MKJ 14/11
cc NMT

10 DOWNING STREET

THE PRIME MINISTER

18 November 1980

Dear Mr. Macpherson

Thank you for your letter of 17 October enclosing your Chamber's position paper. I value your endorsement of our economic objectives and much appreciate the time you spent sending me your Chamber's views.

I agree with you about the crucial importance of reducing public expenditure. You perhaps do not give us sufficient credit for what has been achieved on this score. At the time of the Budget last March we announced a reduction of £5 billion in the current year, 1980-81, with substantially larger reductions planned for the succeeding years. I also agree in preferring to reduce current rather than capital expenditure. But the overriding need is to get the total of public expenditure down for all the reasons you mention and to achieve this we cannot exempt capital expenditure from the necessary reductions. You refer to the need to cut staff numbers. The size of the Civil Service has already been reduced from 732,000 when we took office to 697,000 now. Our aim is to reduce the number further to about 630,000 by April 1984, which would mean the smallest Civil Service since the war. Sir Derek Rayner is advising me on improving efficiency and eliminating waste, and under his guidance considerable savings have already been identified by Departments. I agree that it is of paramount importance to control public sector pay. As you know, the Government has now announced the abolition of the Clegg Commission. This year, in order to set an example for other groups, the Government decided not to pay

/in full

DSG

in full the amounts recommended by the Top Salaries Review Body. We have been making it clear that next year's cash limits will be based upon single figure pay settlements.

You suggest that the Government take steps to prevent local authorities from raising rates to compensate for reductions in central government grants. The Government is taking powers in the Local Government Bill to strengthen control over local authority spending. The new system of block grant will discourage excess local authority current expenditure; the new capital control system will prevent local authorities from increasing capital spending above the Government's plans by increasing rates. These measures should ensure local authority spending is firmly under control.

As far as interest rates are concerned, I can assure you that it is our firm intention to reduce them over time, but this must depend on monetary developments and conditions. Our first priority must be to get inflation down further. To reduce interest rates prematurely would jeopardise our success so far in reducing inflation and would, I am convinced, in the long run place industry under even greater strain. You urge the Government to extend the system of tax relief on interest charges to benefit companies making insufficient profits to obtain relief. We have considered a number of suggestions along these lines. Any scheme that was administratively workable, however, would spread a subsidy over a much wider group of companies than those it was intended to assist. The annual cost to the exchequer could thus run into hundreds of millions of pounds at a time when we need further cuts in public spending and borrowing.

I fully appreciate the problems that a high sterling exchange rate can cause for industry. But the current level has not been sought as a matter of deliberate policy. Since the abolition of exchange controls last autumn, the rate has been determined by the market. If we were to attempt to control the exchange rate - and it is by no means certain that this would be possible - then we would have to cease to give priority to monetary targets. This would risk jeopardising the fight against inflation and thereby damaging competitiveness - not improving it except possibly in the very short run. You advocate improved export credit facilities with full exchange risk cover. ECGD already offers a range of facilities broadly comparable with, if not better than, those available to your competitors. We are already spending about £500 million a year at current interest rates on the fixed rate export credit scheme, and further subsidies for exporters would be likely only to postpone the reduction in inflation and interest rates that industry needs.

I recognise that recent increases in energy and telecommunications prices have added to your burdens at a difficult time. Our problem is to persuade the nationalised industries to be as cost conscious as the private sector has to be. We set tough financial limits only to find that monopoly power enables those industries to put up prices.

I entirely agree that public purchasers should buy British wherever possible. In fact the public sector has a good record in this respect; over 90 per cent of purchases are from British sources. We believe, however, that more cooperation can help in making industry more efficient, so that it can maximise its markets both at home and abroad.

I hope you will find these comments useful.

Yours sincerely

(sgd) MT

R. T. S. Macpherson, Esq.