example, it is common for shops to remain open during the evenings and throughout the weekend and indeed some are open for 24 hours a day, while in Britain there are still legislative restrictions on shop hours. There is also enormous competition between financial institutions to provide new and better services, employing more staff.

4. Some examples of ways in which UK tends to discriminate against the service industries are given in the Annex.

HM Treasury
26 August 1983

DISCRIMINATION BETWEEN MANUFACTURING AND SERVICES IN THE UK

The following are examples of fiscal discrimination between manufacturing and services which could affect the growth of employment in services in the UK.

(1) Taxation

The main area of discrimination against services is in capital allowances, where industrial buildings get 75 per cent first year allowances, whereas commercial buildings get no allowance and hotels get 20 per cent. (To give allowances for commercial buildings would have an eventual cost of some £1½ billion a year.) In addition, the small workshop scheme provides 100 per cent allowances only for small industrial workshops; and the Business Expansion Scheme is not available for certain kinds of financial companies. Development land tax is deferred on developments for the developer's own use in the case of industrial developments; this deferral has temporarily been extended to all developments but the extension ends in April 1984.

? More generally, the direct tax system tends to favour consumption rather than saving, and this affects those providing savings-related services. However, within this framework, there is a relatively attractive tax regime for pensions and life assurance; and the favourable treatment of housing also helps related services such as building societies, banks, insurance companies and estate agents. The tax system also is less generous to the renting of property than to trading.

For indirect taxation, the picture is more mixed. There is relatively heavy taxation of services in three areas: services linked to the supply of alcoholic drinks (eg in pubs, restaurants); betting and gaming; and road transport (through fuel duties and VED). In the case of VAT, however, about 50 per cent of consumers' expenditure is zero-rated or exempt, and some of this relates directly to services, eg financial services including insurance and banking, health, education and passenger transport. Elsewhere it relates to goods, including the retailing of those goods: eg food; children's clothing; coal, gas and electricity; books, newspapers and periodicals.

/(2) Regional Policy

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For these reasons, the second report on regional economic policy has recommended that the qualifying activities for RDGs should be extended to a range of service industries which are nationally or internationally traded services and whose location could thus be influenced by eligibility for grants. It has also recommended that OSIS should be merged with the mainstream RSA into a single scheme of selective assistance providing equal treatment for the manufacturing and service sectors.

THE PRIVATE RENTED SECTOR

The private rented sector in England now comprises only some 2 million dwellings and is losing about 175,000 of them each year. The principal (although not the only) reason for this decline has been and continues to be the operation of rent control. In the past, Conservative Governments have considered that abolition of rent control would have little or no practical effect, given the 'blight' caused by the prospect of a Labour Government committed to restoring it. This political 'blight' may now be less of an impediment. If so, the ending of rent control could reduce unemployment in two ways - by improving labour mobility and thus the working of the labour market, and by increasing demand in the construction industry.

a. Labour mobility

2. There is evidence that private rented sector tenants are far more mobile than those in other sectors. A DOE study showed that (excluding students and members of the armed forces, and adjusted for age, occupation etc) the probabilities of moving house in each sector as compared with the owner-occupied sector are:

	Movement in Same Region	Movement between Regions
Owner Occupiers	100	100
LA Tenants	152	16
Unfurnished Rented	288	123
Furnished rented	489	320

3. The numbers involved are small (about 40,000 moves a year in the private rented sector). But these results reflect the relative ease of moving in the private rented sector - the costs of a move are low (unlike the owner occupied sector) and there is no waiting list (as for local authority housing).

4. Hence it is clear that, if private rented accommodation were more generally available, it would be easier for people to move to other parts of the country to seek jobs. DOE estimated a figure of 90,000 moves a year, assuming that people from other tenancies were prepared to move with the same frequency as private tenants. But this estimate is an upper limit: for the market to deliver an increase in the supply of suitable rented accommodation, the level of rents would have to rise, and this would reduce the attractiveness of a move (even temporarily) into private rented accommodation.

b. Construction

5. New building under the assured tenancies scheme now attracts a 75% initial capital allowance with 4% per year thereafter, which is sufficient to offset the subsidy to the owner occupied sector. The scheme also allows approved landlords to charge economic rents. But it is taking off slowly and even if, by the late 1980s, it accounted for 5% of new housing, would generate no more than 10,000 direct jobs a year before allowing for displacement.

6. Ending rent control would probably not greatly help new build. But it should increase spending on improvement, by allowing landlords to make an economic rate of return (estimated to be 6%, which would mean rents in Greater London almost trebling and those outside almost doubling). If it led to improvement activity on 10% a year of a stock of around 1 million, with expenditure of £10,000 per dwelling, this might lead to around 60,000 direct jobs a year before displacement. But this displacement offset would be considerable, since many rented dwellings now are improved when sold on vacant possession into the owner occupied sector.

7. DOE Ministers are at present considering proposals by their officials which would end control of rents, although maintaining a degree of security of tenure. Such a measure could not be implemented until mid 1985 at the earliest and its effect would probably be phased. Landlords would also want to be sure that it was permanent, so it could be the late 1980s before it had any noticeable impact.

HM Treasury
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CONFIDENTIAL 6 PAPER 6

by HM Treasury

EMPLOYMENT IN THE USA

During the 1970s the number of people in employment in the USA grew steadily, broadly keeping pace with the growth in the labour force. More recently, employment has lagged behind but it is now increasing.

2. The main reason for the buoyancy of the US employment figures is the continued growth in the service-producing area. This has to some extent offset the decline in the goods-producing industries during the recession. (The number of people employed in the service-producing sector is almost three times that in the goods-producing sectors, excluding agriculture).

3. The major reason for the greater mobility of labour in the US is the capacity of its service sector to create jobs. There are various reasons for the increase in employment in the service-producing sector. First, no action was taken by the Federal Government to try to discourage the growth of employment in the service sector, as it was in Britain at the end of the 1960s through the introduction of the Selective Employment Tax. Second, the status of employment in service industries is, by and large, higher in the United States than it is in Britain. Many jobs in this sector are therefore attractive to native Americans and not just to disadvantaged immigrants. Finally, the standard of service offered to the consumer is generally higher in the US than in Britain. For example, it is common for shops to remain open during the evenings and throughout the weekend and indeed some are open for 24 hours a day, while in Britain there are still legislative restrictions on shop hours. There is also enormous competition between financial institutions to provide new and better services, employing more staff.

4. Some examples of ways in which UK tends to discriminate against the service industries are given in the Annex.

HM Treasury
26 August 1983

DISCRIMINATION BETWEEN MANUFACTURING AND SERVICES IN THE UK

The following are examples of fiscal discrimination between manufacturing and services which could affect the growth of employment in services in the UK.

(1) Taxation

The main area of discrimination against services is in capital allowances, where industrial buildings get 75 per cent first year allowances, whereas commercial buildings get no allowance and hotels get 20 per cent. (To give allowances for commercial buildings would have an eventual cost of some £1½ billion a year.) In addition, the small workshop scheme provides 100 per cent allowances only for small industrial workshops; and the Business Expansion Scheme is not available for certain kinds of financial companies. Development land tax is deferred on developments for the developer's own use in the case of industrial developments; this deferral has temporarily been extended to all developments but the extension ends in April 1984.

More generally, the direct tax system tends to favour consumption rather than saving, and this affects those providing savings-related services. However, within this framework, there is a relatively attractive tax regime for pensions and life assurance; and the favourable treatment of housing also helps related services such as building societies, banks, insurance companies and estate agents. The tax system also is less generous to the renting of property than to trading.

For indirect taxation, the picture is more mixed. There is relatively heavy taxation of services in three areas: services linked to the supply of alcoholic drinks (eg in pubs, restaurants); betting and gaming; and road transport (through fuel duties and VED). In the case of VAT, however, about 50 per cent of consumers' expenditure is zero-rated or exempt, and some of this relates directly to services, eg financial services including insurance and banking, health, education and passenger transport. Elsewhere it relates to goods, including the retailing of those goods: eg food; children's clothing; coal, gas and electricity; books, newspapers and periodicals.

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THE TAXATION SYSTEM AND EMPLOYMENT

Changes in the rates and thresholds of all the major direct and indirect taxes would have effects on employment to a varying degree but they must be considered within the context of the Government's overall fiscal stance. This note therefore focusses on those measures which would have a very direct impact on employment or which would be relatively self-contained.

National Insurance Surcharge (NIS)

2. The abolition of the 1 per cent National Insurance Surcharge would have a direct effect on labour costs. The Government is already committed to taking this step when resources are available. It would, however, be a very expensive operation. Changes in the NIS take about four months to implement from the date of their announcement. If abolition were announced in the 1984 Budget and took effect from the following August, the direct cost (ignoring second order effects) would be £450m in 1984-85 and £900m in 1985-86. If, alternatively, abolition were announced this autumn and took effect from next April, the first year direct cost would be £710m. All these estimates assume that the savings accruing to the public sector would be clawed back through adjustments to cash limits and EFLs.

Restricting Capital Allowances

3. Capital allowances have a dual purpose: they both allow for the depreciation of capital assets and provide an incentive for investment. There is clearly a "deadweight" cost attached to the provision of capital allowances, as tax relief is granted on some investment which would have taken place in any case. However, it has never proved possible to quantify this. While there is certainly a case for encouraging companies to re-equip themselves in order to remain competitive, a reduction in capital allowances would help to achieve a fairer balance between the tax treatment of capital and labour by reducing at the margin the incentive to substitute capital for labour.

4. Various adjustments to the rates and scope of the capital allowances would be possible but in practice, it is only changes in the allowance for plant and machinery (100 per cent in the first year) which could yield significant amounts.

5. The rate could be cut across the board. Virtually no equipment has a life of less than two years so that a reduction in the first year allowance to, say, 75 per cent (with a 25 per cent annual writing down allowance on the balance) would, in most cases, still leave it at a generous rate in terms of commercial depreciation in relation to historic cost. The reduction would have no direct revenue effect in 1984-85 but would save £300-450m in the following year, with a peak saving of £400-650m in 1986-87, gradually reducing to zero in subsequent years.

6. An across the board cut in allowances would be much easier to handle than a selective reduction but the administrative and presentational advantages of the immediate 100 per cent write off would, of course, be lost. The cut in the incentive for investment would be felt right across industry. On the other hand, the savings made could be used to help industry in other ways (eg as a contribution towards the cost of abolishing NIS).

7. Alternatively, the 100 per cent first year allowance could be retained but only on an even more discriminatory basis than obtains at present. Largely as a result of decisions by the Courts, the allowance now extends to a range of items not normally regarded as either machinery or plant. The position could therefore be rationalised by removing from the scope of the allowance buildings and structures, fixtures and fittings, hard and soft furnishings and a number of miscellaneous items, such as holiday caravans.

8. It is very difficult to estimate the revenue effect of such changes but reductions in the allowances on fixtures and fittings alone, while having no effect in 1984-85, could produce savings of £90-150m in the following year and peak savings of £130-200m in 1986-87.

However, the definitional problems involved in the change would be considerable and the necessary legislation would be difficult to draft. There is also a significant risk that in focussing attention on this issue, Ministers would come under great pressure to extend rather than narrow the boundaries. Removing the 100 per cent allowance on fixtures and fittings and on furnishings would have its biggest impact on the commercial sector where there is already the greatest pressure to provide new allowances - for commercial buildings.

Business Expansion Scheme (BES)

9. The Government has focussed a great deal of attention on improving the tax regime for small firms, in the belief that this is one area of the economy which has substantial potential for generating employment. The purpose of the Business Expansion Scheme, introduced in this year's Budget as a development of the earlier Business Start-Up Scheme (BSS), is to encourage outsiders to contribute equity capital to registered trading companies by giving them relief for their investment at their marginal rate of income tax, including investment income surcharge. The scheme recognises the risky nature of this type of equity investment and has substantially altered the ratio of reward to risk. We know of no other country which offers a more generous tax relief of this nature.

10. It is far too early to determine how much additional investment the BES is stimulating or to assess the impact the scheme has had on the companies in which the investment is placed. Nevertheless, there has been strong public interest in the scheme and the signs are reasonably encouraging.

11. A number of technical modifications were made to the BES in this year's second Finance Act but no attempt was made at that stage to introduce substantial changes. Nevertheless, there is in principle a strong case for making changes in the following areas:

(a) Takeovers: A company may at present use BES money to take over the trade or assets of another company but not to take over its shares.

(b) Overseas subsidiaries: The aim of the relief is to expand activities in the UK. A company can qualify for relief if it carries out ancillary activities overseas through a branch, provided that most of its production, employees etc are in the UK. But a company cannot qualify if it carries out its ancillary activities abroad through an overseas subsidiary.

(c) Company structure: There are a number of other restrictions on the structure of a group which may make it ineligible for BES money. For example, it must not have a dormant subsidiary; it must not have subsidiaries; and it must not hold its property in a separate investment company for the group.

All these restrictions could reasonably be removed.

(d) Subsequent trading on the Unlisted Securities Market: BES relief is withdrawn if the company gets a listing or is traded on the Unlisted Securities Market within 3 years of the issue of the shares for which relief has been given. This period might reasonably be reduced to 2 years.

(e) Start-Ups: When the original Business Start-Up Scheme was widened into the BES, no distinction was made between the treatment of new and existing companies. In the case of new companies, there is a strong argument for reducing from 5 to 3 years the period over which the investor has to hold his shares in order to get the full measure of the relief. This would, however, reintroduce into the scheme some of the complexity for which the BSS was criticised and which the 1983 Budget removed.

12. All these amendments to the present scheme warrant careful consideration but there is also a case for arguing that it would be better to assess the effect of the tax concession announced last March before introducing further refinements.

Share option relief for smaller companies

13. Gains made by an employee when he exercises an option on shares in his company (except under approved SAYE schemes) are liable to income tax. The tax can already be paid by instalments but proposals have been put forward for replacing the income tax charge on exercise of the option by a CGT charge on the ultimate disposal of the shares.

14. A general relief of this kind would be quite costly (with a deadweight cost probably in the region of £50-100m) as well as politically contentious and would run counter to the policy of encouraging remuneration in cash rather than benefits. However, it would be possible to introduce a relief limited to smaller companies. The aim would be to shake able executives out of larger firms into new and smaller ones. New firms can rarely compete by offering higher salaries. An incoming executive can normally take a stake in his small firm by raising a loan but a share option relief could be an additional route to financial reward for those prepared to take the relatively risky course of committing themselves to a smaller business. Treasury Ministers will be investigating this possibility further.

HM Treasury
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