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10 DOWNING STREET

THE PRIME MINISTER

2 December 1980

Dear Sir William,

Thank you for your letter of 31 October and the enclosed memorandum on the exchange rate and industrial competitiveness.

I recognise there is a widespread feeling among industrialists that our policies are placing too heavy a burden on the manufacturing sector and there is no doubt that an imbalance has developed between the personal and company sectors. Consumers have experienced a gain in real living standards, even though output has been falling, through higher pay settlements and the effect of the strong pound on import prices. On the other hand, companies have suffered declining profit margins due to rising domestic costs and the strong pound. High interest rates have also been adding to the problems of the company sector.

We have recently taken a number of measures to deal with this situation which are designed both to consolidate the progress we are making towards reducing the rate of inflation and to limit the burdens the company sector is now facing. Despite the harsh difficulties caused by the recession, we have taken steps to contain public borrowing and expenditure next year. This will ensure that the planning total for public expenditure in 1981-82 will still be some £5 billion below the level planned by the last Government, and that the burden will fall less heavily on the company sector. We have also made it clear that we intend to place strict limits on the cost of public expenditure as well as its growth in volume terms. As I mentioned in my letter of 1 December, we have announced that the Cash Limit for the 1981-82 Rate Support Grant will provide for earnings increases of 6%; and we have also said that provision for pay increases in other cash limits will be subject to broadly the same financial disciplines.

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We have also taken or announced a number of specific measures which will do much to help the manufacturing sector. First, and most important, we have been able to announce a 2% reduction in MLR. Secondly, we have announced our proposals for changes in the Stock Relief Scheme. These are designed to remove the threat of "clawback" and will give more help to the manufacturing sector. Thirdly, industry will benefit from our proposals to provide further selective assistance for investment and support for industrial research and development.

In your memorandum you place a great deal of emphasis on the role of the exchange rate in relation to our international competitiveness and suggest a number of ways in which industry's costs might be reduced. Before commenting on some of your specific suggestions, I think I should make one general comment. Although I recognise that a strong pound has placed a burden on industry, by far the most important and fundamental factor behind our loss of competitiveness has been industry's willingness to concede inflationary pay settlements far in excess of productivity. While we have seen some welcome signs of more moderate pay increases in the private sector in recent months, it really is astonishing that in the past year so many companies have been willing to pay wage increases in excess of the rate of increases in prices, particularly in the light of the CBI's assessment that a 1% reduction in the increase in earnings is three times more beneficial to industry than a 1% reduction in MLR. When one compares these increases with the proposals you put forward for reducing industrial costs, it is evident that the measures the Government can take to improve our international competitiveness directly are of very limited significance by comparison with the steps which industry can take to contain its own costs. I must also point out that the proposals you make for reducing industrial costs would all add to Government borrowing and expenditure which in turn would make it more difficult for us to achieve our monetary targets and to secure further reductions in interest rates.

The possibility of eliminating or reducing the National Insurance Surcharge has been looked at on a number of occasions. But this is an important revenue raiser - £3½ billion in 1980-81 -

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and, even if we were to consider abolition only in the case of the specific sectors you mention, it would still be necessary to find alternative sources of revenue and to find the means of overcoming the considerable administrative difficulties involved.

We recognise the strength of the representations made by industry regarding the burden of local authority rates. Better control of spending is the most effective way of controlling rate burdens; and you are, I am sure, aware of the efforts we are making to achieve this through the new Block Grant system. We are also looking at the future of the rating system but you will not be surprised to learn that progress is proving difficult.

I certainly recognise that the duties on road fuel and fuel oil add to industry's costs. But, I think it is important to remember that these duties are important revenue raisers and that in some cases (e.g. petrol) the rates of duty are significantly lower than those of our main competitors.

We are, of course, continually looking at ways of improving our funding techniques and, indeed, have already experimented with the issue of variable rate stocks. But I am not sure that a large-scale conversion would be feasible. In choosing the maturities of stocks we must have regard to the preferences of purchasers, particularly major institutional funds who have long-term liabilities.

I hope you will forgive me if I do not comment in detail on the proposals you make for changes in the tax treatment of gilts, though I have arranged for these to be drawn to the attention of officials in the Treasury and the Bank of England.

Once again, I am most grateful to you for writing and do assure you that all your proposals, including those relating to the taxation of gilts and other negotiable instruments, will be studied most carefully.

Yours sincerely

Margaret Thatcher

Sir William Lithgow