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Part. C.

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Begins: 3/3/81.
Ends: 30/4/81

PO -CH /GH/0084
PART C

Chancellor's (Howe) Papers:

REPRESENTATIONS ON TAXES
AND INFLATION FOR THE
1981 BUDGET

Disposal Directions: 25 Years

D Andrews

26/7/95

PART C

Z

R

10 DOWNING STREET

om the Private Secretary

3 March 1981

I enclose a copy of a letter the Prime
Iinister has received from Councillor
avid Bevan, M.P., together with a copy
f his report on small businesses in his
onstituency.

I would be grateful for a draft reply
hich the Prime Minister might send to
ouncillor Bevan to reach us here by
riday, 13 March.

I am sending a copy of this letter and
nclosure to John Wiggins (HM Treasury).

N. J. SANDERS

from: Cllr.David Gilroy Bevan MP

3

HOUSE OF COMMONS
LONDON SWIA OAA

DGB/CAVB
26.2.81

3/3

The Prime Minister,
10 Downing Street,
London.

Dear Prime Minister

I have been regularly visiting many medium and small business firms from January to the current date.

Some, especially those that are metal and engineering based, are feeling very substantially the effects of the recession and indeed desperately require some further economic encouragement to sustain them at this moment, as many are threatened with closure.

I am taking the liberty of sending a copy of a report that I have compiled on these firms, hoping that it will commend itself to you for urgent action in view of the rapidly deteriorating situation in my constituency and in this sector in the West Midlands.

Yours sincerely
davidgbevan

David Gilroy Bevan.

from: Cllr.David Gilroy Bevan MP

3

HOUSE OF COMMONS
LONDON SWIA OAA

DGB/CAVB
February 17th,1981

REPORT ON SMALL BUSINESSES IN MY CONSTITUENCY.

A plea to the Prime Minister and the Chancellor of the Exchequer.

I have kept very closely in touch with businesses large, medium and small in my constituency and have noticed with concern and alarm the deteriorating situation as it is affecting, particularly the small business.

In a series of factory visits in my constituency of Yardley made during January and February, amongst others I visited and spoke at some length with the following:-
Car Trade - Two garages and distributors and factors of car component parts.
Wholesalers supplying tools for the machine tool industry,
Woodwork and marine fabricators, a wholesale electrical supplier to the trade, a specialist off-set photographic litho-printer, a retail office supplier, two butchers and a medium-sized plastic manufacturer.

The reception was mixed and indeed experiences were mixed, but those who were car based (garages and engineers) commented that there would be a huge "knock-on" concept if British Leyland were allowed to "go west", and who resented an anti-British Leyland feeling. After a bad start where the Metro allocation had failed and initial results were disastrous, the picture with regard to this model had substantially improved and the situation regarding the Rover and Range Rover is considered good.

The garages and machine tool suppliers particularly asked for short term protection against the invasion from the Far East, particularly Japan, which defied all competition on prices and from Taiwan, where there is no reciprocal legal arrangement, thus allowing unsafe parts into the country at clipped prices.

While the garages found their P.O.L.business was steady, big clients could not afford to pay but continued hoping that they could trade their way out of it. There had been "write-offs" on several large bad debts.
The servicing of the private sector was substantially down.

Resentment was felt about the special car tax and VAT and this was cited as being a tax on a tax.

The used car market was badly down and a plea for the easing of hire purchase restrictions both as regards the one third deposit and the two year period was asked for. Certain off-shore companies were breaking these rules in any event.

The second car distributor employed nearly 300 full time workers and 40 part-timers, with a turnover of 15 million pounds and three thousand vehicles sold per annum. The constant reiteration of attack was instanced here as elsewhere:-
1) high interest rates, 2) high fuel and energy costs and ever-increasing rises (gas, electricity and water), 3) the public sector drawing inflation-proof pensions was particularly damaging to the private operator and with the City of Birmingham today increasing rates by 31.5% will mean a further bankruptcy of businesses and further subsequent redundancies.

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HOUSE OF COMMONS
LONDON SWIA OAA

Job Pay in the private sector could not compare and a £6,000 appointment was lost to the public sector who paid £8,500 for the same job with better pension, car loans, etc.

It was thought to be fatal to split British Leyland off and to hive off the profitable parts.

It was felt that small factories were too greedy and that bad management in large companies had resulted in a continually deteriorating situation.

It was felt the British press was insular and Germany was even restricting tourists going overseas.

The biggest danger was with regard to pay and not interest rates. Relief of employers' surcharge was desperately necessary and whilst gross profits had gone up by 20% (mainly due to inflation) gas, oil, electricity, other outgoings in the public sector had gone up by at least this amount.

The motor factor supplying specialist equipment had a staff of six, having made one part-time redundancy, turnover approximately £250,000 p.a. Business was not too bad and again rates, electricity, taxes, water and the nationalised sector charges were described as diabolical and rates horrific.

The South side of the town was said to be more affluent and business on the North side much worse.

With Wilmot Breedens closed there were people "folding up".

The private sector accepted high taxation, but the nationalised sector was seen as a "wicked uncle".

The principal felt his contribution to assist was to have a happy contented staff who receive slightly above average wages after a very low start.

An insurance broker was employing over 30 employees with a million pound turnover and earning commission of £180,000 had made £8,000 loss on his trading. The public was short of money and lacking in confidence. Public had too high standard of living, two t.v.'s, cars, etc. Profits were down even with the big brokers of 60-70%. His own overheads had increased by 22% and commission was only up by 5% (inflation) and which should have been up by some 20% to keep up.
Telephone and postal charges were extortionately high, this firm having had a 50% increase last year and a further 15% in January of this year. Petrol and rates were up by 30%. Had only remained in business as a result of investments and would retire if the situation continued another year. Seven smaller client companies had gone bankrupt in twelve months. It was felt the tax system disallowed investment in good times. The pendulum effect was such that it had swung nearly to the point of no return.

Builder's Suppliers were in desperate straits, being down 40% down in turnover and caught in a system of everybody living on credit. There was praise for the Prime Minister's action, but regrettably no cash flow and customers could not pay their bills. When the sales side was "taken from the purchase

HOUSE OF COMMONS
LONDON SWIA OAA

side" they were always paying out and could only last in these circumstances until March. Given a chance they would sell out romorrow.

By contrast, the joinery and boat builder, though griping of course about high outgoings, fuel, oil, post and telephone and the fact that nationalised industries can pay twice the wages and wanting to abolish the road tax system was nevertheless doing well. Though his boat building was minimal his main business now lay in furbishing the interiors of clubs throughout the country. He employed eight men and had a turnover of some £80,000 p.a.

Another very satisfied business was a discount electrical supplier who had only opened at the beginning of 1979 and who employed three part-time girls and found the electrical business extremely good. There were credit accounts and two thirds of trade was self-employed electricians. They had been able to cut the price of the traditional suppliers substantially and had a turnover of £10,000 per week at one location (there were two). They had done this by dint of hard work. Had no complaints of the Government though many regarding costs of gas, water, rates, etc.

Raw materials had only gone up 1½% in 12 months whereas outgoings had spiralled. It was felt the Government was doing a pretty good job and that inflation should be substantially reduced.

Specialist Printer had some 60 employees including 30 representatives. Stationery supply had been disposed of as it was felt to be a lost leader. Very down at the moment in profitability with a highly competitive home market. Could possibly continue business for another 12 months, but it was felt matters would get worse. Advertising had been cut back and industry had substantially reduced orders. Interest rates had nearly doubled last year and charges were a substantial burden. Complaints were on fuel, electricity, wage increases, attitude of Union negotiators, still wanted expensive wage awards in excess of the agreed house rate. Wanted reduction in the working and increased holiday pay, greater overtime, etc.
Educationally printing was down by 40% in 12 years. The problems which had arisen over 150 years from the Industrial Revolution had been far superceded by those in one year currently. While broadly agreeing with the Government he would create two million jobs tomorrow. 5% of his business had been cancelled at a late date.

The jig and gauge company was virtually a co-operative with all directors working with three in the shop and three on the road and a work force of nearly 20 and an establishment of 20 years. Non Labour.

Heavy press business had disappeared and the main business was jigs. Badly affected by the slump in the automotive industry and currently on 40 hour week. The firm nearly folded some six years ago and only the directors were left. However, it was felt the situation today was worse, there was no order book and they were working from week to week and day to day. Cash flow was bad and October accounts were only just being paid. Breakeven figure was currently halved and whilst there was no bank overdraft the directors had guaranteed the situation back to the company. Redundancies must come immediately if the situation continued. Plant would not fetch anything like it's worth if sold on a bad market. After redundancy it was impossible to get labour back and there was reluctance to work in a "dirty trade" when there were high wages in other areas. BL did not help, employing anybody

HOUSE OF COMMONS
LONDON SWIA OAA

when times were good and laying off when times were bad. The Prime Minister was considered good at the start getting rid of the bad wood, but now was getting rid of all the good wood and had gone too far. Drop in bank rate ws urgent.
A different price for fuel and energy for industry was asked for and was instanced to be the case in France. Really big firms were on 3 day week and strikes were still occurring.

Would prefer to get rid of their own rubbish than have an inadequate dustbin collection service and have it knocked off the rates. Thought that February would decide their future. Regeneration is required urgently in weeks not months and high interest rates could only perpetuate the "knock-on" effect.

Hand tool and machine tool cutting firm were suppliers to electrical companies, Massey Ferguson, etc. Turnover down by 30% on the previous year. Most of their trade was very bad. Particular complaints regarding cost of telephones, postage, electricity, rates and water charges. Rent had also nearly doubled. Cash flow had been extenuated and had got worse. Have had to make some redundancies. VAT caused a tremendous amount of work - 15% with discounts actually worked out at approximately 14.77% and often had to be recalculated when customers claimed discounts whether or not they were time entitled to them. VAT should remain constant on the original invoice whatever the discount.
Comparisons were quoted, i.e.

British head brake adjuster	-	three dozen	=	£21.00
Japanese " " "	-	three dozen	=	£10.96

Fear is felt for the future of the business. Trade was extremely bad.

A tool and gauge company employing some twenty men on a profit sharing basis, substantial suppliers to Aerospace. They felt there would be a sharp decline commencing in March and flattening until October. They were however selling to Germany and Japan. When British were sold up machinery goes abroad at knock down prices to compete against us. The conquering of inflation was forgotten and all their concern now was in high interest rates which it was felt should be reduced by 5% at least. Problems were discussed in the factory, no "them and us" situation. Had reduced luxuries and drawings and explained to workforce what was being done. It was felt help should be given to big business and small businesses will get the spin-off.
The thrid world was now a manufacturing force and required quick action on our behalf.

An office suppliers was experiencing substantially reduced turnover as firms cut back.

The butcher with several shops was holding his own, but several of his smaller colleagues had gone out of business.

The Midlands were the "powerhouse" of England and already have suffered substantially as a result of other areas having assisted and grant aided status both from National Government and Europe.

The "iron-heart" of England is bleeding, it's oil lying in pools on the factory floor while the machinery grinds to a halt through lack of orders and ever increasing numbers on the employment market.

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HOUSE OF COMMONS
LONDON SWIA OAA

The Government was praised for certain things they had done for business, but the seriousness of the situation must be counted at every step. The increased Youth Employment scheme and CEP programmes were biting and helping, but once laid off by redundancies labour was virtaully impossible to re-engage.

The balance must be redressed of the large nationalised sectors are subsidised and the public sectors increase their charges without competition by whatsoever their costs escalate then so must a formula be found for the private sector and the small business.

Interest rates and ridiculously high nationalised sector charges must be attacked immediately and a breathing space gained.

The large nationalised sectors could possibly "forward order" from the small industrialists and stockpile as the sales on successful new models like the "Metro" escalate. These parts will be taken up and not sold at subsidised prices like the Euro-butter mountain and wine lake. It is desperately necessary to install a pacemaker to assist the "iron heart" of England and to provide manufacturing employment in the tradition trades who cannot re-adjust to the change in international trading and manufacturing at a stroke.

D. Gilroy Bevan
MP for Yardley.

The Sub-Contractors Trade Protection Association

Park Court House, 272 Rotton Park Road, Edgbaston,
Birmingham B16 0JH.
Telephone: 021-429 2727

WE BUILD BRITAIN
SUB-CONTRACTORS TRADE PROTECTION ASSOC

President: Aidan J Coyle
Chairman: D.W.O'RIORDAN, ACIS, ACMA, AMBIM, AInstTA, FRSA, Cert.Ed.
Secretary: ~~E. McDARBY~~ J.A.L.M. Rust

Secretary's Office: ~~446 Birchfield Road, Perry Barr, Birmingham B20 3DB.~~ 39-43 Mill Street, Luton, Beds.
Telephone: ~~021-356-3568~~ Luton(0582)411308

8

23172

Our Reference: DWOR/BG
Your Reference:

Chairman's Office
35a, High Street,
West Bromwich,
West Midlands B70 6PB.
021-525-6798

J 6/3

4 March 1981.

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CH/EXCHEQUER	
REC.	- 6 MAR 1981
ACTION	PS/IR
COPIES TO	

10/3
11/3

The Rt. Hon. Sir Geoffrey Howe, M.P.
Chancellor of the Exchequer,
Treasury Chambers,
Parliament Street,
London SW1P 3AG.

Dear Sir Geoffrey,

Sub Contractors - Tax Exemption Certificate Scheme
for the Construction Industry

May I remind you of the memo. submitted by this Association to yourself and the Board of Inland Revenue in March 1979, seeking amendments to remove the worst features of the politically motivated (as admitted by Mr Healey on radio), Finance No.2 Act 1975 and the Act of 1976. The observations in it still hold good, particularly as regards -

1. Absence of right of appeal against cancellation of certificate (a basic denial of a human right which our committee wishes to take to the Commission on Human Rights).

2. The resulting deduction of 30% of income which is far higher than any likely tax liability and puts most firms out of business before an appeal against refusal to re-issue can be heard.

3. The fact that cancellation is taking place in the case of small firms on grounds not specified in the Act, whilst certificates are not cancelled in the case of large wealthy firms who can afford High Court costs for an order for restoration (C.P. William Press Ltd).

4. The fact that innocent taxpayers cannot have excessive costs reimbursed, when incurred in defending themselves against unjustified revenue accusations.

5. A scheme was put forward last year by Mr Michael Jump, of Loncolns Inn for amendments with safeguards for the Revenue, and Mr Rees or his department have a copy.

As a Conservative Local Government Prospective Candidate myself, I must say that I am very disappointed at this governments failure to stop the Revenue putting small firms out of business in this and other industries without regard to the effects on unemployment and the economy in general. We have also written to Mr Rees.

Yours sincerely

D.W.O'RIORDAN
Chairman of the Assoc.,

P.S. A page from our evidence to the Keith Committee is attached quoting remarks made by the Chairman of the Special Commissioners on the subject (marked in red ink). If learned counsel feels so strongly, surely our case for amendment has merit. He made it clear that we are at liberty to quote his remarks

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REMARKS MADE BY CHAIRMAN OF SPECIAL COMMISSIONERS IN CAULFIELD BROS. (BRAINTREE) LTD. CASE 1980

publically quoted) "I regard the Act(Finance No:2 Act 1975) as an insult to the Commissioners" - " if I had had to conduct a business under these rules, I should have ended up in jail long ago" - (my client remarked that he had only a C.S.E. 5) - "you realise, Mr. O'Riordan, that however sympathetic we may be, subject to what the Revenue can bring up, it is difficult for us to do anything, because our powers are so restricted by the Act" In a thirty-three judgement in which Revenue allegations of fraud etc., were dismissed the Commissioners had to finish by saying amongst other remarks 'Since the Statutory Provisions and the High Court Authorities lay down that we have no discretion in this matter we are therefore bound to dismiss the company's appeal and refuse its application for a sub-contractor's certificate, (copies of four pages of decision, Appendix 6 attached). The client at twenty-five years of age had built up a flourishing business of £300,000 per annum which is now in ruins and he and his brother are being harassed by the investigators when they try to obtain employment. The 'investigators' often withdraw a certificate on the grounds that 'it has been misused' when in fact the firm (or individual) is being blamed because it was deceived by the fraudulent use of some other certificate, since they know full well the small man cannot afford the cost of high court action to secure its return. Yet Wm. Press Ltd., a large wealthy firm were allowed to retain their certificate even though sundry of their personal were charged with offences. The Revenue investigators are not over scrupulous in observing the rules of law or the Judges rule if they know the victim is not rich enough to fight them in Court, yet they allow real offenders to go free. For e.g. in my presence and that of a Member, Mr.P. Martin, (permission to quote name attached) an Investigator, Mr. Cooper was told where he could find two men involved with a firm called Shape Renovations Ltd., but was not willing to act even though its stolen or forged certificate keeps cropping up all over the building and constructions sites in England, and involving innocent or naive men in paying them gross for supplying labour, not knowing that the certificate is fraudulent, so that the Inland Revenue Investigators can later descend on the victims and withdraw(probably unlawfully if Counsel's opinion is correct) their certificates whilst the Inspector of Taxes later demands payment, on a collector's assessment (Regs.1960 (9)(B) under Finance No:2 Act of 1975) of the 30% tax with little chance of success in an appeal held behind closed doors (at which the press cannot be present to report the facts) The unfortunate contractor or intermediate sub-contractor has to pay twice and his licence to work is cancelled and he is put out of business. In not one case that we know of have the Inland Revenue offered any proof that would stand up in a Court of Law that the Tax had not in fact been paid by the holder of the alleged fraudulent certificate, before collecting from the deceived victim.

11

10, DOWNING STREET,
WHI. .HALL S.W.1

As request copy also
sent to DOT

IB Both In and
PA
TAW 3/4

With the Private Secretary's
Compliments

fle P[illegible] 12

cc BIR

10 DOWNING STREET

From the Private Secretary

9 March 1981

The Prime Minister has asked me to [illegible] for your letter of 19 February about the taxation treatment of your drivers. Mrs. Thatcher understands the problems that would be caused if the status of the drivers was changed in the manner proposed by the Inland Revenue. However, she hopes you will accept that if the drivers should properly be treated as employees, then the Revenue has a duty to ensure that Pay As You Earn is operated.

The principles governing the distinction between the employed and the self-employed have been fairly well established in law over a number of years. Essentially, if the worker enters into a master/servant relationship where he works under the supervision and control of the firm, then for taxation purposes he should be regarded as an employee and that status is not changed simply because the worker signs a statement which says - to use the words of the agreement form signed by new drivers engaged by Swanbrook Coaches - that he "will be a self-employed person".

It all depends of course on the arrangements which exist between the firm and its workers. On the basis of the facts relating to your drivers, which have been established by the Revenue Special Office at Solihull, the Revenue have no doubts that the claims to self-employment cannot be maintained and the reasons for this view have been fully explained to your accountants, Messrs. [illegible] Whitehill & Co. If this view is accepted it follows that the drivers should be treated as employees and that Swanbrook Coaches, as the employer, should deduct tax from their remuneration under the PAYE system. If, on the other hand, you do not accept the Revenue contention, then the remedy lies in an appeal to the local Commissioners of Taxes. No doubt your accountants will be happy to advise you on the procedure.

The statement in the Special Office letter of 10 February that tax might be assessed for the years 1974/75 onwards was intended to emphasise the view that in strictness PAYE should have been applied in the past, as well as the present. However, on reconsideration, the Revenue have decided that whether or not agreement on the introduction of PAYE can be reached, they do not propose to assess tax on your firm for years prior to 19[illegible] [illegible] that this assurance will help to alleviate the difficulties to which you refer.

Billy Thomas, Esq.

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pwp

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State (L)
PS/Minister of State (C)
Mr Ridley
Mr Cardona

FRINGE BENEFITS

It may be helpful to have the facts on Season Tickets and Free Petrol drawn together from recent minutes.

P J CROPPER
10 March 1981

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BUDGET 1981 - FRINGE BENEFITS

1. SEASON TICKETS

i) Background. There has been a growth of schemes in the last year or two under which employers provide their employees earning below the threshold with season tickets for travelling to work without this attracting tax in their hands. This is achieved by the employer contracting directly with British Rail or London Transport to provide the employee with a season ticket (so that he is not meeting the latter's pecuniary liability), under an arrangement which ensures that the employee is not entitled to a refund or that the ticket is not in place of a wage increase (so that it is not convertible into cash) and without involving the exchange of a voucher (to avoid taxability under the vouchers legislation). The season ticket itself cannot be taxed as a voucher since it is not capable of being exchanged for services, a pre-requisite of taxability under the vouchers legislation. (Employees earning above the threshold are taxable in any event on the provision of season tickets.)

ii) The Figures. Out of a commuter population of around 1 million, some 250,000 are now provided with season tickets by their employers. Of these 250,000, roughly half already pay tax on the benefit (including directors and employees earning above £8,500, and all who are provided with vouchers which they exchange for tickets or are reimbursed the cost of the ticket). It is only a minority (100,000 or so) who escape tax: these are employees earning less than £8,500 whose employers have entered into schemes which avoid tax (through a loophole in the law).

iii) Argument. The minority escape tax, while the majority are either taxed on the benefit of the season ticket provided or pay for their travel from home to work out of taxed income. This is very unfair. It fuels the pressure for tax relief for travelling expenses from home to work (which would cost some £1 billion). Taxing all season tickets would to some extent reduce that pressure (or at least remove a source of grievance).

It is our policy to encourage employers to reward in cash rather than in kind. A watertight tax on the provision of season tickets would be

ntirely consistent with this. And, by preventing avoidance through schemes drawn up for the purpose, it would end the preferential tax treatment enjoyed by a minority of commuters.

2. FREE PETROL

i) Background. Last year, in his Budget speech, the Chancellor said: "I have also been considering whether I ought to take action to charge tax on the value of petrol provided by employers for private use by their employees. This would present severe administrative problems, both for employers and for the Inland Revenue. Even so, I shall feel bound to contemplate action next year, if the provision of free petrol continues to spread at anything like its present rate.".

ii) The Figures. It is believed that provision of free petrol for private motoring is now normal practise in about two-thirds of large companies (and probably more widespread in smaller ones). Some 50 per cent of employees with company cars are believed to get their petrol free.

iii) The Proposal. In his 1981 Budget Speech the Chancellor says: "Last year I referred to the growing practice of employers providing free petrol and said that I should be bound to contemplate action if it continued to spread. That warning has largely been ignored. I propose therefore to take action which will ensure that tax is chargeable in all cases where petrol is provided for private use of a higher paid employee or director. The Inland Revenue will consult employers' organisations over the administrative implications of the various possible methods of achieving this."

10 March 1981

pwp 17

CHANCELLOR ✓
CHIEF SECRETARY
FINANCIAL SECRETARY
MINISTER OF STATE (C)
MINISTER OF STATE (L)
MR NEWTON
SIR DOUGLAS WASS
SIR KENNETH COUZENS
SIR ANTHONY RAWLINSON
MR W S RYRIE
MR T BURNS
MR UNWIN
MR RIDLEY
MR CARDONA

cc Sir Lawrence Airey - IR
Sir Douglas Lovelock - C&E
Ian Stewart MP

11/3/81.

CONSERVATIVE PARTY FINANCE COMMITTEE - 10 MARCH 1981

The Chancellor attended the Committee directly after his Budget speech, accompanied by the Financial Secretary, Minister of State (C) and Minister of State (L). 200 present.

1. The Chancellor outlined the salient details of the Budget:

Maintenance of the Inflation Strategy
Regretfully petrol
Income Tax measures
Public Expenditure and its problems
The Loan guarantee and Start-ups measures
MLR, leaving UK interest rates at least in line with, if not below, corresponding rates abroad, eg in Germany and the USA.

"This is the stage in the Parliamentary term at which previous government have been driven off course; this is the worst moment at which to allow that to happen again. So we can present this budget as precisely right for the moment".

2. Terence Higgins felt that most of the reasons for the severity of this budget were to be found in massive failure to get to grips with public expenditure. He had considerable misgivings about the bank tax.

3. Robin Maxwell-Hyslop felt 20p on petrol would have devasting consequences in rural areas.

4. John Brown supported the Budget, save in respect of index linked gilts and the fact that the government was holding to its monetarist policies without properly dealing with the labour cartels.

5. Pat Cormack felt the Budget would add to the difficulty of fighting the next General Election.

6. Tim Renton was very worried by the decision to tax bank profits. What was the point of taxing banks in order to provide funds for the Department of Industry to dish out to loss making nationalised industries.

7. William Rhys-Davies was concerned that we were doing all sorts of things for new business, but little to help existing businesses.

8. Peter Hordern pointed to same contradiction. He also thought indexed bonds were an unfortunate gimmick.

9. Jill Knight hoped the Chancellor would not attempt to justify the petrol tax by arguing that petrol was cheaper in UK than elsewhere.

10. Jock Bruce-Gardyne congratulated the Chancellor on the courage of his arithmetic, and hoped that he would be able to persuade his spending colleagues that they needed to mend their ways.

11. Paul Dean welcomed encouragement to the wealth producing sector.

12. Sir Frederick Bennett hoped the government would not attempt to bracket petrol in the same group as drink and tobacco. It was very different. He wondered what had been done, if anything, on the £25,000 mortgage interest limit.

13. John Townend congratulated the Chancellor on keeping his nerve. The inability to raise the tax allowances was simply a consequence of running out of steam on the public expenditure front.

General impression. Non-plussed, worried, very put out by the failure to contain public expenditure. increase in petrol tax, and potentially furious about the failure to contain public expenditure.

P J CROPPER
11 March 1981

13/3/81

19

Worth giving strictly ltd circuln. to those – Mins, D.W, R.G etc 1 or 2 at.

Pse return

Clerks –
pl copy these letters
to CST
FST
MST(C)

Mr Middleton

Personal

20

10 DOWNING STREET

March 11

Dear Geoffrey,

If I may presume, I would like to congratulate you on your budget. I know how difficult it was to convince colleagues of the need for such measures.

From my brief contact with the City I believe that the general view is one of admiration for your courage in doing the right thing — an admiration which I fully share.

Although I differ on details, I am sure that the general stance is right.

Yours
Alan Walters

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THE DAILY MAIL, LONDON

Telegrams, Daily Mail, London, E.C.4.
Telephone, 01-353 6000
Registered No. 898269 England

Northcliffe House,
London, EC4Y OJA

March 13, 1981

PRIVATE AND CONFIDENTIAL

The Rt. Hon. Sir Geoffrey Howe, QC, MP,
Chancellor of the Exchequer,
11 Downing Street,
London. S.W.1.

Dear Geoffrey,

I would like to say how much I have admired your actions this week and the courage you have shown over the budget.

You may (or may not) have noticed some time ago we did attack you fiercely. This was because I really felt that there was a weakening of conviction and spirit and that the medium term strategy was being abandoned, which in my view would have been one of the most disastrous things every to have happened to this country in recent times. However, my reading of the situation and your part in it, Geoffrey, was completely wrong. And I regret my criticism. You may (or may not) have noticed that I have expressed those regrets in print and withdrawn the Mail criticism.

Since you appear to be loosing some allies and friends (in a political sense, of course) within Westminster, I hope the regaining of an ally and a friend in Fleet Street may be of some small help. We shall support you all that we can and have done just that all this week.

continued ... 2

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THE DAILY MAIL, LONDON

Telegrams, Daily Mail, London, E.C.4.
Telephone, 01-353 6000
Registered No. 898269 England

Northcliffe House,
London, EC4Y OJA

Incidentally, I watched you on Question Time last night and thought that you more than wiped the floor with the opposition - such as it was. Mind you, you were helped by the very attractive lady from Unigate. However, the truly interesting thing about that programme was the genuine understanding and support you had from a truly representative cross section audience. My reading of reaction from readers is many, including some of your Cabinet colleagues, are being far too swayed by the political rhetoric over the Budget.

I am tending to find a much more muted and indeed even sympathetic reaction from ordinary people. No one actually likes the Budget, but there seems to be much more acceptance and indeed understanding from the man in the street than many union leaders, politicians and commentators would have us believe.

The people want to get the economy right and are willing to accept sacrifice. I am convinced about this, which is why I profoundly believe that your budget has been accepted.

I hope very much to see you before long.

Yours sincerely,

David

DAVID ENGLISH
Editor

13/3/81. 23

PUP

Mr Kerr

Budget Speech - Draft 8

I think people would be interested in, and perhaps expect, some reference to the oil price factor earlier than G3. Should something like G5-6 find a place in the opening paragraphs? ?? That would be v. tricky

Block E is good stuff but strikes me as rather long. We agreed - but decided to keep it

In G3 line 8 for "spent" read "brought to account." OK

H2: last 3 sentences could be condensed to 2. to T. Done.

H5 say: "The target of 630,000 by April 1984 which we set ourselves ... ."

ACR 11/3

pa 26

16/3/81.

Chancellor.

I told Keith I would pass this to you. You only need to skim through it.

TELEX 885792

Dear Peter,

After you have read the attached, would you please pass it on to Sir Geoffrey Howe. Can't we have a speech which refers to the Civil Servants on strike and say something like - The members of the Civil Service want more money but without inflation and more borrowing this can only be paid for by further taxes - where is it suggested - higher rates of income tax? more on everybody's (including Civil Servants) beer and tobacco? The expenditure which some people feel is inadequate on health, education, financing nationlised industries or helping big business require the increases about which complaints are heard."

When is the publicity machine to roll?

Yours ever

Keith

P.Cropper Esq.,
Special Adviser,
H.M.Treasury,
Whitehall, S.W.1.

BUDGET REVIEW

A full analysis of the proposals contained in the Chancellor's Budget cannot be made until the publication of the Finance Bill. Following its publication the specific provisions mentioned in the Bill will be discussed in detail over the succeeding weeks together with an updating during the debate in the House and in the committee stage. At this stage it is necessary to consider the information provided in respect of the Budget and comment thereon so that action which will have to be taken when the detailed provisions are available can be considered. It may also help to select those clients to whom advice should be given. For assistance to readers information of assistance to check coding notices and assessment notices for 1981-82 are set out on pages 00 and 00. They are shown under the general heading 'File for future Reference'. In this review only direct personal taxation will be discussed.

INCOME TAX SCHEDULE E BENEFITS

While the limit distinguishing lower paid from higher paid employees remains at £8,500, the scale charges for motor cars are to be increased from the 6th April 1982 by about 20 per cent. The actual figures have not yet been determined bu no doubt the Chancellor will take into account both an increase in the market value of the vehicles as well as an increase in the cash equivalent. When these provisions were originally introduced it was pointed out to the Inland Revenue that the scale rates would under the legislation as enacted cover all expenses paid by an employer direct and not involving reimbursement to an employee. The Revenue at that time took the view that every employee paid for his own petrol. Subsequently when various credit card arrangements were provided specifically to deal with petrol, the Inland Revenue attacked many of the schemes but since none came before the Courts it would seem that either their attack was unsuccessful or the matter was not pressed by the employee. The Chancellor now proposes that provision will be made whereby all private petrol provided by the employer will be taxable as a benefit regardless of the manner in which the payment is made. As is not uncommon in tax legislation, a complete circle has been traced. Prior to the introduction of the tables in the famous legislation of 1976 it was usual to ascertain the total costs appropriate to a motor vehicle in a year and treat a proportion of the total expenses as a benefit. The proportion was determined by multiplying the amount expended (including capital allowances) by the number of non business miles and dividing by the total mileage. In introducing the scales the then Chief Financial Secretary to the Treasury indicated that the reason for their introduction was the feeling that employees incorrectly returned the non business mileage and the need to make the assessments

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involved substantial administrative work on the part of the Inland Revenue staff. However, where reimbursement of petrol expenses was made to an employee it was found that despite the table figures it was necessary to make the calculations on the basis of miles. It would appear that either a similar basis will have to be adopted or alternatively each employer will have to agree a scale rate in respect of each employee. Of course an agreement between the employer and the local Inspector is not necessarily binding upon the employee. The employee will only be prepared to accept it if he appears to be doing better by accepting a scale rate rather than adopting, for example, a mileage rate. Inevitably this means that apart from the normal compromise which must take place in such agreements there must be a bias in favour of the employee otherwise the matter will be the subject of numerous appeals before the General or Special Commissioners throughout the country, ~~who will be~~ ~~have been~~ Having been involved in trying to agree mileage rates (and subsequently) in some cases trying to revise them~~)~~, it seems that the provision of a car is likely to give rise to a continuing saga of administrative work, mileage allowances and miles run. In any case the provision of the scale rates has always meant that correspondence has to take place with the Revenue on changes in cars particularly where these move out of one band and into another. It seems extremely doubtful whether there has been a substantial reduction in the administrative work; it seems more probable that the Revenue have been able to code in figures so that taxpayers are paying tax more quickly than they did under the old mileage scheme.

SEASON TICKETS AND CREDIT CARDS

All employees, regardless of whether they are lower or higher paid will be chargeable on any benefit which they derive in the year 1982-83 or any subsequent year from the use of a credit card provided by their employer and under which they are entitled to purchase goods and services. No doubt there are cases where the employer allows an employee a relatively free licence to charge up private expenses against the employer's business. No doubt in practice some limit is applied. Clearly the argument adopted by the taxpayer in the past has been that since he cannot turn the right into money or money's worth there is no liability. However the drafting of the legislation will have to be carefully done if the matter is not to result in a further administrative muddle. It is possible that the credit card is placed at the employee's disposal and prima facie used for business purposes, but occasionally used for priaate purposes. The purchase of petrol being an obvious example where part of the tankful may be used to travel on business miles and part on private miles. Similarly the credit card may be used to

pay an hotel bill when the employee is away on business but it may also be used to buy flowers for his wife. In each case in any month's payment the amount remitted to the credit card company may be partly for business purposes and partly for private purposes. If the whole amounts paid on the credit card are to be returned annually to the Inspector of Taxes to be followed by an employee submitting an expenses claim under the wholly, exclusively and necessarily incurred in the performance of his duties rule the amount of paper work will increase substantially. Unless the statutory provisions can avoid this administrative muddle the Inland Revenue staff will not be reduced since a substantial part of that staff is already involved on the PAYE scheme. There would probably be greater savings by reducing the PAYE numbers by 10 or 20 per cent. and perhaps requiring the employers to pay corporation tax on the amount of the private expenditure.

Employees earning under £8,500 per annum have been able to take part in schemes whereby the cost of their season ticket is met by their employer and the amount is not treated as a benefit. In practice the Revenue have attacked many of these schemes and have frequently been successful in either convincing the taxpayer that the scheme was not within the exemption provisions, or alternatively the taxpayer has not felt it possible to appeal in view of the amounts involved. However for 1982-83 such schemes are to be brought to an end. The effect will be to reduce the subsidy which the Government is giving to British Railways and other transport services through the tax system; it may of course increase the subsidy necessary by the direct payment!

MEDICAL INSURANCE PREMIUMS

It seems unusual for a Conservative Government to retain as a benefit in kind for the higher paid employee a perk which they then specifically exempt for the lower paid employee. Since the 1976 Finance Act all private medicine contributions made to cover medical expenses in the United Kingdom have been treated as benefits in kind regardless of the amount of the employees' emoluments. This will cease for 1982-83 where an employee's emoluments are under £8,500 per annum. While it is clearly advantageous to increase the provision of private medicine to all persons there is certainly no logic in this proposed revision.

TERMINATION PAYMENTS

Where any payment (not otherwise chargeable to tax) is made, whether in pursuance of an legal obligation or not, either directly or

indiredtly in consideration or in consequence of, or otherwise in connection with the termination of a holding of an office or employment or on any change in its functions or emoluments, including any payment of commutation or annual or periodical payments (whether chargeable to tax or not) a charge is made under s.187, Taxes Act 1970. There are certain exemptions provided in s.188 of which the most common are payments made on the termination due to death or on account of injurty or disability. If the payment is made and the Revenue can show that it is really made for past services, liability arises under the normal Schedule E rules and not under s.187. In practice the Revenue regard as non-chargeable under s.187 any genuine redundancies if -

(a) payments are made only on account of redundancy as defined in s.81 of the Employment Protection (Consolidation) Act 1978;

(b) the employee has been continuously in the service of the employer for at least two years;

(c) the payments are not made to selected employees only; and

(d) they are not excessively large in relation to earnings and length of service.

These rules are applied even though the payment may be calculated by reference to the length of service or the amount of remuneration or is conditional on continued service for a short period consistent with the reasonable needs of an employer's business. They are also prepared to accept that payments fall under the foregoing headings and therefore within s.187 where schemes are devised in respect of the closure of a particular factory or branch. By a statement of practice the Revenue have indicated that the Inspectors will be prepared to give advance clearance in respect of any proposals on being informed of the ~~fill~~ full facts.

For payments made on the 6th April 1981 and after that date the first £25,000 of any payment to an employee will be exempt. The need to aggregate two or more payments from the same employer or associated employers will remain. Instead of the present top slicing relief and the standard capital superannuation benefit relief, the taxable sum is to be charged at one half of the taxpayer's marginal rate. For those people who before the 10th March 1981 have contracted to make and receive payments which will be payable on or after 6th April 1981, an election can be made to apply the existing law if it is to the taxpayers advantage instead of the new provisions. It would seem that the new provisions will continue to require the taxpayer to limit his other income in the year of assessment during which he becomes redundant. It would seem that it may be preferable for him to cease employment early in a year of assessment rather than a later ~~year~~ date, because the marginal rate of tax will be determined by his total income in the year.

An employee ending his employment on the 31st March in a year of assessment will have little opportunity to reduce his marginal rate. Subject to consideration of the detail rules it would appear that the effect will be to permit the addition of thepersonal reliefs and other deductible charges to the sum of £25,000 in determining the rate of tax. On the next£11,250 the marginal rate will be 15 per cent; on the next £2,000 20 per cent; on the next £3,500 22½ per cent; on the next £5,500 25 per cent; on the next £5,500 27½ per cent; and any excess over the aggregate of £52,750, the personal reliefs and deductible charges will be chargeable at 30 per cent. In effect the top rate taxpayer will pay capital gains tax on the excess over the last mentioned amount.

The Revenue have also announced as a Statement of Practice that if part of the arrangement relating to the termination of an employment is that the employer will make a special contribution into an approved retirement scheme, the Inland Revenue will not seek to charge such payment. Similarly they will not seek to charge the amount expended in purchasing an annuity for a former employee from a Life Office providing that the transaction can be approved under Chapter II of Part II of the Finance Act 1970 (the legislation relating to occupational pension schemes). This Statement or Practice merely confirms arrangements which could be negotiated in the past.

STOCK RELIEF

Details of the proposed legislation relating to stock relief have already been discussed following the issue of the Consultative Document on the 14th November 1980. The principal changes from those in that document are :

(a) there will be no credit restriction where the stocks exceed £1m;

(b) a clawback charge will only arise on outright cessation or where the scale of the activities of the business becomes small in comparison with their scale for any period of account within the previous six years;

(c) under the transitional provisions businesses will be able to opt for relief under the rules that have applied up to the 14th November 1980 where the benefit of that option to the taxpayer is at least 25 per cent. of the new scheme relief or £10,000, whichever is the less;

(d) where clawback has been deferred to a period of account ending on or straddling 14th November 1980 the relief under the old scheme will be available in respect of any increase in stock values over the whole of that period up to the amount of the deferred charge; and

(e) payments on account which are receivable will not be brought into account in determining the stock relief even thoughthis does not agree with the appropriate accounting standard provided by the Institute.

To summarise under the new scheme :

(a) relief will be calculated on the basis of stocks and work in progress at the beginning of a period of account;

(b) in the case of new businesses the average monthly stock level over the period will be used, or reasonable estimates where these are not available;

(c) relief will be given by reference to percentage movements in a single index over the period of the account;

(d) the first £2,000 of stock will not qualify for relief;

(e) the existing arrangements for partial claims, write-off of relief over six years and 'roll-over' of relief on certain successions will be incorporated in the new scheme;

(f) there will be some technical changes in the definition of stock and work in progress but the existing practice on goods sold, subject to reservation of title, and the concessionary treatment applying to certain contracts containing vesting clauses will be embodied in the new legislation.

It is suggested that the deduction of the first £2,000 of stock held will avoid complex calculations in small cases. In fact it seems to add an additional stage to every calculation where the stock exceeds £2,000. It would seem simpler to merely avoid stock relief where the total stock does not exceed £2,000 but where it does to give relief on the full amount of the stock.

The new scheme applies for periods of account ending on or after 14th November 1980. Under the new scheme there is a straight deduction from the profit for the year. Assume the profit for the year is £172,000, the opening stock is £280,000 and there has been a percentage increase of 10 per cent. in the all stocks price index. The calculation will be as follows :

Profit	£172,000
Stock relief £280,000 - £2,000 x 10 per cent.	27,800
Trading income chargeable to corporation tax	£144,200

The foregoing figures and those in the following example are taken from the Inland Revenue's press announcements. The following illustration deals with the transitional provisions. Assume the following information -

(a) a period of account from 1st January 1980 to 31st December 1980;

(b) a trading profit after capital allowances for the period of £140,000;

(c) an opening stock value (the closing stock value of the previous period of £500,000);

(d) closing stock value of £585,000; and

(e) stock value at 14th November 1980 of £580,000.

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The increase in the all stocks index for the year to 31st December 1980 was 9.3 per cent.

Note. It is important to know the stock value at the 14th November 1980 because under the transitional relief the option is to be calculated in respect of increases in stock values up to that date.

Computation of relief -

Trading profit (after capital allowances)		£140,000
Stock relief is the greater of (a) or (b):		
(a) new relief £500,000-£2,000 x 9.3% =	£46,314	
(b) old relief		
closing stock value	£580,000	
opening stock value	500,000	
increase in stock value	80,000	
Profit restriction £140,000 x $\frac{10.47}{12}$ x 15%	18,322	
	61,678	
Less 25% of £46,314 = £11,579 or £10,000 whicheveris lower	10,000	51,678
Trading income chargeable to corporation tax		£88,322

It will be noted that the profit restriction is computed on a time basis and the figure of 10.47 is the period in months from the 1st January to the 14th November.

If a recovery charge of £60,000 had been deferred to the period to 31st December 1980 under Schedule 7 of the Finance Act 1980 a further calculation is necessary to determine whether a greater relief could be obtained under (b). If this calculation is made it is necessary to take the actual closing stock at the end of the accounting period and not that at the 14th November 1980. The figures become -

Closing stock value	£585,000
Opening stock value	500,000
Increase in stock value	85,000
Less profit restriction £140,000 x 15 per cent.	21,000
Old relief	64,000
Limit relief to amount of deferred charge	60,000

The clearing banks have indicated that in general they do not regard the possibility of a clawback charge as being a major factor in assessing loan applications. The stock relief provisions will be further

considered and illustrated when the Finance Bill is published.

ENTERPRISE PACKAGE

In the Finance Act 1980 the Chancellor introduced an enterprise package and a number of reliefs available to smaller businesses. These included a removal of a condition necessary to obtain relief for interest on money borrowed for investment in a close company, a removal of the monetary limits on retirements annuities, relief for losses on unquoted shares in trading companies and the incidental costs of obtaining loan finance and the introduction of enterprise zones and small workshops so that initial allowances under the Industrial Buildings legislation could be given. In such zones there were also other benefits in connection with development land tax.

He has increased the size of the package by further benefits. All these are to be publicised in a business opportunities programme which is intended to provide information on the help, advice and incentives available to small businesses so as to encourage start-ups of those businesses particularly by persons receiving redundancy payments. Of necessity these are modest in amount but it is hoped that they will provide the incentive to start businesses and reduce the number of unemployed. It is frequently forgotten that if each small business in the United Kingdom took one extra employee the majority of the unemployed would be in gainful employment.

The first of the schemes is the business start-up scheme. This applies to individuals who invest in a company by taking a minority interest in the equity. The effect of the relief is to deduct from the marginal rate of tax of the investor the amount invested. There is however a limit of £10,000 per person in each year and each investment must be not less than £1,000 in any single company. The relief is to be available for shares issued in 1981-82, 1982-83 and 1983-84. The individual will have to make the investment and then obtain repayment from the Revenue. The investment must be for a period of at least five years. Matters which require consideration when the Finance Bill is published are :

(a) the meaning of "the investor is not connected with the company in which he invests'. Does this mean that he must not previously have held shares or loan stock or madeloans to the company? Or does it mean that the other shareholders in the company must not be relatives and if so what is the definition of relatives? Will connected persons be given the same definition as for capital gains tax or for capital transfer tax or for corporation tax?

(b) the relief is only to be given in respect of investment in new business ventures in certain kinds of trade; it seems fairly clear that such trades will not include the

investment in land and buildings, the construction of buildings, dealing in stocks and shares, dealing in commodities, financial businesses or businesses of a professional character. The obvious candidates are high technology industries, such as micro chips, and manufacturing. It might however be quite reasonable to provide the relief where the business will be labour intensive since this would help to reduce the unemployed and may in fact be of particular advantage in that the majority of the unemployed may not be sufficiently skilful to deal with micro chips and high technology.

(c) whether the marginal rate will include the investment income surcharge.

The profit limits for small companies have been increased so that corporation tax will be paid at 40 per cent. on profits up to £80,000 and at 52 per cent. on profits in excess of £200,000. Between the sums of £80,000 and £200,000 the formula provided will not increase the marginal rate above 60 per cent.

INTEREST RELIEF

Last year the interest relief was given where money was borrowed to invest in a company even though the individual was not actively involved in the management of the company. This relief has been extended to partnerships. In respect of interest paid after 10th March 1981 it will no longer be necessary under paragraph 12, Schedule 1, Finance Act 1974 that the lender has personally acted in the conduct of the trade. While the provision is unlikely to affect professional partnerships, because of their rules of etiquette, it will enable limited partnerships to be formed in respect of trades. A relative will be able to become a limited partner under the Limited Partnerships Act and restrict their liability to the amount invested in the partnership instead of, as previously, being liable for all the debts of the business. This must be of considerable assistance to the smaller trades since the older and richer relative will be able to assist the new younger member of the family to set up in business. A similar relief is to be given to an individual where he contributes capital to an industrial co-operative. This is likely to be of particular assistance to the farming industry but it may result in an increase in the number of industrial co-operatives which are being set up.

TAX RELIEF FOR CAPITAL LOSSES ON SHARES IN UNQUOTED TRADING COMPANIES

In section 37, Finance Act 1980 income tax relief was given, instead of capital gains tax relief, where an individual made a capital loss on disposing of shares subscribed for in unquoted trading companies. The individual has the right to elect for either income tax relief or capital

gains tax relief. This relief is to be made available to investment companies by setting off the amount of the loss against its investment income. However the provisions will not apply where the investment company controls the company in which it has invested or they are under common control.

TRUSTS

Substantial alterations in the capital taxes appropriate to trusts is envisaged in the Finance Bill. Capital gains tax roll-over relief will apply where an individual transfers property to a settlement as it applies following the enactment of sectin 79, Finance Act 1980 to gifts between individuals. In the case of the roll-over relief for individuals both must be in the United Kingdom and it would seem that the Finance Bill will contain provisions that the settlement must be in the United Kingdom at the tme the gift is made and probably for a period thereafter. Any capital transfer tax paid on the gift will be treated on a subsequent disposal by the trustees as expenditure incurred by them. However this relief cannot be used to create a loss. The new relief will apply to disposals made on or after 6th April 1981.

Section 17, Capital Gains Tax Act 1979, which applies to non-resident trusts,provides that any U.K. domiciled resident or ordinarily resident beneficiary can be charged to capital gains tax on gains made by non-resident beneficiaries. The amount is to be apportioned in a just and reasonable manner between persons having interests in the settled property. The chargeable gain is to be apportioned so far as possible also according to the respective values of the interests of the beneficiaries. There is a provision that the possibility of defeasance is to be ignored. The Revenue recently won a case in which two beneficiaries living in the United Kingdom who it was unlikely would ever receive any monies were liable for the whole of the tax on the capital gains ~~tax~~ made by non-resident trustees. This unjust decision is to be reversed. A beneficiary will for 1981-82 be charged on the amounts received and there are to be transitional provisions for events between the 10th March 1981 and the 5th April 1981 (both dates inclusive). In order to prevent further schemes involving the transfer of trusts abroad, as in Chinn v. Collins, the disposal of an interest in a non-resident trust will not be exempt from capital gains tax from the 10th March 1981. The precise wording in the statutory provisions will need to be carefully considered. There may be genuine situations where all the beneficiaries are non-resident although originally there were beneficiaries resident in the United Kingdom. The removal of such trust abroad may be for the genuine benefit of the non-

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resident beneficiaries. If this is the case to continue a latent liability to capital gains tax, which may be impossible to collect, would seem to be ridiculous. It would seem that this may be a further area in which a clearance procedure with the Inland Revenue should be provided. As with all clearance procedures there ought to be some provisions for appeals. The Revenue have a written statutory concession (D2) whereby a person who is treated as resident in the United Kingdom for any year of assessment from the date of his arrival here but has not been so regarded at any time during the period of thirty-six months immediately preceding that dateis charged to capital gains tax only in respect of chargeable gains accruing to him from disposals after his arrival in the U.K. Similarly where a person leaves the United Kingdom and on his departure is treated as not resident or ordinarily resident he is not chargeable to capital gains tax accruing to him on disposals made after the date of departure. This concession will not apply where trustees commence or cease residence in the United Kingdom after 10th March 1981. This means that it is important for trustees to become resident on a 6th April or alternatively not carry out any transactions, particularly if they are becoming non-resident, until the following year of assessment.

For capital transfer tax purposes the starting date for the periodic charge on discretionary trusts is to be deferred to the 1st April 1983 or where distributions can only be made with the leave of a Court the deferment continues until the 31st March 1984. This will mean that the capital transfer tax on distributions made from discretionary trusts will remain at 20 per cent. up to the 31st March 1983. Draft clauses for discretionary trusts are to be drawn up and will be issued as a basis for discussion. The law relating to reversionary interests is to be revised. Section 24, Finance Act 1975 provides that capital transfer tax will not be charged on transfers of reversionary interests unless -

(a) the interest has at any time been acquired (whether by the person entitled to it or by a person previously entitled to it) for a consideration in money or money's worth; or

(b) it is one to which either the settlor or his spouse is beneficially entitled; or

(c) it is an interest expectant on the determination of a lease which is treated as a settlement i.e. the lease is for a period ascertainable by reference to death.

In future the foregoing are to be extended so as to include reversions to which the settlor or his spouse have been entitled. The relief which applies for capital gains tax when settled property reverts to the settlor or his spouse will be restricted to those cases where the settled property consisted of a reversionary interest. Theseproposed changes will apply where a

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reversionary interest was acquired or a settlement was made on or after 10th March 1981.

Life tenants will be entitled to a business relief of 30 per cent. on transfers of settled property used by the life tenant in his own business.

DISABLED PERSONS

Although the Chancellor has been described as a skinflint or providing a Budget appropriate to a monk with a mortgage (the Daily Express) he did provide that in the case of capital gains tax trusts for the disabled will be able to obtain an exemption of £3,000 as against the normal £1,500 for other trusts. The exact conditions will be relaxed but the grouping rules under which trusts made by the same settlor have to be aggregated in determining the total gains which are to be compared with the sum of £3,000 will apply where the same person makes more than one trustfor the disabled from the 10th March 1981.

CAPITAL GAINS TAX AND MARKET VALUE

When the capital gains tax legislation was enacted in 1965 the Revenue felt that there would be possibilities for avoidance in certain circumstances, e.g. where a person acquired an asset by a bargain other than at arm's length. They therefore insisted that in those cases regardless of the amount actually received or paid, the market value of the asset should be substituted. They used this ~~case~~ provision to contest the valuation of an issue of loan stock in Nairn v. Williamson. They were successful in showing that loan stock issued to replace loans should be valued at market value where the person receiving the loan stock was the holding company of the debtor. As with a number of anti-avoidance provisions, it became apparent to taxpayers that the use of the market value was a two edged sword. While there were circumstances where it benefited the Revenue there were others ~~whom~~ where it could be clearly made to benefit the taxpayer. A number of capital gains tax avoidance schemes were involved which deliberately placed the taxpayer within the anti-avoidance provisions of section 19 so that the consideration had to be equal to the market value. The Revenue propose that the Finance Bill shall contain legislation which will provide that the acquisition cost will never exceed the actual amount given for an asset unless there is a corresponding increase in the consideration brought into the computation of the chargeable gain or allowable loss of the disposer. This change, together with one dealing with the creation of a loss on shares acquired through a reorganisation of share capital, will apply from the 10th March 1981.

CAPITAL TRANSFER TAX - OTHER AMENDMENTS

A new rate schedule for lifetime gifts to apply for transfers made on or after 10th March 1981 will be enacted. Details will be found on page 00. The annual exemption for lifetime transfers is to be increased to £3,000 per donor per year. This increase will apply from 6th April 1981. Similarly the present ceiling of £250,000 in respect of the payment of tax by interest free instalments will be removed.

Two major changes are to be provided. The first will restrict accumulation of lifetime gifts or gifts during life with the transfer at death to transfers made within a period of 10 years before the transfer in question. The exact basis on which the cumulative gross figures and the tax appropriate thereto will be adjusted are not given in the press releases and the matter will have to be studied in further detail on the publication of the Finance Bill.

The second amendment is to remove from the 10th March 1981 the rule that on the disposal of an individual's assets the property held in a discretionary trust made by the transferor or his spouse before the 22nd March 1974 should be taken into account. Property included in such trusts will no longer be related property so far as the individual is concerned.

There is also a provision that from the 6th April 1981 the provisions of sections 115 and 116 of the Finance Act 1976 will be repealed. This amendment is not necessarily advantageous to the taxpayers. When the original legislation dealing with capital transfer tax was debated in 1975, it became apparent that if a parent lent his flat to his son for a period of time or two strangers did so, a liability could arise since the property immediately before the transaction was entered into was worth X£ whereas immediately after the transaction it would be worth less because the donor no longer had the use of the property. Where longterm loans and similar transactions are carried out this loss in value concept contained within the capital transfer tax legislation continues to apply. Sections 115 and 116, while appearing to be charging sections, in fact gave substantial reliefs in respect of short term loans either of money or of property. Under the provisions the amount of the charge usually fell within the exemption classes or alternatively were specifically exempt, e.g. loans to companies which the lender controlled. The sections were brought in as a rsult of the representations made by the Conservative Opposition at the time of the 1975 debates. Careful consideration will have to be given to the repealing provisions to ensure that the mischief against which the Opposition was complaining is not effectively recreated by repeal of these

sections.

A further important relief applies to let agricultural land where a business relief of 20 per cent. will be appropriate not only where the tenanted land is owned by an individual but also where shares are transferred in companies owning let agricultural land. To avoid the 'double discount' on let land where the property is let by one person to a partnership of which he is a member or from which he retired, the Revenue will provide that from the 6th April 1981 the land if valued on a tenanted basis will obtain relief of only 20 per cent. Transitional measures are to be introduced where the arrangements have been made before the 10th March 1981 but the first transfer of land is after that date. Where there is a grant of a lease of agricultural land at a full market rent no charge to capital transfer tax will be possible. The tax on all property which qualifies for agricultural relief without any limit of £250,000 may be paid in future by interest free instalments. This will be of benefit where the tax is chargeable on let land.

The successive charges relief will in future only be given under section 30 of the Finance Act 1975 which gives relief by way of credit against tax payable on the second occasion of the charge. This will have the effect of applying this relief against successive charges on settled properties. Where the second occasion or charge is on or after 10th March 1981 the new provisions will apply but so that the relief will be over five years starting at 100 per cent. in the first year and decreasing by 20 per cent. in each of the succeeding four years.

The present provisions relating to trusts for the disabled do not seem to have worked satisfactorily so that for trusts or additions to existing trusts made on or after 10th March 1981 the disabled person will be deemed to have an interest in possession in the trustproperty. This will have the effect of giving relief where appointments out of the property are made to the disabled person. The present relief does not extend to such appointments.

DEVELOPMENT LAND TAX

Three changes are to be made in the provisions relating to development land tax -

(a) development land tax will be deferred on developments which begin before the 1st April 1983 for the owner's own use. The new relief will cover all forms of commercial and other use. The main conditions which will have to apply are -

(i) the development which gives rise to the deemed disposal must relate to property to be used and occupied by the person liable to d.l.t.;

(ii) the development must have full planning permission when the project begins; and

(iii) the development must begin before the 1st April 1983.

(a) extensions to a building will be exempt if the cubic capacity is not increased by more than one-third (at present the limit is one-tenth);

(c) builders will qualify for a special increase of 50 per cent. of their acquisition costs in working out the tax chargeable at the start of a residential development. This will only affect relevant Base Value C provided under section 5, Development Land Tax 1976. This will mean that the deduction for such builders who are carrying out residential developments on land held as part of his stock in trade will be 150 per cent. of the acquisition costs of the land including all improvements. Land acquired by builders from local authorities for residential development will benefit from this provision. All the changes apply to developments which begin on or after 10th March 1981.

CAPITAL ALLOWANCES

The rate of initial allowance appropriate to industrial buildings on expenditure incurred since 12th November 1974 is 50 per cent. This rate will continue on expenditure incurred up to and including the 10th March 1981 but for expenditure after that date the rate will be increased to 75 per cent. The balanes of the expenditure will bontinue to be written off at 4 per cent. per annum on a straight line basis.

Apart from the changes applicable to small workshops and mentioned in our issue of the 13th March further provisions are to apply not only to small workshops but also qualifying hotels, buildings in enterprise zones and industrial buildings. These are :

(a) where a person who has constructed an industrial building and qualified for capital allowances subsequently sells it there is an adjustment of the tax allowances. However the provisions do not apply to gifts. This has the effect of providing that if the transferee subsequently sells the building to a third party the liability on him is restricted to the allowanees given to the transferee. Thus gifts between husband and wife can be used to avoid tax being paid on the ultimate sale proceeds. The balancing adjustment rules are to be broadened so that a transfer of the relevant interest in an industrial building, small workshop etc., shall be made even in the case of gifts.

(b) Schedule 7, Capital Allowances Act 1968 is to be extended so that it will apply on any sale between connected persons as defined in section 533, Taxes Act 1970.

(c) market value is to be substituted not only where the sole or main benefit which is to be expected in the obtaining of a tax allowance or deduction, but also where there is likely to be the avoidance of a tax charge.

These changes are to apply to transfers or sales made after 10th March 1981

except where made under a contract made on or before that date.

OIL TAXES AND TAX ON BANKS

Since these are of specialised application they are not dealt with in the foregoing summary of the Budget although no doubt they will form a substantial part of the Finance Bill when published.

Ronald Brech Incorporated

Economic and business advisers

The Guild House
32 Worple Road
Wimbledon SW19

01-946 8641/2

Directors
R J Brech
W K Kennedy

PM

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16th March, 1981

The Rt.Hon. Sir Geoffrey Howe, QC, MP,
The Chancellor of the Exchequer,
11, Downing Street,
London,
SW1.

2

Dear Chancellor,

I have enclosed a copy of our latest Economic Commentary which includes an appraisal of your recent Budget.

I feel that most of the criticism levelled against the Budget was due to the fact that people have not really understood the basic choice concerning this nation - namely, whether to continue as we have been going or, to become internationally competitive. I still feel that to get the economy on to its right course requires a very massive Public Relations program. Most of the government's policy assumes that British management is both competent and efficient. I personally think that assumption is invalid.

With best wishes,

Yours sincerely,

Ronald Brech

Professor R. J. Brech.

Enc.

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Economic Commentary

THE RONALD BRECH PARTNERSHIP

14

MARCH 1981

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The Ronald Brech Partnership

ECONOMIC COMMENTARY

No 14 MARCH 1981

The aim of the Economic Commentary is to analyse and discuss the dynamic factors operating in both the World and the UK economies - the factors behind the figures.

It does not pretend to forecast, although it contains a section on prospects covering the next 12-18 months.

Its intention is to elucidate the critical factors that should be monitored and to assess both the probabilities and the changing probabilities of the different possible scenarios.

The analysis has been prepared by Ronald Brech Incorporated

for

The Ronald Brech Partnership

Triannually (March, July and November), by subscription
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Guild House
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Wimbledon
SW19 4EF

RB/E/14

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C O N T E N T S

INDEX OF SPECIAL TOPICS

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SUMMARY

1 The publication of this issue has been delayed so as to include an appraisal of Sir Geoffrey Howe's third Budget. For the same reason, the Special Topic which was to have been devoted to the latest UK population forecast has been switched to the Budget appraisal. The population forecasts will be included in a future issue.

2 The world economy has progressed much as expected and we still think that the impact of the recession in 1981 will be greater than in 1980. But our view of its depth and length has been modified slightly.

> We now think it will be almost as deep (if not as deep) as the 1974/1975 one and that recovery may be three months later, e.g. 2Q/82. Much depends on the speed at which the USA corrects its domestic inflationary pressure.

3 So far, US economy has not even started to enter its corrective phase. Admittedly, both output and demand recovered somewhat in 4Q/80, but productivity was negative, unit labour costs rising at +11% (+13$\frac{3}{4}$% 3Q/80) and consumer prices +12$\frac{1}{2}$% (12$\frac{3}{4}$% 3Q/80).

> President Reagan's policy plan aims to curb inflation and to make the US economy efficient once more. But this could take up to 12 months to materialise --- longer if the tax cuts come significantly before the expenditure cuts (Britain's mistake).

Most countries are faced with falling demand, dwindling output, increasing unemployment, lower productivity, rapidly rising unit labour costs and accelerating retail price rises. Some slight moderation in 2H/80 (+11$\frac{3}{4}$% against +12$\frac{1}{2}$% 1H/80). But practically all countries are being forced to take corrective action to curb price rise and to reduce deficits in their balance of payments.

4 World output GDP +1% (+2% 1H/80:= 2H/80). Industrial production -$\frac{3}{4}$% (+1$\frac{1}{2}$% 1H/80; -2$\frac{3}{4}$% 2H/80). Pattern similar in all countries except South Africa (continuous growth).

Price rise +12$\frac{1}{4}$% 1980 (+9$\frac{1}{4}$% 1979). Peak 2Q/80 +12$\frac{3}{4}$%.

Materials prices moderating. Dollar base +7$\frac{1}{2}$% 1980 (+31$\frac{1}{4}$% 1979); +11$\frac{1}{2}$% 1H/80 and +3$\frac{3}{4}$% 2H/80. Sterling base -2% 1980 (+19$\frac{1}{4}$% 1979); +$\frac{3}{4}$% 1H/80 -4$\frac{1}{2}$% 2H/80. Oil +60%.

Wages $+9\frac{3}{4}\%$; productivity $+\frac{1}{4}\%$ ($+1\frac{3}{4}\%$ 1H/80:$-1\frac{1}{2}\%$ 2H/80).

Unit labour costs $+9\frac{1}{2}\%$ 1980 ($+5\frac{1}{4}\%$ 1979); +8% 1H/80; $+11\frac{1}{2}\%$ 2H/80, but $+10\frac{1}{4}\%$ 4Q/80. This is the real problem facing the industrial countries.

Costpush moderating but not so much as we expected. End 1980 probably still $+9\frac{1}{2}\%$ or $+8\frac{1}{2}\%$ on current replacement costs. (We suggested +7%).

5 World trade (volume) expanding at reduced rate. Total exports $+1\frac{1}{4}\%$ (1979 $+5\frac{3}{4}\%$); manufactures $+5\frac{1}{2}\%$ (1979 $+5\frac{3}{4}\%$). World price of exports of manufactures $+11\frac{1}{4}\%$ 1980 ($+14\frac{1}{2}\%$ 1979) with peak +13% 2H/80. Price of commodity exports $+14\frac{3}{4}\%$ 1980 ($+15\frac{1}{4}\%$ 1979) but trend from $+25\frac{3}{4}\%$ 1Q/80 to +8% 4Q/80.

Trend in trade balances for our sample of ten countries, continued to show improvement since 1Q/80.

6 Prospects for world economy in 1981 poor. All countries will be taking corrective action. USA, Japan and Germany likely to be effective. France, too, but delayed (Presidential election April/May). Sweden possible. Italy problematical. In total, this means restricted demand with cut in real wages and also in public expenditure.

Wageround likely to moderate and so, too, price rise. First because of cheaper raw materials followed later by smaller rise in unit labour costs (could get down to +4% 2H/81).

Consumer prices also moderating from $+12\frac{1}{4}\%$ 1980 to $+5\frac{3}{4}\%$ 1981 with +4% 2H/81.

But industrial production 1981 -3%.

7 British picture similar to USA. Effective correction delayed. Wageround too high; productivity too low; too much inflationary pressure. Public expenditure still expanding in real terms and faster than any other demand component except exports. Increase in money supply and public sector borrowing requirement both well above target. Private sector still being sacrificed for public sector. British management still not responding to challenge of the recession. Manning levels not yet down to battle strength. This should have been achieved in 1980. With luck, will be achieved by end 1981!

8 Output down, but not so sharply as expected. GDP -3%; (excluding offshore oil $-3\frac{1}{4}\%$). Industrial production $-6\frac{3}{4}\%$; (excl. MLH 104 $-7\frac{1}{2}\%$); manufacturing output -9%. Employment in manufacturing -6%. Hence productivity $-3\frac{1}{4}\%$.

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9 Rise in unit labour costs is still accelerating, from +16% in 1Q/80 to a peak of +25% in 3Q/80 moderating to +20% in 4Q/80. The cause of this is twofold

- the wageround has been excessively high

- productivity has been negative (i.e. declining)

It is this experience which is causing the British economy to be inefficient and uncompetitive and thereby lose its employment potential.

10 Some moderation in the wageround has taken place in 4Q/80 and there are hopes for a substantial moderation during 1981. But as we have frequently pointed out, this may have come too late to protect British manufacturing output.

11 The retail price rise has moderated as expected because of cheaper raw materials. It peaked with +22¼% in 2Q/80 then dropped to +16½% 3Q to +15½% 4Q/80 and to +13% in January 1981. The present costpush is still around +14%. But on the basis of replacement cost accounting, it is below +10% and probably approaching +8½%. With sterling weakening once more, this will reduce the benefit of cheaper materials.

Strong sterling in 1980 has given British business a 10% cost advantage in raw materials.

12 The balance of payments has shown a vast improvement during the year: from -£68 million in 1H/80 to +£2,484 million in 2H/80 making +£2,416 million for the year, against -£1,763 million in 1979. This turnround of £4,179 million was made up as follows:

Non-oil trade	+£1,345 million
Oil trade	+£3,325 million
	+£4,670 million
Smaller surplus on "invisibles"	-£491 million
	+£4,179 million

13 What are Britain's prospects?

13.1 The British economy is still heading very definitely towards Scenario OIL TWO (pessimistic future). If the government is unable to spur both the public and private sectors to becoming more efficient within the next twelve months, this trend will be irreversible. Even if the government's policy is successful, it may take at least four years to ensure British manufacturing output remains genuinely internationally competitive.

13.2 As regards 1981, wageround for the private sector appears to be settling at around +8%. If public sector can be held to a genuine +10% overall average, the national wageround could be held at +8¼%.

Output -3% (all components down except public expenditure no change or small plus, and inventories no change)

If employment declines more, say -3½% (2½ million unemployment), productivity would increase by +½% and unit labour costs +7¾%.

If unemployment reaches 3/3¼ million, productivity would rise by +4½% and unit labour costs by only +3½%.

We think that a midway stage between these two is likely to happen with unit labour costs in 2H/81 +5½%.

13.3 Even on present showing, there is a reasonable chance that the British costpush by the end of the year could be down to +5%. This is based on materials input costs -4½% (already achieved in 2H/80), crude oil +60%, and unit labour costs +8%.

14 The analysis for this issue was completed and the comments made before Sir Geoffrey Howe's third Budget. On the basis of that Budget, we would make the following amendments:

Much of the budget had already been included in our forecasts for the past 12 months --- in terms of the impact, but clearly not the details. (We cannot foresee to that extent). We still think GDP in 1981 -3% (Treasury -2%); consumer expenditure -2¾% (Treasury -¾%). This could be even -3% with the abolition of the Rooker-Wise amendment. The only change we would make is to revert to our previous price forecast of +11% 1981 (+13% 1H/81 and +9¼% 2H/81 with +8½% 4Q/81).

If on more mature appraisal and deeper analysis we find that the budget is likely to alter our forecasts more than we currently think, we shall send a note to all our subscribers giving the amendments.

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I CURRENT TRENDS

I.1 WORLD

1.1 The official database for the present analysis is up to and including 3Q/80. But wherever possible the information has been extended by us to include 4Q/80. This applies chiefly to the ten main economies.

> The slowdown in world output has been very marked since 2Q/80 with world GDP 3Q/80 $+\frac{1}{4}\%$ on a year ago and 4Q/80 = (provisional). But 4Q/80 showed a small recovery on 3Q/80. There is some moderation in the consumer price rise after reaching its peak in 2Q/80, due to cheaper raw materials. Unfortunately, the increase in productivity has slowed down and in 3Q/80 was negative (-2%), while the rise in unit labour costs has continued to accelerate reaching nearly +13% in 3Q/80. There are certainly problems for both the world economy and the main individual countries.

The world recession is truly with us and the USA has still not yet taken effective corrective action against its own domestic inflation. The intention has been spelt out by President Reagan in his 'State of the Economy' message, but the action has still to come.

> So far, the recession has gone much as we had expected. But the genuine corrective measures have been delayed in most countries and for political reasons. We think our previous forecast could be wrong in that recovery may be delayed until 2H/82. Much depends on how effective and how quickly the US Administration puts its economic house in order.

1.2 World output in terms of GDP increased in real terms in 3Q/80 by $+\frac{1}{4}\%$, compared with +1% in 2Q/80 and +3% 1Q/80. Of our sample of ten countries, only three showed declines on a year ago in 3Q/80: UK ($-2\frac{1}{2}\%$), USA ($-1\frac{1}{2}\%$), Canada ($-\frac{3}{4}\%$). (See Table 1). The others ranged from small increases: Germany $+\frac{3}{4}\%$, Sweden $+1\frac{1}{4}\%$ to +9% for South Africa and $+5\frac{1}{4}\%$ for Japan. France could be no change or negative in 3Q/80.

TABLE 1 : GDP, OECD COUNTRIES

Percentage change on a year ago

	2H/79	1H/80	1Q/80	2Q/80	3Q/80
	%	%	%	%	%
USA	+1.45	=	+1.0	-1.0	-1.5
CANADA	+2.4	+0.35	+0.8	-0.1	-0.8
JAPAN	+6.35	+5.95	+6.4	+5.5	+5.3
AUSTRALIA	+1.75	+2.3	+1.2	+3.2	+2.7
S. AFRICA	+4.65	+8.6	+8.4	+8.8	+9.0
FRANCE	+3.5	+2.95	+3.3	+2.6	
GERMANY	+4.4	+3.6	+5.8	+1.5	+0.7
ITALY	+5.2	+6.45	+6.6	+6.3	+2.4
SWEDEN	+3.85	+1.2	+3.9	-1.5	+1.2
UK	+0.7	-0.8	+1.7	-3.2	-2.6
AVERAGE OF ABOVE	+3.0	+2.0	+3.0	+1.05	+0.3

Source: OECD Data

Comparable data do not exist for 4Q/80. But national statistics suggest some recovery in USA, although $-\frac{3}{4}\%$ on a year ago. And a further worsening in UK ($-5\frac{1}{2}\%$ on a year ago). Canada is also expected to be negative. Germany, Sweden and France could be either no change on a year ago or slightly negative. Australia and Italy slightly up on 4Q/79 or no change. South Africa and Japan are the only two economies whose GDP in 4Q/80 has a very high probability of being larger than a year earlier.

But all ten economies are displaying the same trend over the year --- a definite weakening after 1Q/80.

World industrial production shows a similar but deepening picture. The rate of increase has been slowing down from 1Q/79 to 1Q/80, then declined abruptly, and for the past three quarters has been below its level of a year ago. The two sharp marginal declines (quarter on quarter) occurred in 2Q/80 (-2½%) and 3Q/80 (-2½%). Provisional data for 4Q/80 suggest a slight recovery (+1½% quarter on quarter) but still some -2½% on 4Q/79.

The details are given in Table 2.

TABLE 2 : INDUSTRIAL PRODUCTION

(Percentage change on a year ago)

	2Q/79	3Q/79	4Q/79	1Q/80	2Q/80	3Q/80	4Q/80
	%	%	%	%	%	%	%
USA	+4.95	+3.1	+1.25	-0.15	-5.0	-6.9	-2.7
CANADA	+4.8	+5.4	+2.2	+0.6	-1.9	-3.9	+1.0
JAPAN	+7.8	+8.4	+9.05	+11.3	+8.9	+4.3	+2.5
AUSTRALIA	+4.8	+9.6	+8.6	+5.6	+2.7	+0.9	+1.0
S. AFRICA	+4.2	+6.9	+8.0	+10.8	+9.5	+10.2	
FRANCE	+2.65	+8.0	+3.45	+4.35	=	-3.3	-4.2
GERMANY	+6.3	+5.3	+5.2	+6.0	+1.7	-2.5	-1.65
ITALY	+4.9	+5.9	+8.2	+10.6	+11.2	+1.4	-0.2
SWEDEN	+8.8	+8.6	+7.4	+7.3	-3.0	+1.0	-2.0
UK	+5.75	+2.3	+3.05	-1.1	-8.0	-8.7	-10.0
OECD WORLD	+5.5	+5.1	+4.1	+3.8	-0.4	-3.4	-2.5

Source: OECD Data

The pattern has been fairly consistent between countries. The two possible exceptions are South Africa which showed a slight recovery in 3Q/80 against 2Q/80 and Sweden, the same picture. But with Sweden, output was exceptionally depressed in 2Q/80 because of the short sharp national strike, so that its underlying trend during the year was probably the same as the other countries, leaving South Africa as the only true exception.

In USA industrial output has been below the upward revised data for 1979 in each of the four quarters, with the biggest declines in 2Q and 3Q/80. Canada has been below its previous year's level since 2Q/80 onwards, but it is possible that in 4Q/80 it recovered to slightly above 4Q/79. Germany (surprisingly) was negative in 3Q and 4Q/80 and France in 3Q/80, although the provisional data for 4Q/80 suggest an even bigger decline compared with a year earlier. Sweden probably became negative (or no change) in 4Q/80, but Italy apparently recovered.

The UK (which is dealt with in more detail later on in Section I.2) has been negative throughout 1980 with the gap between the two years increasing with each quarter.

The three main "pluses" are South Africa, whose economy was still booming towards the end of 1980, Japan where the rate of increase on a year earlier slowed up dramatically during the year from +11¼% in 1Q/80 to +2½% (prov.) 4Q/80, and Australia which decelerated from +5½% in 1Q/80 to +1% in 3Q and 4Q/80.

With such a picture, there is little doubt that the world economy is in recession. The two vital questions are how long and how deep? Was ex President Carter right when he claimed (in his election campaign) that the USA had experienced the shortest recession in its history? Or was it simply the end of inventory liquidation?

1.3 The structure of demand is shown in Table 3 for the four main economies. They all refer to 3Q/80.

The two highly consumption orientated economies were Germany (where 102% of supplies were devoted to consumption with 35% public and 67% private) and the UK (18%, of which 12% was private and 6% public). Germany had also a sizeable allocation to investment (33%) and exports (46%). The offsetting item was inventory liquidation, equivalent to -81% of supplies. In the UK, both investment (-21%) and exports (-18%) were negative, with inventory liquidation accounting for -79%.

TABLE 3 : CONTRIBUTIONS TO CHANGE IN OVERALL DEMAND

(Change in demand categories as a percentage of change in overall demand on a year ago at constant prices)

	USA 3Q/80 %	JAPAN 3Q/80 %	GERMANY 3Q/80 %	UK 3Q/80 %
Private consumption	-14	16	67	12
Public current expenditure	17	-8	35	6
Fixed investment	-75	6	33	-21
Inventory change	-47	1	-81	-79
Exports	19	85	46	-18
Overall demand	-100	100	100	-100
% change in overall demand on a year	-1.85	+4.25	+1.5	-3.3

In Japan, exports accounted for +85%, investment for +6%, consumption for +8% (private +16%, public -8%) with inventory accumulation +1%. In USA, exports accounted for +19% and consumption +3% (private -14%; public +17%). Investment however was -75% and inventory liquidation equivalent to -47%.

Inventory liquidation has been particularly heavy in both USA and UK in 1-3Q/80. In USA it was almost matched by the decline in investment, whereas in the UK the latter was affected only in 3Q/80 and onwards.

Taking 1-3Q/80 as a single period, the four countries split into two groups: USA and UK; Japan and Germany.

In USA and UK total demand fell compared with a year earlier, but exports increased accounting for +134% for USA and +54% UK; consumption +105% USA (private +27%, public +78%) and +55% UK (private +24%; public +31%). Investment declined (-170% USA; -7% UK), and so too inventories (-169% USA; -202% UK). Both of these are export/consumption dominated resource allocations.

Japan and Germany total demand increased, with exports accounting for +75% Japan and +42% Germany. Investment took +11% Japan and +31% Germany, while consumption accounted for +9% Japan (+ 19% private; -10% public) and +33% Germany (+21% private; +12% public). Inventories increased slightly in Japan (+5%) but declined slightly in Germany (-6%). These are export/ investment dominated resource allocations although Germany has a surprisingly large increase in consumption (presumably the public sector was window dressing for the autumn election).

1.4 Inflation in 2H/80 showed signs of a modest deceleration. The average of our sample was +12½% for 1H/80 (with peak in 2Q/80) and +11½% for 2H/80 making +12% for the year. This compares with +9% for 1979 (+8% 1H/79; +10¼% 2H/80). This easing was less than expected because unit labour costs continued to rise right up to the end of the year, offsetting the weakening of materials prices.

TABLE 4 : CONSUMER PRICES

Percentage change on a year ago

	3Q/79 %	4Q/79 %	1Q/80 %	2Q/80 %	3Q/80 %	4Q/80 ‡ %
USA	+12.0	+12.9	+14.3	+14.4	+12.8	+12.6
CANADA	+8.65	+9.4	+9.4	+9.6	+10.55	+11.15
JAPAN	+3.5	+5.0	+7.3	+8.1	+8.2	+7.5
AUSTRALIA	+9.2	+10.1	+10.5	+10.7	+10.2	+9.2
S. AFRICA	+13.6	+14.1	+13.65	+14.05	+12.3	+14.5
FRANCE	+10.8	+11.5	+13.3	+13.6	+13.6	+13.6
GERMANY	+4.8	+5.3	+5.45	+5.9	+5.4	+5.35
ITALY	+15.7	+18.9	+21.4	+20.9	+21.5	+21.0
SWEDEN	+8.75	+9.8	+12.6	+12.8	+12.5	+11.5
UK	+16.0	+17.2	+19.5	+22.2	+16.6	+15.6
OECD WORLD*	+9.7	+10.7	+12.2	+12.6	+11.6	+11.3

Source: OECD Data

‡ partly estimated
* average of above (excl. S. Africa)

Of our sample of ten countries, two had price rises in 1980 less than +10% (Germany +5½%; Japan +8%) and Australia came down to this level in 4Q/80 but its average was +10¼% with Canada +10½%. Sweden averaged +12½% and three countries +13½%: USA, France and South Africa. UK was +18½% and Italy +21½%.

Most of the countries showed some moderation in 4Q/80 compared with earlier quarters. The two exceptions were South Africa and Canada (still rising).

In France and Italy, the moderation was very slight. In the USA and Germany it was even slighter compared with 3Q/80 but quite definite against 2Q/80. Six countries peaked in 2Q/80 (USA, Australia, France, Germany, Sweden, UK); two in 3Q/80 (Japan, Italy) and two in 4Q/80 (Canada, South Africa).

1.5 Trends in employment have continued to vary as between countries. In four countries, the trend was definitely downwards more or less throughout the year: USA, Canada, France and UK. In all the others, it increased at least until 3Q/80. Sweden, Italy and Germany all declined in 4Q/80 against 3Q/80 and 4Q/79. In Japan the level appears to have declined slightly in 2H/80 but it was still higher than 2H/79. In South Africa, the employment trend was definitely upwards throughout the year. Up to date, official information is lacking for Australia but according to our calculations total employment in 1980 increased by +2½% while the labour force increased by +2¼%.

Unemployment on balance has also tended to increase. This trend was definite in UK, France, Germany, Japan, Sweden and USA (in decreasing order of definiteness). Unemployment was declining in Australia and South Africa. In Canada and Italy the trend wobbled.

1.6 The current costpush in the world economy is still surprisingly high. In 1H/80 we calculated it as +12½% made up as follows:

		Cost equivalents
1H/80	Manpower	+5%
	Materials and fuel	+7½%
		+12½%

In 2H/80 the costpush had modified slightly to +11½% but the breakdown had changed.

		Cost equivalents
2H/80	Manpower	+8%
	Materials	+2%
	Fuel	+1½%
		+11½%

If the major economies, led by the USA, continue to take effective action to curb domestic inflationary measures and in particular to prevent excessive wage increases, then the costpush could moderate very sharply during 1981 (see Section III on "Prospects").

TABLE 5 : PRICES, COSTS AND PRODUCTIVITY

Percentage changes on corresponding quarter a year ago

		Consumer Prices %	Wages %	Productivity* %	Unit Labour Costs %
USA	2Q/80	+14.4	+8.0	-3.1	+11.5
	3Q/80	+12.8	+8.6	-4.5	+13.7
CANADA	2Q/80	+9.6	+9.7	-1.7	+11.6
	3Q/80	+10.55	+10.1	-1.4	+11.65
JAPAN	2Q/80	+8.1	+8.55	+8.55	=
	3Q/80	+8.2	+8.1	+3.8	+4.1
AUSTRALIA	2Q/80	+10.7	+9.4	+2.7	+6.5
	3Q/80	+10.2	+11.8	+0.9	+10.8
S. AFRICA	2Q/80	+14.05	+21.35	+5.3	+15.25
	3Q/80	+12.3	+25.6	+5.4	+19.2
FRANCE	2Q/80	+13.6	+14.8	+1.3	+13.3
	3Q/80	+13.6	+15.6	-2.2	+18.2
GERMANY	2Q/80	+5.9	+6.3	-1.2	+7.6
	3Q/80	+5.4	+7.0	-3.0	+10.3
ITALY	2Q/80	+20.9	+23.2	+9.6	+12.4
	3Q/80	+21.5	+22.5	+0.15	+22.3
SWEDEN	2Q/80	+12.8	+5.2	-4.0	+10.0
	3Q/80	+12.5	+8.65	+1.0	+7.6
UK	2Q/80	+22.2	+17.8	-4.4	+24.7
	3Q/80	+16.6	+21.4	-2.0	+24.9
AVERAGE OF ABOVE (excl. S. Africa)	2Q/80	+12.6	+9.9	+0.2	+10.0
	3Q/80	+11.6	+10.6	-2.1	+13.1

* based on industrial output

Source: OECD Data, S. African Department of Statistics

The rise in unit labour costs (ULC) reached +13% in 3Q/80 and our estimate for 4Q/80 is +13¼%. In 3Q/80 five countries were above average in terms of increase in ULC (in descending order): UK, Italy, South Africa, France, USA. Five countries were below average: Australia (10¾%), Canada, Germany, Sweden, Japan (+4%). For Japan, it was the first time since 1977 that its ULC increased (i.e. was positive rather than negative). Germany rose at an exceptionally high rate for it (+10%).

The rise in ULC can be due to one or both of two causes: too high wages or too low productivity.

Those countries whose wages were above average: (in order) South Africa, Italy, UK, France, Australia. Those below average: Canada, Sweden, USA, Japan, Germany (lowest increase).

Those countries whose productivity was below average: Germany, UK, France, USA (biggest decline). Incidentally, UK was -2%, but Germany -3%. Those above average: South Africa, Japan, Sweden, Australia, Italy, Canada.

Hence of the five countries whose ULC were above average, UK and France were both due to too high wages and too low productivity while Italy and South Africa were due to too high wages.

1.7 The trend in industrial materials prices (excluding petroleum) has continued to be erratic. The rise in dollar prices moderated sharply in 2Q/80, accelerated slightly in 3Q/80 and moderated again in 4Q/80 but still increasing. On the other hand, sterling prices continued to rise in 1Q/80 and then fall, sharply in 2Q/80, and more sharply in 4Q/80. This reflects the strength of sterling as well as the underlying trend in the market.

Because the international value of both the dollar and sterling have varied during the year, we have tried to create a notional international "real term" base for commodity prices (industrial materials) so as to assess what might be regarded as the genuine pressures of supply and demand on market prices. But then both demand and supply are influenced by currency speculation and political factors, pre-empting or postponing purchases, building up or liquidating inventories.

The following inset table shows the trend in prices (as percentage change on a year earlier) on dollar, sterling and notional bases. There has clearly been a significant moderation in the price rise during 1980, but it moved into a negative position only in 1Q/81.

Industrial Materials Prices

(Percentage change on corresponding period a year ago)

	1H/79	2H/79	1H/80	3Q/80	4Q/80	1Q/81*
Dollar Base	+37%	+26%	+11¼%	+6¼%	+1½%	-11½%
Sterling Base	+26%	+13¼%	+¾%	-¾%	-8¼%	-15½%
Notional Base	+35%	+26%	+12%	+8¼%	+2¾%	-9%

* estimated

TABLE 6 : COMMODITY PRICES

Percentage change on a year ago

	FOOD	INDUSTRIAL MATERIALS	FOOD	INDUSTRIAL MATERIALS
	dollar-based		sterling-based	
	%	%	%	%
3Q/79	+27.5	+29.6	+10.8	+12.6
4Q/79	+24.5	+22.9	+15.2	+13.7
1Q/80	+28.2	+21.9	+14.8	+9.1
2Q/80	+25.25	+1.0	+14.6	-7.4
3Q/80	+21.5	+6.2	+13.6	-0.6
4Q/80	+19.1	+1.5	+7.6	-8.3
1Q/81*	+7.0	-11.5	+2.0	-15.5

Source: The Economist Indicator

* partly estimated

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Oil prices during 1980 increased sharply despite the developing world recession and the general decline in oil consumption. Saudi Arabian increased by +65% in 1980 and by 36% in 1979.

OIL PRICES

Saudi Arabian Official Light Crude Price

$ per barrel

	1Q	2Q	3Q	4Q	Year
1980	26.00	27.33	29.33	31.33	28.50
	+94.9%	+74.1%	+62.9%	+42.4%	+65.1%
1979	13.34	15.70	18.00	22.00	17.26
	+5.0%	+23.6%	+41.7%	+73.2%	+35.9%

According to our calculations, the higher price of oil in 1980 added ~1¾% to the increase in world consumer prices.

Incidentally, the increase in international food prices has moderated quite definitely on both dollar and sterling bases: dollar +28¼% 1Q/80 to 19% 4Q/80; sterling +14¾% 1Q/80 to +7½% 4Q/80.

1.8 World trade has continued to increase in volume but at a reduced rate. In 1979 both total exports and exports of manufactures increased by nearly +5¾% (volume). In 1980 total exports increased by +1¼% and manufactures by nearly +5½%. The quarterly figures are not highly reliable. The trend for manufactures in 1980 would seem to have been 1Q/80 +11%;2Q/80 +5¾%; 3Q/80 +2½%; 4Q/80 +1%, all against corresponding periods a year earlier. This would at least seem consistent with the general trend in the world economy.

World price of export manufactures (unit value) increased to a peak of +13% 2Q/80 (+12½% 1Q/80) and then modified to a little under +11¾% 3Q/80 and to 8¾% 4Q/80 (prov), making +11¼% for the year, against +14½% in 1979.

Prices of commodity exports of developing countries increased by +14¾% in 1980 and +15¼% in 1979. Hence the terms of trade have still moved against the industrial countries and in favour of the developing ones. But by 4Q/80 the terms had begun to swing the other way. The commodity export prices increased by +25¾% 1Q/80, moderated to +16¾% 2Q/80 to +9¾% 3Q/80 and to +8% 4Q/80 against +8¾% for manufactures.

1.9 The trend in trade balances for our sample of ten countries has continued to show an improvement since 1Q/80. The deficit in 3Q/80 was some 70% of the peak. Only three countries enjoyed surpluses throughout this period: Canada, Germany, Australia.

TABLE 7 : TRADE BALANCES

$ million --- monthly averages --- seasonally adjusted

	3Q/79	4Q/79	1Q/80	2Q/80	3Q/80	4Q/80
USA	-2088	-2300	-3359	-1647	-606	-1272
CANADA	+166	+359	+482	+408	+514	+545
JAPAN	-1017	-1736	-1446	-1664	-418	
AUSTRALIA	+197	+330	+270	+213	+30	+77
S. AFRICA*	-100	-155	-175	-488	-675	
FRANCE	-475	-435	-1096	-1231	-1279	-1032
GERMANY	+855	+520	+515	+432	+381	
ITALY	-350	-1178	-1287	-1401	-2827	
SWEDEN	-157	-169	-215	-376	-180	-41
UK	-727	-952	-1086	-834	-84	+487
TOTAL OF THE ABOVE	-3696	-5716	-7397	-6588	-5144	

Source: OECD Data, S. African Reserve Bank

* excluding gold

USA and UK showed considerable improvement during the year (reducing deficits), and Japan and Sweden more modest improvements. Canada's surplus in 3Q/80 was higher than 1Q/80 or 2Q/80.

Three countries with deficits deteriorated during the year, Italy, South Africa (excluding gold) and France. Two countries with surpluses deteriorated during the year: Australia and Germany.

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I.2 UNITED KINGDOM

2.1 It is clear from all the official statistics and from our own experience of business that the British economy is not only in recession, but perhaps in the most severe one this century (as we had suggested two years ago). Demand has fallen; output has fallen more than demand; employment has fallen less than output; productivity is negative; the wageround (+20%) excessive and unit labour costs rising much faster than our international competitors.

Nevertheless despite the strong pound, imports have declined proportionately more than exports, and the visible trade deficit of £708 million 1H/80 was converted to a surplus of +£1882 million in 2H/80 yielding a surplus of +£1174 million for the year. The current account deficit of -£68 million in 1H/80 became a surplus of +£2416 million for the whole year.

2.2 Demand support in 3Q/80 became once more consumption dominated, accounting for +18% of the increase (private +12%; public +6%). This was more than offset by investment -21%, exports -21% and inventory liquidation -79%. This pattern is expected to have continued into 4Q/80. Total demand in 3Q/80 declined by $-3\frac{1}{4}\%$.

In the period 1-3Q/80, total demand declined by -1%. The main support came from consumption (+55%) and exports +54%. Of the consumption, private accounted for +31% and public for +24%. Investment was -7% and inventory liquidation -202%. We think official figures may have overestimated private consumption (See Section II.2, paragraph 2.14).

2.3 Output declined sharply after 1Q/80 and at an increasing rate. GDP (output) was $-1\frac{1}{4}\%$ 1H/80 and $-4\frac{3}{4}\%$ 2H/80 (with $-5\frac{1}{2}\%$ in 4Q/80). Excluding MLH 104 (offshore oil and gas) the declines were $-1\frac{1}{2}\%$ 1H/80 and $-4\frac{3}{4}\%$ 2H/80 (reaching -6% 4Q/80). Agriculture was virtually the only support with $+9\frac{3}{4}\%$ 1-3Q/80; industry $-5\frac{1}{2}\%$; transport $+13\frac{3}{4}\%$; distribution -1% and other services $-\frac{1}{4}\%$. This really is a picture of recession, or an advert to "return to the land".

Industrial production has been below 1979 level throughout 1980 and by December was back to its 1975 level despite offshore oil and gas. 1H/80 $-3\frac{3}{4}\%$; 2H/80 $-9\frac{3}{4}\%$; excluding construction 1H/80 $-4\frac{1}{2}\%$; 2H/80 $-9\frac{1}{2}\%$.

GDP (output) (1975 prices)

	1Q	2Q	3Q	4Q
On a year ago :				
1980	+1.3%	-3.7%	-3.9%	-5.5%
1979	+2.0%	+3.7%	+1.2%	+1.7%
Quarter on quarter (annual rate)				
1980	-3.2%	-6.4%	-7.5%	-4.8%
1979	-1.5%	+14.7%	-6.9%	+1.8%

GDP (output) (excl. offshore oil and gas)

On a year ago				
1980	+1.0%	-3.85%	-3.7%	-5.9%
1979	+0.9%	+2.7%	+0.1%	+1.2%
Quarter on quarter (annual rate)				
1980	-4.0%	-6.2%	-7.4%	-6.1%
1979	-3.3%	+14.4%	-7.8%	+3.0%

	1Q	2Q	3Q	4Q
Industrial production (total)				
On a year ago				
1980	-0.1%	-7.3%	-9.1%	-10.5%
1979	+2.3%	+4.0%	+1.5%	+2.4%
Excl. offshore oil and gas (MLH 104)				
On a year ago				
1980	-1.0%	-7.7%	-9.3%	-12.0%
1979	-0.3%	+1.5%	-1.1%	+0.9%
Manufacturing output				
On a year ago				
1980	-2.15%	-9.8%	-9.9%	-14.0%
1979	-0.6%	+2.7%	-1.6%	+1.1%

With MLH 104 excluded, the figures do not differ greatly because oil production in 1980 was only +1% and the official figures still regard the oil price increase as a pure price increase and not a change in price relatives. 1H/80 $-4\frac{1}{4}\%$; 2H/80 $-9\frac{3}{4}\%$.

Manufacturing output declined the most, and in December was over -10% below its 1975 level. 1H/80 -6%; 2H/80 -12%. The rate of decline accelerated from $-2\frac{1}{4}\%$ 1Q/80 to -14% 4Q/80.

2.4 Total employment has been declining since 2Q/79, but only slowly in 2H/79 ($-\frac{1}{2}$%). 1H/80 $-1\frac{1}{4}$% on a year earlier and 3Q/80 -3%. Nevertheless, the decline was not as large as output.

Employment (seasonally adjusted) numbers (000) + percentage on year ago

Total Employment	1Q	2Q	3Q	4Q
1980	24,794	24,607	24,263	
% change	-0.7%	-1.6%	-3.0%	
1979	24,977	25,015	25,008	24,929
% change	+0.6%	+0.7%	+0.4%	-0.3%
Production Industries				
1980	8,775	8,638	8,421	8,150
% change	-2.3%	-3.8%	-6.0%	-8.0%
1979	8,980	8,965	8,961	8,879
% change	-0.8%	-0.7%	-0.6%	-1.1%
Manufacturing				
1980	6,854	6,727	6,526	6,280
% change	-2.9%	-4.5%	-7.0%	-9.5%
1979	7,058	7,041	7,014	6,937
% change	-1.1%	-1.0%	-1.1%	-2.0%

Employment in production industries declined more rapidly 1H/80 -3%; 2H/80 -7% (from $-2\frac{1}{4}$% 1Q/80 to -8% 4Q/80). But again output fell faster.

Employment in manufacturing sector continued its downward trend, and again at a faster rate than for the production industries (from -3% 1Q/80 to -9% 4Q/80) 1H/80 $-3\frac{3}{4}$%; 2H/80 $-8\frac{1}{4}$%. And once more output fell even more sharply.

The trend in productivity has been disappointing, if not somewhat alarming. For the total economy productivity increased in 1Q/80 but thereafter declined. For 1-3Q/80, it was a little under $-\frac{1}{4}$% (including MLH 104) and a little over $-\frac{1}{4}$% (excluding MLH 104).

In the production industries, which should be showing the biggest increases, the decline was greater. For the year (including MLH 104) $-1\frac{1}{2}$% (1H/80 $-\frac{3}{4}$%; 2H/80 $-2\frac{1}{4}$%); excluding MLH 104 $-2\frac{1}{4}$% for 1980 (1H/80 $-1\frac{1}{2}$%; 2H/80$-3\frac{1}{4}$%).

Manufacturing industry showed an even steeper decline from $+3\frac{1}{4}$% 1Q/80 to $-4\frac{1}{2}$% 4Q/80. For the year -3% (1H/80 $-2\frac{1}{2}$%; 2H/80 $-4\frac{1}{4}$%).

The implications of these trends are quite serious. (See Section II.2).

Productivity (percentage changes on a year ago)

	1Q	2Q	3Q	4Q
Total economy (incl. offshore oil, MLH 104)				
1980	+2.1%	-1.9%	-0.6%	
1979	+1.4%	+3.0%	+0.8%	+2.0%
Total economy (excl. offshore oil, MLH 104)				
1980	+1.8%	-2.1%	-0.4%	
1979	+0.3%	+2.0%	-0.3%	+1.5%
Production industries (incl. MLH 104)				
1980	+2.25%	-3.6%	-1.3%	-3.0%
1979	+3.1%	+4.7%	+2.1%	+3.5%
Production industries (excl. MLH 104)				
1980	+1.3%	-4.05%	-2.6%	-4.0%
1979	+0.5%	+2.2%	-0.5%	+2.0%
Manufacturing industries				
1980	+0.8%	-5.55%	-3.1%	-4.5%
1979	+0.5%	+3.7%	-0.5%	+3.2%

2.5 The wageround for 1979/80 turned out to be +18.9% as expected. The new wageround started with some startling increases $+36\frac{1}{2}\%$, $+43\frac{1}{4}\%$, but much of this was probably backpay. By November, the rate had declined to +17%.

TABLE 8 : UK, AVERAGE GROSS EARNINGS

(Whole economy --- new series --- seasonally adjusted)

Cumulative percentage changes (annual rates)

1979/80 July to:		1980/81 July to:	
Aug	+2.4	Aug	+36.5
Sept	+0.4	Sept	+43.3
Oct	+13.4	Oct	+18.2
Nov	+17.1	Nov	+17.1
Dec	+17.5	Dec	+18.9
Jan	+14.0		
Feb	+17.5		
Mar	+19.2		
Apr	+19.1		
May	+18.4		
Jun	+20.4		
Jul	+18.9		

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On a calendar year basis, the picture looked as follows:

	1Q	2Q	3Q	4Q
1980	+19.65%	+21.4%	+22.3%	+19.4%
1979	+13.9%	+13.5%	+15.7%	+18.6%

The peak was clearly reached in 3Q/80 but the moderation could be quite significant during 1H/81 unless the government gives way to the public sector.

2.6 The trend in costs and prices is shown in Table 9. The picture is worrying.

TABLE 9 : UK PRICE/COST INCREASES

Percentage change on a year ago

	1979 %	1Q/80 %	2Q/80 %	3Q/80 %	4Q/80 %	1980 %
Earnings	+15.5	+19.5	+21.4	+22.2	+19.4	+20.7
Unit Labour Costs (manuf.)	+14.15	+18.1	+24.7	+24.9	+20.4	+22.0
Materials Prices	+15.9	+28.55	+23.3	+18.8	+10.6	+19.9
Wholesale Output Prices	+12.2	+18.4	+18.45	+15.4	+13.4	+16.3
Retail Prices	+13.4	+19.1	+21.5	+16.4	+15.3	+18.0

Earnings reached a peak in 3Q/80 and then moderated slightly. Unit labour costs (manufacturing) also peaked in 3Q/80 but were still +20% in 4Q/80. The rise in input prices moderated quite considerably in 2H/80 and by January, 1981, was only +8¾%. The relief from this sector is likely to continue for at least 1H/81, if not throughout 1981. Wholesale output prices peaked in 1Q and 2Q/80 and by January 1981 had moderated to 11%. Retail prices also peaked in 2Q/80 and the rate of increase was down to +13% in January, 1981.

The present costpush is still around +14/15% which suggests that profit margins generally throughout the system (but more particularly on the retail side) are being quite heavily squeezed. On current replacement cost accounting, however, the current costpush is only +11% and moderating quite rapidly.

The strong pound has given Britain a strong competitive advantage in terms of internationally cheaper raw materials. But it has been and is still being whittled away by rapidly rising unit labour costs. If the USA had had the same advantage as the UK, its retail price rise in 2H/80 would have been +9% instead of +13½%.

2.7 The trend in personal disposable income has been upwards +3¼% 1-3Q/80, real terms (according to official figures). Money PDI increased by +20¼% and the price deflator used by CSO is +16½%. If we use the OECD price index (+19½%), the rise in real PDI comes out at a little under +¾%, which we feel is a more accurate indicator than +3¼%.

This adjustment would also apply to the official figures for consumer expenditure and retail sales. In each, the lower price deflator has been used in the official statistics. Officially, consumer expenditure (real terms) 1-3Q/80 is +0.6% and retail sales (volume) +0.9% or +0.65% for the full year. Using the alternative price index, consumer expenditure (real terms) (1---3Q/80) -1.9% and volume of retail sales -0.9% or -1.1% for the full year. (See discussion in Section II.2, paragraph 2.14).

2.8 Britain's trade position has continued to improve dramatically. The visible balance went into surplus 2H/80 and achieved +£1,174 million for the year. This compared with a deficit of -£3,497 million in 1979, a turnround of £4,671 million. With an invisible surplus of +£1,242 million (+£1,734 million 1979), the current balance showed a surplus for the year of +£2,416 million against a deficit of -£1,763 million in 1979, a turnround of £4,179 million. The details are given in Table 10.

TABLE 10 : UK BALANCE OF PAYMENTS

£ million

	Year 1979	1Q/80	2Q/80	3Q/80	4Q/80	Year 1980
Exports	40687	11871	11915	11700	11868	47354
Imports	44184	12259	12235	11084	10602	46180
Offshore Oil (gross income estimated)	5385	2100	2190	2150	2270	8710
Visible Balance	-3497	-388	-320	+616	+1266	+1174
Invisible Balance	+1734	+442	+198	+302	+300	+1242
Current Balance	-1763	+54	-122	+918	+1566	+2416

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The visible trade turnround of £4,671 million was made up as follows:

Reduced quantity, imports	+£2320	
Increased quantity, exports	+£712	+£3,032
Higher prices, imports	-£4316	
Higher prices, exports	+£5955	+£1,639
		+£4,671

As oil affects both imports and exports, we can analyse the turnround in terms of oil and non-oil trade.

Change in non-oil trade		+£1,345
Oil change: quantity	+£140	
price	+£3185	+£3,325
		+£4,670

If we deduct from the favourable turnround of £4,671 million in visible trade, the adverse turnround in invisibles (-£492 million), we obtain +£4,179 million which is the favourable turnround in the current balance.

Exports have been surprisingly buoyant in 1980 despite both stronger sterling and the inclusion of offshore oil. It suggests that Britain's export trade under the influence of strong sterling is trading up. The increase in the value of exports has been slowing down during 1980 but for the year was +16½% against +16% in 1979. Volume of exports declined from 2Q/80 onwards but was +1¾% for the year (1979 +3½%).

Imports, however, declined quite dramatically, despite the upvaluation of sterling. Value 1H/80 +17%; 2H/80 -6¼%; year +4½% (1979 +20¾%). Volume +2¾% 1H/80 but -12½% 2H/80; year -5¼% (1979 +11½%).

TABLE 11 : UK OVERSEAS TRADE

Percentage change on a year ago

(Balance of payments basis)

	Year 1979 %	1Q/80 %	2Q/80 %	3Q/80 %	4Q/80 %	Year 1980 %
Exports						
Value	+16.0	+42.8	+10.7	+11.5	+6.75	+16.4
Volume	+3.6	+21.55	-5.9	-2.65	-2.7	+1.7
Imports						
Value	+20.7	+25.8	+8.4	-1.5	-10.9	+4.5
Volume	+11.6	+8.7	-3.4	-10.4	-14.35	-5.2

Exports of manufactures in 1980 increased by +1¾% (volume) and finished manufactures by +4¾%. Fuels +5¾%; food, drink and tobacco +5½%; basic materials +14%. Imports of all manufactures -1¼% and finished manufactures -1¾%. Fuels -15½%; basic materials -13½% and food, drink and tobacco -6¾%.

TABLE 12 : UK OVERSEAS TRADE

£ million

Changes on previous quarter, seasonally adjusted

	Year 1979	1Q/80	2Q/80	3Q/80	4Q/80	Year 1980
Exports						
Value	+5616	+753	+44	-215	+168	+6667
due to:						
Volume	+1212	+111	-280	-334	+178	+680
Price	+4404	+642	+324	+119	-10	+5987
Imports						
Value	+7567	+366	-24	-1151	-482	+1996
due to:						
Volume	+4260	-406	+128	-992	-499	-2320
Price	+3307	+772	-152	-159	+17	+4316

Table 12 shows imports and exports split between value and volume. In terms of relative price exports contributed £1,671 million more than imports. In volume exports contributed +£3,000 million making a total of £4,671 million.

Offshore oil output in 1980 increased by only +1% in volume, or +£0.05 million. But the price rise of +60% gave an equivalent output value of £3.3 billion giving a total increase of +£3.35 billion i.e. +£8.7 billion in 1980 against £5.4 billion in 1979.

II INTERPRETATION OF CURRENT TRENDS

II.1 JUDGMENT ON THE WORLD ECONOMY

1.1 The world recession is certainly developing, but it is questionable whether the genuine corrective phase of the business cycle has yet started. The position in 1980 can be summarised as follows

- world demand is growing much more slowly and is probably now actually declining
- world output also declining and more than demand, hence
- inventories are being liquidated
- governments still not curbing either money supply or public expenditure sufficiently. Hence
- wagerounds well in excess of increases in productivity.
- employment has declined but not so much as output, hence
- productivity has risen much more slowly and in many industrial countries has declined. Hence
- unit labour costs have continued to rise sharply.
- some moderation in the rise in consumer prices but this is the cheaper raw materials rather than increased efficiency in the industrial nations.

1.2 Recession is a time when both companies and countries can make themselves more efficient. It is a positive opportunity, which should not be missed, to introduce a three pronged program:

to invest in knowledge

to invest in people

to invest in equipment (so as to help people operate more effectively)

and in that order.

1.3 The seeds of a recession are sown in the initial recovery stage of the business cycle. Governments are then anxious to improve business confidence and to get the economy expanding once more. They therefore encourage a situation where too much money is chasing too few goods. At this early stage, the national resource allocation is encouraged to become consumption orientated. With time, this imbalance increases and is revealed in one or both of two indicators.

- retail price rise accelerates

- the balance of payments deteriorates.

When one or both of these reach politically unacceptable proportions, corrective measures have to be taken, and the recession ensues. A recession is thus the corrective phase of the business cycle: correcting the imbalance in the national resource allocation created at the beginning of the recovery phase.

1.4 The period of correction involves two stages.

(i) In the boom phase of the business cycle where too much money is chasing too few goods, double or treble ordering becomes rife and inventories are built up because given rising prices, goods bought in t_{-1} always look cheaper than those bought in t_0. Once the correction takes place, and surplus cash no longer exists, the double and treble orders dissipate into thin air. The demand for liquidity increases and inventories are liquidated.

Two factors operating at the same time cause output to decline sharply. First, demand itself is reduced. Secondly, inventories have to be liquidated. Thus output has to be less than demand.

(ii) The second stage comes after inventory liquidation. Once this has ceased, output clearly rises, even though total demand may still be falling. The next problem is to ensure that the excess demand for consumption is neutralised so that the imbalance in the national resource allocation can be corrected. This inevitably means a transfer of manpower and hence an increase in unemployment.

It is during this phase, that companies can improve their own efficiency by getting manning levels down to battle strength and by improving their knowledge of their customers /consumers and their resources --- in both cases actual and potential.

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1.5 The world economy is not yet at stage two, although the US economy would seem to have ended its inventory liquidation. Yet its corrective phase has not yet begun although it was announced recently by President Reagan. In stage two, employment should decline more than output so that productivity would increase.

> The United States still accounts for over 30% of world output. It is also a very large importer of both industrial materials and fuel, and manufactures. Hence any significant change in the US economy has ramifications throughout the world. Germany and Japan together are not yet powerful enough (and not sufficiently large importers) to counterbalance the USA. But the EEC could, if it had a genuinely coordinated economic policy.

1.6 Currently, the US has a lot to do to curb its domestic inflation. If Congress cuts taxation before effectively cutting public expenditure (i.e. falling into the Thatcher trap), then genuine corrective action will be delayed and a false boom could be created.

> All countries are currently suffering from a degree of inflationary pressure and imbalance in resource allocation. In some cases, this resource imbalance has been created by external factors. If, for example, US demand falls and the US is Germany's main export market, then German exports will also decline (unless alternative markets can be found quickly). If German domestic consumption is sustained or even increased to protect the level of employment, a resource imbalance will clearly be created, especially if sustained or increased consumption encourages more imports.

1.7 The main industrial countries are faced with two opposing problems: excessive wage demand and declining productivity. If inflationary pressures are to be curbed, the wageround should be no greater than the expected rise in productivity. It is currently substantially higher in all our sample of ten countries, even in Japan in 3Q/80.

> Correction to the world economy will not have taken place until the rise in unit labour costs (ULC) is down to under +5% p.a. and if possible to below +3% p.a. This means either a sizeable reduction in real wages generally and/or an increase in productivity which implies a greater decline in employment than in output.

1.8 The sharp rise in the price of crude oil (+60%) that the industrial countries have had to accommodate has exacerbated the problem rather than created it. It really increases the need for the industrial economies to become more efficient. Regrettably, it has given them an excuse to increase domestic inflationary pressures and thereby become less efficient.

1.9 One indicator of tight money policy is whether the economy has a positive or negative real rate of interest. Positive suggests tight money. This is not a straightforward exercise. We have taken the official discount rate and then provided judgmental adjustments when the operational rate was significantly higher.

In 2H/80, only three countries had a technically positive real rate of interest: Canada, Australia and Germany. Towards the end of 1980 and to date under the new regime the USA has a positive real rate of interest in terms of its prime rate. The three most negative were South Africa, Italy and France.

Inflationary pressures cannot be curbed except by making money supply both scarce and dear.

1.10 The leading indicators provided by 18 countries of OECD, were definitely signalling a recession last October. But now a change has occurred. The USA is signalling a recovery, but we think this is a false alarm, or perhaps a misinterpretation. But three other countries (Canada, Australia and the UK) are signalling a "probable recovery", while Switzerland is showing no change. Three countries are signalling a possible decline (Denmark, Germany and Japan) and the remaining ten (Australia, Belgium, Finland, France, Ireland, Italy, Netherlands, Norway, Spain Sweden) a definite decline.

	Oct 1979		Feb 1980		June 1980		Oct 1980		Feb 1981	
	No of countries	%	No of countries	%	No of countries	%	No of countries	%	No of countries	%
+	6	34.8	2	8.9	1	2.25	=	=	1	35.7
+?	2	2.6	1	0.6	=	=	=	=	3	10.7
=	4	3.9	4	31.4	3	28.0	3	17.0	1	2.2
-?	4	49.4	4	7.2	6	12.75	2	36.0	3	27.7
-	2	9.3	7	51.9	8	57.0	13	47.0	10	23.7
	18	100.0	18	100.0	18	100.0	18	100.0	18	100.0

Their weighting is based on their contribution to OECD world industrial production in 1975. Hence the proportion of output signalling a possible or definite decline has shrunk from 83% last October to $51\frac{1}{2}$% now. The proportion suggesting a recovery has switched from zero to $46\frac{1}{2}$% (but $35\frac{3}{4}$% alone represents the United States). We discuss prospects for 1981/1982 in Section III.

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II.2 <u>JUDGMENT ON THE UNITED KINGDOM</u>

2.1 The first point to make is that the present government has wasted the first $1\frac{1}{2}$ years of its political life. In terms of positive change in the economy, it has achieved very little indeed. Its approach to the economy has been that of a narrow minded accountant, instead of a broadminded chief executive wedded to increasing efficiency.

These are severe strictures. Can they be justified? The purpose of this section is to do just that.

2.2 But first, let us clear up or at least prevent certain misunderstandings. We do not believe that the present recession was created by the Conservative government, nor that the government is in any way responsible for its severity.

The seeds of the present recession were sown in late 1977 by the Labour government with the generous tax give-aways. The consumption dominated imbalance in the economy was continued throughout 1978 and into 1979. The Conservative government took little or no effective action to correct this until early 1980.

Total demand in 1978 increased by $+3\frac{3}{4}\%$ in volume. Output (non-oil) however increased by only $+2\frac{1}{2}\%$ while imports of manufactures increased by $+12\frac{1}{2}\%$. In 1979, the picture was similar. Total demand $+3\frac{1}{2}\%$ (real terms). Non-oil output $+1\frac{1}{4}\%$; imports of manufactures $+14\frac{3}{4}\%$. Even in 1980 with total demand $-1\frac{3}{4}\%$ non-oil output -3%, imports of manufactures -1%.

Total employees in <u>employment</u> increased in 1977, 1978 and 1979. But employees in production industries declined in 1978 and 1979. On the other hand, employees in the public service not only increased in 1978 and 1979 but proportionately more in each year than total employees in employment. Similarly although both declined in 1980, the public service declined proportionately less.

2.3 We have not been surprised about the severity of the British recession but we have been somewhat surprised about the speed at which it has developed. We have been warning for some time now that this recession was likely to be the most severe of this century. The analysis that led us to this conclusion was complex. But the two overriding indicators were

- that once British unit labour costs began to rise at twice and often more than twice the rate of those of its main international competitors, and

- that once North Sea oil came ashore in sufficient volume to ensure a surplus in the balance of payments

British industry would be at a competitive disadvantage. If this had to be rectified to protect the long term employment prospects of the country, then the correction phase would have to be severe and perhaps even long.

2.4 We thought that Tory policy would more likely provide a genuine correction than Labour policy, which in our political model has been described as "too little and too often". The Tory policy document, "The Right Approach" was a clear statement of intention to make the British manufacturing sector internationally competitive. The first steps were taken in Sir Geoffrey Howe's first Budget (June, 1979). In Economic Commentary No. 9, we discussed the provisions and their likely impact. Perhaps we may permit ourselves to republish the last three paragraphs of that discussion. They are just as appropriate today.

"3.5 But the budget is based on two implicit assumptions:

- that the British consumer will ensure that competition works effectively in keeping prices down, in rewarding the efficient (especially from a genuine marketing point of view) and in penalising the inefficient

- that British management is capable of ensuring minimal increases in unit labour costs, either by increasing productivity or by resisting exorbitant wagerounds.

3.6 We have no experience in the postwar world to show that either of these two implied assumptions are valid. In fact, what experience we have would suggest the opposite. Moreover, neither the consumer nor management have been put into such a situation for forty years or more.

3.7 This does not mean that the budget will fail in its objective. But it suggests that it could fail, unless the government starts to educate the British public into how the economic system works and to show how common-sensical, orthodox economics is. It is not the whim or ideas of one man or even a group of men. It is the consolidated wisdom of society as it evolved in terms of free choice. It is inherent in life and living. It is a decision system in conditions of scarcity where individual and group actions are based on mutual self-interest."

(Economic Commentary No. 9, Page 34)

2.5 We think that there is evidence to show that the British consumer is perhaps at long last using competition to put pressure on producers and distributors to become more efficient. But producers and distributors do not seem to be so happy with this state of affairs. One indicator is that the rise in retail prices during the past six months has been less than the rise in costs, indicating a squeeze in profit margins. In Britain, retail prices have usually tended to rise more than costs.

The efficient well run firm welcomes competition and reacts to it positively. If a competitor achieves an advantage in the market place, the efficient firm asks two questions

- how can we match him and even improve on him (tactical)?

- how was it that we did not think of it, first (strategic)?

2.6 As we have often stressed, a recession is a time when the professional manager comes into his own. In the boom, where too much money is chasing too few goods, virtually anybody can make a profit (at least a paper profit). In a recession, where too many goods are chasing too little money, every unit of profit made requires more effort, more knowledge, more skill, more expertise. But as we pointed out in the Special Topic of Economic Commentary No.9, the experienced and well-trained manager can often make more profit in a recession.

2.7 There is no indication that the government has done anything to make British business more efficient. Indeed, unit labour costs in 2Q/79 were rising at 12%, while in 4Q/80 at 20/25% (+25% in 3Q/80 and a slight moderation in 4Q/80). This suggests the opposite. Moreover, output has fallen much more than employment. Hence productivity has declined. Manning levels have still not been reduced to battle strength. Fat has still to be squeezed out.

An efficient firm would use the first year of recession to do two things

- to understand and improve its marketing

- to get manning down to an absolute operational minimum

The second year can then be used preparing for the recovery.

2.8 The government's only effective action to encourage efficiency was to reduce the burden of tax on top incomes. The professional man is not motivated by money, that is what the concept of a profession means. But management was then put into a very awkward situation. The government had given it the equivalent of a 30% pay increase and yet it should have made certain that its staff's real wages declined. This did not happen. Hence the wage explosion which reached +20%. As productivity was declining, British unit labour costs rose twice as fast as those of our world sample. This was the same picture as under the Labour government.

2.9 Again, British industry's objections to the so-called "high interest rates" and the strong pound show that British management wants the easy way out. In the first place, the interest rates, certainly in the short term, are low since they have been negative in real terms. Secondly, with weak sterling, British exports trade down, marketing goes out of the window, and we sell on price. We sell what we want to produce.

> A strong currency (as the Germans have discovered and as the better run British firms are now discovering) means a general trading up in exports. Understanding what the customers and consumers want and satisfying them. Ensuring both reliability and service. But good marketing is the difficult option. Cut price selling is the easy one.

2.10 The government has failed to be the chief executive for the public sector, to specify the objectives that have to be achieved within what time span. The recent coal miners' debacle could have been collusion between the Board and the unions to get more public funds. But the government response should have been the posing of three questions

- do we want this industry to become efficient (and to specify in numerate terms what this means) to ensure its longer term future?
- how can this be achieved?
- within what time span?

What is applicable to coal, is equally applicable to steel, railways, water, gas, electricity, telecom etc. The real debate is likely to be centre on thedifferent meanings of the concept "efficiency" and the different criteria of measuring it.

2.11 A similar approach could have been used for the civil service, local government, national health and the like. The government could have specified a target increase in productivity of say +2% a year. (Productivity is defined as the percentage change in the volume of output related to the percentage change in the volume of resources used). The discussion would then centre on how to achieve this and within what time span. Funds could then have been allocated to those which increase efficiency, and withdrawn from those whose efficiency has not increased.

> Any output and input can be evaluated. The important point is to get agreement on its significance and interpretation.

2.12 Currently the government is penalising the efficient to support and keep alive the inefficient. And it is doing this in both the public and private sectors.

2.13 Our judgment on the British economy has remained unaltered. It is certainly in a bad way. The only indication of improvement is in the balance of payments and overseas trade. We think the British economy is still heading very definitely toward Scenario OIL TWO and that the manufacturing sector may not recover from this recession.

* * *

2.14 In measuring the change in personal disposable income and consumer expenditure, the CSO is using a price deflator which suggests a much smaller increase than the usual price series. They are using the GDP price deflator on the grounds of consistency. This is an accounting approach. It is in fact similar to accountants using the same price deflator for the different components of a company's value added. With this approach the addition of the parts is straightforward.

> Strictly speaking each component should be deflated by its own price series. This means constructing a new index for each period, if the data must add up precisely, or have a small residual item.

Our test of any economic series is whether it portrays and conforms to the general business experience. And the experience of 1980 is a useful illustration. The general experience of the retail trade is that 1980 was a very difficult period with even the more efficient retailers having problems to maintain profitability.

According to the CSO, consumer expenditure in real terms increased in 1980 by $+\frac{1}{2}\%$. In money, it increased by +16% with an implied price rise of $+15\frac{1}{2}\%$. The OECD statistics give the consumer price rise for the UK as $+18\frac{1}{2}\%$. On this basis, consumer expenditure in real terms would have declined by -2%.

The same applies to retail sales where the volume change for 1980 is given as a little under $+\frac{3}{4}\%$, whereas most retailers think that the volume of trade must have declined. It would seem that if we use the same price correction, the volume of retail trade would be shown to have fallen by over -1%.

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III PROSPECTS

III.1 WORLD PROSPECTS

1.1 Probability of a major war receding, and likely to recede further with President Reagan. Wars often happen through misjudgment. A frank forthright President can prevent misunderstandings.

1.2 With President Reagan, probability of present recession becoming a depression (loss of business confidence) is also declining. He may opt for a quick, severe correction. But he is unlikely to mislead either the business community or the general public about his intentions. Confidence is not lost when -A is forecast and -A happens, but when +A is forecast and -A happens.

1.3 World recession may now be a little deeper than we have been forecasting and may last a little longer. Much depends on how quickly Congress takes the appropriate corrective action i.e. cuts in public expenditure. If it accepts the tax cuts quickly, and delays the cuts in public expenditure, then the corrective process will take much longer.

1.4 No sign of any corrective movement in USA yet: inflation rife, unit labour costs +11%, prices +12½%, productivity negative.

But most other countries showing the same symptoms; even Germany and, to a lesser extent, Japan.

1.5 Last issue's view of Reagan's policy was right except for tax cuts. We knew that he had campaigned for reduced taxation, but we thought (or hoped?) that the tax cuts would be made conditional on the expenditure cuts and that they would therefore come later.

1.6 General pattern for 1981 in USA and most other countries

<u>real wages</u> to decline (much more modest wage increases)

<u>unemployment</u> to rise, with employment falling more than output so that productivity increases

personal consumption will therefore decline and with it imports

exports will be less buoyant

investment should increase, but more likely to decline

public expenditure to decline and money supply reduced (interest rates to become positive in real terms)

hence demand unlikely to increase, more likely to decline.

Some moderation of price rise and costpush will come first from materials (oil +60%; materials -11%; net impact -6% or -2¼% in terms of retail prices). This relief is likely to continue during 1981 and should increase. Later (for example, 2H/81) the smaller rise in unit labour costs will also bring relief --- especially in 1982.

1.7 Prospects can be summarised in the following figures. Figures in parentheses are our forecasts given in the November issue. All percentage changes are on the corresponding period, the year before.

Industrial production

1H/80	(actual)	+1½%	
2H/80	(actual)	-2¾%	
1H/81		-3½%	(-4%)
2H/81		-2½%	(-1½%)

Unit Labour Costs

1H/80	(actual)	+8%	
2H/80	(actual)	+12%	
1H/81		+8¾%	(+7%)
2H/81		+4%	(+3%)

Consumer Prices

1H/80	(actual)	+12½%	
2H/80	(actual)	+11¾%	
1H/81		+7½%	(+8%)
2H/81		+4%	(+5%)

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III.2 UK PROSPECTS

2.1 As will be noted from Section II.2 above, our view of the British economy is somewhat jaundiced. We think many fruitful opportunities have been missed. But we do not think the position is hopeless. We think the government can still achieve much, if it really puts pressure on both the public and private sectors to become increasingly more efficient.

With the public sector, the question is not only one of keeping to cash limits but also of keeping to specified productivity targets, with personal and corporate penalties if they are not achieved.

With the private sector, the pressure is from a positive real rate of interest, a scarcity of money to prevent financing exorbitant wage claims and an encouragement to export by some form of tax bonus.

2.2 The British economy is still heading very definitely towards Scenario OIL TWO (the pessimistic long term). Even this can still be corrected (at a cost). It would mean that British unit labour costs between 1983 and 1987 would have to rise significantly more slowly than those of its main international competitors.

2.3 What we expect in 1981 in terms of resource allocation is total demand (real terms) down. Consumer expenditure -2½/3%; public expenditure no change; investment -5/7%; exports -2%; and little or no further inventory liquidation. Output would decline by -3%.

2.4 We think the current wageround in the private sector is substantially below +10% and possibly nearer +8% or even +7%. If the public sector could be kept to +10% (overall average), the wageround could be kept to +8¼%. If unemployment is allowed to approach and reach the three million mark, then unit labour costs could be rising at barely +5½% in 2H/81. Even if unemployment stays at around the 2½ million mark, the rise in unit labour costs need not be much above +8%.

On this basis, with materials input costs -4½% and oil +60% the costpush in 2H/81 and especially 4Q/81 could be +5% or even lower. This would be an achievement. And if it led to a 5% wageround in 1982 with a price rise of +3½% and a genuine reduction in total personal tax (because of cuts in public expenditure), personal demand could start to rise at +2½/3%.

2.5 The more immediate prospects for the British economy can be summarised as follows:

<u>Output</u>	-3%	
<u>Consumer expenditure</u>	$-2\frac{3}{4}\%$	
<u>Consumer/retail prices</u>		
1H/81	$+11\frac{1}{2}\%$	(previous forecast +13%)
2H/81	$+8\frac{1}{2}\%$	(previous forecast +9%)

2.6 <u>Post Budget Reconsideration</u>

The analysis and the Commentary (except for the Special Topic) has had to be prepared prior to Sir Geoffrey Howe's third Budget. The following comments amend, if necessary, any of the conclusions discussed in Section II and the prospects given above, a more detailed discussion of the Budget is given in Section IV as a Special Topic.

The only change we would make to our forecasts is for the retail price change. We would revert to our original +11% for 1981 with +13% 1H/81 and $+9\frac{1}{4}\%$ 2H/81. Yet 4Q/81 $+8\frac{1}{2}\%$.

The other possible amendment is that given the abolition of the index linked tax allowances, consumer expenditure in real terms could decline by as much as -3%.

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IV. SPECIAL TOPIC

THE MID-TERM BUDGET

1. The Position to Date

1.1 Sir Geoffrey Howe's third Budget is critical because of its timing. It is the last chance this government has of getting its strategy right before the next election. It will of course have a chance later on to deal with tactics and cosmetics.

Our remark presumes that to date the government has not got its strategy right. Let us therefore first recap on the government's objectives and its progress towards achieving them.

1.2 The objective of any government policy, no matter what party, must be to increase national efficiency.

The first area of discussion would centre on the definition of the concept "efficiency". Some would prefer to take it in its narrower academic economic sense of maximum monetary output from minimum monetary input. Others might prefer the wider psycho-sociological approach of maximum happiness for minimum effort or sacrifice. And there would be a host of variations in between.

The second area of discussion would be on the means adopted to achieve the agreed objective, together with the criteria to be used to indicate the degree of achievement or non-achievement of the objectives.

1.3 As we understand it, the present government's definition of national efficiency is for the British manufacturing sector to become internationally competitive. Its method of achieving this is by

- neutralising domestic inflationary pressures
- reducing the public sector burden on society
- revivifying the market economy
- increasing the freedom of choice for the individual
- making decision takers responsible for the consequences of their decisions.

1.4 In terms of the overall objective, no progress at all has been achieved. In 1979, British unit labour costs increased by +14% against +5½% for OECD world. In 1980, the respective figures were +21% and +9½%. In other words, British industry during the past 18 months has become internationally <u>less competitive</u>.

1.4.1 Nor has the success in neutralising domestic inflationary pressures been any better. Although the rise in retail prices has moderated considerably from a peak of +22% in May, 1980 to +13% in January, 1981, as with the Labour government in 1978, this was not due to government action. It was caused by cheaper raw materials. Admittedly the present government could rightly claim that its previous policy of strong sterling helped in this respect. It gave British industry a 10% cost advantage in terms of input materials. But the main relief came from the actual decline in world commodity prices.

1.4.2 The burden of the public sector has not been reduced. Public consumption and public investment together accounted for 27.3% of GDP (market prices, real terms) in 1980, compared with 27.05% in 1979 and 27.1% in 1978.

1.4.3 The market economy has not been revivified. It has been sacrificed for the benefit of the public sector --- to satisfy the "wets". The full brunt of the corrective process has fallen on the private sector instead of being shared between the private and public sectors.

1.4.4 The progress towards increasing freedom of choice has clearly been marred by the downturn in both the world economy and the British economy and the inevitable increase in unemployment.

1.4.5 Making decision takers responsible for the consequences of their decisions has progressed only in the private sector. The trade unions still appear to be running the country. Small groups of politically minded, determined despots can still hold society to ransom without any comeback. This government was elected to deal with this particular issue and so far it has failed lamentably.

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1.5 In Sir Geoffrey Howe's first budget, the public sector borrowing requirement was planned to be +£8¼bn. In the event, it turned out to be +£10½bn. In his second budget it was planned at +£8½bn and the best estimate of turnout is +£13½bn. Is this a successful policy of curbing government expenditure?

1.5.1 Moreover public consumption in 1980 increased in real terms by +1½% (prov) whereas total output (GDP) declined by -2% (prov). In 1979, when output increased by +1%, public consumption increased by +2%; while in 1978 output rose by +3% and public consumption by +2¼%. The most that can be said is that the rate of increase in the volume of public consumption has moderated during the past two years. It has certainly not been cut.

1.5.2 The picture for controlling the increase in money supply is similar. The government's own laid down targets and actual outturns were as follows:

Increase in Money Supply*

	Target Range	Outturn (financial year)
1978/9	+8-12%	+14.4%
1979/80	+7-11%	+13.0%
1980/81	+7-11%	+16.0% 1
1981/82	+6-10%	?

* Sterling M3

1 (first three quarters of financial year).

1.6 What then has still to be done? Judging from paragraph 5 above, one could say: "Everything". But the two critical criteria are:

- to increase productivity in the public sector, by reducing the value of resources used <u>without reducing</u> the quantity or quality of output.

- to increase productivity in the private sector.

2. The Basic Choice

2.1 The basic choice confronting the British nation is between the two strategic scenarios which we have labelled "Scenario OIL ONE" and "Scenario OIL TWO". These describe the two most likely end regions of a possible range. They are not the extremes.

The development of offshore oil and gas means two things to the British economy

- first, that there is unlikely to be any balance of payments restraint for many years to come. In other words, sterling will become and remain strong. This is not so much because of the volume of oil output as the fact that the price of oil is likely at least to maintain its international purchasing power, if not increase it.
- secondly, the British standard of living is likely to rise (at least for the next 10-15 years) at a consistent annual rate, far higher than ever before. The question is whether this rise will be based on an increasing volume of home produced goods and services or on an increasing volume of imported manufactures. The latter would depend on the relative international competitiveness of British manufacturing output.

Hence there are two possible scenarios

Scenario OIL ONE: this assumes that up to 1983 or possibly 1985, Britain's basic economic problems will be solved, such that from 1985 onwards Britain's unit labour costs (in international terms) would be no higher than those of its main competitors. This is the optimistic scenario.

Scenario OIL TWO assumes that the current disparity between Britain's unit labour costs and those of its international competitors will continue its present trend. This is the pessimistic scenario.

2.2 We first identified the possibility of this problem in 1974, but we did not then think it would materialise. It was given only an 0.05 probability. By 1976 we had specified the situation in more detail and its probability had risen to 0.4. A discussion on this was included as the Special Topic in issue No.3 of The Economic Commentary (June 1977).

Mr. James Callaghan as prime minister referred to this problem at the TUC annual conference in Autumn 1977, and again in Autumn 1978 when he proposed a 5% wageround. Indeed that was the reason for his suggesting such a low wageround.

Mrs. Thatcher has also frequently referred to it, although perhaps not so directly. It is, however, the raison d'etre for the government's present policy, which was spelt out in the Conservative party's document "The Right Approach" issued after the party's conference in Autumn, 1978.

2.3 Historically, it is normal in a developed industrial country for the proportion of the labour force employed in the manufacturing sector to decline. Employment may also decline in terms of numbers. The manufacturing sector has usually the highest productivity in the economy (excluding offshore oil and gas) so that its output tends to rise proportionately more than its employment.

In Britain, employment in the manufacturing sector rose to a peak of 8.5 million in 1966 and has since declined on average at -1.8% a year. Even during the consumer boom of 1978 and 1979 employment in the manufacturing sector was nearly -4% below its 1975 (recession) level.

In 1980, manufacturing output declined more sharply than employment, by -9% against -6%, so that productivity fell by -3%.

2.4 As a long term trend, we would expect the proportion of the labour force devoted to manufacturing to decline from, say, 34% in 1960 to 25% in 1980 to 17½% or possibly only 15% in 2000. This would be offset by a proportionately greater increase in employment in the broad services sector. This secular trend would reflect <u>not</u> the decline in manufacturing output, but the increasing productivity in the manufacturing sector, particularly compared with the services sector.

2.5 With the advent of the microprocessor and the new automatic information systems (the so-called information revolution), the productivity of manpower in the manufacturing sector should rise very sharply during the next 10 years. This implies that given stationary or falling output, the employment level will decline very much more. Even with expanding manufacturing output employment may not increase.

But this new technological development will also apply (but not so dramatically) to the services sector. If the process of adaptation is reasonably leisurely, no great social hardship will ensure, since expanding output should ensure an adequate level of employment. One important impact of the new technology will be to reduce costs and therefore relative prices, and so enable demand to expand. This presumes that this increased efficiency will not be whittled away by dearer (less efficient) energy, transport, public sector enterprises or public administration.

2.6 But Britain's problem is different, although it cannot escape the impact of this new technological revolution. It is simply that for a vast range of manufactures British costs per unit of output are significantly higher than those of its main international competitors. Hence given the EEC or any significant degree of freedom of trade, the British manufacturing base will be eroded by imports. Import controls could help only as a short term shelter, if it was known with reasonable certainty that within a year or two British manufacturing could be made genuinely internationally competitive once more.

The social problem associated with this is that the speed of run down may be quite rapid --- in fact, too rapid for the changing economy to cope with. This will not only create increasing unemployment but also increasing social hardship.

3. The Debate on Monetary Policy.

3.1 The discussion on the efficacy and inefficacy of monetary policy has taken a new turn with the publication of the report of the Treasury and Civil Service committee "Monetary Policy Vol.1" (1981).

But, quite frankly, the debate so far --- both the arguments for and against --- have been too doctrinaire, almost too academic, to be useful. Perhaps a better insight can be obtained by working through from basic principles.

3.2 If inflation is a situation where too much money is chasing too few goods, then it can be neutralised in only one of two ways

- either, by reducing the flow or supply of money
- or, by increasing the flow or supply of goods and services.

In a recession, the latter is difficult if not impossible. But in any case this latter approach, the so-called "dash for growth" has been used on several occasions since the war, and each time without success. It simply exacerbated the inflationary pressures in the economy, despite the presence of controls in one form or another. Note in particular the Selwyn Lloyd dash in the early 1960's when retail prices were rising on average by only +3% a year, and Tony Barber's dash in 1972 when prices were rising on average at +7½% a year.

3.3 Both experience and commonsense would seem to suggest that the only effective way of curbing inflationary pressure is by reducing the increase in money supply. Such an action would undoubtedly reduce total demand. That is its purpose. As money becomes

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scarce, it will become dearer. The cost of holding inventories will increase and the demand for inventories will decline. Hence output will fall more than consumption.

3.4 But an inflationary situation creates an imbalance in the national resource allocation which sooner or later has to be corrected. Resources have to be diverted from consumption (both public and private) to investment and exports. This process inevitably creates unemployment. This represents the social cost of correction. The more enlightened and skilful is management and the more amenable the trade union movement towards achieving increasing efficiency, the smaller this cost of correction will be.

3.5 Hence monetary restraint in isolation cannot be effective unless two particular assumptions are valid. (See paragraph 2.4, page 26). In Britain it needs to be supported by the inculcation of the right ethos, the correct attitudes. The objective is to make the British economy more efficient. Management, whether in the private sector or public sector, in manufacturing, or in services or in public administration, should be constantly striving to achieve ever increasing efficiency. But in Britain this has not been true since the war, and certainly not during the 1970's.

3.6 How then does monetary restraint increase efficiency? It operates in two different ways:

- one, negating the pressure and inducement towards greater inefficiency generated by an inflationary situation
- the other, by applying positive, direct pressure towards increasing efficiency.

Let us examine both of these in slightly more detail.

3.6.1 Efficiency stems from taking right decisions which, in turn, depend on correct thinking and correct information. An inflationary state provides misleading information and encourages people to think wrongly. It creates a monetary demand greater than true demand. That is its purpose. It causes prices to rise, which suggests that profitable buying and selling is inevitable. Rising prices cause consumers to pre-empt purchases and so exaggerate real demand further. Marketing tends to be abandoned and selling takes over. Paper profits expand, but true profits may well decline and the capital stock could be eroded. In a situation like this, you do not have to be efficient to live and make money profits.

3.6.2 In a period of monetary restraint, the professional manager comes into his own. The ephemeral demand vanishes. If prices are actually falling, people will buy only when they have to. Book profits decline but true profits and the value of the capital stock increase. Each unit of profit requires more skill, more expertise and more knowledge. Hence the inefficient go out of business and the efficient ones (after the initial impact of the recession) prosper. In a period of monetary restraint, figured information is no longer misleading, since the unit of account is no longer itself devaluing. Money demand relates more closely to true demand, and confidence in future stability is engendered.

The pressure of monetary restraint means that wages have to be earned by the wage-round reflecting more accurately the increase in productivity. In the same way profits have to be earned in the sense that an increase in profits reflects an increase in efficiency.

3.7 But the British economy is clearly not yet there. Admittedly the government has not yet been able to restrain the increase in money supply effectively nor to make any genuine cuts in public expenditure. The public sector has become less efficient because output has declined more or increased less than resources used.

But the same is true of the manufacturing sector where, as we have seen, output in 1980 declined by -9% and employment by -6%. British industry has failed (or perhaps refused) to use the first year of the recession to get rid of surplus manpower and to increase productivity by getting down to battle strength. It took the easier option of closing down whole plants. Hence output declined more than employment. The pressure on management in 1980 was not great enough. In the circumstances, the policy should have been re-inforced by education, exhortation and example. The government itself should have shown how it could have governed more effectively with fewer ministers, junior ministers and other hangers-on!

3.8 Such then is the background against which we must judge Sir Geoffrey Howe's third Budget. Any budget should be analysed in terms of three dimensions :

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- its cosmetic or psychological appeal
- its impact on money flows, public expenditure and transfer incomes
- its impact on demand, resource allocation and general business efficiency.

The mid-term budget will be discussed under these headings in Section 5 below.

4. The Budget Measures

4.1 The budget measures have been well publicised. We are summarising the main points here.

4.2 Personal Sector

- increased excise duties on beer, wines, spirits, tobacco and petrol, and extension of car tax to motor cycles (£2.2bn)
- increased vehicle duty (£0.2bn)
- no index linked tax allowances (no change in tax "revenue" but loss to personal sector of £1.9bn)
- certain tax relief to blind, redundancy payments etc. (-£6mn)
- taxation of fringe benefits etc. (+£95mn full year)

4.3 Business Sector

- new stock relief system (-£450mn full year)
- corporation tax adjustments (-£100mn)
- industrial buildings: 75% initial allowances (-£25mn)
- supplementary petroleum tax + adjustments (£1,000mn 1981/2 but £300mn in full year)
- Capital gains and transfer taxes (-£30mn)
- Special tax on banking deposits (£400mn)

4.4 Overall tax changes

£m	1981-82	Full Year
Inland Revenue	+1,217	+230
Customs and Excise	+2,425	+2,450
Bus Fuel Grants	-31	-31
	+3,611	+2,649

4.5 Monetary Impact

- MLR reduced from 14% to 12%
- PSBR reduced from £14bn (£13½bn expected outturn 1980/1) to £10½bn.
- increase in money supply targetted to +6/10%.

5. The Impact of the Budget

5.1 In terms of cosmetics or psychology, the interim Budget has a very clear message. No let up on monetary policy; a determination to cut public expenditure and to reduce domestic inflationary pressures. The Chancellor's words:

"To change course now would be fatal"

How true! How true!! At least that lesson has been learnt.

On the other hand the opening sentence of Part III of the "Financial Statement and Budget Report 1981-82" (p.21) states:

"The past year has been difficult as the economy has had to adjust, against a background of world recession, to a higher exchange rate and lower inflation".

What more striking official criticism of British management and business could there be! Difficult to adjust to the correct things of life. Strong sterling has pressurised British business to adopt good marketing in the export trade by selling reliable goods supported by superb service. Reduced inflation means coming back to the realities of life instead of living in a fool's paradise.

No, the message of the Budget rings loud and clear. A serious attempt is being made to encourage the British economy to become internationally competitive. The whole tenor of the Budget

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speech was the same. No excuse for the overrun of public expenditure and PSBR, simply an expression of disappointment and of a hope to claw back some of the overrun in future years.

5.2 The monetary side of the Budget is ambivalent, and as yet, it is not quite clear what the real impact on the economy is likely to be. The overrun of the 1980/81 budget was quite frightening. We can only hope that a lesson has been learnt and stricter control will now be enforced.

Money supply (sterling M3) +20% (Feb 80 to Feb 81) against target +7/11%. PSBR £13½bn against £8½bn. The new budget has put the increase in money supply down to +6/10%, and if the public sector expenditure is really kept under control, the outturn for March 1982 could be +7%. The PSBR for 1981/2 would have been £14bn but the Budget has reduced this by £3½bn to £10½bn. If this reduction is genuinely achieved this year, then the change from £13½bn to £10½bn will impose quite a monetary squeeze on the economy.

5.3 On the other hand the MLR has been reduced from 14% to 12% to satisfy the clamour of the business community. This means that the MLR will be negative in real terms, certainly for the next three months and possibly for the next six months. If the Chancellor persists in pulling the MLR down ahead of the moderation in the price rise, then he is once more encouraging business to finance unwarranted wagerounds. The long term rate of interest at 10%, however, is likely to be positive in real terms, almost certainly for the next three years.

Hence the economy is faced with a situation where the money supply is (hopefully) being effectively restrained, while at the same time the cost of money is being reduced. The worst implication is that the overrun in the increase in money supply in 1981/2 might be as large as 1980/1. The alternative is that money might become dearer, in absolute or relative terms. This might well be the reason for the Chancellor's suggestion to abolish the MLR concept later this year. After all "Granny bonds" have been extended to the 50 year old's only because they are likely to be a cheaper form of finance for the government than the 19th issue of savings certificates.

Another argument in favour of interest rates not falling sharply, is the fact that the government is likely to attempt to finance a large part of the PSBR by genuine savings instead of by inflation-creating bank credit.

5.4 The balance of transfer incomes for 1981/2 would appear to show no change on 1980/1. The additions to the social security benefits are estimated to cost £2,000 million. On the other hand the equivalent loss of the index-linked income tax allowances is estimated at £1,900 million.

5.5 How will the budget influence demand, resource allocation and business efficiency? Total demand should decline by at least -1½% and possibly by -2%. But personal demand is likely to decline more. PDI in constant prices could decline by -2¼%. This is based on +8½% wageround and +11% on prices. The budget has added +2% to the RPI. Further, the adjustment to the income structure caused by increasing unemployment could reduce PDI by at least -¾% and possibly -1%; the abolition of the index-linked tax allowances will reduce PDI by a further -½%, making a total decline of, say, -3½%. Hence consumer expenditure could fall in real terms, by -2¾% or even -3% (allowing for a savings ratio decline), while public sector demand will decline relatively from +1½% (real terms) 1980 to +¼% 1981.

Hence some switch in the resource allocation should take place, at least from consumption to exports. Investment demand should increase, with inventory liquidation coming to an end and given lower interest charges. But that is very unlikely. Very few firms have confidence in forecasting or in making realistic risk assessments or even carrying out effective discounted cashflow appraisals. We think investment will continue to decline, and in all sectors, except perhaps offshore oil and gas.

5.6 Now we are left with the most difficult assessment of all. What impact has the budget on business efficiency? Some tax relief has been given to industry, but it appears to be only a little over £½ billion, even with the help to small businesses included. The aid to new factory construction and the decline in MLR should provide some small encouragement to investment. But there is nothing in the budget to put pressure on firms to increase productivity. Admittedly, the employment tax was not abolished, but this did not cause British business to shed more manpower than output in 1980. We think that the small benefit from lower interest rates could be frittered away on continuing to finance surplus labour. Nevertheless, if management has understood the message of the budget, it knows that it must not relax in its drive for increasing efficiency.

6. Judgment on the Interim Budget

6.1 Let us admit that one day after the budget is too soon to pass proper judgment. There are still too many unknown variables and too few equations. We shall however, interpret judgment as meaning

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how far the budget is likely to affect our previous forecasts.

6.2 We had in fact assumed a slightly tougher budget in one sense (bigger cuts in public expenditure) and a milder one in another (slight relaxation on the personal sector). We are assuming that the government intends to honour its pledges to maintain its policy.

6.3 We still think output in 1981 could be -3% within the range -3½% to -2¼%, followed by a small "plus" in 1982. The Treasury forecast is -2% for GDP in 1981 and +1% 1H/82, and -6½% for manufacturing output in 1981 with +1¾% 1H/82.

6.4 The Treasury forecast for consumer expenditure 1981 is -¾%, against our forecast of -2¾% (unchanged) within the range of -3½% to -1½%. Note: Treasury estimate for 1980 +½% against ours of -2%.

6.5 The only forecast we would feel compelled to amend is our price change. A year ago we gave this as +11% (+13% 1H/81 : +9% 2H/81) which we have since amended to +10% (+11½% 1H/81 : +8½% 2H/81). We would now return to the original forecast and say a little over +11% 1981 (+13% 1H/81 : +9¼% 2H/81).

The Treasury forecast for retail prices 4Q/81 on 4Q/80 is +10% (against our +8½%) and 2Q/82 on 2Q/81 +8% (against our +7%).

6.6 We are retaining our forecast of consumer expenditure at -2¾% although the lower end of the range has been extended to -3½%. The implication is that the "actual" for 1981 could show a bigger decline rather than a smaller decline than we have suggested. Further, this -2¾% should be related to our -2% for 1980 and not to the CSO's or Treasury's +½% for 1980.

6.7 All in all this budget is well designed, and if effectively and properly implemented, is likely to achieve its objective.

V DID YOU KNOW?

I World Inflation

1.1 Did you know that world export prices of manufactures have only risen about one quarter as fast as gold or oil prices since 1950?

1.2 A table of our own estimates (1950=100):

	Export prices of manufactures expressed in terms of	
	(i) Gold	(ii) Oil
1950	100	100
1955	114	113
1960	127	132
1965	134	140
1970	147	157
1973	74	76
1975	60	42
1980	25	27

1.3 As can be seen, until 1970, export prices of manufactures rose much more rapidly than gold or oil. Even before 1973, the trend had changed dramatically, and by 1980, export prices were way behind. This obviously represents a large transfer of income to the oil and gold producers over the past ten years, and has enabled them to buy such prime pieces of Western property as the Dorchester.

2 The Matching Problem

2.1 Did you know that if cloakroom attendants were to hand out coats at random after a play, the probability that at least one person receives his own coat back is just under two thirds, no matter how many people attend the theatre?

2.2 If n people attend, the probability that at least one person is lucky is given by the formula:

$$1 - \frac{1}{2!} + \frac{1}{3!} - \frac{1}{4!} + \cdots \pm \frac{1}{n!}$$

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(where the sign on the final term is plus or minus depending on whether n is odd or even).

2.3 As n increases, the probability becomes approximately equal to

$$1 - e^{-1} = 0.63212$$

that is, just below two thirds (e, the exponential constant, is equal to 2.71828 ...).

2.4 Problems like this are called matching problems, and were first analysed by the French mathematician, Montmort in 1708.

3 <u>The Precepts for a Leader?</u>

Let me be an instrument of peace.

Where there is hatred,
let me sow love;
Where there is injury,
pardon;
Where there is doubt,
faith;
Where there is despair,
hope;
Where there is darkness,
light;
Where there is sadness,
joy.

May I not so much seek

to be consoled, as to console
to be understood, as to understand
to be loved, as to love.

It is in giving, that we receive.
It is in pardoning, that we are pardoned.
It is in dying, that we are born to
eternal life.

(circa 1200 AD)

No prize is given for identifying the source.

4 <u>What Rate Government Inflation?</u>

Financial Statement and Budget Report - 1971 issue, price £0.45
Financial Statement and Budget Report - 1981 issue, price £4.40 (+25.6% p.a.)

Retail Prices Index - same period (+13.7% p.a.)

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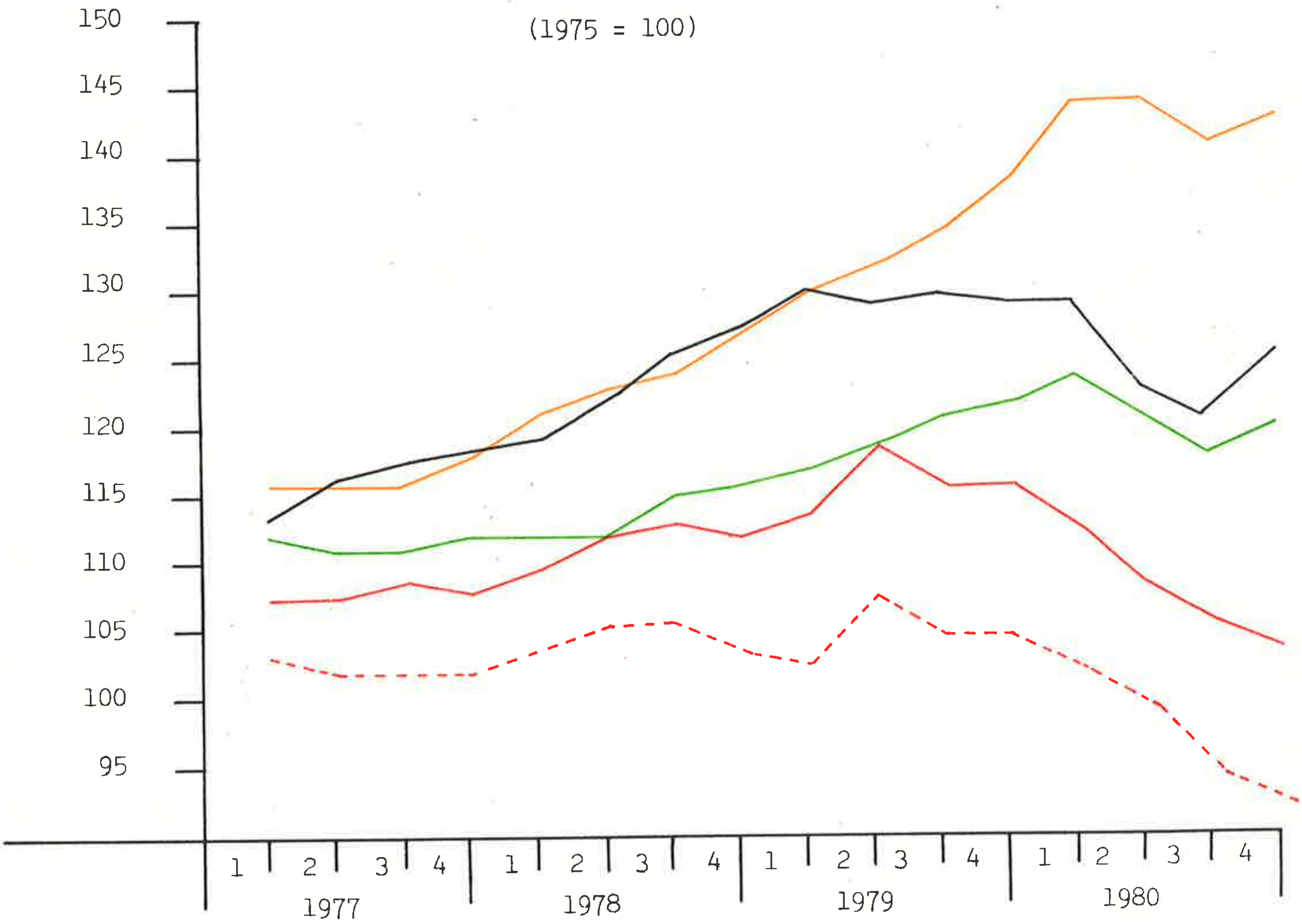
CURRENT INDICATORS.

1. INDUSTRIAL PRODUCTION (excluding Construction).

(1975 = 100)



USA	+4¾	+5½	+5½	+5½	+4½	+5	+6¼	+7½	+8	+5	+3	+1¼	-¼	-5	-7	-2¾
JAPAN	+7½	+4½	+1½	+2½	+3¾	+5½	+7¼	+8	+7½	+7¾	+8½	+9	+11¼	+0	+4¼	+4½
GERMANY	+4¾	+2¾	+1	+1	=	+1	+3½	+3½	+4½	+6¼	+5¼	+5¼	+6	+1¾	-2½	-1½
UK	+7	+4	+4¾	+2	+1	+3¾	+3¾	+3¾	+3¾	+5¾	+2¼	+3	-1	-8	-8¾	-10
excl off-shore oil *	+4	+2	+2	=	=	+4	+3	+2	-¼	+1½	-1	+1	-1	-7¾	-9¼	-12

* incl construction

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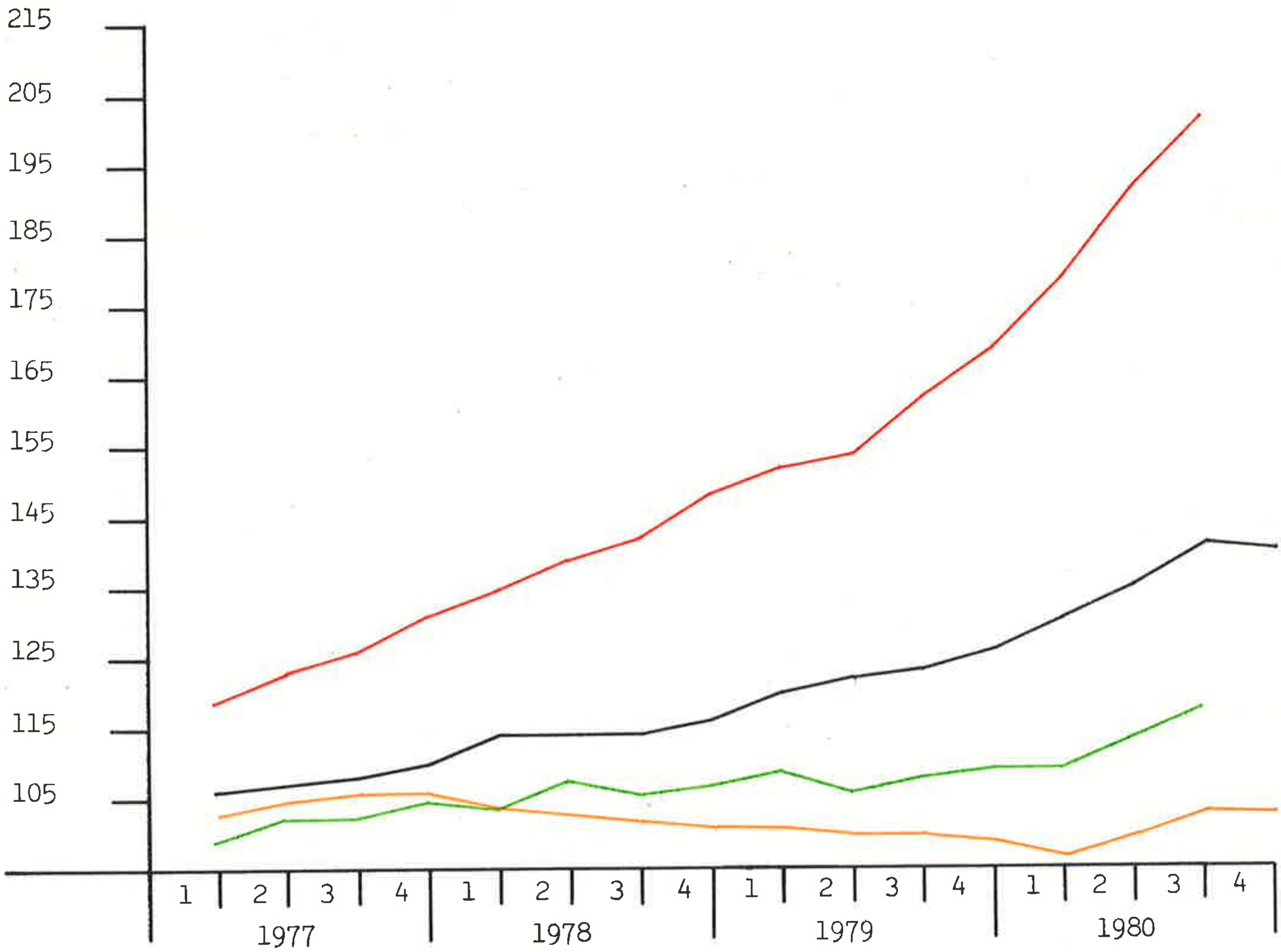
CURRENT INDICATORS

2. UNIT LABOUR COST.

(1975 = 100)



USA	+6	+7	+7	+11	+7½	+6½	+5½	+5½	+5¼	+7	+8	+7¾	+7½	+11½	+13¾	+11
JAPAN	=	+5	+6	+4	+1	−2	−3¾	−4¾	−3	−3	−2	−2	−4	=	+4	+3½
GERMANY	+2	+4	+3	+4	+5	+4	+3	+1	+4¾	−2	+2	+3	=	+7½	+9	
UK	+9	+10¾	+9½	+12	+13¼	+13	+12½	+12¾	+12¾	+11	+13¾	+13¾	+17	+23¾	+24	

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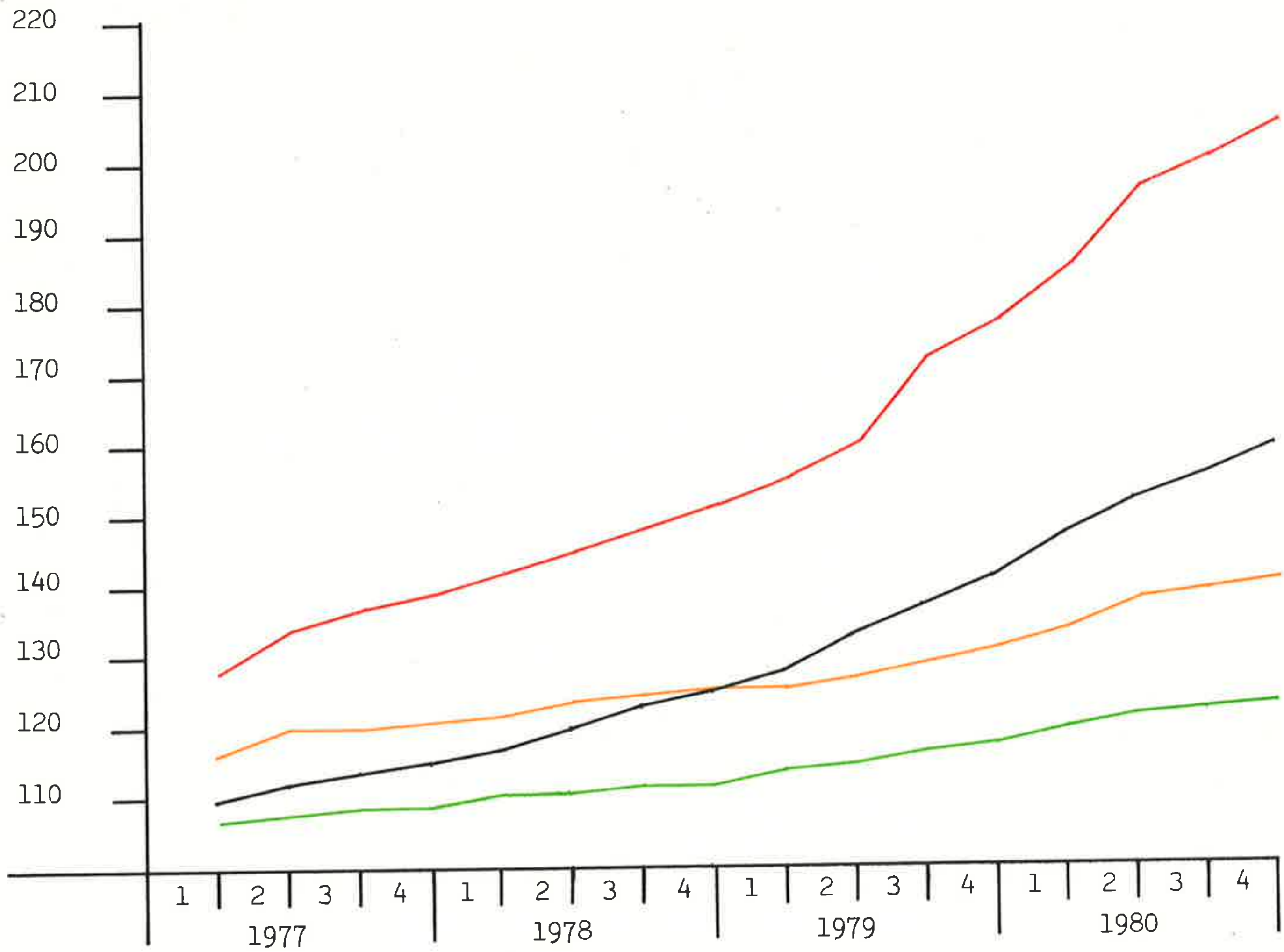
CURRENT INDICATORS.

3. CONSUMER PRICES

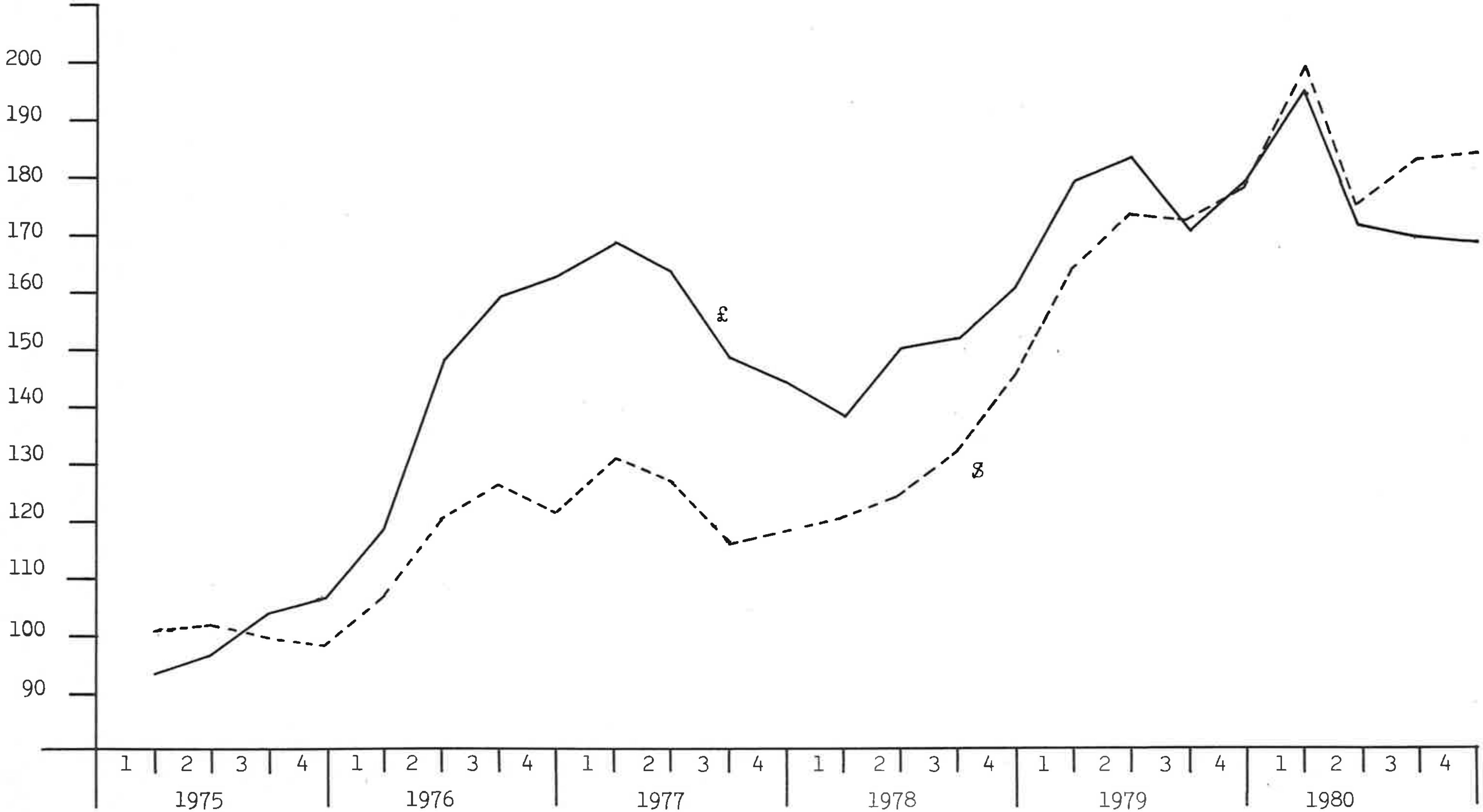
(1975 = 100)



USA	+5¾	+6¾	+6½	+6½	+6½	+7	+8	+9	+9¾	+11	+12	+13	+14¼	+14½	+12¾	+12¾
JAPAN	+8½	+9	+8	+6½	+4¾	+4	+4½	+3¾	+3	+3¼	+3½	+5	+7¼	+8	+8¼	+8
GERMANY	+4	+3¾	+4	+3¾	+3¼	+2¾	+2½	+2¼	+3	+3¼	+4¾	+5¼	+5½	+6	+5½	+5¼
UK	+16¼	+17½	+17	+14	+11	+8¾	+8¼	+8¼	+9¼	+10¼	+16	+17¼	+19½	+22¼	+16½	+15½

CURRENT INDICATORS

4. COMMODITY PRICES - INDUSTRIAL MATERIALS (1975 = 100)



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A NEW
ECONOMIC INFORMATION SERVICE

In an uncertain world error will always exist. It forms the inherent risk of business. The uncertainty of the changing environment is part of that inherent risk, and at times a large part of it. For us, forecasting is intimately interwoven with the identification, understanding and assessment of the nature and incidence of this inherent risk.

Nobody can foresee the future. But the probabilities of different possible outcomes can be assessed for different time horizons. Forecasting is concerned with applying probability analysis within a time dimension. Because of this, much of its value lies in isolating and understanding those factors which form the "motor mechanism" of change.

Our new economic information service is concerned with analysing and assessing the vital factors that will influence the course of the world economy, the British economy and the future prosperity of the firm. Although the forecast outputs will consist of quantified data, the essence of the service will be an appraisal of the changing relevant factors (and their changing probability weighting) that determine the forecasts. For this reason the service inevitably involves discussion and dialogue, especially with those people who are going to use the forecast information. Among other things the discussion will concentrate on the effect of changing the basic and internal assumptions so as to provide a form of sensitivity analysis. It will also draw forth the implied assumptions of the forecast outputs, and examine other possible sources of errors.

Two levels of service are available.

> The main one relates the background forecasts to the operations of the firm and also provides a longer term perspective.
>
> The restricted service is concerned only with the background forecasts.

Enquiries to:

The Ronald Brech Partnership
Guild House
32 Worple Road
Wimbledon SW19 4EF

01-946 8641(PBX)

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10, DOWNING STREET,
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With the Private Secretary's Compliments

All pages between 1 and 2 to be referred to Cabinet Office

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10 DOWNING STREET

THE PRIME MINISTER

16 March 1981

Dear Emmanuel,

Thank you for your letter of 9 February, in which you described in stark terms the problems you and Maurice Hodgson face from the high value of sterling. I recall the letter you wrote to me on the same subject in April last year, and I saw Geoffrey Howe's reply.

I am very well aware of the pressures you and other companies are now enduring, and I have been impressed by the way that companies have fought to maintain their market share. Exporting is not easy at the best of times and it is particularly difficult now, at a time of world recession. I realise, too, that the most efficient firms had little scope for cost-cutting. Since you wrote, the sterling rate against both the dollar and other currencies has, of course, fallen appreciably; but I recognise that a good many companies are still finding it too high for comfort.

Against the short-term advantage that industry might derive from a lower exchange rate than we presently have, it would of course carry with it the dangers of higher inflation which could put at risk our economic recovery in the medium term. But whether or not a lower rate would be desirable, experience has shown that governments cannot manipulate the rate except possibly in the short run - and even then the costs can be very high. The fact is that the strength of sterling has to a

/ very large

very large extent been related to our possession of North Sea oil and confidence in our determination to defeat inflation. Our high interest rates may also have contributed, and I would dearly have liked to have seen interest rates falling earlier. But while we were borrowing so heavily - and that too I regret - an earlier and bigger fall in interest rates would have meant throwing away our whole strategy of beating inflation. That in turn might have pushed the exchange rate down; but it would have meant the complete reversal of everything we have been trying to do and it could all too easily have led to a major depreciation of the kind the country experienced in 1976.

You asked specifically about our plans for the Temporary Short Time Working Compensation Scheme. As you may know, expenditure on this scheme has increased very rapidly in the last few months and is likely to total more than £400 million this year. Despite the costs, we decided in November to continue the scheme for a further year until March 1982 and to increase the maximum period of support from six to nine months.

It is too early to say what effect an interest rate of 12% will have on the exchange rate, but at least our interest rate is coming down at a time when that of some of our competitors seems to be rising.

Yours ever

Margaret

Sir Emmanuel Kaye, CBE.

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10 DOWNING STREET,
WHITEHALL S.W.1

With the Private Secretary's Compliments

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10 DOWNING STREET

THE PRIME MINISTER

16 March 1981

Dear Mr Kinnock,

Thank you for your letter of 9 February about Boulton and Paul Ltd. I cannot comment in detail on the affairs of that particular company, but I am of course conscious that the severe drop in demand for steel is causing acute difficulties for both the public and private sectors of the steel industry in the UK, who have now been faced with a prolonged spell of severely reduced capacity working. There are considerable areas of overlap between the BSC and the private sector which, in current conditions, have led to some friction. Keith Joseph has therefore made it clear to BSC and to the private sector producers that we would welcome viable propositions for joint companies. One joint venture has already been announced and other discussions are in progress. I hope this demonstrates that we are already encouraging a joint approach.

More generally, I know that the overall business climate at the moment is an extremely difficult one. But in attributing these problems to the effects of our policies you take no account of the world recession, which has created similar difficulties across the industrialised world, or of the long-term failings of the British economy: poor productivity, excessive pay rises and resistance to necessary change.

Unless we tackle these underlying problems, we will never restore the economy to steady and sustained growth. Unless we defeat inflation our international competitiveness will continue to suffer, investment will be discouraged and more jobs will be lost. Of course, there are costs in the short run: high interest rates are as unwelcome to me as to anyone and I am very glad that

/ Geoffrey Howe

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Geoffrey Howe was able to announce a reduction in MLR in his Budget.

The same overriding need to conquer inflation explains why we have to keep public expenditure, including housing expenditure, under firm control. This is why it is mistaken to call for "reflation". Such a policy would merely create new inflationary pressures, very quickly robbing us of any short-term increase in output and employment. The experience of the last few years shows clearly that such an approach leads only to more inflation and higher unemployment.

As for the exchange rate, it is again the lesson of experience that it is set by the market and cannot be maintained by Government at a level either above or below its market value.

Finally, you suggest that the housing moratorium should be lifted. I cannot accept this. The moratorium does not represent a cut in the planned level of expenditure but is intended simply to prevent capital expenditure by local authorities exceeding the cash limit that has already been set. Furthermore, the moratorium does not fall on committed expenditure, so it has not affected building work already in progress. Over the course of 1980-81 we expect local authorities' gross capital expenditure to be about the planned level of some £2200 m. Given the overriding need for public expenditure restraint, I could not agree to a proposal which would go beyond this.

Yours sincerely

Margaret Thatcher

The Rt. Hon. David Ennals, M.P.

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10, DOWNING STREET,
WHITEHALL S.W.1

With the Private Secretary's Compliments

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10 DOWNING STREET

THE PRIME MINISTER

16 March 1981

Dear Mr. Kinnock,

Thank you for letting me have this letter from your

Please assure Mrs. Gowing that, although I have to visit other countries and meet their leaders, this country always has the first place in my thoughts. I know how painful the present level of unemployment is for those who are out of a job themselves and for their families. If there was a way in which the Government could create overnight thousands or millions of jobs which would last, then we should not hesitate to take it. Sadly, there are no easy options. Everything we are doing is devoted to laying the foundations for a sustained economic recovery, which will lead to new jobs that will be both secure and lasting. To bring that about, we must control inflation. I am afraid that bringing inflation under control is bound to have difficult consequences in the short term, and that is the stage which we are going through at the moment.

/ I can understand

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I can understand Mrs. Gowing's feelings that we could make progress more quickly, and her wish to see more jobs available now. Those jobs will come, and they will come as a result of our policies. I am afraid that they cannot be bought more quickly without doing substantial harm over the following years.

Yours sincerely,

Margaret Thatcher

The Rt. Hon. David Ennals, M.P.

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10 DOWNING STREET,
WHITEHALL S.W.1

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pa 24050 54

CH/EXCHEQUER

REC. 19 MAR 1981

ACTION

COPIES TO

10 DOWNING STREET

THE PRIME MINISTER

18 March 1981

Dear Mr Radcunic,

Thank you for your letter of 24 February about interest rates.

I recognise that the high level of interest rates in the past year or so has placed a heavy financial burden on the industry. But I do not think they are a consequence of the banks' desire to see MLR higher than inflation. Their concern is that lending rates should allow a margin on the. rates they pay for deposits. High interest rates have been, however, a necessary part of our strategy to reduce inflation and bring money supply under control. I understand your concern that they might actually increase rather than decrease inflation. It is true that in the short term an increase in interest rates will push up companies' costs and may thereby increase their need for borrowed funds but over time there can be little doubt that they will reduce the demand for credit and tend to cut inflation.

We have had considerable success in bringing down inflation and monetary growth is also now slowing down. We have been able, therefore, to cut MLR by 5% since last summer, including the 2% reduction announced in the Budget. I accept, nevertheless, that companies' borrowing rates are still relatively high and I can assure you that we do hope to reduce interest rates further, but when, and by how much must depend on further progress on inflation and monetary conditions.

/ As you say,

2

E5

As you say, the banks have profited from high interest rates. It was for this reason that the Chancellor announced in the Budget a special tax for 1981-82 only on banks' deposits. We estimate that the yield from this should be around £400 million. The revenue raised from this new levy on bank deposits will allow relief to the severely pressed industrial and commercial sector, and especially manufacturing companies.

Yours sincerely

Margaret Thatcher

J.H.M. Mackenzie, Esq.

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TSB

TRUSTEE SAVINGS BANKS
CENTRAL BOARD

From
Sir John Read
Chairman

3 Copthall Avenue
London EC2P 2AB
Telephone 01-588 9292

24523

TOP COPY CH/EX

ACU
LAY

CH/EXCHEQUER	
REC.	23 MAR 1981
ACTION	Mr Pirie
COPIES TO	Mr Middleton
	Mr Monck
	PS/FST

formal
[illegible] that
we undertake by
a similar formal
note

√ 23/3

Dear Geoffrey,

I know this letter does not help in the great battle you are waging and which everyone wants to see you win.

However, I think it is a very fair request which I do hope receives favourable consideration.

Ever yours

John

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TSB

TRUSTEE SAVINGS BANKS
CENTRAL BOARD

From
Sir John Read
Chairman

3 Copthall Avenue
London EC2P 2AB
Telephone 01-588 9292

JR/DMB

19th March, 1981.

The Rt. Hon. Sir Geoffrey Howe, QC., MP.,
Chancellor of the Exchequer,
H. M. Treasury,
Parliament Street,
London, SW1P 3HE.

Dear Chancellor,

Special Tax on Banking Deposits

I am writing, on behalf of the sixteen regional Trustee Savings Banks and as a result of today's meeting of the TSB Central Board, to ask you to reconsider your decision to include Banks in the TSB Group within the ambit of the Special Tax.

For the undernoted reasons we believe that the TSBs, who are carrying out the programme of transition laid down in the Trustee Savings Banks Act 1976, as supported by all political parties at Westminster, should be exempted from the terms of the tax proposals.

The TSBs, apart from their very modest current account balances, operate on the narrowest of margins between the earnings of their portfolios and the rates offered to customers across a mix of deposit services. The total current account (non-interest bearing) balances at 20th November, 1980 were £555 millions which sum was held on behalf of 2,754,000 customers giving an average balance of £200 per account. Accounts with a maintained balance of £50 do not pay banking charges so it is obvious that no 'windfall profit' accrues to the TSBs in this sector. Indeed it is basically a loss leader and is used by the regional Banks to provide a cheap money transmission service for personal customers rather than attempt to process high transaction business more expensively, through the pass-book services.

The TSBs have presently approximately £1,100 million lodged at the disposal of the Treasury through the National Investment and Loans Office. On this vast balance the TSBs are paid 7½% p.a. in accordance with an agreement entered into prior to the 1976 Act. No matter how this issue is viewed the regional Banks are suffering revenue losses on this money akin to a crushing burden of tax, at source, at a time when the Treasury is enabling the competitive National Savings Bank to pay 15% p.a. to its depositors on one month's notice of withdrawal.

contd...

The TSBs have over the last three years unequivocally agreed to Treasury requests to support E.C.G.D. refinancing and thus play a part in reducing the P.S.B.R. Including the tranche promised for the forthcoming year the TSBs will have £650 millions committed to Export Refinancing which represents over 10% of their liabilities to customers.

The TSBs have no access to capital markets and must build their reserves to levels satisfactory to the Bank of England in the lead up to "recognition" under the Banking Act 1979. They have an enormous need to refurbish, re-site and reconstruct many branches of their networks and bear the cost of computer systems development and other automated processes if they are to have any success in their appointed role in competition with the Clearing Banks and other Institutions.

As a final statistic their pre-tax profits, from the commencement of their transitional period are as follows:-

20th November,	1976 (Actual)	-	£43.4 mn.
" "	1977 (Actual)	-	£77.6 mn.
" "	1978 (Actual)	-	£89.6 mn.
" "	1979 (Actual)	-	£92.1 mn.
" "	1980 (Actual)	-	£99.9 mn.
" "	1981 (Estimated)	-	£75.6 mn.

From the above it is clear that the TSBs have been steadily going about the business of equipping themselves financially and performing to pre-arranged plans as agreed with the Treasury and the Bank of England in pursuit of full banking status.

I hope I have demonstrated that no element of''windfall' profiteering' exists either in the non-interest bearing balances of the TSBs or in the historic build-up of their reserves, and I trust that you will reconsider the decision and exempt them from this Special Tax as a matter of both logic and equity. If this is not practicable, may I suggest that the base figure be raised to such a level as to exclude the smaller TSBs and other institutions who are obviously not your real target?

Yours sincerely,

John Rees.

Top Copy CH/EX. ACK copy

24806

CH/EXCHEQUER

REC. 25 MAR 1981

ACTION: Mr R I G ALLEN

COPIES TO: CST, FST, MST C, L, SIR D WASS, SIR K COUZENS, Mr BURNS, Mr RYRIE, Mr UNWIN, Mr CROPPER, Mr DIXON, Mr KEMP

From: Sir Brandon Rhys Williams, Bt., M.P.

59

26/3

HOUSE OF COMMONS
LONDON SWIA OAA

20 March 1981

for MST(L) 20/3

++ for OF's view? 24/3

Dear Geoffrey,

As I was not called in the Budget debate I am writing to put to you some points I would have liked to have made. Firstly, may I say how glad I am to welcome the increase in child benefit.

I would like also to welcome the index-linked fund for pension schemes. I am sure it is right to put the private schemes in a better position to keep retirement incomes up to date with economic changes and there are concealed savings to the Government if fewer people in retirement are obliged to resort to supplementary benefits as they grow older. I hope, however, that you will not again use the R.P.I. as the index. The British taxpayer does not control the level of prices. The public's commitment should be linked to some measure of the performance of the economy as a whole, such as the g.n.p., or the volume of earned income. The same factor should be used for uprating benefits in the National Insurance Scheme. The R.P.I. cannot enter into any viable insurance contract, and in using it as the bridge between public and private sector schemes you are not, in fact, closing the gap which separates them.

Public Sector Pensions

The reform of public sector pensions seems to me an urgent matter. I would not support de-indexation, but I think that here too the index used should be a measure of the performance of the economy as a whole, not the R.P.I. State servants should not be a protected elite, but should continue to belong to the national economy in their retirement like everyone else, participating in its ups and downs.

There is another reform of the public sector pensions schemes which I think ought urgently to be implemented. It concerns the level of contributions. I believe that the benefit of a guaranteed indexed pension is so valuable at the higher earnings levels that it should be paid for in higher contributions. It is difficult to assess what indexation is worth, but it is obvious that the public believes it to offer a most enviable advantage. It can be argued that the highest earners get more compensation for inflation than the lowest. State sector employees who retire with so little pension that they have to resort to supplementary benefit in fact get no effective uprating of their pensions at all, because their incomes are indexed anyway.

I therefore suggest that all public sector employees should be required to contribute an extra 10% of that part of their income which exceeds £2,000 a year. I understand that on that basis the yield of the extra

/contributions would be ..

contributions would be about a thousand million pounds a year. Though it might have the appearance of a rise in income tax of selective application, the higher contribution to state sector pension funds would in fact constitute an increase in savings which could properly be applied to the finance of a higher level of public sector investment.

The Balance of Consumption and Investment

This brings me to my main comment on the budget, which is that it still does not do nearly enough to channel spending away from consumption into investment. The public will accept the pressure of extra taxation on consumer goods and petrol provided that they can see a recovery of the economy coming quickly through modernisation and re-equipment. The best way to stimulate new ventures is to make a further reduction in interest rates.

The reaction of the market to the Budget shows that another cut in interest rates could safely be made immediately. Please therefore consider seriously the possibility of another cut in MLR at the first available opportunity, followed by further reductions at frequent intervals until the pound has fallen back to its real purchasing power parity. There is still a long way to go.

The Government's strategy should be to use the benefits of North Sea Oil to create an unusually favourable climate for investment in Britain through low interest rates, rather than a freakish opportunity to import goods into Britain at the expense of the home producers because of the artificial exchange rate and lethal levels of interest. What the country needs is an investment-led boom. The high exchange rate is simply creating an atmosphere of unreality which has nothing to do with sound money.

I do not support the petrol rebels because I recognise the need to finance investment in the public sector by taking resources from current spending, I still think, however, that you should instead have raised V.A.T., so as to spread the burden. The cost of living does not regulate wage settlements any longer, if it ever did; but if V.A.T. could be set in Britain for the foreseeable future at something like continental levels, it would give the economy somewhat more of a slant towards investment and exports and away from consumption, which is what is urgently necessary.

There is no time to be lost in creating the conditions in which the investment-led boom can get under way, because capital projects inevitably take a long time to mature. I realise that it is the Government's strategy to encourage investment by stabilising the purchasing power of the currency, but that is patently not enough, particularly since, by the methods you have chosen for attacking inflation, you have created an unfavourable climate for capital expenditure and are thereby defeating the main purpose of your whole endeavour.

I recognise that North Sea oil makes London a popular place for foreign investors and currency speculators, but you have a choice between a high exchange rate, giving an artificial stimulus to the consumption of imports, or a lower-than-average level of interest rates, whereby

/to give a boost ..

to give a boost to investment. I would like you to take much more active measures to bring the sterling exchange rate broadly into line with its purchasing power parity and I do not believe it would prove as difficult as is often made out.

Reviving the Propensity to Invest

There are three main ways in which I believe the Government should act to restore investors' confidence. I accept that they are long-term projects, but investment is a matter of long-term decisions. Entrepeneurs must be convinced that there are favourable answers to each of the following questions:

1. "Will the unions return to a policy of cleaning up equity profits and imposing restrictive practices as soon as the economy revives?"

I do not recommend the re-introduction of a national incomes policy to govern remuneration in the private sector, any more than I would suggest a national procurement policy to fix the level of stocks. What we need is a granular incomes policy, in which each firm comes to its own decision about remuneration, but the aggregate effect of all the decisions is such as to keep wages in line with the level of consumption that is warranted by the performance of the economy as a whole. To achieve this aim the Government needs to take positive measures. We have to find a cure for the industrial sickness which manifests as the "two sides".

In the last two years the end of this unhappy syndrome (what I call "playing Normans and Saxons") has come within sight. We must now seek to bring about an "Historic Compromise", under which investors and workers, through their representatives - the managers and the trade unions - arrive at a real form of partnership. We have to demonstrate to the unions that their new role is to create the conditions in which capital is attracted to the service of the working group.

Will look further

I will deal with this idea more fully in another letter, but in principle I think that investors have to be persuaded - as their part of the bargain - to content themselves in future with dividends related to value added rather than profit. Company tax should accordingly be adjusted to encourage the adoption of a new class of share which reflects this change.

If investors give up the right to an equity profit, the free collective bargainers must give up the right to strike. This compromise is the only practical foundation for an incomes policy that will last and hence of the higher propensity to invest, without which private capital cannot again become really fruitful in this country.

I will try to draft an appropriate amendment to the Finance Bill, but of course it needs more than a change in the principles of company tax to achieve the fundamental changes of role that are needed. The essential point I want to make is that the Government should now be moving towards industrial peace on all parts of the front. We must show that Britain does not have to choose between mass unemployment and a national incomes policy because we can offer a third way.

/This is a ..

This is a serious matter in political as well as in social terms because, if we fail to offer a convincing escape from the dilemma, the voters will inevitably turn back toward incomes policy as a lesser evil than unemployment.

2. "Can we depend on continuity of political policy towards business not just from year to year, but from Parliament to Parliament?"

I do not believe that we shall convince investors that the climate for enterprise will remain predictable and benign over the span of time necessary for really fruitful investments to mature without some measure of electoral reform. The Government will not secure a revival of investment on the scale we need simply by getting the rise in the R.P.I. down to single figures during a short span of time, during which exceptional factors can be seen to be operating. You have to create a general sense of confidence that it is not just the present Government, but the next and the next and the one after that, which will now stick to policies which maintain economic stability. You will not "get inflation out of the system" until there is more general confidence in the system's likelihood of long-term survival in something like its present form.

I realise that this is not a matter for the Budget, but I mention it because I believe it has a significant bearing on the choices people are making between consumption and saving.

3. "Will international monetary conditions evolve in a reasonably predictable way?"

I believe that the breakdown of the Smithsonian agreement marked the final collapse of the gold standard, but that the present floating regime being operated by I.M.F. member states is not a substitute. We are merely going through a period of transition towards another kind of world monetary regime. Sooner or later some decision-making agency will win acceptance for a new, permanent, internationally respected measure of value. I do not think that the maintenance of a stable national paper currency is compatible in the long run with universal suffrage.

We accordingly should place no confidence in the S.D.R. or the E.C.U. or any other contraption twisted together out of paper. It seems clear that the market will eventually establish an alternative currency founded on tangible values. If it does not, we shall find we have slipped inexorably into semi-socialist economic regimes in all democratic countries, under which no important investment project can ever again be financed unless it is underwritten by the taxpayer.

I am aware of the resistance that is felt to any resort to indexation; but the critics should learn to discriminate. The gold standard was merely a system of indexation. We have to distinguish between the use of indices which are inherently poisonous for the economy, like the R.P.I., and others which induce stability and discipline.

/The British Government ..

The British Government - and indeed the American too - is on a futile quest if it hopes to restore the golden age of private capitalism on the basis of its own paper currency alone. We should be doing everything possible to accelerate the arrival of a new international monetary regime, beyond the influence of politicians, to which we can all relate. No single ethnic paper currency can bear the weight of the re-industrialisation of the West.

Economic nationalism will soon be seen to have failed and governments and central banks in democratic countries will come under increasing pressure to stop "doing their own thing". The voters themselves are learning the lesson. Having brought about the end of the gold standard they will soon insist on its being replaced by some other international regime as far as possible beyond manipulation by sectional interests. As a guess, I would say that the "energy standard" seems the most likely eventual winner.

During the period of transition we have to make the best we can of the adverse climate for private sector investment which has been induced by the alarming unpredictability of interest rates and rates of exchange. We should therefore seek to enter into a workable currency pact which will lend a greater measure of stability to the British economy than we could ever achieve on our own.

The campaign simply to attach the pound to the E.M.S. seems to me to be misjudged. We have first to overcome the special problem (which only really afflicts London and Frankfurt) that the importance of capital movements is so great that they can dominate the market. In the prevailing conditions in the principal world financial centres the movements in and out of sterling can be enormous. No stabilisation fund, however large, could bear the pressure which sudden changes of sentiment can generate. The impact of capital transfers into and out of sterling can only be carried on the rate of exchange.

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<u>A United European Market for Capital</u>

To build up a zone of stability in the currency markets of Western Europe we have therefore first to create a united European capital market - or time-zone - in which London is only one of the principal centres. If there were no restrictions on the movement of funds in and out of the other main European financial centres and if, over the course of time, it had been possible to build up the range of ancillary services to hold the European capital market together, (i.e. the Stock Exchange, the commodity markets, the money-transfer systems, insurance,

/export credit ..

export credit, personal contacts, etc.) the effect of any sudden movements of funds, which would be de-stabilising in isolated markets such as we have now, would be spread automatically by arbitrage across the whole of the European monetary system, or even wider. Pressure to buy sterling in large volumes, for example, would have the effect of immediately raising the other currencies in the time-zone as well, so that the cross-rates would be much less volatile and the whole system would tend to move up and down with the minimum of internal distortion.

My final recommendation, therefore, is that the Government should actively follow up its de-restriction of the capital market in London by pressing other Community member states to follow suit. The creation of a unified European market for capital is envisaged in the Treaty. I suggest we should take the opportunity of the British presidency this year to get it accepted by our European partners as a practical objective. An Anglo-German monetary agreement might be the best way to start.

Yours ever

Brandon

The Rt. Hon. Sir Geoffrey Howe, QC, MP,
Chancellor of the Exchequer,
11 Downing Street,
London S.W.1.

24774

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Standard Telephones and Cables Limited

CHAIRMAN AND CHIEF EXECUTIVE
Sir Kenneth Corfield

STC HOUSE
190 STRAND LONDON WC2R 1DU

TELEPHONE: 01-836 8055
TELEX: 22385
TELEGRAMS: RELAY, LONDON, WC2

TOP CH/EX

CH/EXCHEQUER
REC. 25 MAR 1981
ACTION MR NORTON
COPIES TO PS CST
MR RYRIE
MR BURGNER

23rd March, 1981

The Rt. Hon. Sir Geoffrey Howe, QC, MP,
Chancellor of the Exchequer,
11 Downing Street,
London, SW1

Dear Sir Geoffrey,

Your invitation to discuss and enlarge upon the contents of my letter of the 6th March was warmly appreciated, as indeed was the time you so generously allocated this morning.

I hope that I managed to convey something of the importance of the opportunity for the British telecommunications industry and of the high technology industries which depend upon it, to become one of the handful of world leaders through the modernisation programme for the British network and the investment in the next generation switching system which we call System X.

The design, development and manufacture of these products lies squarely in the private sector which will provide the working capital required and productively employ tens of thousands of people.

That the responsibility for the overall project lies with British Telecom is a matter of fact and that similar responsibilities are discharged by national authorities in our competitor countries is also a fact. Though there are many calls upon the national budget, this investment is seen to have outstanding merit in each of the highly industrialised countries.

The difficulties with which you are faced were not lost upon me and I agree that British Telecom should give a firm undertaking that any funds that they may be permitted to borrow for this purpose should be used only in the successful prosecution of this essential investment.

In closing may I repeat how grateful I was for the opportunity to put these and other points to you and for the close attention which I felt you paid to them.

Yours sincerely,
Kenneth Corfield

Registered in England, No. 106921
Registered office STC House, 190 Strand, London WC2R 1DU

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10, OWNING STREET,
WHITEHALL S.W.1

With the Private Secretary's Compliments

All pages between 1 and 2 to be referred to Cabinet Office

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10 DOWNING STREET

CH/EXCHEQUER 24846
REC. 26 MAR 1981
ACTION
COPIES TO

THE PRIME MINISTER

25 March 1981

Dear Mr White.

I am replying to your letter of 16 March with which you enclosed one from Mrs. E. Thomson, a constituent of yours.

May I assure Mrs. Thomson that I am as concerned as anyone about the waste and heartache caused by unemployment. It is an illusion however to think that any Government can switch employment off and on like a tap. Unemployment is increasing now, but has been on a rising trend for several years, because of deep-rooted problems within our economy, such as past failures to adjust and low productivity. These problems have been with us for decades and can not be remedied overnight. The best way that Government can help industry and therefore secure improved job prospects, is to pursue responsible financial policies. This will curb inflation and bring down interest rates. The Budget was an important further step in this process.

The Government is particularly concerned to help the most disadvantaged among the unemployed, namely school leavers and young people generally. This year the Youth Opportunities Programme will ensure that a place in training is offered to all unemployed school leavers by Christmas.

/I sympathise

I sympathise wholeheartedly with Mrs. Thomson's concern over inflation. Our policy against inflation is showing real signs of success. The rate of inflation has fallen sharply since last Spring and further significant falls are in prospect with the rate perhaps into single figures around the turn of the year. A combination of earlier artificial price restraint and worldwide increases in the cost of energy has meant that gas and electricity prices have increased faster than prices in general.

In conclusion may I offer Mrs. Thomson my sympathies for the difficult circumstances in which she finds herself: I hope that her situation will soon improve.

Yours sincerely,

Margaret Thatcher

Frank White, Esq., J.P., M.P.

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10, DOWNING STREET,
HITEHALL S.W.1

With the Private Secretary's Compliments

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10 DOWNING STREET

THE PRIME MINISTER

25 March 1981

Dear Dr Corcoran

I am replying to your letter of 13 March with which you enclosed a letter you had received from Mr. Chapman, a constituent of yours.

Mr. Chapman states that the Budget helped businesses at the expense of the personal sector. That indeed was the Budget's intention. Between 1977 and 1980, the real (ie after allowing for inflation) after-tax income of individuals rose by about one-sixth. But the real disposable income of industrial and commercial companies fell by one-quarter. By helping business, the Budget will help employment and foster recovery. The personal sector has not been alone in providing the wherewithal to help business; those companies that have weathered recent times well are contributing. That is why we have introduced a further tax on oil companies North Sea operations and imposed a levy on the banks.

Mr. Chapman questions the justification for increasing pensioners' income. We think it only right that the weaker sectors of society should be protected. That is why we have maintained over time the real value of pensions; that is why we are sustaining the growth of NHS expenditure; and that is why the Budget gave special help to the blind and handicapped. Families have been helped by full price protection of child benefit.

/I agree

I agree wholeheartedly with Mr. Chapman in regard to the need for improved productivity. I recognise that improved incentives through the tax system will facilitate this. The projected level of public expenditure implies a tax burden significantly higher than the Government would wish. There is a limit to the amount of expenditure that can responsibly be covered by borrowing. By responsible I mean without placing unacceptable pressures on interest rates and inflation. After a certain point extra expenditure has to be paid for by higher taxation. This fact of life was reflected in the Budget. Such hard realities cannot be described as 'immoral theft'. The alternative is inflation, which redistributes income covertly, hitting the poorest sections of the community worst.

Yours sincerely,

Margaret Thatcher

The Right Honourable John Concannon, M.P.

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10 DOWNING STREET,
WHITEHALL S.W.1

With the Private Secretary's Compliments

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10 DOWNING STREET

THE PRIME MINISTER

27 March 1981

Thank you for your letter dated 3 March enclosing copies of correspondence from one of your constituent firms, Transparent Paper Limited, about the price of gas to industry which you copied to Keith Joseph, Geoffrey Howe and David Howell. Joel Barnett also wrote to David Howell about a similar letter he had received from Transparent Paper. I am replying on behalf of myself and my colleagues.

Energy is becoming increasingly scarce worldwide. For every three barrels of oil which are used, only two are being discovered. World prices for energy have risen very sharply and will continue to rise in the future. Against this background the Government's approach to UK energy prices is that each fuel, including gas, should be so priced as toreflect the full cost of supply on a continuing basis, taking account of short and long term market factors.

The aim is to give accurate signals to consumers about the cost of energy consumption, to achieve a balance between supply and demand and to promote energy conservation. In the particular case of gas, the British Gas Corporation have a well-established policy of relating prices broadly to that of the competing oil product. This policy is the Corporation's own, but has been endorsed by successive governments as the best means of balancing supply with demand, particularly at times of shortage such as the present.

/With the

With the increase in oil prices and uncertainties over oil supplies in 1979, there has been a massive upsurge in the potential demand for gas which British Gas are at present unable to meet during periods of peak winter demand. To hold prices down now would only make matters worse. Nevertheless, British Gas have modified the impact of their industrial pricing policy in response to the problems being faced by industry generally. Since last spring they have been renewing firm industrial contracts at less than the price of the competing fuel, gas oil, so that they are now at about 70 per cent of this price. The Gas Corporation have also decided to modify the price in all 3 year contracts, after the first year. And, most recently, as we announced on 10 March, they are also to hold the prices at which they renew industrial contracts at their present levels until 1 December and will not apply the provisions for price escalation in existing firm gas contracts.

Other countries, too, are having to face major increases in energy prices. Although the rise in the value of sterling has made it less apparent from the UK, prices of gas to French industry have risen by up to 120 per cent, over two years, while the Germans have experienced similar rises to ours.

The whole subject of comparative energy prices was examined in the recent NEDC Task Force Report. This found that prices to the majority of industrial fuel consumers are in line with the rest of Europe. The report did identify disparities for large, energy intensive users of gas and electricity. To an important extent these have been due to the strengthening of sterling against other European currencies during the second half of last year. We have announced further measures in addition to the action already being taken by the gas and electricity industries, at a cost of some £120 million in 1981/82, to assist customers affected. The Government will also be providing grants to assist industry in coverting to coal. Details are set out in the enclosed press notice.

/Finally,

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Finally, Mr. Fairbarns refers to details of his firms' contract with British Gas. It would not be appropriate for the Government to intervene in these matters and although Mr. Fairbarns has already had discussions with the Corporation I am copying this correspondence to the Chairman asking him to look into these more detailed points and reply to you direct.

I am copying this letter to Keith Joseph, Geoffrey Howe, David Howell and Joel Barnett.

Yours sincerely,

Margaret Thatcher

F.R. White, Esq., JP, MP.

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10 DOWNING STREET

THE PRIME MINISTER

30 March, 1981.

Dear Nicholas,

Thank you for your letter of 23 February, with which you

I have also seen a copy of Geoffrey Howe's reply to you. I hope that this will help to reassure Mrs. Whitworth that we have by no means forgotten the difficulties facing families like hers. It will inevitably take time for the changes we have made to bring major benefits to small investors, but we have set in hand many measures which will prove to be of real benefit as the national economy begins to recover.

Yours ever,

(SGD) MT

Nicholas Winterton, Esq., M.P.

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10 DOWNING STREET,
WHITEHALL S.W.1

With the Private Secretary's
Compliments

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10 DOWNING STREET

THE PRIME MINISTER

31 March 1981

Dear Mr. Rowlands,

Thank you for your letter of 4 March about the recent announcement that Hoover are being forced to declare 287 redundancies at their Merthyr Tydfil factory and operate short-time working. You copied your letter to Nicholas Edwards and I have been in touch with him.

These measures by Hoover are of course part of the overall cut-back the firm are being obliged to make - almost 900 redundancies in all - which also involve 400 jobs at Cambuslang and 200 at Perivale. They reflect the falling demand for the home-produced product and of course the competition from imported appliances, about which I know you have been expressing your concern recently with the Departments of Industry and Trade. On this latter question I understand that the Department of Trade feel that in the context of imports from Italy there is not sufficient past evidence that there has been a breach of the Treaty of Rome to bring a promising case formally to the European Commission.

/ But

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But Cecil Parkinson has, as you know, written to Mr. Andriessen, the new Commissioner for Competition, to ensure that no question of improper subsidisation arises.

I very much welcome the improvement in productivity at the Merthyr Tydfil factory, and it is especially disappointing that the fall in demand for washing machines is necessitating a further cut-back in employment. The reduction in interest rates announced in the Budget (and some weakening of sterling which is becoming apparent) can, I hope, be expected to ease Hoover's problems. This, together with further measures which the company will, I am sure, be continuing to take to achieve greater efficiency, ought to help to secure the future against the time when the economy picks up.

Yours sincerely,

(sgd) Margaret Thatcher

Ted Rowlands, Esq., M.P.

25699 40

* Top copy Ch/ex Acu LA7

CH/EXCHEQUER
REC. - 2 APR 1981
ACTION Mr H. Davies
COPIES TO PS | C + E

HOUSE OF COMMONS
LONDON SWIA OAA

3/4

1st April, 1981.

Dear Geoffrey,

I was invited to attend a meeting last Friday evening with members of the six NFU branches that are situated within my constituency, or which overlap its boundaries.

They put to me their anxieties about the financial plight of agriculture, using the basic arguments that have appeared in recent NFU briefing. I need not repeat the details as they will be very familiar to you.

They particularly left me with the impression that they are finding it difficult to carry out their investment plans. Many overdue projects have been deferred. This could of course lead to a decline in the effeciency of agriculture, after many years during which it has been one of our most successful industries.

I have written to Peter Walker about some aspects of the meeting, but meanwhile I thought I should convey two points to you.

(a) They are earnestly hoping for further reductions in MLR before long, and would then appreciate a period of stability so far as interest rates are concerned.

(b) They criticise the fuel tax increase in the Budget and put very heavy emphasis on diesel fuel. I defended the Budget in our discussion but I feel I should pass on to you the impression that any reduction that could be made in the increase on diesel fuel, when it comes to the Finance Bill, would be very helpful indeed to farmers (and no doubt to people in other industries).

I would be most grateful if you could let me have a letter which I could circulate to those who were present.

Yours,
Reg

Reg Prentice

The Rt. Hon. Sir Geoffrey Howe, Q.C.,M.P.,
Chancellor of the Exchequer.

81

10, WNING STREET,
WHITEHALL S.W.1

With the Private Secretary's
Compliments

82

10 DOWNING STREET

THE PRIME MINISTER

6 April 1981

Dear Mr. Prescott,

You wrote to me on 17 March with a letter from

value added tax and charities.

There seems to be an impression that the actual money donated to charities is subject to VAT. This is not the case. Most charities do not pay VAT as such: it is paid by the people who supply goods and services to them, and they pass it on as part of the price they charge. Charities are affected by VAT only to the extent that they spend their income on things subject to VAT, but they spend a great deal on things that do not bear VAT, such as staff costs, the rent and purchase of buildings, food, and cash grants. On average, the proportion of donations that goes in VAT is really quite small.

What charities want is to be able to claim a refund of the tax that their suppliers have paid and passed on to them as part of a price. This would put heavy administrative burdens on all concerned. I do <u>not</u> think that VAT relief for charities would be unfair to the rest of the community, but it would be very difficult to administer fairly, and I do not believe that it is the right way to help them. I want to help charities as much as Government resources permit in these difficult times and there are other approaches. In his Budget last year, Geoffrey Howe announced a new package of

/reliefs

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reliefs from direct taxation (income tax, capital gains tax and development land tax) specially designed to help charities. We think it will be worth about £30 million a year when it is in full operation. This is building on an existing system of relief for charities which has been found to work well in the past, and can work even better in future if charities can persuade generous folk to give regular donations under covenant, which brings relief from income tax.

I do hope that this explanation helps to make our attitude clearer, and that Mr. Powell will reconsider his decision not to contribute any more.

Yours sincerely

Margaret Thatcher

John Prescott Esq, M.P.

84

10 Downing Street,
Whitehall S.W.1

With the Private Secretary's
Compliments

85

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10 DOWNING STREET

From the Private Secretary

6 April 1981

The Prime Minister has asked me to reply to your letter of 6 March about the VAT affairs of your company.

As a registered trader, the Blue Arrow Staff Service is required to make returns, and to pay any tax which is due, within one month after the end of each three-monthly accounting period. The company therefore has from one month to four months before it has to remit to Customs and Excise the tax charged on supplies made to its customers, less the tax charged to it by its suppliers during the same period. This is a situation from which most businesses derive a cash-flow benefit.

I understand from Customs and Excise that your company has persistently failed to make returns and pay tax when due, and that the return for the tax period 1 September to 30 November 1980 was not made until 3 March 1981. Although this return showed £98,474.59 tax to be due it was accompanied by a payment of only £40,000.00 and a request for deferred payment of the balance until 18 March.

Customs and Excise have a statutory responsibility for the care and management of VAT and cannot normally agree to its retention as working capital in a business after the date when it is due to be remitted. They are, however, prepared

/ to assist

to assist businesses which find themselves in unexpected difficulties by accepting brief delays in payment. Such assistance has been given to your company before but there is a limit to how far it can go as public funds have to be safeguarded and deficits in the revenue have to be made good by increasing the Government's own borrowing.

In view of your company's previous history of delayed payment, Customs and Excise felt unable to agree to a further delay. A demand for immediate payment was, therefore, delivered to your premises. Normally, such demands are sent by post. In this case, however, because an officer from the local VAT office was making a visit to your premises, this demand was delivered by hand. The officer asked to see a director but as none was available gave the letter to the person responsible for the company's VAT affairs with whom he normally dealt. This seemed to be a reasonable action at the time, but the Commissioners ask me to convey their apologies for the embarrassment which has resulted from it.

I understand that you paid the balance of the tax due on 18 March and that, happily, no question of levying distress for that period now arises.

M. A. PATTISON

E. C. Hood, Esq.

87

26235

See + urgently

RAC

Motoring Services

JAW/IWL

83 Pall Mall
London SW1Y 5HW
Telephone: 01-839 7050

The Rt. Hon. Sir Geoffrey Howe, QC, MP,
Chancellor of the Exchequer,
The Treasury,
Treasury Chambers,
Parliament Street,
London SW1P 3AG

8th April 1981

√9/4 TOP CH/EX ACK LAY

CH/EXCHEQUER
REC. -9 APR 1981
ACTION PS CTE
COPIES TO CST FST MST(C) MST(L) SIR D WASS MR RYRIE O/r MR MIDDLETON MR BATTISHILL MR UNWIN MR CORLETT MR GRIFFITHS MR CROPPER PS IR

18
13/4

Dear Chancellor,

MOTORING TAXATION AND ROAD EXPENDITURE

In my previous letter dated 23rd February, I set out the view of the RAC on motoring taxation and road expenditure for your consideration prior to the Budget Statement. Regrettably, however, you decided to impose swingeing further increases of motoring taxation.

With no plans to increase the grossly inadequate level of road expenditure, I have to tell you that there is growing dissatisfaction about the unfair and ever-increasing gap between the revenue obtained from road transport users and the Government's expenditure on roads and other essential ancillary facilities.

In answer to a recent Parliamentary Question it was confirmed that the ratio between the motor tax income and the attributable public road costs previously at the unacceptable level of 2.2:1 has now risen to 2.6:1 for all motor vehicles and from 2.8:1 to 3.2:1 for cars. The calculation for this purpose, however, takes no account of the revenue from VAT on sales of cars and motor fuel. The British Road Federation has estimated that inclusion of the income from that source would raise the above mentioned levels to 3.3:1 for all vehicles and 4.6:1 for non-business cars and 3.8:1 for business cars.

The Parliamentary debate following the Budget Statement demonstrated that Members of Parliament are well aware of the discontent of motorists in all parts of the country about the hardship caused by the increases. It surely must be recognised that motoring is essential for the mobility

of a high proportion of the community for purposes such as travel to work - especially residents in rural areas and shift workers who are particularly dependent on private transport due to the inadequacy of public transport. Moreover, the increased taxes will inevitably raise substantially the cost of living.

The RAC has decided that it must launch a campaign to encourage motorists and motor cyclists to make their strong feelings known to MPs in order to persuade them to influence you to reconsider your Budget strategy and to reduce the excessive motor tax increases. I enclose a copy of a press notice announcing this together with one of the campaign leaflets which will be distributed in all parts of the country.

I urge you to reconsider your strategy in this matter. Press reports have suggested that consideration is being given to other ways to raise revenue to compensate for any reduction of the petrol tax including perhaps a new tax on the towing of caravans. I must point out that such a measure would not raise a large sum and would be regarded as an unfair burden on caravanners who already provide additional revenue because a car's m.p.g. is usually considerably lower when towing a caravan.

It has also been suggested that you might decide to introduce a lower rate of tax for diesel fuel. We wish to stress that this would in no way placate motorists and motor cyclists who would be all the more incensed if they could obtain no benefit from any such arrangements.

Moreover, a move in this direction would undoubtedly result in much greater use of diesel engined cars imported from countries where lower diesel costs have encouraged the growth of production in this form. I therefore also urge that no decision be taken to introduce differential rates of tax in favour of diesel fuel without prior consultation about the implications of this with all interested bodies.

I very much hope that you will find it possible to take account of the considerable outburst of public resentment at the new level of fuel tax because it has put an unacceptable burden on the use of the car and the motor cycle which must now be regarded as essential for the movement of people in business, at work and in private life.

Yours sincerely

J A Williams

J. A. Williams
Chairman
Public Policy Committee

80

RAC

Support our Campaign

STOP THIS RIP-OFF

£70 Car Licence		83p Petrol Tax
+£10	1981	+20p
+£10	1980	+22p
£50	1979	41p

PROTEST TO YOUR M.P.

After the 1981 Budget •

PETROL TAX + VAT
Now 83p per gallon
Doubled in 2 years

MOTOR TAX REVENUE
Now £8,450 million per annum
Up 49% in 2 years

VEHICLE TAX
Now £70 per car
Up 40% in 2 years

GOVERNMENT TRUNK ROAD SPENDING
Now £600 million per annum
Down 2.5% in 2 years

THESE FIGURES AFFECT EVERYONE'S COST OF LIVING

MOTORING IS NOT A LUXURY – IT'S ESSENTIAL

Second fold under

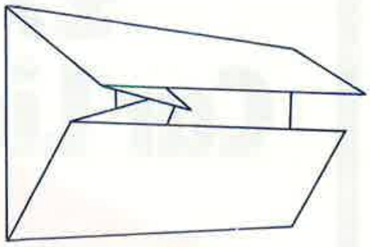
STAMP

....,

M.P. for ....
House of Commons
London SW1A 0AA

First fold under

Send this form to your M.P. Now!



To post, simply fold as indicated, tucking in the flaps to form an envelope.
Please affix Postage Stamp

Third fold under and tuck in

I SUPPORT THE RAC CAMPAIGN TO CUT MOTOR TAXES

Signed ....

Address ....

....

....

PLEASE TELL THE CHANCELLOR – THIS MUST STOP

FROM PRESS AND PUBLIC RELATIONS

RAC NEWS

Press Enquiries: 01-839 7050 (9.30—5.30) 01-930 9142/3/4 (all other times), 83—85 Pall Mall, London SW1Y 5HW.

80 years of service to the motorist and the nation

10

8th April, 1981

'STOP THIS RIP-OFF' - RAC

Campaign Against Increased Motor Taxes

A nationwide 'Stop This Rip-Off' campaign attacking the Government's increases in taxes on petrol and motor vehicles was launched by the RAC today.

Tens of thousands of leaflets have been distributed to all parts of the country urging Britain's 25 million motorists and motorcyclists to make strong protests to their MPs.

The leaflet, which needs only be signed and posted, points out that tax on petrol has doubled in two years and now totals 83p a gallon, and the vehicle tax has gone up by 40 per cent to £70 a year for a car in the same period.

It also states that during the same two years motor tax revenue has risen by 49 per cent and now totals £8,450 million a year.

Yet Government spending on trunk roads is down by 2.5 per cent to only £600 million a year. Moreover, as a result of the succession of cuts in earlier years, it is about 31 per cent less than the expenditure in the mid-70's when the total income from motoring taxes was only about £3,000 million.

Mr. Jack Williams, Chairman of the RAC's Public Policy Committee, said: "This latest move by the Chancellor is the biggest rip-off the motoring public of this country have ever had to face. There is an enormous surplus - now at a level of £6,000 million - taken by the Exchequer after allowing for all attributable public road costs, including expenditure by local authorities as well as Government.

/more.....

"We have launched this campaign because there is widespread discontent throughout the country about the excessive level of motoring taxation which is causing great hardship.

"It is time for the Government to recognize that motoring is in no way a luxury. Cars and motorcycles have to be used by a large section of the British public for very many essential purposes, including travel to and from work, especially by people living in rural areas and shift workers who are dependent on this because of inadequate public transport services".

In a letter to the Chancellor of the Exchequer, Mr. Williams has stressed that the increased motor taxes have inevitably raised substantially the cost of living and he has urged the Chancellor to lower the petrol tax as soon as possible.

- ends -

MEM. TO EDITORS: Copy of leaflet enclosed

To Wiggins Treasury

Caxton House Tothill Street London SW1H 9NA
Telephone Direct Line 01-213 6400 GTN 213
Switchboard 01-213 3000

Tim Lankester Esq
10 Downing Street
LONDON SW1

9 April 1981

Thank you for your letter of 2 April in which you asked for a draft reply for the Prime Minister to send in response to a letter from the Director General of the Institute of Directors.

I am sending a copy of the draft to recipients of your letter.

MARIE FAHEY
Private Secretary

93

3

Walter Goldsmith Esq
Director General
Institute of Directors
116 Pall Mall
LONDON SW1Y 5ED

Thank you for your letter of 31 March about consultations on the Green Paper on trade union immunities.

The Government is expecting to receive comments on the Green Paper from the main employers organisations by 30 June and, as you may know, Jim Prior has told the TUC that he cannot extend the consultation period. I realise that for some organisations this is a tight timetable and that they may be able to let us have their considered views only around the end of June. It will, of course, take a little time after the end of consultations to assess all the comments received. However I can assure you that this timetable would not preclude further legislation in the 1981/82 Parliamentary Session if that were shown to be necessary or desirable.

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10 DOWNING STREET

From the Private Secretary

2 April, 1981.

Dear Richard,

I would be grateful for a draft reply for the Prime Minister to send in response to the enclosed letter from the Director General of the Institute of Directors.

I am sending a copy of this letter and its enclosure to John Wiggins (HM Treasury), and David Heyhoe (Office of the Chancellor of the Duchy of Lancaster).

Yours sincerely,

Tim Lankester

Richard Dykes, Esq.,
Department of Employment.

From the Director General

ctor General
lter Goldsmith

116 Pall Mall
London
SW1Y 5ED
Telephone
01-839 1233
Telegrams
Boardrooms
London SW1
Telex 21614

95

Rt. Hon. Margaret Thatcher MP,
Prime Minister and First Lord of the Treasury,
10 Downing Street,
London SW1

31st March, 1981

Dear Prime Minister,

As I am sure that you will be aware, a large number of employer organisations and other groups representing commerce and industry will be submitting their views on your government's Green Paper on trades union immunities.

My purpose in writing to you now is to raise a technical point. Many groups are unlikely to be in a position to make their submissions until the end of the consultation period of 30th June. Yet, in the event of a clear consensus emerging upon the need for legislatory reform, doubts have been raised as to whether this timetable would allow the government to include such legislation in the 1981-2 parliamentary session.

To my certain knowledge a great deal of staff time and resources, together with voluntary work of lay committee members is being devoted to this particular consultation exercise throughout the representative business organisations.

In these circumstances I should be exceptionally grateful for your reassurance that the exigencies of the parliamentary timetable will not set at nought all these endeavours should a common view emerge.

Yours sincerely

[signature]

WALTER GOLDSMITH

P.S. The Institute of Directors plans to have its' submission ready by the end of May to help generate debate during June. Walter

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Caxton House Tothill Street London SW1H 9NA
Telephone Direct Line 01-213 6400 GTN 213
Switchboard 01-213 3000

Tim Lankester Esq
10 Downing Street
LONDON SW1

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97

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Institute of Directors
116 Pall Mall
LONDON SW1Y 5ED

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plus

PR PL 98

cc Mr Wiggins
Mr Mathews
Mr Warden
Mr Michael
Mr Unwin
Mr G. Ingham - HF3
(for information)

10 DOWNING STREET

From the Private Secretary

10 April 1981

Dear Stephen.

Thank you for your letter of 9 April about correspondence addressed to Alan Walters.

We see no difficulty in the arrangements which you propose: indeed, I think Alan will welcome not having to write substantive replies himself, except where he particularly wishes to.

As regards the letter of 20 February from the International Textile Company, Alan has in fact already replied to this one (copy enclosed). He has now had a further letter from this company, and I have suggested that he finish this one off himself. Of course, this is the kind of letter which in future we would deal with under your approach (ii) as you suggest.

I am sending a copy of this letter to John Wiggins.

Tim Lankester.

P.S. I see that you are arranging for an official reply from the Treasury to the International Textile Company. In view of what I have said above, you will no doubt stop this.

S.A.J. Locke, Esq.,
HM Treasury.

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10 DOWNING STREET

12 March 1981

Dear Mr Robinson,

Thank you for your letter of 11 March. We have checked our files and we cannot find having received your letter of 20 February, a copy of which you have subsequently sent to me.

I gather that your main objective is to put an additional tax on all credit, presumably except building society credit, which would be over and above the normal income tax paid by those who receive interest payments. As you can well imagine, it is an idea which has been already tried extensively in many other countries with various mixtures of regulation and control. For example, the United States operated a regulation Q which restricted the rate of interest payable on deposits. Correspondingly, there was also an interest rate equalisation tax. More recently I have seen similar systems in operation in Argentina and Chile.

As you would expect, however, such taxes on intermediation by the banking system result primarily in credit being diverted out of the banking system. I suppose the best example of that in Britain in recent years was the institution of a corset from mid-1978 to mid-1980. Essentially banking intermediation was taxed by virtue of increased reserve requirements. This resulted simply in the diversion of credit outside the banking system. And in America the institution of regulation Q simply resulted in the shift of the capital market from the United States to the Euro dollar market in London. Similar effects have occurred between Germany and Luxembourg. It seems highly likely to me, for example, that if people in the United Kingdom saw that they could get only 5% from the banks and yet they could buy 20% dollar CDs in New York, they would be highly unlikely to put much money into the British bank. If you had stringent exchange controls, then of course everything would be different. You would have to, of course, stop all the leaks - a difficult job as you will recall with respect to the Kuwait gap, etc.

Since you would have such a small supply of credit flowing into the sector that was not zero rated, that is the private, industrial and commercial sector, I suspect that, unless credit was rationed, the interest rates would be extraordinarily high, or the sector would get most of its capital by overseas borrowing, probably from British funds that have fled overseas!

In short, I believe that your suggestion would give rise to a bad policy. I do not deny that the banks make considerable profits on their current account deposits during years when the interest

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rates exceed the costs, put at about 9%, of servicing those accounts. As you will have seen, the Chancellor has imposed a once and for all levy with respect to these accounts.

Finally, I would add that I doubt if politicians would have any difficulty in understanding your proposal. If I may say so, you expressed it with admirable clarity and brevity.

Yours sincerely

A A Walters

P.N. Robinson, Esq.,
International Textile Company,
Victoria Mill,
Skipton,
Yorkshire,
BD23 1QX.

101

10, DOWNING STREET,
WHITEHALL S.W.1

With the Private Secretary's Compliments

Cabinet Office

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10 DOWNING STREET

THE PRIME MINISTER

13 April 1981

Dear Sir Herbert,

Thank you for your letter of 8 April. The illustration you provide of the positive assistance offered by the Chancellor is most helpful. I am grateful to you for taking the trouble to set this down for me.

Yours sincerely,

(sgd) Margaret Thatcher

Sir Herbert Redfearn, J.P., D.L.

BK

ASH LEA. WOODHOUSE LANE BRIGHOUSE, WEST YORKSHIRE HD6 3TH

TELEPHONE BRIGHOUSE 714813

105

P 10/4

8th April 1981.

Dear Prime Minister,

I believe that (so far as manufacturing companies are concerned) the most difficult period will be summer and early autumn when the half yearly accounts are produced, and that you will require to muster all your arguments and powers of persuasion again to prevent some of your back-benchers from making derogatory speeches during the summer recess.

Many companies similar to ours have this year in particular been insulated from the worst of the recession in the eyes of their shareholders because of the exceptional credit of stock relief taxation. You will see from the figures I enclose that our manufacturing profit last year was £600,000 less than in 1979, yet when we have paid the same dividend our retained profit will be only £12,000 less and will allow us to increase our equity interest in line with inflation. If however, the order books do not improve quickly and the first six months profits are only equal to the last six months of 1980, I am afraid my co-directors and managers will be very gloomy indeed. We shall however survive because as you will see we have, by good fortune, or good management, been able almost to maintain the value of our equity since 1972. It is companies which have used their capital to meet demands for excessive salaries, wages and dividends that are in trouble.

I write this and send you the enclosed figures as practical proof of the assistance given by the chancellor to companies who have had the initiative to use it aright.

There are unfortunately, still far too many so called managers, who will blame anyone but themselves and it is so easy to blame THE GOVERNMENT. I am sorry your Cardiff speech did not get the wider coverage it deserved.

Cont'd

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Sir Herbert Redfearn.

The Prime Minister,
10 Downing Street,
Westminster.

MANUFACTURING		1980		1979
PROFIT BEFORE TAX				
JAN-JUNE	242 000		477 000	
JUNE-DEC	27 000		491 000	
		269 000		968 000
TAXATION				
CURRENT YEAR	(60000)		(500 800)	
PRIOR YEARS	8700		5900	
EXCEPTIONAL CREDIT (STOCK RELIEF)	353200		113 500	
		331 900		381 400
PROFIT AFTER TAX		600 900		586 600
PROFIT ON SALE OF PROPERTY				25 700
		600 900		612 300
DIVIDENDS		94 000		94 000
PROFIT RETAINED		506 900		518 300

SIDDALL & HILTON LIMITED AND ITS SUBSIDIARY COMPANIES

8 YEAR RECORD

	1972 £	1973 £	1974 £	1975 £	1976 £	1977 £	1978 £	1979 £	1980
FUNDS									
ORDINARY SHAREHOLDERS									
SHARE CAPITAL	38 600	38 600	38 600	38 600	38 600	38 600	38 600	38 600	38600
RESERVES	1 244 245	1 416 560	1 640 355	1 880 851	2 218 477	2 471 756	2 783 200	3 301 930	3508830
EQUITY INTEREST	**1 282 845**	**1 455 160**	**1 678 955**	**1 919 451**	**2 257 077**	**2 510 356**	**2 821 800**	**3 340 530**	3547430
PREFERENCE SHAREHOLDERS	43 660	43 660	43 660	43 660	43 660	43 660	43 660	43 660	
	1 326 505	**1 498 820**	**1 722 615**	**1 963 111**	**2 300 737**	**2 554 016**	**2 865 460**	**3 384 190**	
DEFERRED TAXATION	28 240	34 537	215 192	345 316	617 609	763 474	839 876	894 170	
	1 354 745	**1 533 357**	**1 937 807**	**2 308 427**	**2 918 346**	**3 317 490**	**3 705 336**	**4 278 360**	
EMPLOYMENT OF FUNDS:									
FIXED ASSETS	622 094	697 804	861 139	945 186	1 161 864	1 383 722	1 522 155	1 470 177	
UNLISTED INVESTMENT	500	500	500	500	500	500	500	500	
STOCKS	360 930	560 042	706 314	831 699	1 216 333	1 403 390	1 389 438	1 830 487	
DEBTORS, LESS CREDITORS, TAXATION AND DIVIDENDS	144 275	(72 772)	245 549	393 787	258 759	319 080	475 005	484 674	
LIQUID RESERVES	226 946	347 783	124 305	137 255	280 890	210 798	318 238	492 522	
	1 354 745	**1 533 357**	**1 937 807**	**2 308 427**	**2 918 346**	**3 317 490**	**3 705 336**	**4 278 360**	

10, DOWNING STREET,
WHITEHALL S.W.1

With the Private Secretary's Compliments

All pages between 1 and 2 to be referred to Cabinet Office

1

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10 DOWNING STREET

THE PRIME MINISTER

13 April, 1981

Dear Mr. Goldsmith,

Thank you for your letter of 31 March about consultations on the Green Paper on trade union immunities.

The Government is expecting to receive comments on the Green Paper from the main employers organisations by 30 June and, as you may know, Jim Prior has told the TUC that he cannot extend the consultation period. I realise that for some organisations this is a tight timetable and that they may be able to let us have their considered views only around the end of June. It will, of course, take a little time after the end of consultations to assess all the comments received. However, I can assure you that this timetable would not preclude further legislation in the 1981/82 Parliamentary Session if that were shown to be necessary or desirable.

Yours sincerely

Margaret Thatcher

Walter Goldsmith, Esq.

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10, DOWNING STREET,
WHITEHALL S.W.1

With the Private Secretary's Compliments

110

c. DEn
HMT

pc

10 DOWNING STREET

THE PRIME MINISTER

13 April 1981

Dear Mr. Horner,

Thank you for your letter of 20 March and the enclosed aide-memoire on energy prices to the UK chemical industry.

I am keenly conscious of the severe difficulties the chemical industry is facing. I do assure you that it is no part of Government policy to add unnecessarily to these through taxation or through the prices the nationalised industries charge for fuel.

The NEDC Task Force report, to which I understand the Association made an important contribution, found that by the end of last year gas prices to large users had moved out of line with those on the Continent and that electricity price disparities with France and Germany had widened, both strongly influenced by exchange rate movements. In the case of fuel oil it concluded that the period of disparity last year, to which the aide-memoire draws attention, had ended but the position remained volatile.

In response to these movements in relative prices, the British Gas Corporation are holding contract renewal prices for both firm and interruptible gas at their present levels until December 1981. This effectively means a year's ceiling on firm gas prices and more than a year's stability in renewal terms for interruptible gas. BGC are charging lower prices for both than they had planned to, with corresponding benefits to their customers. For interruptible gas, which as I understand the greater part of chemical industry consumption, this already means a price advantage of 2-3p/therm compared with fuel oil when contracts are renewed. No other European Community country

has, as far as

has, as far as I am aware, given comparable undertakings and there should be a marked effect on relative prices as we move through the year.

Electricity is already being sold to large users in England and Wales at prices close to the cost of production. The industry is introducing further flexibility for its large customers. It is also reviewing the Bulk Supply Tariff, and I know your Association is contributing to that review. We cannot match French costs based on hydro-electricity and nuclear power. Nor can we match the unusually low tariffs the Germans offer large, high load factor consumers - because it would mean either a subsidy we could not afford or charging other consumers still higher tariffs. We shall press the electricity industry to be as flexible as possible in its tariff-setting, and we will continue to press them hard on costs.

The Chancellor has, as you say, undertaken to keep the position on the fuel oil duty under review. Norman Lamont explained further in the House on 27 March the effects on gas costs which were mentioned in the Budget Statement. Changes have been announced in the "preponderance rule" which should provide benefits of £2-3 million in a full year to firms in the chemical sector. We have made clear to the oil companies that we expect prices to remain competitive and, as the Task Force Report brought out, consumers too can play an important part in ensuring a vigorously competitive market through their purchasing and negotiating arrangements. Following the latest increases, UK fuel oil prices (post tax) remain in line with Germany but are higher than France. We shall be following the position closely. I hope the chemical industry will also be able to take advantage of the £50 million grants scheme for assisting with conversion of boilers from oil to coal.

The measures we have announced do not immediately close the disparities identified in the Task Force report. But they do represent a substantial allocation of resources to hard pressed sectors of industry such as your own. I can assure you that

we are continuing to keep our general policy on energy pricing under close review.

2

Yours sincerely,

(sgd) MT

J.D. Horner, Esq.

M3

26625

Top copy Ch/Ex Ack
CH/EXCHEQUER
REC. 14 APR 1981
ACTION PS / ENERGY 15/4 16/4
COPIES TO

SOUTH EASTERN
GAS CONSUMERS' COUNCIL
Helena House
348 High Street, Sutton, Surrey SM1 1QA
Telephone: 01-642 1127

CHAIRMAN: Councillor Mrs. M. R. Grimes
SECRETARY: Leslie J. V. Yates

15/4

MRG/SMcN

The Rt. Hon. Sir Geoffrey Howe, Q.C., M.P.,
11, Downing Street,
London S.W.1.

13th April, 1981.

Dear Sir Geoffrey,

May I introduce myself, not only as Chairman of the above Council, but the woman in conversation with Elspeth (in my capacity as Secretary of City Contact) on the train from Swansea.

Since that time I have attended a meeting of the National Gas Consumers' Council and the British Gas Corporation, the Chairmen of whom both seem to be extremely upset by your remarks to the National Consumer Congress, and I quote:

> " The Monopolies and Mergers Commission has recommended the disposal of Gas Showrooms to the private sector and we are considering the best way of doing this. "

They are both absolutely against any suggestion of de-nationalising the showrooms. I can understand Sir Denis' point of view, but am at a loss to understand that of Sheila Black who was appointed only on 1st January by Sally Oppenheim.

I do, however, feel their view is coloured by the fact that neither has been consulted in any way; indeed, their representations to the Department on the Monopolies Commission Report have not even been acknowledged.

I would urge you to take immediate consultation with both these bodies. I did hear yesterday that if BGC were not consulted, and closures seemed a possibility, an immediate strike could be called.

In case you have not seen it, I enclose a document which is being circulated within these organisations.

I understand that various retailing outlets have been approached by the Department of Trade to ask if they would sell appliances. One of these is the C.W.S. - not, I would have thought, the most appropriate outlet to be asked.

I am sure you, as a previous Minister in the consumer field, realise that consultation with both industry and consumer bodies is most important, particularly in the political climate of the moment.

If I can supply any further information I would be pleased to do so.

Yours sincerely,

Marjorie Grimes

Chairman

FOR SAFETY

In o·-- reply to the Government the implications for safe the home, should the Commission's extreme course be adopted, have been emphasised. It should be of the greatest concern.

Figures which have been given to the Government show that year by year, far fewer accidents occur with installations by British Gas than with those of other installers, even though we undertake some 80 per cent of all appliance installation work.

British Gas has always encouraged customers to have their appliances serviced regularly and offers maintenance checks at subsidised prices to domestic customers, including the elderly and disabled. We accept the obligation to keep our charges as low as possible as part of our public service but similar motives could not be expected of private traders.

If British Gas were no longer involved in selling appliances, its role in installation and servicing would be bound to diminish. The likely result would be less regular servicing and a greater danger of death and personal injury.

We do not believe, as the Commission suggested, that any other organisation, such as CORGI, could take over our responsibilities. Without belittling an organisation which the Corporation brought into existence and still funds, its members do not have the experience or resources to encourage safety standards in a trade with 2 million appliance sales and 15 million service calls a year.

FOR EMPLOYMENT

British Gas has told the Government that the Commission badly miscalculated the impact its extreme course would have on jobs. The prospects of at least 25,000 of our employees would be at risk if we were forced out of retailing.

Not only the careers of the retail sales force would be affected but as has been shown in our reply to the Government, the loss of retailing would inevitably curtail customer service. Those employed in that field and indeed in many other functions within the Corporation would inevitably feel the effect.

Not only would there be an obvious drop in the number of jobs available but the future careers of those who could be transferred to other work would also be jeopardised. The Commission hope that some would find work in an expanded private sector but conceded that they would be unlikely to find comparable conditions and opportunities.

Those employed by appliance manufacturers wou also be affected. We are convinced that the loss of British Gas as the leading retailer means that the market for gas appliances would fall and manufacturers would lose confidence. Faced with mounting costs and a smaller market they could not be expected to maintain production levels. Some would cut back and others might switch over to other products or go out of business.

An uncertain home market would certainly be no basis for greater exports which was one of the benefits the Commission looked for from the changes it proposed. Rather, it would be likely to open the door to what remained of the gas appliance trade to imports . . . and the takeover of yet another British market by foreign companies.

FAIR COMPETITION

The Commission's "less radical" option suggested changes in British Gas accounting and other procedures. British Gas has nothing to fear from fair competition. In fact, the Government had previously laid down certain principles to ensure fair competition which have been embodied in the Corporation's policies and assurances have been given that these will continue.

It has also been pointed out that the competitive position in the trade has improved in recent times, a fact demonstrated by the entry of several large retailers into the market.

AND FINALLY

British Gas believes that the evidence it gave to the Commission during its two-year investigation, and to the Government since, shows clearly that there is no justification whatsoever for retaining the "radical option".

It should be pointed out that the Commission itself did not make any positive recommendation between either of its two options, preferring to leave it to the Government to make the choice.

One of the six members of the Commission responsible for this report described the extreme option as "a leap in the dark". British Gas maintains that as an experiment the risk of depriving the Corporation of retailing is too great to be tried, when the present system is acknowledged, even by the Commission, to have provided service of high value to the public.

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To all employees
Fo. .nformation

British Gas replies to the Monopolies Commission

BRITISH GAS

"When we know what the Government have in mind we may need to fight and if that proves necessary – we will!"

Sir Denis Rooke,
Chairman, British Gas

The Corporation's official response to the Monopolies Commission is now in the hands of the Government. Immediately the Commission's report was published at the end of July, work started on preparing our reply to which Headquarters and all 12 Regions have contributed. The result is a statement – 48 pages of closely-reasoned argument, facts and figures – that firmly

- **rejects** the conclusion that our past retailing policies have been against the public interest;
- **rejects** the Commission's "radical option" that we should be forced to stop selling gas appliances to our customers;
- **points out** the many inconsistencies between the evidence and comments favourable to British Gas contained in the report and the Commission's findings, and
- **details** the serious consequences to the industry, our customers, employees and the public interest should the "radical option" be attempted.

Our reply emphasises that British Gas is a service industry for which its skilled and dedicated workforce is a most important resource. The Corporation believes that it has to keep that workforce intact and protect their livelihoods and futures, both in common justice and the public interest.

Discussions have been held, and continue, with many organisations concerned with the continued success of the gas industry. As the full implications of the Commission's extreme course becomes more widely appreciated we see opposition to it growing.

The next step is for the Government to consider our submission and those of other interested parties. These will be the basis of formal discussions between Ministers and the Corporation and other parties, which we expect to start in the next few weeks.

Be assured that the Corporation's representatives will press our case with all the force possible in these talks, in the meantime, keeping in touch with you, your trade union representatives and with all other bodies with whom we have a common interest.

Ur he discussion process is completed the Gov..rnment has undertaken to make no decisions on the Monopolies Commission's findings.

At the end of the day British Gas is confident that if all the factors are fairly and objectively considered, the folly of the Commission's extreme course will be self-evident. But inevitably the period of uncertainty for many of our colleagues continues. The best support they can receive at this time is for us all to continue to strive to run our business as efficiently as possible in the service of our customers. You will be kept informed of developments.

The main points of the Corporation's official response are summarised on the following pages. The contents of this leaflet are not confidential. Your friends and neighbours may like to read it – the issues are important to them too.

The Monopolies Commission's radical option:
"*. . . that the Corporation should cease to undertake retailing functions which would be left exclusively to the private sector.*"

Such an extreme course would have serious and widespread implications—

FOR CUSTOMERS

Showrooms. The present comprehensive service for the payment of bills, requests for service, reporting emergencies and advice on safety and fuel saving would be severely curtailed. Without appliance sales, which make an important contribution to their costs, our national network of 900 showrooms could not be justified commercially on its present scale.

We know that the public would be rightly worried at the prospect of a widespread closure of showrooms. A representative sample of homes throughout the country was recently surveyed which revealed that nearly three-quarters of those interviewed would be concerned, mainly on such aspects as installation, after-sales service, safety and the reliability of appliances. The greatest worries were among the less well off, the elderly and young married couples.

Customer choice would be greatly reduced particularly in those areas where it would not be profitable for a private store. Few private retailers could offer anything like the wide range of appliances available from British Gas. Quite the reverse. They would concentrate on fewer, popular, easy to sell ' ıs many of them electrical which provide a quick turnover and higher profit.

Prices would certainly rise because manufacturers' costs for transport, administration, stocking, spares and marketing would all increase as they switched from supplying about 90 per cent of their output from one large retailer to hundreds of outlets.

Appliance performance benefits in a number of ways from British Gas retailing. Before any new model is accepted for sale it is vigorously tested in our laboratories for efficiency, safety and how well it measures up to customer requirements. Technical and market research, the experience of our sales staff, feedback from service engineers all show how improvements can be made – to the benefit of the customer.

If British Gas were forced to stop retailing, many of these advantages would be lost and we would have little or no say on appliance design, efficiency or quality.

After-sales service would suffer too. Our installation and servicing operations are integrated with both our roles as supplier of the fuel and seller of appliances.

Often a service call arises from a suspected escape of gas but we find an appliance needing service or repair. If British Gas were no longer concerned with appliances its servicing obligations would eventually end at the meter. The customer frustration can be imagined if a suspected gas escape had to be referred back to the customer to contact someone else to repair a faulty appliance.

"On demand" servicing requires enormous stocks of spares to be carried. British Gas holds 2.5 million parts comprising some 30,000 different items. A total of 6.5 million appliance parts are supplied each year from our stores.

In addition to stores, customer service involves the extensive use of other resources – skilled labour, supervisory, engineering and administrative support, premises and transport. These resources are totally integrated to deal with all aspects of gas business from appliance retailing, delivery, installation, after-sales service, breakdowns, metering and emergency work, thus minimising overheads. No private business could hope to match these resources and make the huge investment pay commercially for customer service work only.

All pages between 1 and 2 to be referred to Cabinet Office

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10 DOWNING STREET

THE PRIME MINISTER

14 April 1981

Thank you for your letter of 3 March about the fiscal treatment of charities.

I note that you were not primarily concerned at this stage with the legal position under European Community law, but it may help if I say that the particular Community obligation in question is the Sixth Directive on the Harmonisation of Turnover Taxes, which was implemented in the UK in the Finance Act 1977.

In my earlier letter, I gave a figure of £30 million as the estimated annual 'Exchequer cost' of the measures which the Government introduced in last year's Finance Act as part of a 'Charity Package', aimed specifically at the promotion of greater support for charities. It is of course, difficult to say precisely what effect these measures will have on charitable giving, and the figures which I quoted can only be a reasonable estimate at this stage. However, all the relevant factors have been taken into account in arriving at this figure, including the increased exemption which for Capital Transfer Tax purposes for gifts to charities on death or within one year of death and the increased covenant income which should be one of the results of this 'Charity Package'.

As far as the reduction in the minimum term charitable covenants is concerned, it will be necessary to wait for a full year's figures at least before attempting to draw any conclusion, and higher rate tax relief is not, in any case, available to covenantors until the tax year 1981/82. There is therefore an onus on charities to make these provisions work to their advantage,

/ both by

both by 'selling' the four year covenants to the public generally, and by pressing their higher rate donors to give more generously for 1981/82 onwards at no extra cost to themselves.

I do think that the steps which the Government have taken will provide the right conditions for substantial growth in community help to charities, but it is up to the charities themselves to use the opportunities which they have been given, and the additional benefits which are ultimately derived must, to a large extent, depend on their own effort.

(sgd) M T

Tim Yeo, Esq.

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10 Downing Street,
Whitehall S.W.1

With the Private Secretary's Compliments

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10, Downing Street,
Whitehall S.W.1

With the Private Secretary's Compliments

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1a

10 DOWNING STREET

THE PRIME MINISTER

14 April 1981

Dear Mr. Canavan

Thank you for your letter of 23 March 1981 with which you enclosed a letter from Mr. A.C. Missenden, General Manager of the Inveresk Paper Co. Ltd. Fine Paper Division at Carrongrove.

I am sorry that Mr. Missenden is so dissatisfied with the Chancellor's Budget proposals. In his speech, the Chancellor conceded that the industrial sector had borne disproportionate burdens, while the personal sector had escaped relatively lightly and his proposals are in fact finely judged so as to redress some of this balance without fuelling inflation. The CBI has said that the two point cut in MLR should benefit industry by £700 million in a full year. The energy package in the Budget is worth £168 million, reliefs against corporation and income tax amount to another £500 million and the small firms measures to encourage enterprise will cost £100 million approximately. Altogether, even after allowing for the extra fuel and vehicles duties, the Chancellor has put some £700-£800 million into industry.

The Chancellor considered very carefully the representations made to him about heavy fuel oil (HFO) duty. However, complications arise from arrangements entered into some years ago for gas purchases. The position will be kept under review but in present circumstances the wider national interest is best served by not reducing HFO duty but keeping it at its present level. As for the tax on Derv, I appreciate the additional cost this imposes on industry, but you should note that when expressed in national currencies, figures produced by the European Commission show that UK consumers have faced a lower overall percentage increase in Derv prices than

/ other

other companies in the EEC since the beginning of 1978. The oil companies did not raise Derv prices in their latest round of increases.

We should have liked to reduce the National Insurance Surcharge, but the budgetary pressures resulting from recession simply did not leave sufficient room for the Chancellor to do this. We considered it more beneficial to industry to reduce Minimum Lending Rate and we certainly could not have done both without undermining our efforts to reduce inflation.

A four month deferment on payments of Regional Development Grant was introduced in the 1979 budget as a contribution to the public expenditure savings vital to our economic strategy. I fully appreciate that an end to this deferment would be welcomed by industry but there is a continuing need to restrain public expenditure and this is not a measure to which we can give priority at present. Considerable effort, however, has been made to reduce administrative delays and the current average time taken to process applications has come down from 20 to 14 weeks. This average of course covers straightforward cases which are dealt with much more quickly as well as complex major projects which involve lengthy correspondence before they can be settled.

Following the report of the NEDC's task force on energy prices, the Chancellor made a number of concessions, briefly mentioned above, covering electricity pricing flexibility for high load factor industrial consumers, gas renewal prices, quarterly gas price escalation arrangements and a scheme to assist in converting boilers from oil to coal. I am aware that Mr. Missenden, in common with many other heavy energy users, does not feel we have gone far enough in meeting their complaints but it was the most we felt able to undertake in present economic circumstances. I know this debate will continue.

Your constituent's anxiety about public spending is one I fully share. The recession has made it much more difficult to bring about the cuts we had hoped for. We felt there was no sensible alternative to continued support for BSC and BL. The cost to the public purse if they collapsed would, in the short term and perhaps

/ also in

also in the long term, be far greater than the cost of supporting them. Our support is not intended to finance operating losses but rather the restructuring costs on which depends any chance of returning them to viability. Closures have taken place. Over 100,000 jobs have been shed in the last three years and more will be lost. Working practices are improving under vigorous new management. We have made it quite clear that we cannot allow this cash drain to go on for long: these enterprises must become successful or else be curtailed. Many might agree with Mr. Missenden that investment in roads and railways is desirable, but such programmes cannot be greatly expanded in present circumstances without inflationary consequences.

Our drive to cut the cost of bureaucracy has by no means been unsuccessful. We are determined to keep the pay award for the central civil service to 7%. We have taken steps to encourage local authorities to show similar restraint and in fact, so far this wage round, the average level of settlements in the public and private sectors has been much the same. By 1984 the central Civil Service will be at its smallest since the War and the Rayner exercises are identifying measures which will yield large savings and will be implemented as quickly as possible. Taking wider powers to control the local authorities would constitute a grave constitutional step; we have a system of local democracy which surely cannot be lightly set aside. Finally, as for quangos, I cannot accept that our actions so far have been of little consequence. The estimated savings from bodies involved in winding up, rationalisation or withdrawal of support total £11.6 million. Bodies already wound up include the Metrication Board and the Price Commission. But it has never been our policy to abolish every single quango. Many of them carry out valuable work which could not be more efficiently performed in other ways. Close and continuous scrutiny of remaining quangos will ensure that further improvements are made.

I do appreciate the difficulties of industry, and especially of the paper industry, with its particular energy and exchange rate problems. But the task of Government is to achieve the best possible outcome for the economy as a whole and I do not believe there is any

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alternative to our policy which would be more likely to put this country back on the road to prosperity. In particular, any other policy which involves abandoning the fight against inflation is nothing but the mirage of an oasis in the desert, tempting the thirsty man but luring him to destruction.

I hope these comments will enable you to reply to Mr. Missenden's criticisms.

Yours sincerely

Margaret Thatcher

2

Dennis Canavan, Esq., M.P.

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

PERSONAL

14 April 1981

Francis A Singer Esq
Sheerwood Corporate Services Ltd
36 Chesham Place
London SW1X 8HE

Dear Francis

You wrote to me on 10 February in reply to my letter of 30 January, I have delayed writing in view of your absence abroad.

I am very grateful to you for trying to meet the objections outline in my earlier letter. However, I am afraid that the PSBR point stands. The concept underlying the PSBR is that of the public sector's need for and call on finance as a whole. It is not limite to particular forms of finance, though I agree that use of the word "borrowing" may seem to suggest such a restriction. Hence preference shares or indeed issues of equity would score as financing the PSBR, even though they are not borrowing in the normal commercial and legal sense.

On your other points I certainly accept that, insofar as an element of risk can be built into a share issue of the kind you have in mind, there will be diminished competition with gilts. Your further suggestion that the share issues should be in the form of participating preference shares linked to profits as a means of bringing market disciplines to bear is an interesting one. The discretionary element would have to be a major part in the return if the resulting discipline was to be more than nominal.

A good deal of attention would inevitably focus on the determinatio of profitability. Many nationalised industries, and particularly those in which the investor might be interested, are in monopoly or semi-monopoly situations. There would almost inevitably, therefore, have to be some means of regulating their freedom to improve their profitability by simply raising prices.

I hope you do not feel that we are simply conjuring up difficulties We are, as I said again in the Budget Debate, anxious to consider new ideas in this area. We will certainly keep yours in mind.

Geoffrey

GEOFFREY HOWE

Cabinet Office

Whole Document

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10 DOWNING STREET

THE PRIME MINISTER

15 April,1981

Dear Raymond,

You wrote to me on 24 March enclosing this letter from Mr. E. A. C. Daniel of Willowfield, 2A Castle Avenue, Penarth, about the recent Budget proposals.

I understand the strength of Mr. Daniel's feelings and am aware that many taxpayers are concerned that Geoffrey Howe was unable to increase income tax allowances for 1981/82. This decision has not been taken lightly, and we share the disappointment that everyone will feel. However, what we could do on the income tax front this year was constrained by the overriding need to restrict the size of the public sector borrowing requirement. We did, of course, consider carefully before the Budget all the various options this left open to us. The main reason for acting on personal allowances rather than the basic rate was the potential effect on incentives. If allowances had been fully indexed it would have been necessary to raise the basic rate by 2½p to 3p if the borrowing requirement were not to be increased. This would mean that 24 million taxpayers had a considerable increase in the amount of tax taken from each additional £1 of income.

It is true that leaving personal allowances at the same level as last year hits those with the lowest incomes harder than those in the middle, but taking account of the fact that the higher rate thresholds are being left unchanged as well as the

/personal

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personal allowances proportionately the greatest burden falls on those with the highest incomes. In addition the increase in child benefit, which has been fully price protected, gives the greatest proportionate help to families on lower incomes.

I would like to reassure Mr. Daniel that it remains our firm intention to reduce direct tax, just as soon as resources allow since an important part of our strategy for restoring the fortunes of the country's economy is to increase incentives generally by reducing the level of direct taxation on all sections of our community. Nevertheless, we are determined to continue our programme for the defeat of inflation and, although during the coming year the burden of income tax has to rise, we believe that when the recovery does start bringing lower inflation we can reverse this upward trend in the burden of taxation.

Yours sincerely

Margaret

Sir Raymond Gower, M.P.

CONFIDENTIAL

pwp 15/4/81

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CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Sir K Couzens
Sir A Rawlinson
Mr Burns
Mr Ryrie
Mr Unwin
Mr Ridley
Mr Cropper

Mr I Stewart, MP
Mr A Newton, MP

Sir L Airey - Inland Revenue
Sir D Lovelock - Customs and Excise

CONSERVATIVE FINANCE COMMITTEE, 14 APRIL 1981

Mr Denis Henderson, Commercial Director of ICI, the guest. Mr Ralph Howell in the chair. Attendance poor.

Mr Henderson said he had hoped for better treatment in the Budget. The chemical industry had been in the position of a man in danger of drowning. The Budget was like holding the man's head under water. It was very depressing, though he welcomed the fall in interest rates.

The Budget had significantly increased ICI's costs:

£m

6.5 - extra duty on petrol and derv
50 - supplementary petroleum duty
20-30 - effect of deflation

Against all this, ICI had enjoyed only a £2m reduction in energy costs. The stock relief concession was no good: earnings in the UK were too low.

The recent lowering of the exchange rate had helped. He believed the rate would continue to fall, because "sooner or later someone somewhere" would realise Britain's industrial base was being destroyed.

The world recession had largely been caused by the doubling of oil prices. But chemicals had suffered more than manufacturing; and the UK more than other countries. There were self-inflicted wounds: interest rates and the exchange-rate. If the pound continued high, there might be no UK chemical industry left in 5 years' time.

ICI's costs had risen by £600m in 1980, but they had only been able to recoup £300m. A vigorous attack on costs had taken place, and there had been redundancies. But on the other hand ICI's productivity had been improving for several years: the recession could take no credit for this.

It was doubtful whether there would be an improvement before the fourth quarter. The recovery could not come from Government, or from the private sector. It might perhaps come from the USA.

Julian Amery: How many workers will you take on if there is a strong upturn?
Mr Henderson: None.
Julian Amery: Germany did well with a strong currency.
Mr Henderson: We have low productivity: theirs is high. The pound inevitably carries a premium because of the North Sea: ICI could live with a 20% premium, but not 50%.

John Browne: What is the effect of: currency volatility and Middle East production of ethylene; what about R & D; and will the West face a "capital crunch" in a few years?
Mr Henderson: Currency volatility a nuisance. The Middle East not a threat yet. R & D expenditure had been kept up.

Nick Lyell: Have ICI wage rises been high?
Mr Henderson: Overall wage bill increase is low, because of less overtime and less profit-sharing. The public sector sets a high going-rate.

Tim Eggar: Is there slower destocking?
Mr Henderson: Destocking seems to have largely stopped. There was a modest pickup in sales in February: but it is a long way back to where we were before.

Mr R Howell: Would you favour EMS?
Mr Henderson: It depends on the rate at which you join.

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In answers to questions from the members named above and from Mr Macmillan.

Mr Henderson complained that the UK had never had a coherent industrial policy like that of France or Japan. North Sea revenues should be used to preserve an industrial base for when the oil ran out. The British Government was very poor about helping industry: he had spent 15 months arguing about energy prices with the Department of Energy. He had shown that ICI's plant in Germany obtained electricity at half the UK price. The NEDC task force had shown the UK position was unfavourable. The response of Energy Ministers had been to try to think of new arguments for higher prices.

Mr Eggar pointed out that electricity generating costs were lower in Europe.

Mr Michael Shaw asked whether the Treasury was behind the impasse in the argument over energy prices with the Department of Energy.

Mr Henderson replied he did not know.

GEORGE CARDONA

15 April 1981

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10 DOWNING STREET,
WHITEHALL S.W.1

With the Private Secretary's Compliments

pa 131

10 DOWNING STREET

From the Private Secretary 16 April 1981

You wrote to the Prime Minister on 30 March about tax relief for expenditure incurred by a client of yours who is the owner of a property divided into flats.

The Prime Minister is sorry to learn of the problem faced by your client in claiming tax relief for expenditure on some fire-proofing work which he was obliged to carry out to his property in order to comply with a statutory notice served by the local authority. The Prime Minister fully understands that your client had no option but to carry out the work, but the question of whether the expense incurred is allowable for tax purposes is a matter for agreement with the Inspector of Taxes. If agreement cannot be reached it is of course always possible for your client to exercise his right of appeal to the independent appellate Commissioners.

As much as the Prime Minister would like to help in this connection, unfortunately this is not a matter in which she can intervene.

M. A. PATTISON

D.R. Russett, Esq.

Mrs Case

for draft reply pl, in consultation with copy recipients.

JW 23/4

c. Miss Brown
Mr Mountfield
Mr Ridley
SJ 23/4

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A fairly characteristic letter - of MP's generally, not of him. Full & prompt reply, handled in consultation with A. Ridley

27154

HOUSE OF COMMONS
LONDON SW1A OAA

Top copy CH/EX ack

CH/EXCHEQUER	
REC.	23 APR 1981
ACTION	MRS CASE
COPIES TO	MISS BROWN
	MR MOUNTFIELD
	MR RIDLEY

Rt.Hon.Sir Geoffrey Howe, QC, MP
Chancellor of the Exchequer,
H.M.Treasury,
Parliament Street,
London.SW1P 3AG

16th April 1981

Dear Geoffrey

You kindly asked me to write to you concerning the calculation of the Public Sector Borrowing Requirement (PSBR) as it affects majority or wholly publicly owned Corporations. As I understand the argument, borrowing on the private money market by publicly owned corporations has to be regarded as part of the PSBR because it has potentially to be repaid by the Treasury. Should the Treasury, on the other hand, give a loan guarantee as in the case of I.C.L. then "No public expenditure will be incurred unless the guarantee is called, and there is therefore no effect on the public sector borrowing requirement" (Hansard col 747 6th April 1981). Nonetheless, potentially, and I suspect in reality in this case, the Treasury may have to honour its guarantee and pay out £200 million. Logically, therefore, it should be included in the PSBR.

I gather that the Treasury is taking a peculiarly rigid attitude to British Telecom who will need to borrow extensively from the private sector for investment in what the market will judge to be highly profitable enterprises and on which its future expansion and profitability will depend. Whatever the merits of the accounting argument, the fact remains you will thus be restricting the expansion of a highly profitable enterprise with the resulting restriction of orders to their private sector suppliers. Thus, the creation of new real jobs in a modern, highly technical industry will be prevented and imports encouraged if not made inevitable. Contrast this attitude to that of France or Japan and I know you will be sickened and saddened by the self inflicted wounds we are insisting on raining upon ourselves. I beg you to find a way round these difficulties.

I gather that if a Company's Act company is formed by a publicly owned Corporation then this wholly owned subsidiary can by contrast raise capital on the private money market without that borrowing being counted as part of the PSBR. If this is so, then I welcome it as a device to get around the Treasury's difficulty but I know you will agree that it is logically absurd.

With even greater illogicality, I gather that you have decided that should the Commonwealth Development Corporation (CDC) borrow on the money market, even though this money is raised ~~overseas and not~~ invested overseas even in sterling and will be repaid

overseas/

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Rt.Hon.Sir Geoffrey Howe,MP. 16th April 1981

overseas, then this too is to be regarded as part of the PSBR! Your problem being that to permit such a borrowing would also permit other nationalised industries to borrow in a similar fashion. This, in spite of the fact that practically all nationalised industries would at some time use the loans so raised in Britain and in sterling even if the externally raised loans are used as back-up guarantees. British Airway's aircraft purchases being a possible exception to this.

Surely, there must be a way round this difficulty. Clearly, one distinction that should be made is between those public industries who are profitable and likely to remain so and those that are not. The former are likely to repay their loans without incurring public expenditure and the latter are clearly in a different category. However, even with those who are losing money, the degree to which the loan might not be repaid should be assessed and only that amount counted against PSBR in the manner of contingency reserves in the balance sheet of a Limited Liability company.

In the case of CDC who now pay back to the Treasury more than it draws down if you combine capital and interest repayments and taxes paid, the proposed prevention of its raising money on the private money markets will severely restrict its operations and lead to its contraction in real terms. This will mean that possibly the most effective tool of overseas development we have, which actually makes money for Britain, will be severely damaged. CDC helps others to help themselves, a selfreliant point of view much advocated by the Prime Minister and yourself particularly in your earlier Bow Group days. CDC also contributes to the development of third world countries in a manner with which no Conservative could do anything but applaud. Not only does CDC stimulate British exports but acts as the catalyst and partner of many British firms investing overseas. By increasing the wealth of its host nations it thus enables Britain to sell to those countries.

To cripple CDC and other potentially expanding publicly owned corporations on the basis of a semantic academic accounting/economist's argument to my mind would be unforgiveable in any circumstances but when we are fighting for more jobs and the creation of viable new British industries and investments overseas, it is just sheer folly.

Yours

Bowen

~~Bowen~~ Wells

c.c. Lord Carrington
Lord Kindersley of CDC
Neil Marten,MP, Kenneth Baker, MP, Robert Rhodes James,MP

iwp 134

CONFIDENTIAL

cc: Chief Secretary
Financial Secretary
Sir D Wass
Mr Burns
Sir K Couzens
Mr Ryrie
Mr Byatt
Mr Middleton
Mr Battishill
Mr Dixon
Mr Unwin
Mr Wicks
Mr Ridley
Mr Cropper

MR CASSELL

IMPACT ON THE ECONOMY OF NORTH SEA OIL AND GAS REVENUES

At the Ministerial Group on Energy Price (Misc 56) meeting on 16 April, the Chancellor undertook to circulate a paper to the Group on the impact on the economy of revenues from the North Sea.

2. I should be grateful if you would arrange for the preparation of the necessary paper, drawing on the work already done on this in other contexts. It would certainly be very helpful, if not absolutely essential, if the paper were available for circulation to the Group by the middle of next week.

JW

A.J. WIGGINS
22nd April 1981

SLAUGHTER AND MAY

27344

Tim pl chase IR PM 135 ~~34~~ 1·5

TELEPHONE: 01-600 1200
TELEX: 883486 AND 888926
CABLES: TRUCIDATOR LONDON EC2
FAX GP 1/2 : PANAFAX TEL: 01-606 4600
GP 3 : RAPIFAX TEL: 01-606 0851
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CH/EXCHEQUER	
REC.	28 APR 1981
ACTION	PS/IR
COPIES TO	MST C L
	Mr BATTISHILL
	M CROPPER

24th April 1981

YOUR REFERENCE

IN REPLY PLEASE QUOTE GFR/EAC

✓ 29/4

The Right Hon. Sir Geoffrey Howe Q.C. M.P.
Chancellor of the Exchequer,
Treasury Chambers,
Parliament Street,
London SW1P 3AG.

C

2 MONTHS?

Dear Sir,

Profit Sharing Schemes
<u>Paragraph 10 Schedule 9 Finance Act 1978</u>

We refer to our letter of 27th February in which we wrote, on behalf of Continental Oil Company Limited, asking that consideration might be given to introducing legislation in the forthcoming Finance Act to deal with a problem which had arisen under the above-mentioned legislation. Our letter was acknowledged on 2nd March.

Our clients have asked us to write again enquiring whether we might have an early indication as to whether or not the appropriate amending legislation will be introduced. Our clients' problem is that they wish to introduce an approved profit sharing scheme within the next few months. Accordingly, if for any reason it is felt that it will not be possible to introduce appropriate amending legislation, they will have to give serious thought to ways of overcoming the severe practical problems to which the current legislation gives rise.

Yours faithfully,

Slaughter and May

RESIDENT IN PARIS: G. TURNER S. HARCOURT WILLIAMS P. J. L. KETT
68 BOULEVARD DE COURCELLES, 75017 PARIS TELEPHONE: 267 5679 TELEX: 641122 F RAPIFAX TEL. 380 8769
RESIDENT IN HONG KONG: R. R. S. BEAUMONT T. G. FRESHWATER AMY S. F. KO
1518 CONNAUGHT CENTRE, CONNAUGHT ROAD CENTRAL, HONG KONG TELEPHONE: 5-261031 TELEX: HX86230 RAPIFAX TEL. 5-241938

SLAUGHTER AND MAY

[illegible] WRIGHT
A. W. MALLINSON
C. MCFADYEAN
R. G. NORTON
J. D. SIMON
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S. R. WARD
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R. A. M. WELSFORD

Associates:
Property: A. I. Rankin G. T. B. Stevens Pensions: F. Petheram

TELEPHONE: 01-600 1200
TELEX: 883486 AND 888926
CABLES: TRUCIDATOR LONDON EC2
FAX GP 1/2 : PANAFAX TEL: 01-606 4600
GP 3 : RAPIFAX TEL: 01-606 0851
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	Mr BATTISHILL
	Mr CROPPER

27th February 1981

1B 4/3

Rt. Hon. Sir Geoffrey Howe, Q.C. M.P.,
Chancellor of the Exchequer,
11, Downing Street,
London SW1.

Dear Sir,

Profit Sharing Schemes
<u>Paragraph 10, Schedule 9, Finance Act 1978</u>

We act for Continental Oil Company Limited ("ConOil") and Conoco U.K. Limited ("Limited") which are both wholly owned U.K. subsidiaries of Conoco Inc., a U.S. public company whose shares are listed both on the New York Stock Exchange and on the United Kingdom Stock Exchange.

ConOil and Limited wish to introduce profit sharing schemes for their employees. In the course of drawing up those schemes for approval by the Inland Revenue, a practical problem has arisen as a result of the wording of paragraph 10, schedule 9, FA 1978. Our clients have asked us to write to you on their behalf drawing this problem to your attention and to ask that the opportunity be taken to introduce appropriate amending legislation in the forthcoming Finance Bill to deal with it.

Paragraph 10 provides that:-

"An individual shall not be eligible to have shares appropriated to him under the scheme at any time if in that year of assessment shares have been appropriated to him under another approved scheme established by the company concerned or by -

(a) a company which controls or is controlled by that company or which is controlled by a company which also controls that company ..."

The broad effect of this provision is that if an employee has had any shares appropriated to him under a scheme, however few in number, he may not have any shares appropriated to him in the same year of assessment under another scheme established by the same company or an associated company.

cont'd...

[illegible] February 1981

The Rt. Hon. Sir Geoffrey Howe, Q.C., M.P.,
Chancellor of the Exchequer,
11, Downing Street,
London SW1.

Dear Sir,

PRIVATE & CONFIDENTIAL

Paragraph 15, Schedule 5, Finance Act 1978

[illegible]

[illegible]

Paragraph 15 provides that:-

"An individual shall not be eligible to [illegible] at any time if in that year of assessment [illegible] by the company concerned or [illegible]

(c) a company which controls or is controlled by that company or which is controlled by a company which also controls that company ...."

The [illegible]

contd/2...

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27th February 1981

Rt. Hon. Sir Geoffrey Howe, Q.C. M.P.
Chancellor of the Exchequer

The paragraph does not require the shares appropriated under the two schemes to be aggregated, although that might be thought the fairer result: it prevents any appropriations at all being made under the second scheme.

In our clients' case, this produces severe practical problems, for reasons which we will be glad to explain if required. Unfortunately, these problems cannot be avoided by establishing a group scheme for ConOil and Limited, because they are both directly owned by Conoco Inc. (paragraph 2, schedule 9, FA 1978). Nor can it be avoided by Conoco Inc. establishing a scheme in which ConOil and Limited would be participating companies, because of difficulties which that would create in the U.S.

Our clients are conscious that the circumstances of their case are unusual and that paragraph 10 does not create for most companies the problems which it creates for them. Against that, they believe that paragraph 10 certainly goes further than is necessary or fair and may not be required at all, in view of the protection given to the Revenue by section 58(1) FA 1978.

It is suggested that consideration be given to the simple repeal of paragraph 10. Alternatively, if that is not acceptable, it is suggested that paragraph 1(4) and paragraph 10 might be amalgamated along the following lines:-

"The scheme must provide that the total initial market value of the shares appropriated to any one participant in any one year of assessment under that scheme or under another scheme established by the company concerned or by -

(a) a company which controls or is controlled by that company or which is controlled by a company which also controls that company, or

(b) a company which is a member of a consortium owning that company or which is owned by that company as a member of a consortium.

will not exceed £1,000."

Our clients have asked us to express their reluctance at having to trouble you with this matter, particularly at such a late stage. It is, however, one to which they attach a great deal of importance. If space can be found in the Finance Bill to deal with the point raised, that will be very much appreciated.

Yours faithfully,

Slaughter and May.

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10, DOWNING STREET,
WHITEHALL S.W.1

With the Private Secretary's Compliments

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PA

10 DOWNING STREET

From the Private Secretary

27 April 1981

You wrote to the Prime Minister on 19 March about the approach adopted by the Inland Revenue to the company's extensive arrears of PAYE tax and National Insurance contributions.

Mrs Thatcher is very sorry to learn of your difficulties but she understands from the Inland Revenue that you have recently discussed with your accountants ways of meeting the company's liabilities and she thinks it will be better if you are guided by their advice. She hopes an acceptable solution to the problem will be found.

M. A. PATTISON

D.H. Johnson, Esq.

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10, DOWNING STREET,
WHITEHALL S.W.1

With the Private Secretary's Compliments

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1C

10 DOWNING STREET

THE PRIME MINISTER

27 April 1981

Cabinet Office

Whole Document

Dear Michael

You wrote to me on 24 March about a letter you had received from Mr. D.K. Archbold of the Leeds and Bradford Hauliers Federation. Mr. Archbold wrote to me about the Budget increase in derv duty.

As Geoffrey Howe announced in his Budget speech, we regard it as crucially important this year that Government borrowing should be cut not only to help secure in the short term the reduction in interest rates announced in the Budget, but also as a vital measure to reduce inflation and provide incentives for industrial growth over the long term.

In order to cut Government borrowing, however, we have to cut expenditure and/or increase revenue. Despite the unexpected depth of the recession, which has meant substantially higher expenditure on unemployment benefit and special employment measures, total public expenditure in 1981-82 will be about £5 billion less than the level planned by the previous Government But it is not possible to rely on public expenditure cuts alone if public sector borrowing is to be reduced sufficiently quickly. If the Chancellor had not made the increases

/in taxes

in taxes announced in the Budget, public sector borrowing this year would have reached £14 billion - surely an unacceptably high figure, and quite incompatible with the reduction in interest rates vital to the fortunes of UK industry. So there was no escape from raising revenue, and it was simply not possible to exempt the road fuel duties from their share of the general increases required.

Nevertheless, I should point out that less than one third of the additional revenue which is expected to be raised from the indirect taxes this year will fall on businesses; the large majority will instead come from the private consumer. Moreover, even after the Budget increases, the price of derv will not have increased by more than the general movement in prices since last year, whilst the effective tax burden for businesses will remain lower in real terms than it was in 1970.

Of course we recognise that the increase in derv will increase road freight transport costs; and that some road haulage firms may find the increase significant. It was for this reason that the Chancellor did not increase the rates of vehicle excise duty on the heaviest lorries by any more than on other vehicles, despite the recommendations of the recent Armitage Report and environmental groups.

I am sending a copy of this letter direct to Mr. Archbold.

Yours ever

Margaret

Michael Alison Esq MP

pwp

CHANCELLOR

cc Chief Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Mr Ryrie
Mr Burns
Mr Unwin
Mr Allen
Mr Buckley
Mr Rayner
Mr Folger
Mr Ridley
Mr Cropper
Mr Cardona

TREASURY QUESTIONS: THE RATE OF INFLATION

I shall not be taking part in Treasury questions this week myself. But in this context, and in particular in connection with questions 1 and 3, you may be interested in the attached letter published in yesterday's Daily Express. (I also attach a copy of the original article to which that letter referred.)

What is of interest here is not simply or even principally that the Treasury got it right but that Terry Ward, the adviser to the Treasury Committee, and co-author of the latest episode of the Godley doom saga which was published this week, and which will undoubtedly be raised at Treasury questions, got it so very badly wrong.

NL

NIGEL LAWSON
28 April 1981

Letters THE PAGE THAT YOU WRITE

Daily Express, Fleet Street, London, EC4P 4JT

The experts who got inflation all wrong

WITH inflation currently running at 12·6 per cent, I found it interesting to look back to the Express of last April, in which Geoffrey Levy asked three prominent economists and a Tory politician to forecast what inflation would be in a year's time—that is, now.

Terry Ward, the Cambridge economist and adviser to the Commons expenditure committee said it would be 25 per cent and Joel Barnett, Labour's former Chief Secretary to the Treasury, 20 per cent John Wood, Deputy Director of the Institute of Economic Affairs, forecast 16 per cent.

Only the Tory politician Nigel Lawson, Financial Secretary to the Treasury, was on target — almost spot-on with his prediction of 13 per cent.

Incidentally, the rate in April last year was touching 20 per cent.

C. J. WOOD,
Heybridge, Essex.

What will inflation be a year from now?

PAY YOUR MONEY AND TAKE YOUR CHOICE!

THERE was a time when talk of economic matters was better than a sleeping pill. Today the thunder of argument is loud enough to wake the dead.

Will inflation carry on climbing in the face of hefty wage demands as the Governor of the Bank of England predicts? Or will Mrs Thatcher's firm hand bring us safely back to a more reasonable figure?

Inflation is touching 20 per cent, some wage rises are exceeding that. And yet the Prime Minister's prediction is that inflation will fall slightly later this year.

It seems impossible. Monetarism means holding back the increase in the amount of money released into the system.

Four economists talked to GEOFFREY LEVY about Mrs Thatcher's financial strategy. Two were for, two against. But on one central point they all agreed — big wage rises for some are bound to mean unemployment for others.

13% says NIGEL LAWSON, Financial Secretary to the Treasury

THE policy is the right one and in no way will we lose our nerve. I don't think the large wage rises we have seen in certain quarters will go on at this level, simply because industry cannot afford them.

If wage demands continue to be high then something has to give, and what gives will be the level of employment.

We are determined to bring inflation down, and that is why we are restricting the money supply.

It was around 15 per cent when we took office and we have now reduced it to around 11.

We are committed to this policy. It means that those who negotiate increases, which their companies cannot afford, are likely to make other workers unemployed.

We're confident, but the great danger is for people to expect an improvement overnight. The policy takes time.

We have heard the argument for a wages policy, but this would not make things any easier. It tends to distort the labour market and create shortages of skilled labour, and I don't think the trades unions are in any mood to agree to guidelines of this kind.

We must go along the road we are now on. We have forecast that in the second quarter of 1981 the rate of inflation will be down to 13½ per cent. We stick to that.

20% says JOEL BARNETT, Labour's former Chief Secretary to the Treasury

IF I were a monetarist (which I am not) I could argue that it might work—but only at the expense of unemployment.

I expect upwards of two million people to be unemployed at the beginning of next year. It needn't be as high as that.

It is all very well talking about controlling money supply, but how is that possible when you have 300 foreign banks in the City of London?

"We must have a wages policy. There must be guidelines which everybody understands and which the trade unions will accept as ultimately beneficial to all. This time round it is already to late.

You cannot expect some to get 20 per cent and more, and others to be content with a fraction of that.

If I wtre in government now I would already be talking with all the interested parties — with the trade unions and with the company chiefs — in terms of starting a wages policy before the next round begins in August.

The present inflation will peak around that month. Then I see a small reduction, but not much. A year from today it will still be 18-20 per cent.

And with inflation at that level, the trades unions will negotiate toughly on behalf of their members and there will be a lot of strife.

16% says JOHN WOOD, Deputy Director of the Institute of Economic Affairs

THE Government is right to pursue a tight money-control policy, but it takes time to work—about two years to work its way through the system.

The Government's strategy has been computed to bring the rate of inflation down to nine per cent in the life of this parliament—and that's not really good enough.

No monetary policy ever produced immediate results. And it's no good blaming monetarism for failing.

The muscle of the big unions has meant that some are getting more money than they earn. All they are really doing is providing more unemployment for their colleagues.

I am worried about the lack of progress in cutting Government spending this year. It's almost the same as last, and this is a key part of the strategy.

A wages policy would be an acknowledgement of the muscle of the big unions. It must be left to them all to be reasonable with their demands, and so put fewer people out of work.

It seems to me that in certain areas of the trade unions, they are pushing for bigger wage settlements for purely political reasons. They want to ruin the Government's policy.

In a year's time the inflation rate will be around 15-16 per cent. That is what the rate of increase in money supply was a year ago.

says TERRY WARD,

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THE UNION OF INDEPENDENT COMPANIES

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SIR D WASS
Mr RYRIE
Mr MIDDLETON
Mr BATTISHILL
Mr KELLY
PS/DoI

The Rt.Hon.Sir Geoffrey Howe, QC MP
Chancellor of the Exchequer
The Treasury
Parliament Street
London SW1

29 April 1981

Dear Chancellor,

FINANCE BILL 1981

Immediately following your Budget statement we described the last ten minutes of it as "the most significant change in Government industrial policy in 150 years." We consider that the 1981 Enterprise Package is a tremendous step forward in the encouragement of entrepreneurial enterprise and risk taking. We commend the efforts of both yourself and your Treasury team to produce a co-ordinated package of measures for the independent sector at a time when the recession is at its most severe and other voices are calling for more general reflation.

We support your continued and increasingly successful priority of bringing inflation under control and we look forward to a further, significant reduction in Minimum Lending Rate in coming months. Lower interest rates, assuming that they are justified, are crucial to a resurgence of business confidence.

We remain worried that, despite the efforts which are being made, central and local government spending remains too high as a proportion of Gross Domestic Product. We recognise that the decision not to index income tax allowances and the revenue measures taken in the Budget will raise an additional £5 billion and restrain the PSBR to an estimated £10.6 billion but this cannot hide the fact that public (Government) spending is in excess of 50% of GDP.

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29 April 1981

We have been encouraged by the recent evidence that the Government is prepared to stand firm on public sector wage settlements in the current round within the cash limits target. This is vital to the ongoing credibility of your policy in view of the cost of the recession to the private sector and the realistic acceptance of the fact by many work people in the sector. We urge renewed efforts to reduce the administrative cost of Government which remains excessively high and to control costs in the public sector generally. At present almost the whole of the inflation, which faces us, is originating from that sector.

We enclose a paper commenting on certain aspects of the Enterprise Package and recommending some amendment of the detailed proposals as well as suggesting some additional items for your further consideration. In particular we would draw your attention to our offer, in paragraph 9(6), to obtain the services of Mr Vernon Weaver, former administrator of the SBA in the United States, and to make him available (free of cost) to the Government for the initial period of the pilot loan guarantee scheme.

Yours sincerely,

Peter Mayo

SA Mayo
National Chairman

NATIONAL
INFORMATION
71 Fleet Street
London EC4
01-583 9305 01-589 1945
Telex 298681 ComSerG

THE UNION OF INDEPENDENT COMPANIES

FINANCE BILL - APRIL 1981

General

1 Many independent companies which survive the present recession will do so by using a significant part or all of their retained earnings and even part of their issued share capital. As a result of the erosion of their capital base, they will not be in a position to respond quickly to the opportunities which will present themselves as we emerge from the recession. In addition, their ability to borrow funds in the short term will be severely impaired.

2 It is in this context that we express our concern that the loan guarantee scheme and the business start-up scheme, despite their tremendous innovative potential for new firms and very small firms, do not appear to recognise the needs of the smaller companies which will survive the recession, particularly those in the manufacturing sector.

3 Yet it is these smaller companies which will have a vital role to play in the short to medium term if they have the resources, after the recession, to raise quickly their level of activity and so both provide new jobs and limit the need to increase imports.

4 The two schemes as presently proposed, although imaginative in concept, are too restricted in their scope and therefore likely to be unduly limited in their impact. Whilst accepting the need to control the cost of the proposals and to prevent abuse of them, the initiative should not be stifled by undue caution which is not in accord with their spirit and purpose.

5 Although funds are available to successful, smaller companies, the terms attaching to such funds are generally unacceptable to the entrepreneurs concerned. It is unreasonable and unrealistic to expect a business owner, having survived the recession, to give up part of his equity to an institution or to give option rights to such a body simply because he has an urgent need for funds to respond fully to the new opportunities.

6 Many will not surrender equity "on the cheap" in such circumstances, so that an institution can maximise its potential gain, and will opt through necessity to recover more slowly but within the resources which it has been able to retain.

7 Independence of institutions and outside interference is of fundamental concern and importance to many smaller companies. We believe that this independence must be maintained if we are to break down the enormous concentration of economic power in this country and to create a vigorous free enterprise economy backed by innovation, competition and dynamism.

<u>Government backed loan guarantee scheme</u>

8 The present scheme which is being devised appears to be too cautious on the one hand and yet not sufficiently tough or attractive in its application both as regards the lender and the borrower.

9 We consider that the following points of principle are fundamental to the scope and control of the scheme in the UK:

(1) The scheme must be available to the smaller banks.

(2) The combination of equity packages with loan guarantees is alien to the fundamental basis of need for Government guarantees.

(3) The premium payable by the bank for the guarantee should not exceed 2% annually on the principal outstanding under guarantee.

(4) Default procedures must be pursued by the lending bank in respect of any loan repayment instalment in arrears for more than forty five days or it would forfeit the guarantee cover.

(5) The Department of Industry should be unconcerned with individual loan applications but must undertake effective audit procedures, from time to time, on the systems used by the participating banks to approve and control scheme loans.

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(6) The best available outside consultants should be obtained in the initial stages of the scheme to ensure its successful implementation. We believe it should be possible and is essential to obtain the services of Mr Vernon Weaver, former administrator of the SBA in the United States, and make him available (free of cost) to the Government for the initial period of the pilot scheme.

(7) The maximum amount of each loan should be £250,000 (in certain exceptional circumstances up to £500,000).

(8) The principle of "selling on" the guarantee to institutions, as in the United States, should be established as soon as possible.

Business Start-up Scheme

10 It is difficult to reconcile the basis of need for this new and fundamental type of incentive to encourage minority risk investment by individuals in independent trading companies with the number of pages in the Finance Bill devoted to the restriction of its operation. Many tax practitioners will have an enjoyable and technically stimulating field day but, allowing for the quality of advice that will be required, the need for and cost of such advice may well undermine the motivation and the relief which the scheme seeks to create.

11 Inevitably there will be attempts to exploit the proposals but surely these can be contained within commercial reason and some cost accepted within the much greater purpose of achieving a much greater flow of individual capital to fund new and growing small companies.

12 We consider that the following points of principle are fundamental to the scope and potential success of the scheme.

(1) The scheme should be extended not only to all new manufacturers, wholesalers and retailers but also to existing smaller companies, particularly manufacturers, including those which are holding companies of existing small groups.

(2) The maximum percentage equity stake by an outside investor should be increased from 30% to 49%.

(3) Payment of "reasonable remuneration" should be allowed to a minority investor for specific services rendered to the company.

(4) The incorporation of a subsidiary company should not be grounds for the withdrawal of or failure to grant relief to a company during the five year period.

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(5) The relief should be extended to employees, including directors, of the company who are not members of the "associates" controlling it.

(6) Relief should not be limited to those companies which have one class of share capital only.

(7) There are a number of defined situations in which the minority investor will lose previously given relief as a result of events which are wholly outside his control. These particular restrictions should be reviewed as they are likely to be wholly counter-productive in their impact. At the same time it is necessary to review the restrictive clause relating to the period of time during which interest is payable by the minority investor upon withdrawal of relief and contrast it to the length of the period of time during which the Revenue is not obliged to grant interest to a minority investor following a claim for relief.

Rollover of capital gains arising on disposal of quoted interests <u>if proceeds invested in private trading companies</u>

13 In order to increase the incentive to invest in shares of private trading companies, which require additional permanent funding, we consider that encouragement should be given to the transfer of investments from listed companies and securities to such trading companies without denuding the funds realised by the incidence of capital gains tax.

14 This could be achieved by granting "roll-over" relief on such gains provided the proceeds of sales are invested within six months of the date of disposal in the shares of a private trading company. This will encourage the transfer of investment from publicly quoted securities to private companies and will release funds which would otherwise remain in their present investment.

Graduated scheme of corporation tax without marginal rate penalty

15 We appreciate the increase in the thresholds announced in the Budget for the ceiling of the small companies rate of corporation tax and the brackets of the marginal rate. However we are concerned that the starting rate for the tax on small companies is as high as 40% and that this small company rate of corporation tax is not retained after a certain level of taxable profits is exceeded.

16 Not only do we consider that the small company rate of corporation tax should be retained when the first tranche of taxable profits has been exceeded but also that there should be a system of graduated rates of corporation tax for private trading companies leading up to the full rate of 52%.

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17 We believe that the first £2,000 of taxable profit should be free of all corporation tax and the next £3,000 should only be taxed at a corporation tax rate of 10%. The next three tranches of taxable profits of £5,000 each should be taxed at 15%, 20% and 25% respectively. Following this, the next four tranches of £10,000 should be taxed at 30%, 35%, 40% and 45% respectively. All profits in excess of £60,000 should attract the full rate of corporation tax but without losing the reduced rates on the first £60,000.

Funds for growth - "Metro Bonds"

18 We have been concerned about the need to enable private trading companies to build up a tax free fund for future capital projects and research and development schemes. The availability of internal funds for investment has a key influence on attitudes and the will to expand, together with providing an enlarged base to support any required borrowing.

19 We also wish to discourage such companies from frivolous revenue expenditure immediately prior to their accounting dates, aimed at reducing or extinguishing their liability to corporation tax, and to encourage meaningful capital investment by such companies and to avoid decisions in which fiscal considerations override normal commercial ones based on the ongoing needs of the enterprise.

20 Fully indexed Metro Bonds should be introduced by the Treasury in multiples of £1,000 and with a minimum investment period of one year. The purchase of these bonds would give a deduction of their face value from the taxable profits of the company in the year of acquisition. Any unutilised surplus would be carried forward indefinitely until absorbed by future profits liable to corporation tax. The proceeds of redemption of these bonds would be added to the taxable profits of the company in the year of repayment.

21 We consider that these bonds would result in better planning decisions and the more advantageous use of internally generated resources. At the same time the Treasury would benefit from an additional source of funds, receiving 100% of the taxable profits concerned until such time as sizeable taxation allowances are available to offset against all or part of such profits.

pu[illegible] 153

PS / FST
~~Pl see Ch's m/s comment.~~
1/5 PSJ 3 May.

CHANCELLOR

my speech made exactly the same point — & not the one made by Fred Emery!

cc Chief Secretary
Minister of State (C)
Minister of State (L)
Mr Ridley
Mr Cropper
Mr Cardona

BOW GROUP SPEECH: THE NEW CONSERVATISM

The Financial Secretary has seen the piece in today's Times (copy ... attached) reporting your speech to the Bow Group last night. The political editor names him as having "come close to suggesting that the New Conservatism began with Mrs Margaret Thatcher in 1975."

He would like to draw your attention to the conclusion of his own talk to the Bow Group last August, entitled "The New Conservatism", ... a copy of which is attached.

D L W.

D L WILLETTS

29 April 1981

Tory policy 'true to traditions'

By Our Political Editor

A proud affirmation that the Government's economic strategy was what "had always been part of the Conservative canon" was made last night to the party's Bow Group by Sir Geoffrey Howe, Chancellor of the Exchequer.

By contrast, he mocked Mr Roy Jenkins, joint leader of the Social Democrats, for offering "mañana monetarism" by beginning to curb the money supply next year, not this.

Sir Geoffrey said that when he had discovered the meaning of the labels "the new Conservatism" and "the social market philosophy", he felt a bit like Molière's M Jourdain, who on learning what "prose" meant, realized he had been speaking it all his life.

The present strategy, he said, was "the logical culmination of a tradition of thought which has been continuously developing within the Bow Group and elsewhere for 30 years".

In saying that, Sir Geoffrey was rebutting contentions that the Government must be careful not to depart from solid Toryism, made most notably by Mr Norman St John-Stevas, when in the Cabinet, and Sir Ian Gilmour Lord Privy Seal.

Others, such as Mr David Howell, Secretary of State for Energy and Mr Nigel Lawson, Financial Secretary to the Treasury, have come close to suggesting that the new Conservatism began with Mrs Margaret Thatcher in 1975.

Sir Geoffrey praised the Bow Group's contribution, without noting the change in its political stance. It has moved rightward since its foundation 30 years ago, and since he was chairman in 1955.

In the words of one of the Bow Group's founders, "it was not respectable to be Conservative", Sir Geoffrey noted, adding that today "it is certainly true that in the academic world, in journalism, in intellectual circles generally, the ideas of the free market, individual liberty, and the rule of law, all of which then seemed passé, are now back at the centre of the stage.

"The central themes of discussion are no longer the socialist concepts of equality and state planning."

What he called the "lumpen Marxist groups", while vigorous enough to take over the Labour Party, "offer no intellectual challenge to Conservatism". They made no attempt to convince voters; "like insects feeding on a decaying corpse, they ignore the living world . . .".

As for the Liberals and Social Democrats, "their spokesmen cannot quite decide whether to attack us from the right or from the left", he said.

He noted that Mr Grimond, the former Liberal leader, recently "berated us for excessive moderation in our attack on public expenditure". But Mr John Horam, "the nearest thing to an economic spokesman among the gang of 14",

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EXTRACT FROM 'THE NEW CONSERVATISM'

What, then, really is new about the new Conservatism? In economic terms, as I have tried to show, very little. But equally important, it has a robust commonsense quality that is wholly in harmony with the everyday experience of the ordinary family.

Monetarism, after all, is really rather obvious: if you produce too much of something, its value falls. If you borrow too much, you're likely to get into trouble. It is Keynesianism, which seems to stand everything on its head, which is the difficult and esoteric doctrine.

Nor is distrust of Government and what it can do new either: the novelty is, if anything, the surprising degree of trust and confidence in big Government which so many British citizens displayed for so long after the war.

All that is new is that the new Conservatism has embarked on the task — it is not an easy one: nothing worthwhile in politics is; but at least it runs with rather than against the grain of human nature — of re-educating the people in some old truths. They are no less true for being old.

WALL STREET JOURNAL
WEDNESDAY, 30 APRIL 1981

Clerk
Pl attach to this a copy of the piece by Martin Feldstein in FT p. 6/5.
JW

Reagan's Regan

How the Treasury Boss Spends His Day Selling President's Program

His Pitch for Tax-Cut Plans Appears to Make Progress After His Dubious Start

The Need for a Thick Skin

By KENNETH H. BACON
Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON—At 7:13 a.m. Treasury Secretary Donald Regan sits uneasily in his conference room as technicians from NBC's "Today" show make final adjustments.

"What are you going to ask me?" he asks his interviewer, Chris Wallace, and he is told the questions will concern President Reagan's economic speech to Congress and the nation scheduled for that night.

Two minutes later, Mr. Regan is on the air, saying, "This President and the people have such an affinity, the people will want to support him." The stockbroker-turned-pitchman predicts passage of the President's plan to cut income-tax rates by 30% over three years. He dismisses a suggestion that the administration's deep budget cuts will upset the public, and he emphasizes the prospects for cooling inflation. "When people find out what the budget's going to do, they'll cheer," he asserts.

Thus, Donald Regan begins another day of salesmanship. He is campaigning for spending cuts, relaxed regulation and a tight monetary policy—but most of all for the controversial Reagan tax-reduction plan. "His mission is selling the tax cut to Congress," says Craig Fuller, the secretary of the Cabinet. And reports from Capitol Hill indicate he is making progress.

Several months ago, the former chairman of Merrill Lynch & Co. seemed to be stumbling in Washington after a decade of leadership on Wall Street. The press frequently portrayed the 62-year-old Treasury boss as jealous of the influential budget director, David Stockman, the administration's savvy boy wonder. Mr. Regan denies any tension with Mr. Stockman, but he concedes that the speculation "demeaned me a little." He adds, "When I came down here, I knew I'd need to have a thick skin."

At first he irritated some in Congress with responses that seemed uninformed or arrogant. "I heard a number of complaints about how he talked to Congress initially,"

But now Mr. Conable has nothing but praise for the Treasury boss. "He's very determined, very tough. He's going to make policy in his area, and he's going to win the strong support of the President." As for the Regan dealings with Congress, Mr. Conable says, "I don't know of a Secretary of the Treasury in recent years who has gone out of his way more to meet appropriate members of Congress. Don Regan has really extended himself to get to know this mysterious breed called politicians." Several times a week, Mr. Regan invites Congressmen to his office for lunch or drinks.

Rising Stock

At the White House, Mr. Fuller says, "Early on, Don wanted everything scripted and outlined," but now he is more comfortable and spontaneous in his role as chief economic spokesman. Mr. Regan's stock with the President's intimates has risen as he has adhered to a strict no-compromise stand on the tax package and has called quick press conferences to attack proposals to scuttle it.

The day Illinois Rep. Dan Rostenkowski, the Democratic chairman of the Ways and Means Committee, proposed his own tax plan, Mr. Regan appeared before the cameras in the White House press room to deride the Democrat's plan as "puny." Although Mr. Regan calls himself a political "novice," he generally warns his targets before he makes such attacks.

Mr. Regan's time these days is devoted primarily to selling the economic package. Following Tuesday's television interview, he takes his elevator to his private dining room for the regular weekly breakfast of the "economic quadriad," which consists of Mr. Regan and Mr. Stockman; Martin Anderson, the presidential assistant for policy development; and Murray Weidenbaum, the chairman of the Council of Economic Advisers. But conflicts prevent Messrs. Weidenbaum and Stockman from attending this time.

Mr. Regan begins with a discussion of rising interest rates and the jittery financial markets. "Knowing what I know about Wall Street, I wouldn't worry about it," the Treasury chief says. "The whole thing is psychological."

But he and Mr. Anderson are clearly concerned that rising interest rates reflect a basic lack of public confidence in the administration's program. Mr. Regan says that "Wall Street's still worried about the large amounts of money we've got to raise here" to cover the deficit, and "they're worried

Reagan's Regan: How He Pushes For Passage of President's Program

Continued From First Page

it," Mr. Regan says. "I don't think we can do anything." However, they agree to send Mr. Weidenbaum and other officials too talk with financial leaders.

After discussing positions on a number of other policy issues, Mr. Regan returns to his office, which quickly fills with aides. He tells David Chew, an executive assistant, to get a final version of the speech President Reagan will deliver that night. "What I want you to do is take every damn number in it and check them out," he says. "I don't want anything that's challengeable."

Dennis Thomas, the Treasury's assistant secretary for legislative affairs, says he has a list of Congressmen for Mr. Regan to call as part of the administration's effort to line up support for a bipartisan budget-cutting proposal the House is expected to start debating today.

Then Mr. Regan is off to the White House to head a meeting of the Cabinet Council on Economic Affairs and to join the President for a session with Republican congressional leaders on the outlook for the administration's economic proposals.

At 10:30 the Treasury boss appears before the Senate Banking Committee to oppose placing restrictions on money-market mutual funds, which Mr. Regan helped create when he was at Merrill Lynch. Some Senators are worried that this high-interest-rate competition is draining funds from savings institutions. The Secretary seizes the opportunity to campaign for the economic program as the answer to that industry's problems.

"What the industry needs most at the moment is less inflation and lower interest rates," he says. "The President's program will provide the best solution."

In his car on the way back to the Treasury, Mr. Regan worries about an answer he gave to a question about why the administration's proposal for a 30% cut in income-tax rates would encourage more savings than would an increased tax exemption for interest income. "We need a crisper answer," he tells his aide, Mr. Thomas.

Back at the Treasury at noon, Mr. Regan meets with aides, who make reports and requests. One matter stands out: A prominent Republican Senator has called with concerns about the President's speech. Returning the call, the Treasury chief learns that the Senator is worried because the text doesn't specifically repeat that the administration wants a 30% tax cut. He fears that this omission could lead listeners to think that the President is signaling his willingness to settle for something less.

Secretary Regan says that the President hasn't thought of compromise and that the White House press office has been instructed to stress this if asked about the speech. He explains that the President left out specific reference to the percentage because "it's a red flag to some of the Southern Democrats who ran against Kemp-Roth," the popular name of the administration's tax proposal. He tells the Senator that the speech is designed primarily to win House approval of a

Later, at a "legislative strategy lunch" with nine top staffers, the Treasury boss stresses the importance of avoiding any hint of compromise on the tax bill. He warns them to be particularly alert to a new proposal he learned about at the White House meeting with Republican leaders. That proposal, reportedly being drafted by Rep. Kent Hance of Texas, one of the crucial Southern Democrats, calls for a 25% tax-rate cut instead of 30% and includes provisions for reducing capital-gains and estate taxes. "Start pricing it," Mr. Regan says to his staff, but avoid any sign of support.

"By standing firm, they're coming to us," Mr. Regan stresses, noting that more members of Congress are beginning to talk of a multiyear tax bill with a substantial cut in rates. In discussing the strategy the Treasury will take when congressional committees start writing tax bills in mid-May, Mr. Regan tells his lieutenants, "We need to be preachy to keep them from adding things." He means he wants a strong dose of supply-side doctrine, which stresses big tax-rate cuts to spur savings, investment and hard work.

As aides fill the office with rumors about Democratic maneuvers on budget and tax matters, the Treasury chief begins a series of calls to Southern Democrats to build support for the House budget resolution backed by the administration.

In a typical call, he says, "Hi, Mr. Congressman. Don Regan. Is there anything we can do for you?. It's very close. We keep hearing these rumors that we'll win big. I think they're setting a trap for us. Quite frankly, we don't want the President coming out of the hospital and ending up with egg on his face. If you vote our way, they'll be cheering for you."

Hanging up, he complains to an aide, "This is the third call he's had from the administration today. It's overkill. If I'm going to call, I don't want to be third on the totem pole." Then he says with a laugh, "Get back to the White House and tell them Regan is balking."

But he makes another call. This Democrat, like several others, wants reassurance that a vote for the budget resolution won't commit him to a three-year tax cut. Don Regan assures him it won't.

Off the phone, he says, "If we get them to the first plateau, we'll just let them sit there. Then we'll try to go to the next plateau."

The calls continue until 6 p.m., when he leaves the office to appear briefly at a reception for bond dealers, to meet his wife for a dinner with Republican contributors and then to go on to the Capitol to hear the President's speech.

A J Wiggins Esq
PPS to the Chancellor of the Exchequer

With the compliments of

THE BRITISH EMBASSY

H G Walsh

30 April 1981

WASHINGTON, D.C.

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CHANCELLOR

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Mr Burns
Mr Ryrie
Mr Unwin
Mr Corlett
Mrs Gilmore
Mr Riley
Mr Williams
Miss Deyes
Mr Cropper
Mr Cardona

TREASURY QUESTION TIME : 30 APRIL

I attach supplementary briefing on :

(i) Points on the general economic outlook to help refute attacks by Mr Shore;

(ii) Today's front page FT article by Peter Riddell which includes a figure of ½ million "hidden" unemployment;

(iii) Melvyn Westlake's piece in today's Times on the tax burden and incentives - Robin Hood in reverse (brief prepared by FP).

2. I have also seen Mr Willetts' minute of yesterday which refers to the Financial Secretary's anxieties having seen an agency tape reporting the CBI claim that "the recession has deepened in the past four months." This is true as a literal interpretation of the CBI Survey since the balance of firms report falling output over the past four months. But, as Sam Brittan points out in today's FT Economic Viewpoint it is misleading to take the CBI evidence at its face value. Considering all the available evidence there is a reasonable presumption that output has already stopped

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falling. The more interesting (and more widely reported) conclusion emerging from the CBI Survey is that over the next four months output is likely to be fairly flat. Few people would challenge this view.

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30 April 1981

(i) General economic outlook - counters to Mr Shore

There is a danger here of appearing too bullish. We must remember that the only direct evidence that the recession has bottomed out is one month's industrial production figures. You could say, however :

- there is growing evidence that the fall in output has come to an end; and/or

- the business outlook (as evidence, for example, in the April CBI Survey) now appears much more favourable.

But you would be best advised not to make statements at this stage to the effect that :

- the upturn has come; or (as Sam Brittan claims in today's FT) :

- output is growing a good deal faster than at the snail's pace predicted by the Treasury at the time of the Budget.

There is really only the flimsiest of evidence for such views.

2. In countering Mr Shore it might therefore be safest to go for a rhetorical approach - how can Mr Shore criticise our policies now that there is evidence that output has stopped falling, that business confidence has improved, that (in some industries) there are reports of higher productivity, etc, etc and how can he criticise our policies when his own would mean higher interest rates and/or taxes and undermine any recovery, just as it may have started ?

(ii) <u>Estimates of 'hidden' unemployment</u>

The front page article by Peter Riddell in today's FT refers to an earlier estimate of his that there are ½ million 'missing' workers not included in the unemployment figures. It is quite impossible to estimate hidden unemployment with any accuracy or confidence - estimates range

to the TUC's 1½ million. Ministers are strongly recommended not to get involved in any discussion of figures. The suggested line to take (agreed earlier this year) is :

> "Unemployment figures are published on the same basis as under previous administrations. We are concerned about unemployment however defined. But our policies are laying the foundation for the creation of secure employment."

2. You might also note with favour the following passage from a MSC paper to NEDC :

> "The current definition [of unemployment] provides a good and well understood series for discerning trends and once that firm ground is left there is endless scope for statistical and semantic debate."

(iii) Westlake article

BACKGROUND NOTE

Mr Westlake's article copy attached seems to be based on two sources: the Treasury paper given recently to the Treasury Select Committee on the effects of the last three Budgets on disposable incomes and research by the Low Pay Unit.

2. So far as we can see in the time available, Mr Westlake has reported correctly the figures given in the Treasury paper.

3. As Mr Westlake does not identify the document by the Low Pay Unit which he has used, it is very difficult in the time available to check their figuring. However, DEU2 advise that calculations of the sort he mentions are extremely dubious. The data is simply not available to make comparisons between the low paid and highest paid of this sort. The research available suggests that specific duties are regressive for those earning between two-thirds and one-and-a-half-times average earnings, but it is not possible to make precise statements ~~even about~~ above this that earnings range: Mr Westlake's example of workers earning £75 a week and £600, which is clearly well outside that range, can only be based, so far as we know, on the prejudices of the Low Pay Unit.

4. A large number of supplementaries may be put in Question Time on the basis of Mr Westlake's article. Draft replies to what seem to be the major points which may be raised are attached.

FP Division

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DRAFT SUPPLEMENTARIES

THE BURDEN OF TAXATION HAS INCREASED

The only sure way to get the tax burden substantially lowered is to conquer inflation by maintaining control over the money supply and public borrowing. This has meant a higher overall tax burden in the short run.

THE BURDEN REDISTRIBUTED IN AN UNFAIR WAY, ACCORDING TO MR WESTLAKE

Some of Mr Westlake's figure-work, in particular those figures which he says he has obtained from the Low Pay Unit, looks rather shaky. If we look at the tax proposals in this year's Budget, we will see that the largest cuts in real income fall on those with very high incomes.

LOWEST PAID HAVE BEEN HIT HARDEST BY THIS GOVERNMENT'S TAX CHANGES, ACCORDING TO MR WESTLAKE

Some of Mr Westlake's figure work, in particular, those figures which he says he has obtained from the Low Pay Unit, looks rather shaky. Looking at income tax, where rather more precise estimates are possible, it is true that the higher paid have done better than the lower paid since we took office. This reflects the punitive level of taxation of the higher paid under the previous Administration. We made no secret of our intention to reduce the higher rates of income tax during the General Election campaign.

HIGHEST PAID HAVE BENEFITED MOST FROM THIS GOVERNMENT'S TAX POLICY

True, at least as far as income tax is concerned, but we made no secret of our intention to cut the punitive levels of taxation on the higher paid, during the General Election campaign.

? Previous punitive levels of taxation not a reasonable baseline for judgments of this kind. Remedying a gross injustice isn't favouritism.

ACCORDING TO LOW PAY UNIT, THE PROPOSED INCREASES IN THE EXCISE DUTIES IN THIS YEAR'S BUDGET HIT THE HIGHER PAID LEAST

I know of no empirical data which would substantiate this claim. Our proposals on the indirect taxes will reduce public borrowing and thus help to bring inflation down in the longer run and ensure that it stays down. Our economic policies are designed to benefit all income groups. Failure to index the personal income tax allowances drags $1\frac{1}{4}$ million people into tax who would otherwise have escaped it.

To index personal allowances would have cost £$2\frac{1}{2}$ billion. Circumstances did not permit such a large injection of resources into the personal sector this year. Given recent trends in personal disposable income, moreover, we take the view that other sectors of the economy deserved priority this year. I make no apologies for that policy.

GOVERNMENT'S TAX AND SPENDING POLICIES ARE INCREASING INEQUALITY

Mr Westlake's point is typical of many who complain about the burden of taxation. At the same time that they wish to reduce tax, they wish to increase public expenditure. There could be only one result from such a policy: higher inflation. We do not intend to go down that road.

"WHY WORK"/POVERTY TRAP

As my rt hon Friend the Secretary of State for Social Services made clear in the Budget debate, the effects of the Budget in this area should not be exaggerated. I do not deny that there are problems in this area. But in this area, more than most, lasting improvements can only come if there is sustained economic growth, creating sufficient jobs with adequate rewards. It is precisely to this end that the Budget proposals as a whole are directed.

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TIMES Social Focus

30 APR 1981

How Robin Hood in reverse is pushing the poorest worker into the tax trap

Effect of last three budgets on personal tax burden

Income tax and national insurance contributions as a % of gross earnings plus child benefit (1) paid by typical married man with 2 children, on:

	⅔ average earnings	Average earnings	2 x Average earnings	5 x Average earnings
1978/79	18.7	25.2	29.9	49.8
1979/80	19.3	24.7	27.9	41.2
1980/81	20.8	25.8	28.9	42.6
1981/82(2)	22.8	27.5	31.3	44.7

Source: Note by Treasury to H of C Treasury Committee and independent calculations.
1) Increase in child benefit averaged over financial year.
2) Assumes earnings and prices rise 10% between 1980/81 and 1981/82.

Tax changes in the last three budgets

June 1979

Main personal allowances increased by 18 per cent — double revalorization. Higher rate thresholds substantially increased.

Basic rate of income tax reduced from 33 per cent to 30 per cent and substantial reductions made in the higher rates of tax.

Unification of VAT rate at 15 per cent. Petrol duty increased.

March 1980

Main personal allowances increased by 18 per cent — fully revalorized. Higher rate thresholds increased by between 11 and 12 per cent.

Lower rate band of 25 per cent abolished.

Increases in vehicle excise duty and the specific duties on alcoholic drinks, tobacco and road fuel.

March 1981

Personal allowances and higher rate thresholds unchanged. Vehicle excise duty and the specific duties on alcoholic drinks, tobacco and road fuel increased.

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* If the Government had taken office two years ago with the deliberate intention of redistributing the tax burden from the richest workers to the poorest, of extending the "poverty trap", and of exacerbating the "why work" syndrome, it could probably not improve on its record so far.

Sir Geoffrey Howe's three budgets have not only raised the nation's tax burden by about a fifth overall (comparing tax as a proportion of gross domestic product in 1978-79 and 1981-82) but has redistributed that burden in the unfairest way. The Chancellor has, in fact, acted like Robin Hood in reverse, increasing disproportionately the tax bills of families on low wages and substantially reducing the tax burden of those families in the very highest income brackets. He has, in addition, raised the number of families in the poverty trap by almost 40 per cent during his Chancellorship from 80,000 to around 110,000.

It is a truly astonishing record for a Government which won the election in May 1979 with promises to encourage enterprise and improve incentives by cutting income tax at all levels. Indeed, those people on lowest pay were to be freed from paying income tax altogether, according to Conservative Party election leaflets.

Yet all taxes, taken together, will represent about 47 to 48 per cent of the nation's gross domestic product in the current financial year, compared with 39.7 per cent in the last financial year of the previous Government. Part of this increase is attributable to higher revenue from North Sea oil. But the tax burden on the majority of wage and salary earners has also risen, with the exception of the highest paid.

This is shown clearly in a recent paper produced by Treasury officials at the request of the House of Commons Treasury and Civil Service Committee. For the typical married man with two children, on average earnings (£132.90 a week in 1980-81), the direct tax burden in the current financial year will be over nine per cent higher than three years earlier — that is taking income tax and national insurance contributions as a proportion of gross earnings and child benefit. This assumes for illustrative purposes — as the Treasury does — that earnings this year rise in line with inflation.

The man on twice average earnings has done rather better. The increase in his direct tax burden is only slightly over half that for the man on average earnings, if they are both married with two children. But the man in similar circumstances whose earnings are five times the average has done best of all. His direct tax burden will actually have fallen 10 per cent.

The Treasury does not provide figures for those paid less than average earnings, but such calculations can be derived from the information that it gives in its paper. They show that the typical family man, receiving two thirds average earnings, will experience a rise in his direct tax burden of no less than 22 per cent over the period 1978-79 to 1981-82. Well over a third of all adult, full-time workers earn somewhere between two thirds of average earnings and the average level.

What this means is that the two-child family man, receiving two thirds average earnings, will be just 56 pence a week better off this year, after all stoppages and after allowing for higher prices, than he was three years ago. If child benefit is added to net earnings, he will be £2.06 — or 3.4 per cent better off a week in real terms. The man on average earnings, with the same family circumstances will be £3.43 or 4.3 per cent better off, if child benefit is included; on twice average earnings, £5.84 a week or 4.1 per cent, better off; and the man on five times the average, no less than £38 a week better off, almost 16 per cent.

All of this does, of course, leave aside the increase in the burden of indirect taxes, like excise duties and value added tax. The effects of changes in such taxes on the level of prices is taken into account in the above calculations as they are expressed in real terms.

But the higher indirect taxes have a greater effect on the living standards of families at some income levels than at others. It is, again, those in the higher income brackets that come off best. According to the Low Pay Unit, the increase in excise duties in the last Budget hit workers earning £75 a nearly twice as hard as it did workers on £600 a week.

The married man with two children, on average earnings, is paying this year nearly 17 per cent more in indirect taxes (in real terms) than he was in 1978-79, according to the Treasury.

There are several reasons why the low-wage families have been so badly hit. One important reason has been the failure of the Chancellor to raise personal allowances in last month's Budget in line with inflation. This has meant that — in real terms — the level of income at which families become liable to tax fell by more than £4 a week.

Another factor was the abolition of the reduced rate band of tax on the low paid in the 1980 Budget. This raised the marginal tax rate of the lowest paid from 25 pence in the pound to 30. A third factor is the increase in the rate of national insurance contributions from 6½ per cent to 7¾ per cent.

The failure to index personal allowances in line with inflation had the effect of cutting the real value of these allowances by 15 per cent and drawing 1¼ million low-paid people into the tax net who otherwise would have escaped it. It also means that the tax threshold has continued the downward trend of the last 25 years.

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A quarter of century ago, a family man on average earnings would not have paid income tax at all. But under Sir Geoffrey Howe's Chancellorship, the threshold tax has dropped from 45 per cent of average earnings (plus child benefit) to 38 per cent.

As the Chancellor himself observed in his Budget a year earlier, the failure to index personal allowances not only lowers the real starting point of income tax and increases the number of taxpayers, but narrows the gap between the tax thresholds and the main social security benefits, and hits particularly hard those on the smallest incomes. The cost to the Exchequer of indexing the personal allowances this year would have been about the same as adding three pence to the standard rate of income tax. The latter change would have been better for families earning less than £109 a week, but as we know, the Prime Minister personally vetoed a rise in the standard rate because it would have reversed the celebrated cut in the Budget of June 1979.

In fact, the married man with two children, receiving two thirds average earnings, does not seem to have benefited even from the largesse distributed on that occasion. By contrast £200m — a seventh of the total amount distributed in tax cuts — was divided between the half million people paying tax at the higher rate bands (two per cent of all tax payers), giving them well over £400 each a year. Tax payers on the higher rates enjoyed reductions of up to 23 pence in the pound.

Even before 1979, many tax experts had demonstrated that the British tax system was much less progressive than popularly believed. Today it is possible for a single person to pay the same marginal rate of tax (30p in the pound) on £27 a week as on £240 a week. If national insurance contributions are taken into account, the low paid worker faces a marginal rate of almost 38p in the pound — higher than that paid by those earning nine times as much. This is because, at earnings of £200 or more a week, additional national insurance contributions are not payable.

What the effect of the last three Budgets has been on the relative living standards of different social groups must depend on the original distribution of total gross earnings, as well as changes in unearned income and the "social wage" — that is various cash benefits and free services like those for health and education, provided through the agency of the state.

However, with important elements of the "social wage" being cut, it would be surprising if Britain was not becoming a more unequal society. Government tax and spending policies have been important in reducing poverty and income inequality since the War.

The Government has, of course, laid stress on the need to reduce taxes because of their disincentive effects. In his 1979 Budget, the Chancellor noted that it was not only the top income earners that were affected in this way: those on the lowest taxable incomes were similarly affected. Yet, largely because of the effects of taxation biting deeper into the net incomes of the low paid, many families with children may be little better off, or even worse off, than if the main breadwinner was unemployed.

This so-called "why work" syndrome has been made worse since 1979, as has the "poverty trap" — where the effect of increased earnings for the low paid is largely offset by increased tax payments and reduced benefits. That portion of a typical family's income (earnings plus child benefit) which is tax free is dropping steadily behind the official definition of poverty. That tax-free portion will be down to 38 per cent in November for a man on average earnings. At the same time, the starting rate of income tax on the low paid — at 30 per cent — is said to be the highest in the world with the single exception of Australia.

Calculations of the Low Pay Unit suggest that in November, 1980, the tax-free income of a typical family on average earnings was 78 per cent of the Supplementary Benefit level and 69 per cent of Family Income Supplement. By next November this will be down to 70 and 63 per cent respectively. Such trends, if they continue, are certain to have the profoundest consequences.

Melvyn Westlake