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Secretary of State for Industry

20 February 1980

The Rt Hon Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
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Prime Minister

Sir Keith argues for a reduction in the fiscal burden on industry because of the poor prospects for corporate liquidity - even if this means not fulfilling Rooker/Wise in order to pay for it.

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Dear Geoffrey,

As you consider the balance and main constituents of the Budget, you may wish to have a note of the industrial position as I see it, and the priorities I favour.

This letter is, of course, written without benefit of the latest National Income Forecast now being formulated. I share your reservations about forecasting, especially in present conditions, and I understand that you want to keep the forecast to as minute a circle as possible at this time. Nevertheless, I hope you will agree that I may see the forecasts submitted to you, as I did last Summer though not in the Autumn. I should not be surprised if the forecast indicated a significantly higher earnings and price level increases than in the Industry Act forecast, and a substantially sharper fall in GDP and - more especially - in manufacturing output. The consequences of such trends for corporate liquidity would be very serious and I return to that below.

I understand and strongly share your concern at the likely size of the PSBR, which will be aggravated by the effects of the steel strike, by the adverse trends in earnings, prices and activity suggested above, if they materialise, and by the lower expected output from the North Sea. The effects on interest rates if a PSBR of £10-11b had to be financed would be deeply worrying. I assume from our discussions in Cabinet that the greater part, if not the whole, of the further public expenditure cuts together with sales of assets and any reduction in our EEC contribution will go to reduce the PSBR; and that there will be little if any headroom for net tax reductions - indeed quite possibly the reverse.

The corporate liquidity situation seems to me of pivotal importance. Pressure on corporate liquidity is, of course, one of the mechanisms by which our monetary policy is intended to operate on inflation expectations and wage demands. But there may come a point at which that pressure entails unacceptable damage in two areas - the chances of survival of potentially viable parts of our industrial structure (which we cannot assume will all automatically be picked up and restored to life out of receiverships); and the maintenance of a reasonable level of investment during the recession so that industry can enter an upswing in reasonable shape, rather than becoming even more debilitated and obsolescent. Somehow we have to judge whether that point has been, or is likely to be, reached; and if so how best to adjust for it.

The inter-Departmental official group on Industrial Finance, which reviewed the prospects for the corporate sector in the light of the Industry Act forecast, envisaged a corporate sector deficit (excluding North Sea companies) in 1980/81 a little less severe than in 1974 (4% of GDP compared with 4¾% then). It suggested, however, that manufacturing might be under particular pressure compared both with other sectors and with manufacturing's own position in 1974, even after making substantial reductions in stocks and investment. And it suggested that "perhaps the greatest cause for concern is that this retrenchment by companies will prolong the recession, delay the recovery and further damage output and employment growth". I fear that the forthcoming National Income Forecast will imply a still further significant deterioration in the prospect for industry in general, and for manufacturing in particular, in 1980/81, and that the financial position for the corporate sector may be substantially worse than 1974.

In these circumstances the first point I want to make on the content of the Budget is that, at the very least, there should be no question of actually increasing direct burdens on industry in the Budget. I have in mind particularly the suggestion that we should block VAT deduction on road fuel used by business, with a cost of some £525m in a full year to industry (or £275m for petrol alone); and the suggestions that monthly repayment of VAT to repayment traders should be ended. I hope you will also consider whether any increases in the specific duties can be avoided or moderated where they are of particular weight for industry - the heavy fuel oil duty is a prime candidate here, and Derv is another, for both of which there is a respectable economic case for exemption from revalorisation. But the point is of general application, and I hope you will consider carefully whether any changes you may be contemplating would have direct or incidental adverse effects for corporate liquidity, and avoid or mitigate those effects if possible.

My second point is that I hope you will look closely at the possibility of substantially increasing the take from the North Sea. I think there have been two principal reasons for caution in this area hitherto: the undertakings given to North Sea operators, and the risk of delaying exploration and exploitation. As to the first, whilst I appreciate you have already accepted the last Government's increases, and yourself accelerated payment of PRT, I feel strongly that the recent huge increases in world oil prices and producers' margins fully justify a windfall profits tax (using some instrument which would bring in the additional revenue now rather than with delayed effect as would happen by adjusting PRT rates or allowances). As to the second, if we agree that depletion should be delayed, it seems sensible that we should use tax increases as part of the mechanism to bring this about, and thus kill two birds with one stone. Of course delayed depletion will mean reduced revenues in the medium-term; but a sharp increase in the short-term offset by smaller revenue in the medium-term does fit the profile of our monetary requirements. I believe there is scope for securing very substantial additional revenue in the short-term from the North Sea without unacceptable penalties. I should strongly resist accepting serious damage in the non-oil corporate sector (especially manufacturing) which could have been mitigated by more vigorous action on North Sea taxation.

Third, on the assumption that significant additional revenue is obtainable in the short term from the North Sea, there are several broad directions in which that benefit could be deployed. It could be used to make further progress on our objective of cutting income tax, either on the allowances or on the basic rate. Or it could be used to cut back the PSBR as a proportion of GDP lowering interest rates and releasing resources for private sector use. Either of these, of course, would be welcome in normal circumstances. With some misgivings and after careful thought, however, I have myself concluded that now is the time to direct fiscal easement to the corporate sector. There are of course several possible ways of giving relief but the most satisfactory in my view would be to remove the whole of the National Insurance Surcharge. We spoke about this in November and I said then (in my personal letter of 9 November) that I agreed we could not at that stage decide to reduce the NIS, but added "company liquidity looks awful and may look even worse - and that is why I have to emphasise at this stage." I am aware that changing the surcharge mid-year entails serious administrative penalties for the DHSS and for companies, but I believe those factors have to be subordinated. Alternative reliefs, for example, on the Corporation Tax rate, would not necessarily be widely enough spread or give direct help to the right companies.

Also in the corporate sector, I would put a very high priority on adjustment to the stock relief arrangements to avoid a heavy tax charge where there is a temporary reduction in stock values, about which I have already written to you; this is likely to be a serious problem not only for firms hit by the steel dispute but more generally in depressed trading conditions.

These easements to the corporate sector would by no means remove the acute financial pressure on companies. With industry operating on average at about break-even in real terms, and faced with the necessity of making major cuts in investment programmes, product development expenditure, R & D, stocks and manning levels, I do not think it should be assumed that an easement of this size will leak to a major extent into higher wages. Given the present level of competitiveness of British industry (caused immediately by the exchange rate), any leakage is much more likely to be into prices which would be helpful for our counter-inflation policy, for exports and for manufacturing output.

I believe that the strong case for some easement to the corporate sector stands even if you are unable to secure early additional revenue from the North Sea. I accept that, given the overall conjunctural prospect, to reduce fiscal burdens on industry without additional oil revenue and without increasing the PSBR is likely to entail increases in taxation in the personal sector - though because it could not be implemented until later this year the cost of abolishing the NIS would not be overwhelming in 1980-81. I appreciate the attractions of sharp increases in the specific duties on alcohol, tobacco and hydrocarbons. Given the present threatening prospects for retail prices, however, I think we shall need to be very much on the cautious side. It follows that, without additional oil revenue, the tax reductions I advocate for industry would have to be financed by higher income tax than would otherwise be possible for instance by not fully indexing personal allowances. This would be a bitter pill to swallow, and I should not advocate it were I not so concerned about the prospect for the corporate sector in the period immediately ahead.

Fourth, I know you intend to give some prominence to small firms and enterprise, and we are in separate discussion on that. David Mitchell has, I understand, given you separately his personal suggestions for further technical measures in the small firms field.

Fifth, I have already written to you about the extended reliefs for employee shareholding schemes we agreed recently in the E Committee, which are essential in connection with the privatisation of British Aerospace. I have also given you my views on the desirability of reviving the 1972 share option scheme, which would have negligible cost.

Finally, I had hoped by now to have had details of progress on two major reviews of taxation - capital taxation and corporate taxation both central to my responsibilities. To my considerable regret, neither I nor my officials have been consulted on either of these, and we have therefore been unable to contribute an industrial perspective at the formative stage. Perhaps your officials could let mine have copies of the relevant documents so that we can let you have our initial reactions.

I am copying this letter to the Prime Minister.

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Keith.