PART A

SECRET + PERSONAL

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PO -CH /GH/0098

PART A

Begins: 1/11/82

DD: 25 Years

Ends: 2/11/83 (CONTINUED) 1/9/95

CHANCELLOR'S SECRET AND PERSONAL PAPERS

PO -CH /GH/0098

PART A

CONFIDENTIAL

(pmp)

C.
See P 5.
14 Jun

EXCHEQUER
- 1 NOV 1982
ACTION
COPIES TO Sir K. Couzens / Mr Littler / Mr Carey
Mr Quinlan / Mr Tregarne.

10 DOWNING STREET

Principal
From the Private Secretary

1 November 1982

I enclose a note of the tete-a-tete meeting which took place between the Prime Minister and the Chancellor of the Federal German Republic at 0915 on Friday 29 October, before the plenary meeting. I should be grateful if you and other recipients would restrict it so far as possible to Private Offices, and only make it available to others to the extent that it is operationally essential to do so.

I am copying this letter, and the enclosure, to John Kerr (HM Treasury), Richard Mottram (MOD), Julian West (Energy), Jonathan Spencer (Industry), John Rhodes (Trade), Robert Lowson (MAFF) and Richard Hatfield (Cabinet Office).

E. E. R. BUTLER

Brian Fall, Esq.,
Foreign and Commonwealth Office.

CONFIDENTIAL

NOTE OF A TETE-A-TETE DISCUSSION BETWEEN THE PRIME MINISTER AND CHANCELLOR KOHL AT THE CHANCELLERY ON FRIDAY 29 OCTOBER AT 0915 HOURS

PRESENT

Prime Minister
Mr. Butler

Chancellor Kohl
Mr. Teltschik

SPANISH ELECTIONS

Chancellor Kohl began by referring to the results of the Spanish elections which had resulted in an overall majority for Senor Gonzalez. This was an unwelcome outcome, and it was worrying that Senor Gonzalez had already made remarks against Nato in his victory speech. The European Community must recognise that the accession of Spain under such a Government would raise more problems than that of olives: although it was not a defence Community, defence issues could not be isolated from other Community interests. A similar problem existed with Greece. The Prime Minister agreed that the European Community was founded on the defence of democratic values and that if these were not firmly defended by all members, the future of the Community would be in doubt. No doubt some allowance must be made for election rhetoric in the statements of S. Gonzalez: Mr. Papandreou had made similar remarks about his attitude to Nato, which had not been reflected in his subsequent actions. But it was worrying that Senor Gonzalez had made such comments at the moment of his election victory.

Herr Kohl said that the poor performance of the Christian Democrats in Spain was a disappointment to him. He had worked hard for them for 4 years and had given financial help, although he had withdrawn some 18 months ago when he saw the direction in which things were going. He had greatly resented the actions of the former Spanish government in involving the King of Spain in the Hamburg elections in the Spring, when the King had been induced to pay a private visit to former Chancellor Schmidt in Hamburg 10 days before the elections. It would now be necessary to try to influence the new Spanish government tactfully, but this would not be easy since the Spanish were a proud people. He felt that he could not be expected to open the gates widely to Spain in the European Community if the Spanish government were to shut the door on defence matters. The Prime Minister commented that it would be a bad start for the Spanish government if they were to withdraw from Nato. Britain had supported the accession

/of Spain

CONFIDENTIAL

of Spain to the European Community, but it was difficult for Britain to influence Spain, particularly in the aftermath of Spanish support for Argentina over the Falkland Islands.

THE FALKLAND ISLANDS

The Prime Minister said that, when the Resolution on the Falkland Islands came forward in the United Nations, she regarded it as important that the whole Community, and Germany in particular, should at least abstain. She was confident that the German government understood, in the light of their own position on Berlin, that it was just not possible for the British Government, having had our territory invaded and having lost many lives in defence of freedom and justice, to negotiate with Argentina over the Falklands: Argentina had not even agreed to stop hostilities.

Herr Kohl said that, as the Prime Minister knew, the German government had for good reasons shown solidarity with the British Government during the period of hostilities, and he regarded this as being no less important now. Former Chancellor Schmidt had consulted him at the time and the German stance was one of the few matters which had been agreed jointly between them. The Argentine invasion was an act of aggression, and the quality was more important than the quantity. The stance of the German government had only limited support from German public opinion, because Germany had such close links with the South American countries, particularly Paraguay, Chile, Argentina and Brazil. No countries, including the United States, had so many people of German origin: for example, 4 of the 7 Brazilian cardinals were of German stock. The Prime Minister commented that Brazil had been scrupulous in adopting a neutral position.

Continuing, Herr Kohl said that it was important to work out a common European Community position. A big problem in this was the French, perhaps because they had economic interests at stake. The Prime Minister commented that hesitation on the part of the French was surprising since they had been very supportive during the period of the hostilities and they had a number of island dependencies which were similalrly near the mainland of other powers. Although economic interests were important, the defence of Spain to the European Community, that it was difficult for Britain to influence Spain, particularly in the aftermath of Spanish support for Argentina over the Falkland Islands.

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/of freedom

of freedom and justice was more important. If the Russians invaded Berlin and the Western powers threw them out, it would be ridiculous to suggest that there should then be negotiations with the Russians over Berlin.

THE PIPELINE

Herr Kohl said that he had the impression that President Reagan might be making a new move towards a compromise on the pipeline issue involving new proposals on economic relations with the Eastern bloc. The Prime Minister said that she understood that there was to be a meeting in Washington that day of the 7 countries at Ambassador level, at which a paper was being discussed with the Americans. That paper covered not only the supply of strategic materials but also proposals to set up working parties on a number of issues, including credit for Iron Curtain countries and the supply of technology. The paper carried no commitments except agreement to avoid certain new contracts while the working parties were in operation. She believed that President Reagan was anxious to lift the sanctions and there was some prospect that the wording of the document would be sufficient to enable him to do so. Having looked at the document, she thought that it should be possible for the seven countries to agree on it.

Herr Kohl agreed that it was desirable to do everything possible to enable the President to lift the sanctions without loss of face. It was evident that the decision to impose sanctions had been a mistake, and there had been no mistaking the triumph in ex-President Carter's voice when he had referred to the decision during his visit to Bonn two days before. Mr. Carter had said that he and his party were willing to help President Reagan off the hook. But Chancellor Kohl was worried that an immediate statement by the President might be premature since he was not sure that the paper in its present form went sufficiently far to help him. The French in particular were proving difficult over it. But it was important that the sanctions be lifted: one aspect of them was that they could so easily be evaded through third countries. The Prime Minister said that she did not think the President was likely to make a statement until agreement had been reached among the seven. She was aware that there were still items of dispute with the French but hoped that it would be possible to find words which did not contain damaging commitments for the Europeans but would be sufficient to help the Americans.

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ECONOMIC SUMMIT

CONFIDENTIAL

ECONOMIC SUMMIT

Herr Kohl said that President Mitterrand had expressed his annoyance during the Franco/German Summit that the new date for the Economic Summit announced by President Reagan had not been widely agreed, and had said that he would not agree to attend on the proposed dates. He himself could not say how much consultation there had been with Chancellor Schmidt but since he had taken office consultations had not been intense. Herr Kohl regarded it as important that everyone should attend the Summit and also that it should be agreed in advance what was wanted from it. In his view, the Western Governments could not afford another Summit like Versailles when hundreds of people had attended and nothing substantial had emerged. President Mitterrand had himself said that the arrangements for Versailles had been a mistake and that a much more restricted summit was desirable.

The Prime Minister said that she had understood that the proposed date for the Summit had been agreed. It was essential that everybody should attend, and it was absurd to quarrel over dates. She herself would have liked the Summit to have taken place earlier, but the German elections would make this impossible. She agreed that the form of the Versailles Summit had been much too elaborate, as had been the preparatory meetings beforehand. She regarded the informal aspects of the Summit as the most valuable part, so that the leaders could get to know each other and understand each others political difficulties and then they could easily lift a telephone and talk to each other in moments of difficulty. Ottawa had been better in this respect than Versailles. She did not expect magic solutions to emerge from such Summits, but it had been valuable, for example, that the Heads of Government had been able to agree to tackle their economic problems in a financially sound way and to avoid protectionism: this had been helpful to the leaders in relation to their own electorates. She therefore agreed with President Mitterrand that the arrangements at Versailles had been too elaborate. She accepted that some concrete announcement had to be made to prevent the press from writing that the Summit had been a failure, but she did not regard this as the most important aspect.

/Herr Kohl

Herr Kohl agreed. A middle way had to be found between giving nothing to the press and running the occasion entirely for the press. He would tell President Reagan that, while he regarded it as important to have some announcements to give to the press, the Summit would only be successful if there were also real and lasting agreements underlying them. The Prime Minister commented that there would be two problems: the relations between France and the United States were not very good and the President would want some concrete achievement to announce in view of the United States elections in the following year. Such announcements would have to be negotiated beforehand, but very discreetly. Herr Kohl commented that it would also be important for President Mitterrand that some useful announcements emerged: although he had seven years of office, local elections in France could present him with considerable difficulty.

ECONOMIC ISSUES IN THE COMMUNITY

Herr Kohl said that he was concerned about the way in which France was adapting its economic policies towards protectionism. These would create problems for the Commission. The Prime Minister commented that agriculture was the area of greatest protectionism within the Community, but there were also many others, for example, insurance and air fares. The French always found a way to restrict imports, whereas Britain and Germany were more scrupulous about observing the rules. Both France and Italy had protectionist agreements with Japan which had been allowed to exist because they were made before the formation of the Community. The Community had to take a close look at these unequal trading arrangements.

Chancellor Kohl suggested that he and the Prime Minister should take a day or a day and a half to discuss this question with a minimum of supporting staff within the next two or three months. He would be willing to come to London for the purpose, and it could be said publicly that other matters were being discussed. This was desirable because Germany would have the Presidency from January, but his principal objective would be to achieve a common strategic approach between Britain and Germany through which they could first tackle the French and then the Latin countries of Europe.

/The Prime Minister

The Prime Minister agreed that it would be useful to try to find a date to have such talks.

FISHERIES

The Prime Minister referred to the recent discussions on fish and suggested that it was vital for Britain and Germany that Denmark should subscribe to the recent agreement reached between the other nine EC members. Germany was in the best position to bring effective pressure to bear on Denmark and she hoped that Herr Kohl would use this to ensure that Denmark agreed. Herr Kohl said that a discreet initiative had already been taken with Denmark and he would raise this matter immediately with Herr Genscher. It might be possible to say some more about it in the plenary session. For his part, he found it difficult to understand the Danish attitude.

POLAND

Herr Kohl suggested that he and the Prime Minister would need to say something about Poland following their discussions. Contacts between the Federal Government and Poland, including a personal report which Herr Genscher had had from Archbishop Glemp, suggested that the situation was very bad and if there was a hard winter there could be a calamity. Russian intervention would be disastrous but it was becoming increasingly clear that General Jaruzelski could not deal with the situation. The Prime Minister agreed that she and Herr Kohl should make an agreed statement on their concern about the position in Poland.

EUROPEAN BUDGET

The Prime Minister said that she would like to say publicly, in relation to the European Budget, that she had welcomed the agreement on the arrangements for 1982 but had stressed to Chancellor Kohl the importance of reaching long-term agreement on the budget issue.

F.E.R.B.

29 October 1982

PERSONAL AND CONFIDENTIAL

(PWP)

EXCHEQUER
10 NOV 1982
No copies

10 DOWNING STREET

From the Private Secretary

C

9 November 1982

Dear Brian,

CALL ON THE PRIME MINISTER BY MR. TUGENDHAT

Mr. Tugendhat called on the Prime Minister at 1630 hours today. I enclose a record of the conversation.

I am copying this letter and enclosure to John Kerr (HM Treasury) and Richard Hatfield (Cabinet Office).

I should be grateful if the contents of the discussion could be most closely protected. This letter and enclosure should not be copied beyond Private Offices without specific authority from here.

Yours ever

John Coles.

Brian Fall, Esq.,
Foreign and Commonwealth Office.

RECORD OF A CONVERSATION BETWEEN THE PRIME MINISTER AND COMMISSIONER TUGENDHAT AT 1630 HOURS ON TUESDAY 9 NOVEMBER 1982 AT 10 DOWNING STREET

2

After a brief discussion about the outcome of the Fisheries Council, the Prime Minister raised the question of the EC Budget. She said she was most concerned about the situation. Some Member States argued that the UK should respect the Treaty of Rome. That argument was irrelevant and was simply a device for clinging on to gains they had themselves secured. We had accepted the settlement for the third year of the 30 May Agreement primarily because we were then engaged in the Falklands affair and could not divert energy to continuing the argument. Other Member States had taken advantage of this. They had infringed the Luxembourg compromise because it suited them to do so. Mitterrand had been in London the previous day and had given no hint of his intentions. Schmidt had sent a letter on the matter but this had not been delivered for some days after the Agriculture Council.

Now, there was no Falklands factor. We should be arguing again for the British concepts of equity and fairness - and we should not be taken for a ride again, though that was perhaps a slightly strong expression.

We could not have an agreement which simply lasted for two or three years. The Commission paper must recognise this and incorporate a formula which provided a solution to the problem so long as the problem existed. It would exist until a fundamental reform of the Budget was achieved. And that would be brought about either at the time of enlargement, or when the 1% VAT ceiling was reached. Mr. Tugendhat interjected that it might come about also as a result of the Commission's paper.

The Prime Minister said that she had resented the attempt of other Member States to claw back what they regarded as overpayments. There was no point in imposing a time limit on the

/ solution

solution for the UK problem. The solution must last until fundamental reform was achieved. This might take three or four or even more years. She believed it could take as long as that before Spain acceded to the Community. She understood Mitterrand's difficulties over Spanish accession. We also had a problem with Spain over car imports.

The Commission's paper ought to point to fundamental reform as the final solution and then propose an interim solution until that point was reached. In return for a lasting solution, we could envisage a further adjustment in respect of alleged over-payments, but this would have to be modest and in full and final settlement of that question.

If we had not obtained a reasonable settlement for the third year of the 30 May Agreement, we should have been forced to with-hold our contribution. We did not wish to go down that route now because our habit was to observe the law. But we could not go on paying our unadjusted net contribution or anything like it. It was necessary to raise sights as to what kind of solution was possible.

Mr. Tugendhat said that he knew as well as anyone how un-pleasant this subject was to deal with and how it corroded Britain's position in the Community. He had felt for some time that the French did not wish the problem to be settled. It suited them quite well that it should continue since it dis-tracted attention from some of their misdeeds and served to isolate us.

The Commission would produce two papers, one on the British problem which should be out next week, and the other, a con-sultative document, on the future of own resources.

He had to say that there was no chance of the Commission agreeing to a formula employing the phraseology which the Prime Minister had just used.

/ The Prime Minister

The Prime Minister said that Mr. Tugendhat should try to obtain that formula, even if the rest of the Commission rejected it. It was being said that the UK Commissioners did not fight within the Commission. Indeed, she had heard that Mr. Richard was often away from Brussels. Mr. Tugendhat said that any accusation that the UK Commissioners did not fight their corner would be unjust. The Prime Minister commented that M. Cheysson, when one of the French Commissioners, would have persuaded the Commission to adopt the French position on an important subject. Mr. Tugendhat observed that if he moved too far from the central trend of thinking in the Commission he could lose all his influence. On the subject of the Budget, he was in a minority.

The Prime Minister said that the fact was that we possessed the money in question and could withhold it. Mr. Tugendhat said that he recognised that that was true. Indeed, he had some ideas about the manner of withholding. Some ways would be better than others. But he knew that he could not incorporate the formula suggested by the Prime Minister into the Commission's paper. He did not have the votes. The Prime Minister said that he should repeat his arguments within the Commission time and time again. If he was saying that a suitable formula was not obtainable then we were on a collision course.

Mr. Tugendhat said that he would like to obtain for us as secure a link as possible between the interim solution and the longer-term review. This would not achieve as much as the Prime Minister and he wanted, but it would give us something to build on. The Prime Minister stated that, on the contrary, such a link might prejudice the British position on the longer-term review. Mr. Tugendhat thought this unlikely. The formula he had in mind would imply that if enlargement did not take place, or if the review of own resources did not occur or did not yield a satisfactory solution, then the interim solution would become permanent. The Prime Minister said that she read this as meaning that the interim solution would continue until a fundamental solution was adopted.

/ Mr. Tugendhat

The Prime Minister said that Mr. Tugendhat clearly [illegible] thought that formula, even if the rest of the Commission rejected it. It was being said that the UK Commissioners did not fight within the Commission. However, the [illegible] heard that Mr. Richard was [illegible]. Mr. Tugendhat said that any suggestion that the UK Commissioners did not fight their corner would be unjust. The Prime Minister commented that M. Cheysson, when one of the French Commissioners, [illegible] had persuaded the Commission to accept the French position on an important subject. Mr. Tugendhat observed that if he moved too far from the central trend of thinking in the Commission he could lose all his influence. On the subject of the budget, he was in a minority.

The Prime Minister said that the fact was that we possessed the money in question and could withhold it. Mr. Tugendhat said that he recognised that this was true. Indeed, he had some idea about the manner of withholding. Some ways would be better than others. But he knew that he could not incorporate the formula suggested by the Prime Minister into the Commission's paper. He did not have the support. The Prime Minister said that he should [illegible] his arguments [illegible] time and time again. If he [illegible] that a [illegible] formula was not [illegible] then we would [illegible] Commission consensus.

Mr. Tugendhat said that he would like to obtain formulae which [illegible] as possible to the [illegible] a solution and the longer-term review. This would not achieve as much as the Prime Minister and he would wish but it would give us something to build on. The Prime Minister asked what, in [illegible], such a [illegible] would produce [illegible] the [illegible] position [illegible]. Mr. Tugendhat [illegible]. The formula he had in mind would [illegible] did not take place, [illegible] did not [illegible] [illegible].

Mr. Tugendhat said that he thought the Commission would propose a formula lasting for a period of years. He would wish to link that period to enlargement and the fundamental review so that if these did not take place the interim solution would continue. The Prime Minister said that she interpreted this as meaning that the interim solution would last for x years or until such time as fundamental reform occurred. Mr. Tugendhat said that that was the meaning of the formula but presentationally it would probably not look so attractive as the Prime Minister's words suggested. As to the longer-term solution, he thought that the Prime Minister was right to say that she was opposed to increasing the 1% VAT ceiling. But a distinction could be made between the VAT resources and other forms of own resources. The Commission would propose a variety of options, some of which could be helpful to the UK. There was an illusion in the Community that if other Community policies were developed and resources were increased, the UK problem would be solved. But this was not true. He hoped that the Prime Minister would look at the Commission's proposals on own resources with an open mind. The Prime Minister said that our minds were closed on the subject of own resources. The Government would be attacked if there was any suggestion that it was putting an increased share of national income under EC control. Mr. Tugendhat said that he was not suggesting that the Prime Minister should actively welcome the Commission's proposals. But, leaving aside VAT resources, he hoped that she would not take up a public position against the increase of own resources. This would disarm those critics who said that there could not be a solution to the British problem until own resources were increased. The Prime Minister objected that this argument was untrue. The British problem arose largely because of the way in which the Common Agricultural Policy was operated.

Mr. Tugendhat said that the paper which the Commission envisaged would show that there were ways of diversifying the Community's income which could be beneficial to the United Kingdom. But it ought also to show that all the devices put

/ forward

Mr. Thompson said that he thought the Commission would propose a formula lasting for a period of years. He would wish to use that period to reform and the longer-term agreements; but if these did not take place the interim solution would continue. The Prime Minister said that she interpreted this as meaning that the interim solution would last for years until such time as fundamental reform occurred. Mr. Thompson said that this was the meaning of the formula, but put more bluntly, it would probably not last so long as the Prime Minister's words suggested. As to the longer-term solution, he thought that the Prime Minister was right to say that she was opposed to increasing the 1% ceiling. But a distinction could be made between the VAT resources and other types of own resources. The Commission would propose a variety of options, some of which could be helpful to the UK. It was an illusion in the Community that if other Community policies were developed and resources were increased, the UK problem would be solved. But this was not true. He hoped that the Prime Minister would look at the Commission's proposals on own resources with an open mind. The Prime Minister said that our minds were closed on the subject of own resources. She wondered how it would be viewed if there was any suggestion that it was a thing of increased share of national income under EC control. Mr. Tugendhat said that he was not suggesting that the Prime Minister should entirely endorse the Commission's proposals. But leaving aside VAT resources, he hoped that she would not take up a public position against the increase of own resources. This would disarm those critics who said that there could not be a solution to the British problem until own resources were increased. The Prime Minister objected that this argument was unsound. The British problem arose largely because of the way in which the Common Agricultural Policy was operated.

Mr. Tugendhat said that the Commission's document would show that there were areas of Community activity [illegible] which could be beneficial to the UK. But it ought also to show that all the countries [illegible]

/ [illegible]

forward would not solve the British Budget problem. So Member States would have to spend massively on new policies or agree to deal with the British problem separately - and the latter would be cheaper in the end.

He could not estimate when the 1% VAT ceiling would be reached. This would not be before 1984 and might be later. Even in 1984, the Commission, in drawing up the Budget for 1985, would probably have to choose between keeping just below or going just above the ceiling. Another factor to be taken into consideration was that the European Parliament wanted to budgetise the EDF.

He thought that the British negotiating position would be better if we were seen to be trying to make the Commission's proposals work.

The Prime Minister said that she was not much attracted by the notion that our net contribution would be reduced after an increase in own resources because we should then be paying a greater net and a greater gross contribution. Mr Tugendhat commented that it was recognised that we would only agree to an increase in own resources if neither of those two situations occurred. The Prime Minister reiterated that she was not prepared to have a higher net or gross contribution. We could not transfer more expenditure outside our own control - we knew that the increase would be spent on the CAP.

Mr. Tugendhat said that he still thought it would be better to approach the proposals with an open mind in the belief that they would show that there was no magic cure for the UK problem. It was better to adopt the position "yes, but .." than "no, never". The Prime Minister said that the trouble with that approach was that one was sucked in to ideas that were fundamentally bad.

/ Mr. Tugendhat

to these would not solve the problem. Hence a package [illegible] would have to spell [illegible] on [illegible] and [illegible]

[illegible] could not be before 1984 and might be [illegible]

[illegible] would be better if we were [illegible] to make the [illegible] effective work.

The Prime Minister said that she was not much attracted by the option that our net contribution would be reduced after we [illegible] because we should then be paying a [illegible] net and a [illegible] gross contribution. Mr Tugendhat suggested that it was [illegible] that we could only agree to an increase in own resources if neither of these two alternatives [illegible]. The Prime Minister reiterated that she was not prepared to have a higher net or gross contribution. We could not transfer more expenditure outside our own control - we knew that the increase would be spent on the CAP.

Mr Tugendhat said that [illegible] would be in the [illegible] of the Community [illegible] could show that there [illegible] It was [illegible] The Prime Minister [illegible] that [illegible] concluded.

Mr. Tugendhat suggested that it should be possible to build in constraints which would prevent money going to agriculture. The present system relating to non-obligatory expenditure, where there could be no increase above a certain percentage of expenditure in the previous year unless the European Parliament and the Council agreed, provided a possible model. The concept of a maximum rate could be adapted for use with the CAP - the understanding would be that if expenditure rose above this rate, the excess would be financed in different ways.

The Prime Minister said that all these ideas involved increasing Community income. Our problem was that we were paying too much. Mr. Tugendhat said that the Prime Minister might think that the whole exercise would not produce a successful outcome for the United Kingdom, and that we might therefore have to withhold our contribution. This was certainly a possible outcome. His aim was that we should secure a solution without having to withhold. But if it came to counter measures of that kind, it would be very important for us to create the right circumstances in which to adopt them. If the negotiations had been conducted in such a way that all the blame rested on the United Kingdom, then counter measures could precipitate a grave crisis. If, on the other hand, we were seen to be negotiating for success and could not be blamed for failure, then the situation would be less difficult to handle.

He knew that we attached importance to solidarity with Germany on this question. The trouble was that Germany habitually surrendered on such issues. Conversely, the more they demanded refunds for themselves, the harder it was to achieve a settlement for Britain. What were the Prime Minister's views on timing?

The Prime Minister said that the Commission must go ahead. She wished to assess whether or not there would be a row in Copenhagen. Mr. Tugendhat said that he had assumed the Prime

/ Minister

Minister attached importance to the Commission putting forward its proposals, that she wanted the negotiations to begin but that she did not expect Germany to be in a position to deal with the problem until after its elections on 6 March. The Prime Minister said that it might well be advantageous for the German Government to go into those elections with a public platform of refusing to remain one of the Community's two paymasters, or at least with a limit being set to the net German contribution. She might wish to put this idea to Chancellor Kohl.

Mr. Tugendhat said that he thought we could exaggerate the practicability of working together with Germany on this problem. Germany obtained many advantages from the Community and there were certain questions which the Germans would not wish to be raised. Germany did not lose from the operations of the CAP which in effect helped to transfer resources from North to South Germany, whereas an internal transfer of the same resources would be politically difficult. The German tactic would be to make a fuss and then seek modest refunds which would immensely complicate efforts to obtain a solution for the United Kingdom. The Prime Minister said that she thought we possessed certain levers in respect of Germany which had no connection with the Community.

In conclusion, the Prime Minister reiterated her determination that a satisfactory solution for the Budget problem should be obtained. The discussion ended at 1715 hours.

A.J.C.

9 November 1982

CONFIDENTIAL

Foreign and Commonwealth Office

London SW1A 2AH

EXCHEQUER

29 NOV 1982

ACTION Mr ~~Carey~~ Lavelle 30-11

COPIES TO CST, FST, EST, MST^C, MST^R, Sir A Wass, Sir K Couzens, Mr Littler, Mr Hawtin, Mr Ridley

26 November, 1982

Dear John,

Visit of the US Secretary of State to London: 16-19 December 1982

As you know, the United States Secretary of State will be in London from 16-19 December when he hopes to see Mr Pym and the Prime Minister.

Mr Pym plans to offer Mr Shultz some private entertainment, probably a theatre/supper party on the evening of 16 December and to hold official talks with him on the morning of 17 December. I should be grateful to know whether the Prime Minister would also be able to see him on the 17th.

The State Department have told our Embassy in Washington that Mr Shultz is likely to wish to talk to the Prime Minister about the international economic situation, including the GATT negotiations and the general state of Western economies. The talks with Mr Pym will probably also include the follow-up to the non-paper on East/West relations following the lifting of pipeline sanctions, as well as INF and START and the Middle East.

During his visit Mr Shultz will also be involved in a private meeting of US Ambassadors from American embassies in Europe. He will be staying with the American Ambassador.

I am copying this letter to John Kerr at the Treasury and to Richard Hatfield in Robert Armstrong's office.

Yours ever

Roger Bone

(R B Bone)
Private Secretary

A J Coles Esq
Private Secretary
10 Downing Street

CONFIDENTIAL

10 DOWNING STREET

From the Private Secretary

XCHEQUER
- 1 DEC 1982
Mr ~~[illegible]~~ Lavelle 1.12
CST, FST, EST,
MSF, MST R
Sir D Wass,

30 November, 1982.

Sir K Couzens,
Mr Littler, Mr Hawtin,
Mr Ridley

<u>Visit of the US Secretary of State to London</u>

Thank you for your letter of 26 November.

The Prime Minister would like to give a small working supper for Mr. Shultz at 7.15 for 7.30 p.m. on 17 December. She would be pleased if the Foreign Secretary and Sir Anthony Acland could attend. We also propose to invite the US Ambassador.

The Prime Minister would like to use the working supper to discuss, in the main, foreign policy issues. I am writing to Brian Fall separately about another aspect of Mr. Shultz's visit.

I am sending copies of this letter to John Kerr (HM Treasury) and Richard Hatfield (Cabinet Office).

A. J. COLES

R.H. Bone, Esq.,
Foreign and Commonwealth Office.

But you could say :-

i delighted to hear she plans to see Shultz ...

ii V. much hope that she will explain our concern re deficit/interest rates etc, and describe our (UK) 1981 action — as you did to S. in Washington in Sept ...

iii planning yourself to see him again on his visit ...

iv had intended to cover the i IMF growth and ii the deficit

v. could omit (ii) if she'd prefer that — something to be said for not muddying the water, leaving it to her ...

vi on other hand, pity if he got the impression that Chancellor no longer as bothered about the subject as he was in Sept.

2. 3 Nor are also adamant that

C.

The FCO know that you too want a session with him, and are confident that they will fit it in, pre ECOFIN. The time is being negotiated.

JM.

Later.

See the top letter. Coles and Scholar tell me the subject is the deficit; and that they think she would not wish you to raise it with Shultz, but to leave that to her. Indeed they think she ~~will~~ might take um. If you

x | See him at all.

2. I don't believe x. But, since

PERSONAL AND CONFIDENTIAL

10 DOWNING STREET

From the Private Secretary

EXCHEQUER
- 1 DEC 1982
ACTION
COPIES TO

30 November, 1982.

Visit of Mr. Shultz

I have written separately to Roger Bone to inform him, with regard to his letter of 26 November, that the Prime Minister proposes to give a working supper for Mr. Shultz on Friday, 17 December.

As the Foreign and Commonwealth Secretary knows, Mrs. Thatcher would like to take the opportunity of Mr. Shultz's visit to have some discussion with him about US economic policy in the hope that he will convey to President Reagan the Prime Minister's preoccupations about this matter. Mrs. Thatcher believes (and I understand that Mr. Pym agrees) that this message is best conveyed in a tête-â-tête discussion. I should accordingly be grateful if you could invite Mr. Shultz to call on the Prime Minister at 6.15 on 17 December, with the explanation that Mrs. Thatcher would like a tête-â-tête discussion of economic policy before the working supper. We hope that Mr. Shultz will agree to come alone. (For your own information, we would prefer that no American officials are present.)

Since this matter is of some delicacy, I should be grateful if you and John Kerr, to whom I am copying this letter, could ensure that the fact and purpose of Mr. Shultz's private call on the Prime Minister is not made known beyond Private Offices.

A. J. COLES

Brian Fall, Esq.,
Foreign and Commonwealth Office.

PERSONAL AND CONFIDENTIAL

SECRET AND PERSONAL

PwP

EXCHEQUER
30 MAR 1983 30/3
Mr Monger
COPIES TO
Chief Secretary
Sir A. Rawlinson
Ms Seammen.

DEPARTMENT OF HEALTH & SOCIAL SECURITY

Alexander Fleming House, Elephant & Castle, London SE1 6BY

Telephone 01-407 5522

From the Secretary of State for Social Services

J O Kerr Esq
Private Secretary to the
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

SS (Mr Monger and Mr White) see no need to comment. The CST agrees & I have therefore told Mr Godber to go ahead.
JOK.

30 March 1983

Dear John

PLEDGE ON FUTURE PENSION UPRATINGS

At this morning's meeting on commitments for the next Parliament on the uprating of pensions, I understand that my Secretary of State agreed to give the Chancellor an opportunity to comment on the draft of a minute he intends to send to the Prime Minister. I attach a draft - which the Secretary of State has not yet seen - on which I would be grateful for comments.

We were surprised to see that the Chancellor had already sent his own minute to the Prime Minister without, as far as I can tell, any consultation with us. The Prime Minister will, no doubt, wish to consider the two minutes together.

I would be grateful therefore for comments as early as possible tomorrow.

I am copying this letter (but not the enclosure) to Michael Scholar.

? Publish and Be Damned?

JL

Yours
Steve

I think we had a minority in a swapping of drafts: but no matter

S A Godber
Private Secretary

SECRET AND PERSONAL

DRAFT MINUTE TO THE PRIME MINISTER

PLEDGE ON FUTURE PENSION UPRATINGS

I have been discussing with the Chancellor and the Chief Secretary what we say about future pension upratings. The Chancellor and I take a different view on this. It seemed best that each of us should set out how we see things. This minute sets out my view.

2. My judgement, and that of colleagues here, is that we cannot do less than promise to maintain what we achieved in this Parliament. Accordingly I maintain my preference for the approach set out in my letter of 14 March to the Chancellor, which was copied to you:

> "We stand by what we said in this Parliament - that we shall maintain the value of pensions and related long-term benefits."

I should make it clear that I am not proposing a pledge for the long term but just the lifetime of the next Parliament. I do not believe it would be realistic to set our sights lower than this.

3. We have already limited our future commitments - first, by legislating for prices only upratings and secondly by deciding to restore the historic method and so avoid unintentional bonuses. (The Opposition of course are promising to restore the link between earnings and pensions). We are already saving £500 million a year by breaking the earnings link and this could grow to £2 billion to £3 billion a year by the end of the decade.

4. Looking at this from the point of view of the pensioner, giving no more than price protection will mean - on past experience and present expectations - that there will be a growing gap between the standard of living of those who are retired and those still in work. This can be illustrated dramatically by looking at what has happened since 1948. If we had uprated pensions only in line with prices since 1948, a married couple's pension now would be £22 a week not £52.55 a week.

5. If we seek to offer less than we promised in this Parliament, we shall be asked a number of questions to which there are no politically sustainable answers. For example:

> If you are not able to offer for the next Parliament a promise in the same terms as for this Parliament, does this mean that under your stewardship the country can no longer afford what it could previously afford?
>
> If you thought it right to give a promise in these terms for this Parliament, why is it wrong to do so for the next Parliament?

6. If we expect to be able to continue to price protect pensions, and accept that it would be unrealistic to seek to do less, the right answer is to say now that we will continue to pledge into the next Parliament. I do not believe we could hold the position if we watered down the pledge. Moreover, once we had to give ground, we might finish up with a formula which is not as tight as the one I have suggested. And of course a pledge given under pressure would carry much less weight than one offered freely at the outset.

7. I am copying this to the Chancellor, the Chief Secretary and Sir Robert Armstrong.

10 DOWNING STREET

From the Private Secretary

5 April 1983

Dear John,

The Prime Minister has seen the minute of 30 March by the Chancellor of the Exchequer relating to the Government's long term intentions on social security benefits.

The Prime Minister would like to discuss the contents of Sir Geoffrey Howe's minute with him and with the Secretary of State for ~~Employment~~ Social Services. She has made the preliminary comment that she believes that the Government must "price protect" the basic retirement pension and that we are the more able to do this because inflation will be kept down.

We shall make arrangements separately for a meeting.

I am copying this letter to ~~Barnaby Shaw (Department of Employment)~~ Steve Godber (DHSS).

Yours ever

John Coles.

c/
Nothing sinister in this – No 10 simply got their Normans muddled!
MOM 6/4

John Kerr, Esq.,
H.M. Treasury.

SECRET AND PERSONAL

10 DOWNING STREET

From the Private Secretary

6 April 1983

Dear John,

Your office kindly drew my attention to the fact that my letter of 5 April to you about social security benefits had been wrongly copied to Barnaby Shaw in the Department of Employment. Would you please destroy my letter of 5 April and substitute the enclosed. I have asked Barnaby Shaw to return to me his copy of my original letter.

Yours ever

John Coles.

John Kerr, Esq.,
HM Treasury.

SECRET AND PERSONAL

SECRET AND PERSONAL

EXCHEQUER
REC. - 6 APR 1983
ACTION Mr Monger.
COPIES TO CST.

10 DOWNING STREET

From the Private Secretary

6 April 1983

Revised version!

Dear John,

The Prime Minister has seen the minute of 30 March by the Chancellor of the Exchequer relating to the Government's long term intentions on social security benefits.

The Prime Minister would like to discuss the contents of Sir Geoffrey Howe's minute with him and with the Secretary of State for Social Services. She has made the preliminary comment that she believes that the Government must "price protect" the basic retirement pension and that we are the more able to do this because inflation will be kept down.

We shall make arrangements separately for a meeting.

I am copying this letter to Colin Phillips (Department of Health and Social Security).

Yours ever

John Coles.

John Kerr, Esq.,
HM Treasury.

SECRET AND PERSONAL

SECRET AND PERSONAL

1. cc. Mr Middleton / Mr Monck.
2. Chancellor.

10 DOWNING STREET

From the Private Secretary

12 April 1983

Dear John,

Sterling Interest Rates

The Prime Minister had a discussion this morning about domestic interest rates. The Chancellor, Mr. Middleton, Mr. Monck and Mr. Walters were present.

The Prime Minister said that she was concerned about the impression in the markets that the Bank of England was resisting a fall in base rates. The markets were expecting a fall in base rates, but the activities of the authorities, in particular in not fully supplying market shortages in recent days, and by not bringing down the Bank's dealing rates were wrongly giving the impression that the Government was against a half point fall in base rates. In discussion, it was emphasised that a half percent fall in base rates was confidently expected in the near future, and would be a welcome move. But in present circumstances there was, arguably, merit in allowing the markets to drive down base rates without any action by the Bank to this end. Mr. Volcker would be giving testimony to Congress this evening, and although it was not expected that he would indicate any further tightening in US monetary policy there was always a possibility that the markets would interpret his testimony in this light, and that dollar rates would consequently rise. This would be awkward in our markets if it had been immediately preceded by a fall in base rates evidently prompted by the authorities. Furthermore, we would be tomorrow publishing a CGBR figure significantly higher than that in the Budget Red Book: this would indicate a CGBR for 1982/83 of some £12½b, as compared with the Red Book estimate of £11.3b. A large element in this higher figure was a drastically revised estimate of the defence budget underspend - down from £400m to £4m. It was disturbing that the MOD had so altered their estimate in the space of four weeks, and the Treasury would be investigating this further. The markets might take the CGBR to mean that expenditure in 1983/84 would similarly be higher than forecast; alternatively they might infer that expenditure had been brought forward from 1983/84 to 1982/83, so that public borrowing in 1983/84 might be lower rather than higher than forecast. These considerations, together with the Bank's tactics in relation to the sale of the stock which had been announced on Friday last week, pointed to postponing for a day or so a reduction in the Bank's dealing rates.

/ The Prime Minister

SECRET AND PERSONAL

The Prime Minister commented that such a postponement might cause the Government altogether to lose the opportunity at the present time of a half point cut in base rates. There had been some press comment anticipating a higher than expected CGBR this week, and it was possible that the markets were already discounting this. Furthermore, there was a risk that the authorities' resistance to lower interest rates would highlight the CGBR estimate: those who had been puzzled by the authorities' resistance would assume, when the CGBR figure was published, that it was concern about the prospect for public borrowing which had motivated the Bank.

Summing up the discussion, the Prime Minister said it was agreed that the Bank should aim to avoid driving up the overnight rate this afternoon by supplying in full, so far as possible, the shortage they identified. Thereafter they should act so as to facilitate the half point cut in base rates which the markets were expecting. The Prime Minister said that she hoped that the dealing rates could be cut at 1215 pm tomorrow, before the publication of the CGBR.

There followed a brief discussion of the Government's funding policy. The Prime Minister expressed general satisfaction with this (after expressing some misgiving about the wisdom of Friday's issue, with a yield as high as 11.4%), but commented that she hoped that there would be sufficient index-linked stock available during the run up to a General Election, whenever that was, in order to provide a home in the UK for funds which otherwise might go abroad.

Yours sincerely,

Michael Scholar

John Kerr, Esq.,
HM Treasury

20/4/83

Copy Number 1

1. cc urgently to CST
Mr Mangos.
20/iv.

This arrived after the brief had been written.
MOM 20/4

PRIME MINISTER

PLEDGE ON FUTURE PENSION UPRATINGS

Before the discussion you propose to have on the uprating of long term benefits in the next Parliament, I ought to respond briefly to the further minute Geoffrey Howe sent you on 11 April.

2. Geoffrey focusses on the public expenditure implications of pledging to maintain the value of pensions and related long term benefits in the next Parliament. Of course, if we did cut the value of pensions, then we could make substantial public expenditure savings. But for the reasons set out in my earlier minute of 31 March on pledges and long term public expenditure, I do not believe it is realistic to expect to make further savings in this way. The course we have already set implies that pensioners and other beneficiaries will become worse off in relation to those in work, and that the share of national resources going to the elderly by way of social security benefits is unlikely to change very much until the mid-1990s at least. This reflects the fact that our earlier changes will produce a steadily growing saving in the social security programme by comparison with what it would otherwise have been.

3. In general, my view of trends on social security expenditure is rather different from Geoffrey Howe's:

- the increase in social security spending in this Parliament has been mainly due to more beneficiaries, particularly the unemployed, rather than to raising the real value of benefits or extending the scope of the benefits system;

- whilst it is true that the number of pensioners has been increasing, the trend is now slowing and in a very few years the number of pensioners will stabilise, and remain stable for some 20 years. Moreover, there

Copy Number 1

20/4/83

PRIME MINISTER

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- the increase in social security spending in this Parliament has been mainly due to more beneficiaries, particularly the unemployed, rather than to raising the real value of benefits or extending the scope of the benefits system;

- whilst it is true that the number of pensioners has been increasing, the trend is now slowing and in a very few years the number of pensioners will stabilise, and remain stable for some 20 years. Moreover, there

E.R.

are falling trends elsewhere. For example, the number of children for whom child benefit will be payable will fall from 13.5 million in 1978/79 to 11.8 million in 1988/89;

- even quite modest reductions in unemployment, generated by the success of our economic policies, would more than cancel out the effect of pension increases. The full year cost of an increase of 1 per cent in pensions and other long term benefits in 1984/85 is estimated to be about £200 million. Each reduction of 100,000 in the number of unemployed people would save about £180 million in benefit expenditure and, in addition, there would be increases in tax revenue and national insurance contributions.

4. By the way they have mishandled their pension proposals, the Opposition have made it much easier for us both to defend our pensions record in this Parliament and to resist extravagant demands for the future. This is despite the fact that for reasons we all recognise, we have not been able to match the real increases of previous Governments, and UK pensions remain low by comparison with most comparable industrial nations.

5. Against this background, the last thing we should now be doing is handing the Opposition an opportunity to regain the initiative. If we promised less for the next Parliament than for this Parliament, we should be doing just that. People will understand and respect our refusal to enter into an auction of pension promises. But they would not understand - or accept it - if we refused to undertake not to <u>cut</u> the value of pensions. We could not sustain that position - and, as I said previously, we must start off with a position we can hold. I believe that to be the position commended in my earlier minute.

E.R.

6. I am copying this to Geoffrey Howe. I would also suggest that because of its obvious electoral importance we might widen our discussion on Thursday to include at least Cecil Parkinson - and possibly also Willie Whitelaw and Michael Jopling.

20 April 1983

N F

(Pmp)

10 DOWNING STREET

Mr Kerr

cc Mr Godber
Mr Hatfield

Please ensure that this letter is neither circulated outside the private office; nor photocopied.

MCS 22/4

1. Chancellor.
2. Chief Secretary } to see.

(and return

PMP

10 DOWNING STREET

Mr Kerr

cc Mr Godber

Mr Hatfield

Please ensure that this letter is neither circulated outside the private office; nor photocopied.

MCS 22/4

1. Chancellor.
2. Chief Secretary

} to see.

(and return

10 DOWNING STREET

From the Private Secretary

21 April 1983

Dear John,

Pledge on Future Pension Upratings

The Prime Minister had a discussion this afternoon with the Chancellor and the Secretary of State for Social Services about the Government's pledge on future pension upratings.

After discussion it was agreed to carry forward to the next Parliament the pledge the Government gave for the present Parliament to price-protect pensions and associated benefits. It was also agreed that there should be no acknowledgement in the pledge that, if there were an economic crisis, the pledge would need to be abandoned. The argument here was that, if there were a crisis this would happen in any event, so that there would be no need to create suspicions by announcing this in advance.

In a separate discussion about this year's uprating it was agreed that, if there were to be a June election, consideration would need to be given from the outset about what should be said about the May RPI figure, to be announced on 17 June, which was to be the basis of the November uprating. Meanwhile, the formula to be used about the June figure should continue to be that it would be "in the region of 4 per cent".

I am sending a copy of this letter to Steve Godber (Department of Health and Social Security), and to Richard Hatfield in Sir Robert Armstrong's office.

Yours sincerely,

Michael Scholar

John Kerr Esq
HM Treasury.

Prayers tomorrow?

PMJ

PERSONAL & CONFIDENTIAL

FROM: NICHOLAS RIDLEY
DATE: 6 May 1983

CHANCELLOR

cc Chief Secretary
Economic Secretary
Minister of State (C)
Minister of State (R)
Mr Ridley

PENSIONS

I enclose a note by Treasury and Revenue officials which describes a possible way forward on the pensions question. This arose out of my meeting with officials on Wednesday.

An immense amount of study, testing, and costing will have to be done on this before we can be sure if it leads anywhere. But it could be a way forward, and it could enable us to:-

* abolish 3 reliefs - yielding some £2bn for increasing tax allowances generally or reducing tax rates;

* Solve the portable pension problem;

* limit the cost of occupational pensions to Industry.

The trouble is of course that it istoo early to say anything if we have to produce an early manifesto. I tried my hand at a draft, but this was only a cockshy to see how it would look. To give any hint on this we would need to test the scheme and consult with colleagues first. Perhaps we should discuss?

pp [signature]
NICHOLAS RIDLEY

This note summarises the main factors involved in examining pension schemes and outlines a possible new approach.

The Main Factors

2. There are four aspects of the current arrangements for pensions which can give rise to concern :

(a) the disadvantages suffered by the "early leaver" from an occupational pension scheme. These are inequitable in themselves and can inhibit job mobility;

(b) the cost of tax reliefs for pension schemes;

(c) the increase in the burden of pensions as both the State earnings related pension scheme and occupational pension schemes mature;

(d) the need to give individuals greater freedom to determine their own pension provision.

These aspects do not have to be tackled at the same time - or on the same timescale - but it is important to bear in mind the links between them.

3. It is probably best to start by examining how the new State pension scheme fits into this picture.

4. The scheme matures in the late 1990s. People retiring after that date will have built up full entitlement to earnings related pensions. This pension will be in excess of the Supplementary Benefit level. This applies to those contracted into the State scheme and to those contracted out. In the case of the latter, the employer has to provide a guaranteed minimim pension (GMP) at least equal to the State earnings related pension.

5. When the State scheme matures the vast bulk of the population will no longer suffer an early leaver problem. The earnings related element - both for contracted in and contracted out - will be revalued in line with his average earnings up to the point of retirement - no matter how many times an employee changes jobs. The earnings related element is related to earnings up to the upper earnings limit (UEL), currently £235. The UEL is, and will no doubt remain, well above average earnings.

[illegible] ISSUES.

This note draws [illegible] the main factors involved in reforming pension schemes and [illegible] there is possible [illegible] approach.

<u>The main [illegible]</u>

1. There are four aspects of the current arrangements for pensions which now give rise to concern:

(a) the discrepancy and distortion caused by the "early leaver" from an occupational pension scheme. These are inequitable in operation and can inhibit job mobility;

(b) the cost of the existing State pension schemes;

(c) the increase in the burden of pensions as both the State earnings related pension scheme and occupational pension schemes mature;

(d) the need to give individuals greater freedom in making their own pension provision.

These aspects do not have to be tackled at the same time - or on the same timescale - but it is important to bear in mind the links between them.

2. It is probably best to start by examining how the new State pension scheme fits into this picture.

3. The present scheme matures in the late 1990s. People retiring after that date will have a full entitlement to earnings related pensions. This pension will be [illegible] at the [illegible] level. This applies to those contracted into the State scheme and to those contracted out. In the case of the latter, the employer has to provide a guaranteed minimum pension (GMP) at least equal to the State earnings related pension.

4. When the State scheme matures the main body of the population will be [illegible] the early leaver problem. The earnings related element (and the GMP in the contracted out [illegible] - will be revalued in line with earnings up to the point of retirement - no matter how many times an employee changes jobs. The earnings related element is related to earnings up to the upper earnings limit (UEL), currently £220. The [illegible] and will be about [illegible] of [illegible] average earnings.

6. But there remains the early leaver problem until the State scheme matures. And we will continue to have an early leaver problem after 1998 for people with earnings above the UEL whose pension rights above this level will not be protected. Such people include middle-managers, who are a vocal group and who may be particularly important in the context of job mobility. They are also the group most likely to want and to be able to take advantage of a greater freedom in determining their own pension provision.

7. The simplest way of dealing with the early leaver problem both in the period up to 1998 and beyond is to ensure that all preserved rights in an old scheme are revalued at least in line with prices or possibly with average earnings (as applies to the GMP). But if this is not to involve an overall increase in the resources devoted to pensions by occupational schemes (which is arguably undesirable) then there must be redistribution of resources between early leavers and stayers. The Government's current position is that it looks for an early response from the pensions industry. Only a change along these lines would provide that immediate improvement in the position of early leavers which is so desirable. No amount of ingenuity can create for early leavers resources which their own pension scheme is not willing to give.

8. There could be considerable advantage for some early leavers in creating a system of portable pensions. These would be designed essentially for the high flyers who expected to be mobile. Such schemes would not give immediate relief to early leavers. But they would enable people who expected to be mobile to start building up, perhaps in a personal trust, pension rights which would be independent of job changes. This would also fulfill the objective of greater freedom in determining ones own pension provision. Insofar as these portable pensions attract tax relief, the government would have a legitimate right to place certain conditions on the trust - otherwise we would just be creating a new indiscriminate tax shelter for savings.

A Possible new approach

9. In designing a scheme it is as well to start by identifying the State's interest in pension provision. There seem to be two aspects :

(a) a practical interest in encouraging people to make provision for themselves in order to relieve the State of the burden that would otherwise fall on it - particularly in the form of expenditure on Supplementary benefit. At present about 1.7 million pensioners (out of a total of some 9 million) get Supplementary Benefit at a current cost of £1.7 billion;

[illegible]

1. But there remains the early leaver problem until [illegible] will continue to exist as early leavers [illegible] life [illegible] Such people include [illegible] may be particularly important in the context of job mobility. They are also the group most likely to want [illegible] their [illegible].

2. The simplest way of dealing with the early leaver problem would be to [illegible] and legislate to ensure that all preserved rights [illegible] the same [illegible] group [illegible] (1971). [illegible] to involve an overall increase in the resources devoted to pensions by occupational schemes [illegible] then there must be redistribution of resources between early leavers and stayers. The Government's current position is that it [illegible] for an early response from the pensions industry. [illegible] would provide that [illegible] improvement in the position of early leavers which is so desirable. [illegible] early leavers [illegible] pension scheme is not willing to give.

3. There would be considerable advantage for such early leavers in creating a system of portable pensions. These could be designed [illegible] for the high flyers [illegible] expected to be mobile. Such schemes would not give [illegible] to early leavers. But they would enable people who expected to be mobile [illegible] pension rights which would be independent of job changes. This would also fulfil the objective of greater freedom in determining [illegible] pension provision. [illegible] the government would have a legitimate right to [illegible] a new [illegible] for savings.

4. Portable pensions

4. In [illegible] identifying the [illegible] interest in pension provision. There seem to be two aspects:

(a) [illegible] interest in encouraging people to make provision for themselves in order to relieve the [illegible] that would [illegible] in the form of expenditure on supplementary benefit. At present about [illegible] million pensioners (out of a total of some 9 million) get supplementary benefit at a current cost of £[illegible] million;

(b) a social concern to encourage savings generally and particularly savings in a form which avoided a sharp drop in income after retirement.

10. Historically the second objective has predominated. But today it is arguably of less relevance. Most people are well aware of the desirability of providing for themselves and their family in retirement. They do not need the State's ecnouragement. This suggests the State's main interest now is to keep pensioners off Supplementary Benefit.

11. Against this background the first issue is the extent to which any scheme should be compulsory. The logic above suggests contributions should be compulsory up to the level required to provide a pension in excess of Supplementary Benefit.

12. This approach is reflected in the State scheme. As already mentioned, when the scheme matures the State will provide a pension for those contracted in which is in excess of Supplementary Benefit. This leads to the proposition that contributions should be compulsory for employers and employees up to the nic contracted in rates.

13. As now, there should be scope to contract out of the State scheme as long as the employer continues to provide the guaranteed minimum pension. For the contracted out the position would be :

(a) compulsory contracted out contributions to the state scheme by employer and employee; and

(b) compulsory contributions by employer and employee equal to the excess of the contracted in rate over the contracted out rate. This would differ from the present position under which there is no requirement that contribution must be made up to nic contracted in rates - only that the scheme provides the GMP. These contributions could be paid into any one of :

(i) the state scheme - so effectively contracting back in
(ii) an occupational scheme run by the employer
(iii) the employee's personal trust. This would provide portability for those who wanted it.

(f) giving contracted-out schemes various freedoms generally and particularly in relation to GMPs which provided a sharp spur in favour of contracting-out.

9. Historically the recent emphasis has been predominantly, but today it is arguably of less relevance. Most people are well aware of the desirability of providing for themselves and their family in retirement. They do not need the State's encouragement. This suggests the State's main function now is to meet particular and predominantly health.

10. Against this background the first issue is the extent to which any scheme should be compulsory. The State scheme suggests that everyone should be compulsorily up to the level required to provide a pension in excess of Supplementary Benefit.

11. This approach is reflected in the State scheme. As already mentioned, when the scheme matures the State will provide a pension for those contracted in which is in excess of Supplementary Benefit. This leads to the proposition that contributions should be compulsory for employers and employees up to the sum contracted in rates.

12. As now, there should be scope to contract out of the State scheme so long as the employer continues to provide the guaranteed minimum pension. For the contracted out the position would be :

(a) compulsory payment of all contributions to the State scheme by employer and employee; and

(b) compulsory contributions by employer and employee equal to the amount of the contracted in rate with the contracted out rate. This would differ from the present position under which there is no requirement that contributions must be made up to the contracted in rate - only that the scheme provides the GMP. These contributions could be paid into any one of :

(i) the State scheme, so effectively their own fund;
(ii) an occupational scheme run by the employer;
(iii) the employee's personal scheme. This would provide portability for those who wanted it.

14. Contributions in excess of the contracted in rate would be voluntary. These contributions could be paid into :

(a) an occupational scheme
(b) the employees personal trust.

It would probably be necessary to legislate to ensure that companies did not - as they do now - effectively impose membership of a company scheme as a condition of employment.

Tax Treatment

15. The second issue is the way these arrangements should be taxed. The present tax treatment of pensions is as follows :-

(a) State pensions

NIC are made out of post-tax income by the employee. Employers' nic are deductible for tax purposes, and are not treated as taxable benefits in kind in the hands of the employee. State pensions are subject to income tax.

(b) Occupational pensions and retirement annuities

Employees' contributions (if paid) enjoy tax relief, within certain limits. Employers' contributions are treated in the same way as employers' nic. Income and gains accumulated in the funds are exempt. Pensions are subject to income tax (apart from the tax-free lump sum).

The objective of a 'portable pension' is already possible for the self-employed who have taken out retirement annuity contracts.

16. It is difficult to give a precise estimate of the overall cost of the present tax reliefs for occupational pensions but on one assumption the figure would very broadly be in the region of £2 billion, with a further £$\frac{1}{2}$ billion for retirement annuity schemes. (On other, equally valid, assumptions, the figuure could be much higher or much lower.)

4. Contributions in excess of the contracted-in rate would be voluntary. These contributions could be paid into :

(a) an occupational scheme
(b) an approved personal trust.

It would probably be necessary to legislate to ensure that companies did not - as they do now - effectively impose membership of a scheme as a condition of employment.

Tax Treatment

5. The second issue is the way these contributions would be taxed. At present the treatment of pensions is as follows :-

(a) State pensions

NIC are paid out of post-tax income by the employee. Employers' NICs are deductible for tax purposes, and are not treated as taxable benefits in kind in the hands of the employee. State pensions are subject to income tax.

(b) Occupational pensions and retirement annuities

Employees' contributions (if paid) enjoy tax relief, within certain limits. Employers' contributions are treated in the same way as employers' NIC. Income and gains accumulated in the funds are exempt. Pensions are subject to income tax (apart from the tax-free lump sum).

The objective of a 'portable pension' is already possible for the self-employed who have taken out retirement annuity contracts.

6. It is difficult to give a precise estimate of the overall cost of the present tax reliefs for occupational pensions but on one assumption the figure would very roughly be in the region of £2 billion, with a further £½ billion for retirement annuity schemes. (On other, equally valid, assumptions, the figure could be much higher or much lower.)

17. The historical justification for the tax reliefs for occupational pension and retirement annuity arrangements rests on the points in paragraph 9 above. It would be possible to introduce the new portable pension without disturbing the present tax arrangements at all. But arguably the historical justification for such preferential tax treatment for pensions is less valid now than in the past, and there is a good case at least for reviewing the tax position.

18. So far as the State pension is concerned, there seems no reason to change the present arrangements. There is a good case in equity for extending them to the compulsory contributions which employees and employers would make, as proposed in paragraph 13(b) above; if this were not done there would be a tax incentive to contracting out which would be hard to justify. On this basis employees would no longer obtain tax relief for such contributions, but the position of the employer would remain the same as now.

19. So far as the voluntary contributions made by employees, as described in paragraph 14 above, are concerned, it could be argued that there is even less reason for these to attract tax relief. The State has no obvious reason to encourage people to make voluntary contributions, since their compulsory contributions will provide an adequate pension on retirement. Moreover, in principle the fewer tax reliefs that are given for pension arrangements, the less the State needs to be concerned about imposing conditions on pension schemes. (In practice, the trade off is not quite so straightforward : even without relief for employees' contributions, pensions would still be attractive since the tax charge in respect of employers' contirbutions would in effect be deferred for many years. It would therefore be necessary to maintain some restrictions to safeguard the Exchequer.)

20. Withdrawal of relief for employees' pension contributions could yield in the order of £1100m assuming that all employees would continue to contribute at the same level as they do now. To prevent a switch to non-contributory pension schemes, it would be necessary to require some sharing of total contributions between employer and employee (possibly in the same ratio as nic contributions).

21. It may be too large a step to withdraw all the present tax advantages. Payments into occupational schemes and into personal trusts could attract :

(a) a preferential or zero rate of tax for fund income and capital gains. and/or

CONFIDENTIAL

7. The [illegible] justification for the tax relief for occupational pension and retirement annuity arrangements, as outlined in paragraph 3 above. It would be possible to [illegible] the tax [illegible] pension without [illegible] the present arrangements [illegible]. [illegible] the historical justification for preferential tax treatment for pensions is less valid now than in the past, but there is a good case for continuing the tax relief.

8. So far as the State pension is concerned, there seems no reason to change the present arrangements. There is a good case in principle for extending the [illegible] to the compulsory contributions which employers and employees [illegible] make, as proposed in paragraph 4(ii) above. If this were done there would be no incentive to contracting out which would be [illegible]. On this basis employees would no longer obtain tax relief on such contributions, but the tax position of the employer would remain the same as now.

9. So far as the voluntary contributions made by employees, as described in paragraph 7 above, are concerned, it could be argued that there is a strong case [illegible] for these to attract tax relief. The State has no obvious reason to encourage people to make voluntary contributions, since their compulsory contributions will provide an adequate pension on retirement. Moreover, in principle the [illegible] relief is that tax given for pension arrangements, the less the State needs to be concerned about imposing conditions on pension schemes. (In practice, the scope of this is not quite so straightforward: even without relief for employees' contributions, the fund would still be attractive since the tax charge in respect of employers' contributions would in effect be deferred for many years. It would therefore be necessary to maintain some restrictions to safeguard the Exchequer.)

10. Withdrawal of relief for employees' pension contributions would yield in the order of [illegible] assuming that all employees would continue to contribute at the same level as they do now. To prevent a switch to non-contributory pension schemes, it would be necessary to require some sharing of total contributions between employer and employee (possibly in the same ratio as his contributions).

11. It may be too large a step to [illegible] and the [illegible]. Payments into occupational schemes [illegible] could [illegible]

1. A [illegible] income and capital gains [illegible]

(b) allowing lump sums to be paid free of tax. This relief could be restricted by placing a limit on the extent to which pension rights could be commuted into a lump sum. At the moment $\frac{1}{3}$ of pension rights can be taken as a lump sum.

An arrangement for a preferential rate of tax for fund income could be similar to the "pegged rate" of corporation tax paid by life companies. This pegged rate - currently $37\frac{1}{2}$ per cent - could be changed to suit the political needs of the time.

22. There are attractions in looking for greater neutrality between pensions and life assurance schemes; for example removing tax relief for employees pension contributions would point to the removal of life assurance premium relief. This would save over £$\frac{1}{2}$ billion. It could to some extent be compensated for by reducing the pegged rate.

23. In logic tax relief for retirement annuities ought also to be brought into line with the scheme desribed above. This would involve splitting the premiums into two parts. The part analogous to the employee's contribution would not get tax relief. The part analogous to the employer's would continue to do so. This arrangement might save about half the current tax relief of around £$\frac{1}{2}$ billion on these schemes.

Conclusion

24. The State's main interest in encouraging personal pension provision is to keep pensioners off Supplementary benefit. By the end of the century the new State scheme will achieve this.

25. This means the State has little interest in encouraging the provision of larger pensions. It points to the sort of arrangements described in paragraphs 13 and 14 above. A scheme based on these principles would remain viable even if the stated earnings related scheme is scrapped.

26. Judged against the concerns described at the outset of this note, the proposed scheme would :

(a) deal with the problem of early leavers except for those with existing rights in occupational schemes;

(b) lead to tax savings of £1100 million on employee's contributions to occupational schemes and, possibly, of over £$\frac{1}{2}$ billion in

[illegible]

(iv) [illegible] lump sums to be [illegible] 1978 [illegible] relief [illegible] be restricted by placing a limit on the extent to which members [illegible] contributions into a lump sum. [illegible] the whole of [illegible] amount [illegible] as a lump sum.

An alternative is a preferential rate of tax for fund income similar to the "reduced rate" of corporation tax paid by life companies. [illegible] rate - currently 3? per cent - could be changed to suit the political needs of the time.

22. There are attractions in linking the present tax relief between employees and the employer, for example reducing the relief for employee contributions would point to [illegible] pension schemes. This would give over £? million. It could to some extent be compensated for by reducing the [illegible] rate.

23. An alternative relief for retirement annuities might also be brought into line with the [illegible]. This would involve splitting contributions into two parts. The part analogous to the employee's contribution would not get tax relief. The part analogous to the employer's would continue to be [illegible]. This arrangement might save about [illegible] the current tax relief of [illegible] million on these schemes.

Conclusions

24. The State's main interest in encouraging occupational pension provision is to keep pensioners off supplementary benefit. By the end of the century the new State scheme will achieve this.

25. This leaves the State with little interest in encouraging the extension of private provision. It points to the [illegible] arrangements described in paragraphs 23 and 24 above. A scheme based on these principles would secure [illegible] the [illegible] savings [illegible].

26. Judged against the criteria described at the outset of this note, the present scheme works:

(a) [illegible] with the [illegible] greatly [illegible] with existing rights in occupational schemes;

(b) [illegible] in the region of £[illegible] million in [illegible] contributions to occupational schemes and, possibly, [illegible] million on [illegible] respect of life assurance premium relief and, say, £200 million in respect of retirement annuity schemes. This could finance a substantial increase in tax thresholds and or reduction in rates;

(c) by reducing tax subsidisation of pensions, lead to a reduction in pension provision and so a reduction in the overall burden of pensions;

(d) give individuals some more freedom in respect of their pension provision.

PERSONAL AND CONFIDENTIAL

FROM: NICHOLAS RIDLEY
DATE: 11 May 1983

CHANCELLOR

cc Chief Secretary
Economic Secretary
Minister of State (C)
Minister of State (R)
Mr Ridley

PENSIONS

I sent you a paper describing a possible way forward on the pensions question.

... I attach a further note on this from Mr Munro. I agree with what he says about the treatment of funds' income and capital gains. If we are going to encourage people to own capital we should let them take the most out as a lump sum as possible - $\frac{1}{3}$ lump sums may be too small, perhaps $\frac{1}{2}$ would be better.

However I regard the most important part of the proposals on the tax treatment to be that employees' contributions should be made out of taxed income.

I realise that we have a long way to go before deciding anything on this.

pp NICHOLAS RIDLEY

CONFIDENTIAL

From: N C MUNRO

INLAND REVENUE
POLICY DIVISION
SOMERSET HOUSE

9 May 1983

FINANCIAL SECRETARY

PENSIONS

1. If it is not too late, we should like to offer the following comment on Mr Robson's note of 6 May.

2. The alternative approach outlined in paragraph 21 may look attractive at first sight but might entail serious practical difficulties. Taxing funds' income and capital gains, at whatever rate, could be counter-productive, since many funds would either go off-shore (or roll up their investments in off-shore funds) or would become unfunded. Our impression from last week's discussion was that you were not attracted to this option for these reasons.

3. Nor do we think that paragraph 21(b) reflects what was agreed at your meeting. Our recollection is that a continuing exemption for a lump sum of about one-third of total pension rights would be a quid pro quo for the withdrawal of relief for employee contributions. Indeed, this would preserve a broad symmetry since this non-taxable point of the pension rights could be attributed to the employees' contributions made out of taxed income.

4. We should therefore prefer to see paragraph 21 deleted and replaced by the following -

---

cc Mr Monger	Mr Isaac
Mr Moore	Mr O'Leary
Ms Seammen	Mr Munro
Mr Robson	Mr Coote
Mr Aaronson	

"21. No changes would be needed either to the present tax treatment of funds' income and capital gains or to the emerging pension and lump sum. This would make for a broad symmetry: a tax-free lump sum (of about one-third total pension rights, as now) would be attributable to an employees' unrelieved contributions, while the rest of the pension (which would be taxed) would be attributable to the employer's (relieved) contributions and the tax-free build-up in the fund."

NCM.

N C MUNRO

1. cc. Mr Wittles
Mr Unwin.
2. Chancellor.
[signature] 16/v.

10 DOWNING STREET

From the Private Secretary

16 May 1983

See Mr Unwin's comments, below.
[signature]

TELEPHONE CONVERSATION BETWEEN THE PRIME MINISTER & CHANCELLOR KOHL

As foreshadowed in John Holmes' letter of 13 May, Chancellor Kohl telephoned the Prime Minister this morning.

After some discussion of the prospects for the Election campaign, Chancellor Kohl said that he wanted to discuss the timing of the European Council. Important financial decisions would be considered and it would not be easy for the Prime Minister to delegate responsibility for these. On the other hand, he fully appreciated that she would be in the middle of an Election campaign. He therefore felt that the issue of timing should be discussed frankly in order that the right decision was taken.

The Prime Minister said that she wished to attend the European Council but there would obviously be difficulties in the two or three days preceding Polling Day. Chancellor Kohl said that in that case he felt that he and the Prime Minister should agree on a later date for the meeting. He would then put this date to President Mitterrand whom he would be seeing later today. He understood that at Schloss Gymnich some of the Foreign Ministers had informally discussed the possibility of postponement to 18/19 June.

The Prime Minister asked whether it was not the case that Foreign Ministers might agree on a solution to the UK Budget problem on 24 May. In that case she, or her representative, might come to Stuttgart on the dates at present planned in order to confirm a satisfactory solution. This would be most helpful in the Election campaign. Conversely, if there was failure to agree on a satisfactory solution, the effect on the campaign could be most unfortunate.

Chancellor Kohl said that it was his impression that a solution could be found only if the matter were taken up at the highest level. It would therefore be better to change the dates. This would be for the German Presidency to announce and they would say that the postponement was due to the British Election campaign. The Prime Minister said that, if President Mitterrand could also agree to this, it might be an attractive course. We should of course maintain throughout the Election campaign that we expected to get a reasonable solution from our European partners.

/ Chancellor Kohl

Chancellor Kohl commented that 18/19 June seemed to be the only possible alternative to the present dates. In answer to a question from the Prime Minister, he stated that he believed this was the latest possible date for the present Italian Government. The Prime Minister said that the proposed new dates did not pose diary problems for her.

As soon as the telephone conversation was over, the Prime Minister asked me to ensure that an account of it was conveyed quickly to the Foreign and Commonwealth Secretary.

As Chancellor Kohl still has to obtain the agreement of our other European partners to this proposal, and as any announcement would be for the Presidency to make, it is obviously important that the contents of this conversation are very closely guarded. I should accordingly be grateful if you, and John Kerr to whom I am copying this letter, would confine knowledge of the proposal to those who have an absolutely essential need to know of it.

A. J. COLES

Brian Fall, Esq.,
Foreign and Commonwealth Office.

10/6/83

perf

EXCHEQUER
13 JUN 1983
M Miller
M Unwin

A083/1626

MR COLES

European Budget

As foreshadowed in my minute of 1 June, I went to see Monsieur Attali in Paris on the morning of Thursday 9 June. I was accompanied by Mr Williamson, and Monsieur Attali was accompanied by Monsieur Morel.

2. I made it clear that at the European Council at Stuttgart next week we should be looking for agreement upon a framework for discussion of the solution to the long-term financing problem for the European Community, and for a settlement of the interim problem of refunds to the United Kingdom for 1983 in accordance with what had been agreed at the European Council at Brussels in March.

3. Monsieur Attali did not attempt to deny the need for an interim solution for the 1983 refunds. But he said - making it clear that he was speaking after consultation with the President - that there was no way in which the President could agree to an interim solution at Stuttgart. For him the solution to the interim problem could only be part of the settlement of the long-term problem, though he accepted that it should be part of that.

4. Monsieur Attali advanced two reasons for the President's position on this:-

(1) It was of primary importance that the French should be assured that the long-term solution did not prejudice the Common Agricultural Policy. French farmers were already worried about whether there would be enough money in the 1983 budget, within the 1 per cent VAT ceiling, to cover their restitution payments in the second half of this year, and they would be even more worried about next year. The President could not present to French public opinion a settlement of the British problem which might be thought

(however mistakenly) to put the Community's capacity to make those payments at risk. He could present a settlement of the British problem only in the context of a long-term settlement which gave French farmers the necessary assurances on the future financing of the CAP.

(2) The French balance of payments was in substantial deficit, while the British and German balances were in surplus. In this situation it would be very difficult for the President to justify to French public opinion a further payment by France towards British refunds in 1983, unless it was seen as part of a larger package including a satisfactory long-term settlement of the Community financing problem. It was clear from what Monsieur Attali said that the time of year was important in this: the President could not return from Stuttgart having promised the British a cheque which would be a charge on the French balance of payments at a time when, in order to protect the French balance of payments, he was asking Frenchmen to forgo their holidays abroad this year.

5. On the other hand, Monsieur Attali said, the President was extremely anxious to reach an early settlement of the long-term problem. He recognised that it was not going to be possible to conclude a settlement at Stuttgart. He was not, however, looking to a final settlement as a possible achievement of the French Presidency in the first half of 1984, and would prefer to have the matter settled before that began. He would like to see the European Council at Stuttgart agree upon a mandate indicating the agreed basis for a solution and a procedure for working out that solution as quickly as possible. The mandate should be as precise as possible, and the procedure should not be left to the ordinary institutions of the Community. There were various possibilities: the mandate might be placed upon the German, Greek and French Presidencies (in the second half of 1983 they will be the past, present and future Presidencies).

It might be laid upon a single person or on a nominated group of Ministers. It should not be left just to the Council of Ministers in its routine forms. Whoever was given the mandate should be instructed to report a solution by an agreed date; the President would be prepared to agree to 1 or 15 October. The Commission should not be excluded from the discussion, but should not be responsible for conducting it: it should be conducted among high officials of Community countries under the direction of the person or persons to whom the mandate had been given. The mandate should include not only the framework for the long-term solution but instructions for the interim solution for 1983.

6. I said that this would put the Prime Minister in a very difficult position. The British Government was fully committed to continuing membership of the European Community, and public opinion polls were once again showing a majority for continuing membership. We therefore had an opportunity, with a period of relative political stability ahead in the United Kingdom, France and Germany, to think in terms of progress in the Community. The solution to the long-term problem would be an important element in this. But it would be better to discuss the long-term solution with the solution of the interim problem out of the way. The Prime Minister had received certain assurances under the agreements reached at Brussels in March. She would be looking for a settlement of the interim problem at Stuttgart or very soon thereafter, in time for the establishment of the draft 1984 budget in July 1983.

7. I said that I had no authority for supposing that the Prime Minister would change this position. She would undoubtedly be attracted by the idea of accelerated work on the long-term solution, and no doubt she would understand the President's own political problem, as he had understood hers earlier in the year. But she would have to have out of Stuttgart a commitment on the interim solution which enabled her to deal convincingly with any suggestion that she had fought the British Election on a false prospectus in that regard. She would be looking for a commitment to an agreed solution with figures. If she was prepared to move

at all from that position - and I had no authority or reason to think that she might be - she would need a firm and solid commitment that a satisfactory solution would be forthcoming: what used to be described as a "bankable assurance".

8. There was no mention between us of the possibility of withholding. I did not think that I had authority to go beyond talking about very serious consequences; and Monsieur Attali did not ask what they were.

9. Both Mr Williamson and I came to the conclusion that there was no possibility of French agreement to an interim solution before the end of July 1983. The French will argue that the Brussels agreement of March 1983 contained a commitment to incorporate British refunds in the 1984 Budget, but no reference to a date, and that it would be perfectly consistent with that agreement for the interim solution to be dealt with later and incorporated in the 1984 Budget at a later stage in the Budget process.

10. We did not seek to negotiate on possible amounts of refunds to the United Kingdom. Monsieur Attali spoke in terms of a refund of 300 million écu: this was probably arrived at by starting from a figure of 1,300 million écu (about two-thirds of our forecast unadjusted net contribution), minus 1,000 million for the "trop payé" from earlier years. I said that we should be looking for a rebate of two-thirds as in 1980-82; we had already expressed readiness to contemplate a further contribution of up to 200 million écu in respect of the trop payé, and if the solution was otherwise satisfactory the Prime Minister might be willing to consider a slightly higher figure; but we were in very different country from the figures mentioned by Monsieur Attali.

11. As soon as possible after the meeting of the Council of Ministers on 13 June, we shall have to consider the tactics for Stuttgart as a matter of great urgency. We shall have to decide whether to continue to press for agreement on a satisfactory solution to our 1983 refund problem by the end of July 1983 and to be prepared to withhold from 1 August if we do not get it -

as we almost certainly shall not; or whether to accept proposals for an urgent study of the long-term solution and of the interim solution to be completed by October, and to reserve the withholding threat until then. We shall be submitting further advice as soon as possible in the light of the German Presidency's draft report to the European Council, which we have just received.

12. I am sending copies of this minute to the Private Secretaries to the Chancellor of the Exchequer and the Foreign and Commonwealth Secretary. My discussion with Monsieur Attali was, at his request, on the understanding that it was "absolutely confidential"; I should be grateful, therefore, if copies of this minute did not go beyond those with a strict need to know, and if nothing whatever were said to reveal either the fact or the content of the discussion to Community partners.

RtA

ROBERT ARMSTRONG

10 June 1983

CHRISTOPHER TUGENDHAT
VICE PRESIDENT OF THE COMMISSION
OF THE EUROPEAN COMMUNITIES

RUE DE LA LOI, 200
1049 BRUSSELS - TEL. 235 25 14
235 26 10

14th June, 1983

Dear Nigel

I enclose a copy of a letter which I have written to the Prime Minister about the way in which the Community might develop and the British budget problem. I felt you might find it of interest.

I have written separately to congratulate you on your appointment. But once again good luck.

Yours ever
Christopher

Rt. Hon. Nigel Lawson, MP,
Chancellor of the Exchequer,
Treasury,
Parliament Street,
LONDON SW1P 3AG.

From: Christopher Tugendhat

32 AVENUE DE L'HIPPODROME
1050 BRUSSELS
TEL. 649.78.67
(CODE FROM UK: 010.32.2)

10th June. 1983

PERSONAL

Dear Prime Minister

Many congratulations on your election victory.

I felt that at the beginning of your second term I would like to offer you some personal thoughts about the European Community and the context within which the British budget problem is now situated.

Even before 9th June you were already Europe's senior head of government. Now you have the additional political authority that derives from winning an election, something that many of your colleagues know they could not do. You also have the advantage of good relations with Chancellor Kohl. How different from the situation four years ago when Schmidt and Giscard held sway!

The timing too is favourable. The approaching exhaustion of the Community's own resources and the enlargement negotiations together ensure that issues which in the past could be brushed aside must now be faced. Decisions now have to be taken which will determine the shape of the Community for a long time to come.

Against this background I should like to make the following general points about the present state of the Community and the role of the European Council.

1. In its early years the Treaty of Rome constituted a programme for action. A political bargain had been struck; governments knew what they were committed to and the limits of their liability.

Today we have no such framework or "government view" within which to operate. The Commission and individual Member States may have their own but the Community as such has none. Proposals and problems are all too often dealt with on an ad hoc one-off basis and we go round and round in ever widening circles of discord. A new framework needs to be established within which the Member States and institutions can operate.

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The Rt. Hon. Margaret Thatcher, MP

This framework needs to take the form, not of pious aspirations nor idealistic platitudes, but of precise, practical goals for a medium term period of, say, five years. What is required, in other words, is a "governmental programme" for the Community of the kind which parties negotiate before governments are formed in countries whose constitutional arrangements tend to result in coalitions.

2. Only the heads of government - the ultimate source of political authority within the Community - can establish such a programme and enable it to evolve. Others can launch ideas and initiatives, prepare the work of the European Council and carry out its wishes. But only the heads of government can strike a final balance between differing and conflicting interests and set priorities within which Member States and institutions must work.

At present the European Council is not fulfilling this role. It must be put into a position to do so and the Council machinery re-organised so that decisions can be appropriately prepared beforehand and executed afterwards. The Commission can then be expected to use its power to initiate within that context.

3. The classical Community theory of a wide range of common policies, commonly financed, developing through the Community budget to replace national economies on a large scale, is dead. It still lives in the rhetoric and aspirations of the European Parliament and to some extent of the Commission. Some Member States even seek to perpetuate it and the European Council has, unfortunately, failed to disown it. But it is not going to happen; and it is damaging to the prospects of resolving the Community's current problems, including that of the British budget contribution, to pretend that a massive expansion of Community policies is somehow just around the corner.

This does not of course mean that nothing should be done. The structural funds can be further built up in order to meet specific political and economic aims. Certain energy (notably coal) and industrial objectives could also be pursued in part through Community financed programmes. Such developments would, in the right circumstances, be advantageous to the United Kingdom. However, public opinion throughout Europe must be persuaded not to attach so much importance to the creation of commonly financed programmes and the spending of money in assessing Europe's "health" and "progress".

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Attention in Britain should be directed to:

- The Community's potential for helping us to develop our economy through trade and investment.

- The opportunities which working together with our partners provide for exerting political influence in Europe, the Alliance, east-west relations and other areas of concern.

- The fact that political and economic cooperation helps to buttress democracy in Europe and is thus an essential concomittant to the Alliance.

4. The linked construction of the internal market, the Common Agricultural Policy and the Common External Trade Policy will remain the central core of the Community subject to the traditional rules and procedures. Their maintenance may sometimes involve quite radical initiatives such as the steel crisis plan. It is also important to develop the internal market and to beat off the challenge of the protectionists. But they no longer provide the basis or precedent for further development.

The main thrust in the future will come through less formal interstate cooperation within a Community framework. It will concern mainly:

- Economic and monetary matters in both their internal European and external dimensions.

- The subjects covered by political cooperation, the scope of which should be extended and deepened.

- Certain forms of industrial cooperation including but not necessarily confined to the conventional common policy context, and not necessarily involving any significant new public expenditure.

As with EMS and the Falklands sanctions, arrangements will be more flexible than in the classical Community so that not all Member States participate fully in all that is done. There will however be a central core of countries involved in the great majority of enterprises. It will be damaging to Britain's overall interests in the Community to remain permanently outside this core. A crucial decision may have to be made soon over the future of the EMS. France may leave the exchange rate system or opt for a much looser form of involvement in it because of the pressures on the franc and the French Government's inability adequately to control inflation. If this happens you will need to decide whether it is in the long term British interest to see the EMS experiment founder altogether, and with it perhaps any chance of exerting collective European influence on American exchange rates; or whether, despite the petrocurrency difficulties, sterling could usefully be involved in some form of common discipline with other Community currencies.

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Finally, a few words on the budget problem which you will once again be confronting at Stuttgart. You will want to achieve a satisfactory short term settlement as soon as possible and progress towards long term arrangements designed to ensure that the British imbalance will not recur.

Stuttgart is obviously crucial both because of the assurance you obtained at the last European Council and because other governments will only finally decide on their attitude to how much the 1983 rebate should be and their tactics for dealing with the short and long term when they hear what you have to say and feel able to assess your overall approach. Before that - in other words at the Foreign Ministers' Council on 13th June - a number of them will be reluctant to commit themselves. It may well be only at Stuttgart therefore that there will be a real negotiation on the terms of a settlement. And even then, it will still no doubt be necessary to finalise the details and modalities in the light of what is agreed at Stuttgart, in time for incorporation, as agreed at the Brussels European Council, in the draft Community budget for 1984, due to be established on 22nd July.

I should like to make four suggestions for the line you should take at Stuttgart.

1. It is necessary for your colleagues to understand that failure to achieve a settlement in accordance with the assurance you received at Brussels will provoke a British withhold. This is not a threat which you should make in public before the meeting. But you should make crystal clear at Stuttgart that it would be politically impossible for you to allow a draft budget for 1984 to be established which does not contain provision for compensation for the United Kingdom; and that were agreement not reached in time you would have no option but to take unilateral measures to protect your position.

2. While not accepting linkage between the short and long term, and while not committing yourself to any particular outcome or principle, you should be prepared to allow work to proceed on the Commission's long term proposal for new own resources, so long as it is understood that other ideas must be considered as well. In this context you will want to keep the idea of a safety net in the field. It may or may not be negotiable as an alternative to the Commission's proposals. But it could be combined as a complement to them.

3. You should beware of the enlargement factor. An attempt will be made by some delegations to equate hostility to new own resources with a desire to hold up enlargement and to blame those who query the need for new own resources for holding up the enlargement negotiations.

./.

4. You should make it clear that you could only consider the lifting of your objections to new own resources in return for arrangements that guarantee a non-recurrence of the British problem and a satisfactory control of agricultural expenditure. Your colleagues at Stuttgart must be in no doubt that for you to lift your block would be a major change of policy for which you require really substantial reforms of both the Community's financing system and its agricultural policy. This is a more presentationally attractive approach than one which implies that there are no circumstances in which you would ever permit an increase in own resources. It also means of course that you must be prepared to contemplate changes in the agricultural field affecting certain current British interests as part of the imposition of a more disciplined and cost-effective regime.

With best wishes for your second administration

Yours ever

Christopher Tugendhat

Rt. Hon. Margaret Thatcher, MP,
Prime Minister,
10 Downing Street,
LONDON SW1.

CONFIDENTIAL

E.12

FROM: ADAM RIDLEY
21 June 1983

no minute (ie forget it)

CHANCELLOR

I will ask the PM what she thinks is or is not consistent with commitments. N.

cc CST
FST
EST
MST
Mr Middleton
Mr Bailey
Mr Battishill
Mr Mountfield
Mr Monger
Mr Hart

PUBLIC SPENDING COMMITMENTS DURING THE ELECTION

You wanted a quick assessment of the expenditure commitments made by the Prime Minister during the election, and in particular a judgement as to whether the Prime Minister had ruled out any "cuts" from PEWP plans, whatever such an assertion may mean. Here is a quick initial report. I should warn straightaway, however, that a very considerable amount of further time and work is needed before we can complete this exercise with any degree of confidence and satisfaction. In particular we need to see full transcripts of all the Conservative Party's election press conferences, and of a number of other radio and TV programmes which may have included important statements on the subject. I am pressing Conservative Central Office to get the material together as quickly as possible, but it is unlikely that this task can be completed for a good while yet.

2. In the meantime I should report, first, that I can recall no statements at any period during the election by any minister which ruled out reductions in individual programmes as a matter of principle, the sole exception being reductions in social security expenditure which would be in breach of the commitment to price protection of the "pledged" benefits. Second, I can recall nothing being said which ruled out reductions in the "planning total" for public spending set out in cash terms of the PEWP. Third, the statements about expenditure in the period after the end of the PEWP terminal date were directed to answering questions about the possibility of major and drastic cuts, almost always concentrated on certain very sensitive programmes such as social security, health and so on. To deny that the Government has any secret plan for such cuts, or envisages that such decisions will have to be made, does not mean that the Government's hands are totally tied. I would

read the commitments given for the years after 1985-6 to permit, without any doubt whatever, reductions in the real value of any major programme, provided specific commitments such as price protection are not broken; to permit a planning total which falls in real terms from year to year; and to permit major structural changes which do not go as far in scale or character as those suggested by the Government's opponents.

3. Conservative Research Department report that their researches in the election archives have not thrown up a single statement of any importance by the Prime Minister or others which affects such judgements. More important, I have carefully examined the transcript of the Weekend World programme of June 5 in which the Prime Minister was cross-questioned by Brian Walden. I attach the relevant pages, and it may be worth noting briefly the gist of what she argued.

4. Walden was seeking for a long time to get her to commit herself to rule out any cuts in the future. Her response to that boiled down to the following propositions:

(a) One can never give any such unequivocal pledge because of uncertainty:

(b) Nothing is worse than to over-commit yourself on, eg., public spending and then to have to pull in the rope:

(c) Public spending is now planned in cash terms, not in real terms, which makes it wrong in principle to seek pledges whose underlying logic stems from the world of volume planning:

(d) One of the corollaries of planning in cash terms is that one does not automatically increase agreed cash totals to allow for the effect of unforeseen inflation. But there is nothing inconsistent about that, indeed it is simply responsible common-sense financial planning:

(e) As far as the NHS in particular is concerned, there can be no such question of automatic indexation of the planning total.

5. The other two major TV interviews with the Prime Minister were Panorama on May 31, and TV Eye on June 2. Neither contains anything of great importance on the expenditure front. I shall be circulating them separately because of their wider interest, however, not least because they contain some interesting remarks about the employment prospect. No doubt you will let me know if there are any other specific questions to which you want answers in the immediate future.

AR

A N RIDLEY

FROM: G W MONGER
DATE: 23 June 1983

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Economic Secretary
Financial Secretary
Minister of State
Mr Middleton
Mr Bailey
Mr Wilding
Mr Battishill
Mr Mountfield
Mr Hart
Mr Ridley
Ms Seammen

Thanks. N

PUBLIC EXPENDITURE COMMITMENTS

Mr Ridley's minute of 21 June discussed the question whether any commitments have been given which constrain us on public expenditure.

2. During the election campaign, Mr Fowler gave a promise on health. According to "The Times" on 8 June he said on the previous day at a Conservative Party Press Conference:

> "We have set out our spending plans in the White Paper and these plans will be subject to further consideration and upwards review if that is necessary. We are not making a commitment on the amount of money we will be spending above what is in the public expenditure White Paper. There is no question of a downward review taking place on the public expenditure White Paper figures already published."

3. This promise is not perhaps quite so damaging as it appears at first sight. In practice, the question on health will be whether we can resist an increase in the provision. Nevertheless, it is clearly unfortunate that Mr Fowler should have made this promise. As far as I know, Treasury Ministers were not consulted.

4. During the campaign, the Prime Minister also repeated the 1979 pledges against the introduction of hotel charges for stays in hospital and GP consultation fees. She also said that exemptions from charges would continue. Although it is a pity that any options

were closed, the damage is again less than it might have been. We always thought that the two charges mentioned by the Prime Minister would be the most difficult to obtain. The fact that the 1979 pledge against <u>any</u> new charges was not repeated still leaves it open to us to argue for less difficult charges such as cost-related drug charges and a GP registration fee. We are also free to argue for some privatisation of the ophthalmic and dental services. As for exemptions, there was no commitment as to their scale, so we shall be able to argue for a reduction in them.

5. On social security, the major constraint is of course the Manifesto pledge to protect the value of the pension and other related long-term benefits. There are also the pledges to abolish the pensioners' earnings rule, but only "as soon as we can" and to continue the payment of the Christmas bonus. We do not know of any further commitment during the Election.

G W MONGER
23 June 1983

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[illegible]

[illegible] June 1983

PWT

Foreign and Commonwealth Office
London SW1A 2AH

Sir Antony Acland KCMG KCVO
Permanent Under-Secretary of State

5 August 1983

PERM. SEC'S. OFFICE	
Action	
Copies To	MR KERR
	MR LITTLER

P E Middleton Esq
HM TREASURY

Dear Mr Middleton,

HONG KONG: BANKING MATTERS

Sir Antony Acland, who is now on leave, was most grateful for your recent help over Hong Kong banking questions and will make sure that you are kept in touch with any developments.

Meanwhile, he thought you might find it useful to see the enclosed paper on the Hong Kong Monetary System. This has been prepared for the talks with the Chinese in Peking and contains a good deal of useful general background. Much of it will, of course, be familiar to you but it draws the various threads together quite well.

As you see, the paper is only graded 'Confidential' but, because of its use in the talks, we should be grateful if you would restrict its circulation fairly closely.

I am writing similarly to Mr McMahon.

Yours ever,

Barbara Hay

Barbara Hay
Assistant Private Secretary

38-5-8

THE MONETARY SYSTEM OF HONG KONG

Hong Kong

29 July 1983

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THE MONETARY SYSTEM OF HONG KONG

SUMMARY

A wide spread of businesses, both local and international, providing financial and many ancillary services, combine to make Hong Kong one of the world's leading international financial centres. The services sector contributes 25% of GDP. There are many factors which have contributed to this development, the important one being underlying confidence in the stability of government, the steadiness and predictability of its policies, and the integrity of the administration of justice. An example of this is confidence that exchange controls will not be introduced. If confidence failed, Hong Kong would quickly cease to be a financial centre since the relevant assets and people are highly mobile. Other competing regional centres, for example Singapore, would be only too ready to take over Hong Kong's lead.

2. As a financial centre it is dependent on a group of highly skilled and internationally experienced professional people who are attracted and retained by the economic, legal and social environment of Hong Kong. Without them Hong Kong's position could not be maintained.

3. The currency of Hong Kong is the Hong Kong dollar. The exchange rate floats. There is no Government undertaking to hold it fixed by reference to any other currency. There are no exchange controls. While the purpose of the Exchange Fund is to influence the exchange rate, because of the open nature of the Hong Kong financial system the Government cannot fix or hold the rate at any particular level.

4. The bulk of the Government's financial assets are held by the Exchange Fund. The Fund's assets are held mostly in foreign currencies and are managed by the Hong Kong Government under the direction of the Financial Secretary so as to provide high liquidity at all times. The British Government plays no part in the management of the Fund and gains no benefit from it.

5. Reflecting its position as a leading international financial centre and the largest in Asia, Hong Kong has a mature foreign exchange market. There is also a well-developed interbank market in Hong Kong dollars. There are four stock exchanges, which are scheduled to be unified; the stock market, which attracts substantial investment from overseas, is a significant source of new capital to the business sector. Hong Kong also has a large local gold market, as well as providing facilities for trading gold in London, and a commodities futures market.

6. As well as locally incorporated banks, international banks are widely active in Hong Kong. Of 135 licensed banks 100 are foreign based. In addition, a further 115 foreign banks maintain representative offices. There are 29 licensed DTCs and 321 registered DTCs. These institutions with assets of about $950 billion, are active in a wide range of services including the provision of a substantial amount of finance for Hong Kong's economy and trade, which are dependent on them.

7. Banks and DTCs are supervised in accordance with the principles of supervision agreed by the Committee on Banking Regulations and Supervisory Practices which meets regularly in Switzerland.

8. The Government's instruments of monetary policy include intervention in the foreign exchange market, and influence over interest rates both through the Hong Kong Association of Banks (where the Bank of China is one of three continuing members of the Committee) and by operating in the interbank money market.

THE MONETARY SYSTEM* OF HONG KONG

(1) CURRENCY

(a) History

The currency of Hong Kong is the Hong Kong dollar. Until 1935, Hong Kong like China, operated on a silver standard, but when China abandoned the silver standard Hong Kong followed. The dollar was then pegged to sterling, at a rate which remained unchanged until 1967. Meanwhile, soon after the outbreak of the second world war Hong Kong became part of what was known as the Overseas Sterling Area; this meant operating within the net of exchange controls set by the UK authorities.

2. Although the dollar held fast to sterling when sterling was devalued in 1949, in 1967 the dollar was not devalued to the same extent as sterling against other currencies; nevertheless, it remained pegged to sterling, albeit at a new higher rate. When sterling was floated in June 1972 and the sterling area was dismantled, the dollar became in effect a fully independent currency. It was held within a narrow margin around a central rate against the US dollar until 1974, but since then has been floating, without the government undertaking to hold it fixed by reference to any other currency. Since 1972 there have been no exchange controls on the conversion of the dollar into other currencies.

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* "Dollar" and "$" refer to the Hong Kong dollar unless otherwise specified.

(b) Notes and coin

3. Notes are issued by the Hongkong and Shanghai Banking Corporation and the Chartered Bank. Apart from a very small fiduciary element ($95 million), the note issue, which currently totals some $13 billion, is backed by non-interest-bearing deposits which the issuing banks hold with the Government's Exchange Fund; the Fund issues certificates of indebtedness to the banks against these deposits. This procedure ensures that the seignorage (profits) from the note issue accrue to the Hong Kong Government which, in turn, meets most of the costs of the note issue. Coins are issued directly by the Hong Kong Government against payments to the Exchange Fund.

(2) EXCHANGE FUND

(a) Background

4. The Hong Kong Government Exchange Fund was established in 1935 under the Exchange Fund Ordinance (Chapter 66). From its inception the Fund has held the backing for the note issue (as described above). In more recent years the backing for the coin issue and surpluses, other than working balances, from the Government's general revenue account (the fiscal reserves) and other funds have been consolidated into the Exchange Fund, so that nowadays the Fund holds the bulk of the Government's financial assets. Operationally the Fund issues interest- bearing debt certificates in Hong Kong dollars to the general account or other fund in exchange for the surpluses deposited with it.

(b) The Fund's balance sheet

5. Thus, the liabilities of the Exchange Fund comprise certificates of indebtedness issued to the note-issuing bank, debt certificates issued to other government accounts and the Fund's liability in respect of the coin issue.

6. The assets of the Fund are held mainly in foreign currencies, but also in Hong Kong dollars. The foreign currency holdings are spread amongst US dollars, Canadian dollars, Deutschemarks, Swiss francs, guilders, yen and sterling. The assets are mainly held in the form of deposits with major banks, securities issued or guaranteed by governments that enjoy the highest international credit standings, and securities issued by certain international institutions such as the European Investment Bank, the International Bank for Construction and Development and the Asian Development Bank. The assets are managed so as to provide high liquidity at all times.

(c) Role and management

7. Under the Exchange Fund Ordinance (Chapter 66), the Fund "shall be used for such purposes as the Financial Secretary thinks fit affecting either directly or indirectly the exchange value of the Hong Kong dollar and for other purposes incidental thereto." The Fund is managed by the Monetary Affairs Branch of the Government Secretariat, under the control and direction of the Financial Secretary, in consultation with an Exchange Fund Advisory Committee. The British Government plays no part in the management of the Exchange Fund and gains no benefit from it.

(3) FOREIGN EXCHANGE AND MONEY MARKETS

(a) Foreign exchange market

8. Hong Kong, as a major component of the international financial system, has a mature foreign exchange market where the local currency and major international currencies are actively traded. The development of this market has been an integral part of Hong Kong's emergence as a principal international financial centre and the largest in Asia. The absence of any exchange controls and confidence that such controls will not be introduced are two factors which have specifically stimulated the development of the foreign exchange market. Another is the fact that international banks trade through their Hong Kong offices at times when other centres are closed. Meanwhile, the continuous requirements of local industry and commerce in relation to their transactions with the rest of the world have ensured active trading of the local currency.

(b) Local money market

9. There is also a well developed "interbank" market, where wholesale Hong Kong dollar deposits are traded among the banks and deposit-taking companies. Other short-term instruments are less in evidence than in some other centres, partly because the Government is not itself active as a regulator of the monetary system's reserves through open market operations in such instruments, as is the case in most capitalist economies. Thus, although some bills of exchange are held in portfolios, they are not greatly traded. The same has been true of certificates of deposit (CDs) until quite recently, but the secondary market in locally issued CDs has become more active of late, having been helped by the Government's decision to allow CDs issued by licensed banks and licensed deposit-taking companies to count to a limited extent towards the statutory liquidity requirement of all banks and deposit-taking companies.

10. Hong Kong's outstanding borrowings from the Asian Development Bank amount to some $0.5 billion. For constitutional reasons, these are guaranteed by the British Government. There is a small amount of Government-guaranteed debt issued by Government-owned bodies, namely bonds and notes issued by the Mass Transit Railway Corporation, and notes issued by the Hong Kong Building and Loan Agency: the total outstanding is some $0.9 billion. But there is no marketable direct Government debt.

(4) OTHER MARKETS

(a) Stock markets

11. There are at present four stock exchanges in Hong Kong: the Far East Exchange, the Hong Kong Stock Exchange, the Kam Ngan Stock Exchange and the Kowloon Stock Exchange.

12. As a result of the Stock Exchanges Unification Ordinance (Chapter 361) all members of the four existing stock exchanges have been invited to apply for membership of a new Exchange Company, The Stock Exchange of Hong Kong Limited, which will have the exclusive right to operate a stock market in Hong Kong from a date to be appointed by the Financial Secretary. The unification will bring better overall management of the exchanges and provide more effective regulation.

13. The stock exchanges represent a major source of capital to local enterprises and have attracted significant overseas investor interest. The total of new capital raised on the exchanges was $10.1 billion in 1981, $1.3 billion in 1982, and $1.0 billion in the first half of 1983.

14. The Securities Commission, appointed by the Governor and including a majority of unofficial members, is responsible for ensuring compliance with the Securities Ordinance (Chapter 233), the Protection of Investors Ordinance (Chapter 335) and the Stock Exchanges Unification Ordinance (Chapter 361). The Securities Ordinance regulates registration of dealers and investment advisers and trading practices in securities, and provides for the establishment of a compensation fund and the elimination of improper trading practices. The Protection of Investors Ordinance aims at protecting investors by prohibiting the use of fraudulent or reckless means to induce investors to buy or sell securities or to take part in investment arrangements, and regulates the issue of related publications.

15. The staff of the office of the Commissioner of Securities monitor financial transactions concerning securities and scrutinize unusual movements in individual prices. They also investigate possible instances of insider dealing.

(b) Gold

16. The Chinese Gold and Silver Exchange Society operates a gold bullion market which is estimated to be among the four largest in the world. Gold traded in the Society is of 99 percent fineness, weighed in taels and quoted in Hong Kong dollars. Prices, after allowing for exchange rate fluctuations, parallel those in other major markets of London, Zurich and New York. Membership of the Society is closed to 194 member firms.

17. There is a second gold market in Hong Kong, activity in which has been growing in recent years, the so-called loco-London gold market. Dealings principally take place in US dollars per troy ounce of 99.95 percent fine gold, with delivery in London. Major international gold-trading companies are the main participants in this market.

18. The trading of gold futures takes place in the Commodity Exchange. Prices are quoted in US dollars per troy ounce of 99.5 percent fine gold, with a minimum lot of 100 ounces. Early contracts required delivery to an approved vault in London. Local delivery is also now available. Trading has so far been on a small scale.

(c) Commodities Exchange

19. The Commodities Trading Ordinance (Chapter 250), regulates trading in commodity futures contracts in Hong Kong. The Hong Kong Commodity Exchange Limited, established in 1977, is the only company which has been granted a licence under the Ordinance to operate a commodity exchange in Hong Kong. Four contracts are available: gold, cotton, sugar and soya-beans.

(d) Financial futures

20. The possibility of establishing a financial futures exchange in Hong Kong to be linked with London or Chicago is being examined.

(5) DEPOSIT-TAKING INSTITUTIONS

(a) Introduction

21. Three classes of institution are permitted to accept deposits: licensed banks, licensed deposit-taking companies (DTCs) and registered DTCs. This structure was adopted by the Government with two principal aims in mind: to exert some influence over interest rates and to protect so far as reasonably possible the interests of depositors.

(i) Licensed banks

22. The licensing authority for banks is the Governor in Council. The criteria against which applicants are judged are set out at Annex A. Only licensed banks may operate cheque accounts. They enjoy a monopoly of deposits in denominations of less than $50,000 (or the equivalent in another currency). They also have the sole right to take deposits of less than $500,000 with an original term to maturity of less than three months. The maximum rates of interest payable on deposits with maturities up to 15 months less one day are fixed from time to time by the Committee of the Hong Kong Association of Banks (HKAB), with the exception that banks may compete freely for deposits of $500,000 or more taken for less than three months. HKAB is statutorily constituted under the Hong Kong Association of Banks Ordinance (Chapter 364): all banks must be members and observe the maximum rates; the Committee comprises three continuing members - the Hongkong and Shanghai Banking Corporation, the Chartered Bank and the Bank of China - and nine elected members.

(ii) Licensed deposit-taking companies

23. Licensed DTC's may take deposits with no limitation as to their term to maturity but with a minimum size of $500,000 (or equivalent). There are no restrictions on the interest rates they may offer. The authority to grant licences to deposit-taking companies rests with the Financial Secretary. Licensed status is reserved for large companies which have a minimum issued share capital of $100 million and paid up capital of $75 million and which meet certain other criteria outlined in Annex B.

(iii) Registered deposit-taking companies

24. Registered DTC's are restricted to taking deposits of $50,000 or more with an original term to maturity of at least three months. The authority to register DTC's rests with the Commissioner for Deposit-taking Companies. The Commissioner has, at the direction of the Governor, restricted new registrations to companies which, as well as meeting certain basic criteria such as minimum paid-up capital of $10 million, are more than 50% owned by banks in Hong Kong or elsewhere.

(b) Numbers of deposit-taking institutions

25. In Hong Kong there are 135 licensed banks, 29 licensed DTC's and 321 registered DTC's. In addition 115 foreign banks have representative offices. The following table shows the distribution of licensed banks by their place of incorporation:

Place of incorporation	Total
Hong Kong	35*
China	9
USA	21
Canada	6
Japan	13
UK	8
France	7
Germany	8
Other parts of Europe	8
Other	20
Total	135

* includes 3 unincorporated banks

26. There are 1,373 bank branches. The number at the end June in the four years 1979 to 1982 was respectivly 852, 964, 1091 and 1,269.

(c) Monetary sector statistics

27. At the end of May 1983, total assets of all deposit-taking institutions (i.e. banks and DTCs) were $943 billion with the following breakdown:

	Total assets ($bn)	%
Licensed banks	658.4	70
Licensed DTCs	62.7	7
Registered DTCs	221.9	23
All institutions	943.0	100

The breakdown of currency denomination of these assets is as follows:

	Total assets ($bn)	%
Hong Kong dollars	328.4	35
Foreign currencies(*) (mostly in US$)	614.6	65
All institutions	943.0	100

Note:(*) converted to their Hong Kong dollar equivalents.

28. The proportion of assets denominated in foreign currencies has been increasing. The proportion at the end of May 1983 was 65% compared with 55% at the end of 1980. While Hong Kong dollar denominated assets increased by 147% between the end of 1980 and the end of May 1983, foreign currency denominated assets increased by 280%. The pattern reflects Hong Kong's growing importance as an international financial centre, and particularly its emergent role as a foreign currency funding centre.

29. Total deposits (defined as deposits from customers - i.e. excluding those from local or overseas banks or DTCs) with all deposit-taking institutions as at the end of May 1983 were $249.4 billion with the following breakdowns by currency and by type of institution:

	$HK deposits ($bn)	Foreign currency deposits(*) ($bn)	Total ($bn)
Licensed banks	106.8	100.5	207.3
Licensed DTCs	3.3	8.0	11.3
Registered DTCs	21.3	9.5	30.8
All institutions	131.4	118.0	249.4

Note: (*) converted to their Hong Kong dollar equivalents.

The proportion of deposits denominated in Hong Kong dollars was 53% at the end of May 1983. This is lower than the corresponding figure of 86% at the end of 1980, largely reflecting the expansion of foreign-currency business mentioned above, but also influenced by some switching out of Hong Kong dollar time deposits, often on a swap basis, because they have remained subject to interest tax.

30. Total loans and advances extended by all deposit-taking institutions as at the end of May 1983 were $358.0 billion with the following breakdown by type of loans:

	Loan and advances ($bn)	%
To finance visible trade of Hong Kong	28.3	7.9
To finance merchandising trade not touching Hong Kong	2.6	0.7
Other loans for use in Hong Kong	197.8	35.3
Other loans for use outside Hong Kong	113.3	31.6
Other loans where the place of use is not known	16.0	4.5
Total	358.0	100.0

(e) Prudential supervision

31. The Commissioner of Banking is the authority for the prudential supervision of licensed banks. He is also the Commissioner of Deposit-taking Companies, with responsibility for the prudential supervision of deposit-taking companies.

32. The code of behaviour for banks and deposit-taking companies is laid down by the Legislative Council in the Banking Ordinance (Chapter 155) and the Deposit-taking Companies Ordinance (Chapter 328), which stipulate, among other things, minimum levels of capital adequacy and liquidity, and maximum holdings of certain classes of asset - for example, shareholdings, real estate and unsecured lending to directors and director-related companies.

33. The Commissioner's office exercises, under his direction, a comprehensive system of prudential supervision. This approach is in line with trends in banking supervision which have developed internationally.

34. The Commissioner's office includes an International Division, which obtains monthly returns from the overseas branches of Hong Kong incorporated banks and deposit-taking companies, and sends examination teams overseas to examine such branches (where this is permitted by the local authorities). The Government accepts the principles of the revised Concordat issued by the Committee on Banking Regulations and Supervisory Practices, which meets regularly at Basle in Switzerland, and also accepts and is putting into practice through the Commissioner's office, the principle of world-wide consoldiated supervision of banking groups based in Hong Kong.

(6) MONETARY POLICY

35. The monetary system of Hong Kong may be distinguished from that of most other capitalist economies in that there is, as noted earlier, no direct marketable Government debt, and no central bank. In fact the typical functions of a central bank are performed in Hong Kong either by the Government (e.g. managing the foreign exchange reserves through the Exchange Fund; supervising the commercial banks through the Commissioner's office) or by selected banks themselves (e.g. issuing notes; acting as bankers to the government).

36. The Government has the following monetary policy instruments at its disposal:

(i) Intervention in the foreign exchange market

The Exchange Fund is constituted for the purpose of influencing the exchange value of the dollar. This it can do by buying or selling the dollar against foreign currency in the market through its bankers and by operating in the interbank market. With a free exchange market and a highly open economy, the Exchange Fund is not able to fix the exchange rate or hold it at any particular level. Thus, for example, intervention during the past year has not been able to halt a further drop in the exchange rate of the Hong Kong dollar stemming in part from lack of confidence.

(ii) Influence over bank interest rates

All licensed banks are bound by certain rules of the Hong Kong Association of Banks (HKAB). This sets maximum interest rates payable on bank deposits of original maturities up to 15 months less a day, the only exception being deposits of $500,000 or more for terms of less than 3 months, for which banks may compete freely.

In setting these maximum rates, HKAB is statutorily obliged to consult the Financial Secretary, although the final decision on the rates rests with the Association alone.

(iii) Money market intervention

The Exchange Fund operates a scheme which enables it to draw funds out of the local interbank market and ensure that these funds are not directly recycled into that market. This arrangement, which depends upon the cooperation of the Fund's bankers, is capable of tightening up the money market and putting upward pressure on market interest rates in the short term, and may be used to support a particular level of HKAB rates, or to signal an adjustment to those rates.

(iv) Liquidity ratio

The Financial Secretary has the power to vary, in pursuance of monetary policy objectives, the minimum statutory liquidity ratios applicable to banks and deposit-taking companies, but this power has never been exercised.

37. Monetary policy depends upon the spirit of cooperation and mutual trust that exists between the Government and the financial community, and upon the recognition by both parties of their common interest in the maintnenace of monetary stability and confidence, both domestically and internationally.

(7) HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE

38. Hong Kong's position as a major international financial centre depends on the continued presence of large numbers of banks and deposit-taking companies; insurance companies; companies specialising in the management of pension funds and unit trusts, etc; foreign exchange and money brokers; stock and commodity brokers; accountants; lawyers; actuaries; average adjusters and others; which combine to provide a full range of services in the financial and related fields at an international level. Moreover, many providing these services are themselves overseas companies which have chosen to establish a presence in Hong Kong. Many of their customers are also overseas. If confidence failed, Hong Kong would quickly cease to be a financial centre since the relevant assets and people are highly mobile. Other competing regional centres, for example Singapore, would be only too ready to take over Hong Kong's lead. These centres have made no secret of their desire to drain away money, enterprises and people from Hong Kong because of uncertainty.

39. There is a variety of reasons why Hong Kong has evolved to such a position. International companies have been attracted to operate in Hong Kong, or to transact business through Hong Kong, because of its long record of stable and predictable government operating free of external control and its sound and well understood legal framework linked to the UK system and with recourse to an independent Judiciary. Taxation is comparatively low by international standards. Moreover, apart from essential prudential regulation, modest taxation, and the requirement that the Banks should consult the Government on interest rates, the Government does not interfere in business, and allows market forces full play.

40. Hong Kong also provides a satisfactory working and living environment for the highly mobile professional people required in a financial centre, and there is a flexible market in well educated and qualified staff at all levels. Thus, companies operating in Hong Kong can be reasonably confident of being able to attract necessary staff for their own business, whether locally or from overseas, and of obtaining the essential ancillary services that they may require.

41. Hong Kong's geographic position allows it to act as a time link in international financial markets which operate around the clock on a 24 hour basis. Hong Kong has developed and maintained excellent communications with the rest of the world, in respect of both transport and telecommunications, which are essential elements to its international trading role.

42. Hong Kong would never have achieved its pre-eminent position in the financial services field, and would be unlikely to sustain it, were it not for underlying international confidence in the stability of government, in the steadiness of its policies, and in the integrity of the administration of justice.

LICENSING POLICY FOR BANKS

(Based on Speech by the Financial Secretary in the Legislative Council on 27 May 1981)

(a) Applications would be accepted for licences to be granted under section 7 of the Banking Ordinance from banks incorporated outside Hong Kong which satisfy the following criteria:

(i) incorporation in countries the monetary authorities of which exercise effective supervision and have no objection to the establishment of a branch in Hong Kong;

(ii) total assets (less contra items) in excess of US$12,000 million (this figure to be reviewed annually against the list of the world's largest banks in The Banker);

(iii) availability of some acceptable form of reciprocity to Hong Kong banks.

(b) Each licence granted would be subject to the following conditions:

(i) the bank may maintain offices to which customers have access for the purpose of any business, including banking business, including banking business, in only one building. In this context the word office includes any automated teller machine or similar terminal device which provides facilities to customers of the bank;

(ii) the bank will become a member of the Hong Kong Association of Banks and thereafter, in accordance with and subject to the provisions of section 7(1) of the Hong Kong Association of Banks Ordinance, remain a member of the Association.

(c) The Governor in Council would retain discretion to refuse any such applications even though the criteria were satisfied.

Annex B

LICENSING POLICY ON DEPOSIT-TAKING COMPANIES

(Based on Speech by the Financial Secretary in the Legislative Council on 29 April 1981)

(a) Minimum issued and paid-up shared capital of HK$100 million and HK$75 million respectively;

(b) The applicant company is registered in Hong Kong or, if incorporated outside Hong Kong, it is subject to adequate prudential superivion by the recognised banking authorities of its country of incoporation; and that it was a registered deposit-taking company on 10th April 1981 (the date on which the Deposit-taking Companies (Amendment) (No. 2) Bill 1981 was gazetted).

(c) The company has actively traded as a deposit-taking company for at least three years before the date of application;

(d) The company is in reputable ownership (and that the beneficial owner of any holding of 10% or more of the voting share capital is identifiable and reputable).

(e) The management of the company is in fit and proper hands (and the same should apply to the head office of the company if it is outside Hong Kong).

(f) The company should be in good standing in the Hong Kong (and, if relevant, in the internationa) money markets.

(g) The company should have substantial assets (net of contra items) on its books in Hong Kong with a record of steady growth and prudent trading for at least three years.

Foreign and Commonwealth Office

London SW1A 2AH

(pmf).

23 August, 1983

Dear John,

Prime Minister's Strategy Meeting

/ I enclose a copy of the paper on the European Community which has been prepared by the Foreign and Commonwealth Office and the European Secretariat for the Prime Minister's strategy meeting. As you know, this will now take place on 15 September.

A copy of the paper goes to all other participants in the meeting at which this subject will be discussed.

Yours ever

John Holmes

(J E Holmes)
Private Secretary

J O Kerr Esq
HM Treasury

THE EUROPEAN COMMUNITY

INTRODUCTION

1. We are at a moment of opportunity in our Community membership. Our influence over the Community's development in the years ahead should be considerably stronger than it has been in the past. In the immediate future we shall be heavily preoccupied with securing the right answers from the negotiation begun at Stuttgart. But we need now to set about getting a clearer idea of the sort of Community we want, and the way we want it to develop if we are to make full use of our opportunities in the longer term - over, say, the next 5 years. This paper seeks to identify for further study a number of areas in which the development and strengthening of the Community could be advantageous to us.

THE OPPORTUNITY

2. We are at a moment of opportunity in our Community membership for a number of reasons:

(i) The election should have settled the "in or out" question once and for all; even the Labour Party are at last showing signs of recognising this. That will strengthen our position in Europe.

(ii) The balance of power among member states has shifted. The Franco/German relationship is less close than it was and the relationship which the Prime Minister has established with Chancellor Kohl has already proved its importance in a decisive fashion. The Prime Minister's seniority and experience in the European Council will greatly help us to achieve our objectives;

(iii) Stuttgart has opened the way to a lasting solution to the budget problem which has occupied so much time and energy up to now. If this can be achieved (and we must not underestimate the difficulties) the acrimony which has plagued Community discussion in recent years should be reduced and there could be a better and more cooperative atmosphere in which to tackle the problems of the Community's future development.

THE IMMEDIATE FUTURE

4. The preparation of the Athens European Council will dominate the Community agenda in the coming months. There can be no assurance that we shall make decisive progress in December though it would be very much in our interest to do so. The key to securing a reasonably rapid outcome will be the effect of the 1% ceiling: provided the exhaustion of the resources within it remains as imminent a threat as it now appears (with the Community virtually at the ceiling this year), the others will be forced to negotiate seriously and urgently.

The Budget

5. Getting a satisfactory and lasting solution to the budget problem must be our first priority and is crucial to the achievement of our other aims. It will be the focus of our efforts for the next 6 months and quite possibly longer. We are putting on the table a paper setting out our ideas for a "safety net" which will ensure that no Member State has to pay an excessive net contribution. It will not be easy to get agreement to that, even in principle, though there has been a

real change in Community attitudes in the past year or so and there are signs that a good number of member states now accept that some such system is inevitable . Even if the principle is accepted, the level at which a safety net is set will be hard fought.

Agriculture

6. We are also putting on the table a proposal for a binding financial guideline to control the rate of increase of agricultural expenditure. This would ensure that the annual decisions of agriculture ministers are in future subject to an externally imposed financial constraint. We need also to put our full weight behind improvements in the CAP commodity regimes themselves, including a prudent price policy and the ending of open-ended guarantees, which are not appropriate to a Community which is largely self-sufficient or more for many major commodities and whose subsidised exports cause serious problems with some of our trading partners. The entrenched interests of a number of Member States (not excluding our own) will make it hard to get the improvements needed but the VAT ceiling is beginning to change attitudes. The Commission paper will not make our task any easier. It does not deal effectively with the problem of surpluses; many of the 'savings' it proposes are bogus and do no more than transfer the burden from the Community budget to the consumer; and the paper displays a desire to solve the problems of the CAP at the expense of third countries, contrary to the Community's international trade obligations.

Other Policies

7. It will be important in the post Stuttgart negotiations to maintain our support for development of new and existing Community policies, both those with financial implications and those without, when these are sensible and cost effective. Our choice of priorities will depend on our view about the longer-term.

Own Resources

8. We shall continue to insist in the post Stuttgart negotiations that we can only consider an increase in own resources provided that our essential conditions - controlling the CAP and dealing with our budget problem are met; and to argue for savings to be made in present policies and for the development of the Community in ways which do not involve extra finance, such as extending the internal market. But there is a real possibility that we shall only obtain our objectives if we are, at the end of the day, prepared to agree to an increase in own resources within a new specified VAT ceiling. It goes without saying, of course, that we should try to keep any such increase as small as possible. It is helpful that, if our idea for the reduction in our net contribution to be made through modulated VAT is adopted, we are likely still to be paying VAT at less than 1%, even if the rate for the Community as a whole is above 1% (for example if we receive a refund of say, 1000m ecu, this would reduce our own VAT rate from 1.2% to 0.85%).

Enlargement

9. Closely linked with reform of the CAP and of the Community's finances are the problems of enlargement. It

remains in our political interests that these negotiations should succeed, and that Spanish and Portuguese democracy be reinforced and drawn closer to Europe and so to the Alliance. We have to recognise, however, that Spain and Portugal will reinforce the protectionist and agriculturally conservative element in the Community. So we must:

(a) ensure that the costs of applying Community policies to Spain and Portugal are kept under control, and not allowed to impose excessive burdens on the Community's finances.

(b) get access for UK exporters to Spanish markets through early reductions in the high Spanish tariffs.

10. It will also be essential that the restrictions at the frontier with Gibraltar are removed by the time of accession. This may become a major sticking point in the negotiations. If it does it could lead to real difficulties; the Spanish will play on our partners' interest in getting them integrated into the EC and NATO; and we can expect little real support if it comes to the crunch.

11. We shall also want to see Turkey's expectations of early membership if possible deflected or, if Turkey does apply, managed in ways which do least damage to her Western orientation.

THE LONGER TERM - INTERNAL

12. Our present approach to Community policies is heavily conditioned by the need to secure a net benefit from Community expenditure and thus to reduce our budget problem. Assuming that we find a solution to the budget problem we should

rethink our attitude. We do not want to encourage expenditure at Community level merely to see it replace the public sector expenditure we are trying to cut back at home. We must not let our efforts at national level to diminish the role of the state be contradicted by the development of interventionist policies at Community level. We need to establish the criteria for justifying new Community activity. Some possibilities are suggested by the pre-manifesto policy group on Europe:

- where results can be achieved collectively which cannot be achieved nationally;
- where expenditure at Community level would allow savings at the national level;
- where collaboration between firms on a Community basis can be stimulated to help them meet competition from firms outside Europe with large home markets;
- where a reduction of excess industrial capacity needs to be fairly spread throughout the Community;
- where there is a need to see that state aids by other member states do not distort the market;
- where problems are transnational in character such as control of pollution.

We should put work in hand to define these criteria more sharply and to our satisfaction.

The Common Market

13. Against these criteria our first priority should be the development of a genuinely Community wide home market not only

for industrial goods but also for services. We should attack the various technical barriers to trade which hamper UK competitiveness in the market. This involves no new expenditure and the aim is to provide conditions in which market forces can work and the producers of wealth can flourish. If this attack is to be effective, then we should try to concentrate on a relatively small number of important but possibly attainable objectives including:

- measures to free the movement of goods and people across frontiers within the Community including simplification of frontier checks and introduction of a system of deferred payments for collection of VAT;
- liberalisation in the transport field including free movement of goods vehicles, increased cooperation over international rail traffic, liberalisation of air transport and the setting of air fares;
- the elimination of non tariff barriers to trade through the adoption of European-wide standards;
- a common market for services, particularly insurance and air services, such as the Treaty requires;
- an effective policy to control state aids and unfair competition so that British industry is not disadvantaged against industry from freer spending member states;
- effective implementation of the Community's public purchasing policy.

Officials should select a limited number of specific objectives and should work out a long term plan of campaign for the pursuit of the most worthwhile opportunities in these areas. Success will only come slowly over a period of years and we must work consistently for our objectives without arousing excessive short term expectations.

New Technology

14. The second area we might consider is that of industrial policy, research and the encouragement of a more effective European capacity in the new technologies. This is an area where our industrialists would welcome greater efforts by the government to stimulate cooperation at the European level, as the response to ESPRIT has shown, and where European cooperation may well make increasing sense. There are enormous problems but unless the Europeans can work together, our national industries will have little alternative to collaboration with the Japanese or the Americans. While we shall continue to need Japanese and American expertise in many areas, we have now seen the risks that over-dependence on their technology can incur.

15. If we are to further our interests in this field, we must be prepared to bring forward ideas of our own to match those the Commission and the French are producing. The French ideas for "agencies" - or "joint enterprise" as they now call them - to carry out particular cooperative projects, with only some member states involved and funding not exclusively from the Community budget, could contain useful elements and certainly merit further study. Officials might undertake further work in identifying areas where our commercial enterprises are likely to see advantage from European cooperation and where Community action without undue public expenditure is likely to be of the greatest practical use.

Finance

16. Another question that could be looked at again is whether it would be to our advantage to join the EMS exchange rate mechanism. Our line that we will join when the time is ripe will sound increasingly unconvincing to our partners as time goes by. If we did come to the conclusion that joining would help our national economic policies, there would be some useful political spin-off.

17. We should continue within the limit of financial feasibility to press for a larger European Regional Development Fund and Social Fund. We must aim to ensure they continue to bring a net benefit to the UK after enlargement. The setting up of a safety net in the budget negotiations would reduce the importance of this objective but there is presentational value to the Community being seen to support worthwhile projects and employment schemes in the UK.

Institutions

18. It is important that we should do what we can to improve the efficiency and cost-effectiveness of the Community's institutions and to ensure that they operate effectively after enlargement. In the context of the enlargement negotiations we should resist a simple increase pro-rata in the size of the institutions and we should make the most of our willingness to accept one Commissioner per Member State.

European Parliament

19. We should continue to resist calls for increases in the powers of the European Parliament. At the same time we must recognise that they have the ability to cause us considerable problems and that it will be worthwhile to devote some

attention to them. One major problem we shall have to face is the system of elections to the European Parliament. An immediate problem is what response we should make to the Council resolution calling for us to use our best endeavours to extend the franchise so as to allow all European citizens to vote in the 1984 elections.

20. In the rather longer term, we shall need to decide what to do about the system to be used for the 1989 elections, on which we shall again come under strong pressure to adopt some form of proportional representation. This will obviously pose enormous difficulties for us. It will certainly be argued that the European Parliament is very different from a national parliament - and, in particular, that it is a purely consultative body which does not form governments, so the main objection to proportional representation (that it leads to weak governments) falls. The issue will not come to a head for some time. But it certainly will. We shall need to consider very carefully just how to handle it.

THE LONGER TERM - EXTERNAL - EUROPE AND THE WORLD

Trade

21. The counterpart externally of our efforts to promote opportunities for British exporters through the development of the internal market is the task of getting the Community's collective weight put firmly behind the execution of the programme agreed at Williamsburg. Given the extent of the UK's dependence on exports, we have a major interest in seeing economic recovery accompanied and sustained by moves to strengthen the open world trading system.

22. More specifically, we shall want:

(a) to see the work programme agreed at the GATT Ministerial in November 1982 put into effect, notably in:

- the liberalisation of trade in services (an important UK interest);
- trade between developed and developing countries, leading to a new trade round in which we should look for progress in opening up the markets of the newly industrialised countries as a major objective;

(b) to defuse tensions, with the US, particularly over agricultural trade (where work on the CAP in the Stuttgart context will be the key);

(c) to secure action by Japan to reduce its huge and growing surplus in trade in manufactures;

(d) to get effective Community action where we ourselves need help to relieve immediate pressure on industries in the process of re-structuring such as steel and textiles;

(e) to show effective follow up to the Annex to the Williamsburg Declaration on greater exchange rate stability and economic convergence.

23. In all of this, and more generally in the GATT OECD, IMF and other international fora, it is in our interest for the Community to speak with a coherent voice, backed where necessary with a credible threat of action to defend its interests. We must ensure that this voice is properly in line

with the views of the main Member States - particularly our own - on international economic issues. Under Article 113 of the EEC Treaty, decisions on trade matters are already taken by a qualified majority, and it will not necessarily be substantially harder to achieve coherence in a Community of 12 than in one of 10. But we should remain ready to consider ways of improving and speeding up decision-making where this is likely to work to our advantage.

24. As for increasing our own impact on Community external policy, given Community competence in the whole field of trade policy the scope for pursuing options involving different member states according to the issue ("variable geometry" in the jargon) is limited, though the existence of smaller groupings (eg. G5, G10) in the economic policy field may be something we can build on. We shall have to stay close to France and the FRG - often closer than they can stay to one another, given their antithetical views on trade policy. Our close relationship with the US Administration is an asset to us and to the Community and we should build on it in what promises to be a testing period in transatlantic trade and economic relations.

<u>Aid</u>

25. We shall need to continue our efforts to get Community aid spending under better control. In line with this, we shall want to emphasise more effective use of Community aid funds, in terms both of where and of how they are applied. The most immediate agenda item will be the renewal of the Lomé Convention. More than half Lomé beneficiaries are Commonwealth countries, so our approach must be positive; but

if we are to check the serious decline in our own bilateral country programmes we shall want the minimum increase in the aid component. In general, we want to improve EC aid developmentally by encouraging a more integrated approach, covering especially:

- aid for food production, to achieve greater agricultural self-reliance by the developing countries
- a reduction in the volume of direct food aid
- more effective use of Stabex money.

We must maintain the trend towards a bigger role for British firms and experts, who have so far done much less well than they should out of EDF work but whose performance is improving. And we need to resolve the tension between the demands of EC aid and of our own bilateral programme. Constantly cutting at our bilateral programme to make way for unforeseen and unavoidable bids for EC aid expenditure is damaging. We should look at whether our own system of financial management could be adjusted to ease these problems.

Political Co-operation

26. The success of political co-operation is both a UK and a general Community objectives. It is based firmly on shared interests. Nine of the Ten are allies; and the political and economic interests of the Ten are closely interlocked. The coincidence of interest between ourselves and partners is less automatic on politically emotive issues a long way from home (Central America, Southern Africa), but even here it has been sometimes possible to achieve a common approach (eg. over Namibia).

27. There is an important relationship between political co-operation and the external policies of the Community as a whole; the effect of EC trade and aid policies is greatly enhanced if they reflect a consensus on the political objectives which these policies should serve; and a coherent European voice in (for example) the United Nations complements a strong Community position in such organisations as the GATT.

28. But centrifugal tendencies have recently begun to assert themselves, and may increase. Greek accession has been an undoubted setback for co-operation among the Ten, and the addition of Spain and Portugal will not make things any easier. This does not mean that political co-operation is going into an irreversible decline; but breaking the newcomers to harness will take time, and it will be some years before the Twelve work as smoothly as the Nine used to. Meanwhile how can we maintain - if possible increase - the value of the Ten to us and to the Western alliance? Any effort to establish an "inner circle" in the Ten on a systematic and institutionalised basis would be bitterly resented by those outside it, and could do irreparable damage to the whole system. Indeed it is important to us that the consensus rule be retained as the central working principle of political cooperation, for without it the cohesion of the Ten could rapidly become very ragged indeed. This does not, however, exclude very close informal concertation between us and the French and Germans and even the establishment of ad hoc groupings of countries with expertise or capabilities relevant to a particular situation, operating with the explicit or

tacit endorsement of other Member States (as with the Namibia Contact Group or the Sinai MFO). Officials have already been asked to do more work on this.

29. While we have welcomed discussion of non-military aspects of security in POCO and will want to see these go on developing it would not be sensible to go beyond this towards the development of a European identity in the defence field. Apart from the obvious Irish problem, this would be bound to impose new strains on the Atlantic alliance, without holding out any real prospect of a compensating increase in the strength of European defences. The only possible exception to this is in procurement. The civil and military applications of high technology industry are not easily separable and if Community cooperation in this area did take off, it would be bound to have an impact in fields related to defence (eg information technology, aerospace). At that point we should have to consider again whether, and if so how far, the Community as such should become involved more directly in defence and industrial co-operation. There would of course be formidable obstacles to this.

CONCLUSION

31. We do not want a static Community and we should use the opportunity we are likely to have over the next 5 years to make it an easier Community for us to live in and to accepting progress towards greater integration where we are persuaded that action at a Community level will bring us real benefits. Beyond the post-Stuttgart negotiations, our main objectives over the next five years will be:

a) A successful conclusion to the negotiations for the accession of Spain and Portugal.

b) The development of a genuine Community-wide home market, not only for industrial goods, but also for services. Officials should work out a plan of campaign for pursuit of the most worthwhile opportunities in this area.

c) Encouragement of cooperation at a European level between industrialists, particularly in research and the new technologies. We should be prepared to bring forward ideas on particular cooperative projects involving only some member states and to be funded perhaps only partly from the Community budget. Officials should identify areas where our industry would see advantage in such cooperation.

d) Re-examination of the economic arguments for joining the EMS exchange rate mechanism.

e) To improve the efficiency and cost effectiveness of the Community's institutions. With regard to the European Parliament we shall have to consider our response to the Council "best endeavours" resolution calling on member states to extend the franchise so as to allow all European citizens to vote in the 1984 European Parliament elections. Later, when negotiations begin again in Brussels, we shall have to look at the problem of a uniform system for the European Parliament elections in 1989. We shall come under strong pressure to adopt some form of proportional representation.

f) To ensure that the Community's collective weight is firmly behind the execution of the programme agreed at Williamsburg and to encourage moves to strengthen the open world trading system. In GATT, OECD, IMF etc we should work to ensure that the Community speaks with a coherent voice, backed where necessary by the threat of action to defend the interests of member states.

g) To continue our efforts to bring Community aid expenditure under better control.

h) To strengthen political cooperation. Enlargement to Greece and then to Spain and Portugal has and will increase the difficulties. Time and effort will be needed before the Twelve work together smoothly in political cooperation. An effort to establish an "inner circle" on an institutional basis would damage political cooperation but informal consultation between us, the French and Germans need not be excluded.

i) When the budget issue is settled we should continue our effort to present a balanced and favourable picture of the conditions of Community membership and of our increasingly decisive role in shaping its future.

6/9/83

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

I don't think this will do @ all. The capital expenditure figs as conventionally calculated (eg in the PEWP) are useless. Thus capital expenditure is reduced by council house sales (& raised by the municipalisation of private housing), even tho' neither makes any diff to the amount of capital ~~exp~~ expenditure in the economy as a whole; capital grants are scored as 100% capital expenditure, even tho' ~~any~~ the proposition that £1 of grant leads to £1 of additional capital expenditure is palpably absurd; ~~the~~ the NI's ~~the~~ (in effect) contribution is measured as the total of their EFLs (thus if, as now, the improved performance is leading to a long-overdue reduction in their EFLs, this scores as over a reduction in capital expenditure from the ~~[illegible]~~ their investment programme may well be unaffected or even increased; & so on (not to mention the defence anomaly).

I suggest that the relevant aggregates that Cabinet needs are:

1. Current (public) expenditure on goods & services : Absolute & % inc.
2. Capital (public) expenditure on goods & services (essentially GDFCF) : Absolute & % inc
3. Transfer payments : Absolute & % inc
4. NI ~~[illegible]~~ capital investment : Absolute & % inc

This can be done both before & after the 'cuts'.

Both ① & ② should be calculated after excluding defence spending given the absurdity of the current/capital distinction in this area.

N.

CONTINGENCY RESERVE

£bn

Nov 1979 PEWP

	1979-80	1980-81
	0.271 (remaining balance)	0.75

1980 PEWP

	1980-81	1981-82	1982-83	1983-84
	1.0	1.2	1.5	2.0

1981 PEWP

	1981-82	1982-83	1983-84
	1.5	2.0	2.0

1982 PEWP

	1982-83	1983-84	1984-85
	2.25	4.0	6.0

1983 PEWP

	1983-84	1984-85	1985-86
CR	1.5		
Provisional reserves		3.0	3.0

PERSONAL

FROM: J O KERR

DATE: 6 September 1983

OK - put it to the PM, stating that the choice is either 20 or 27, & explaining that, on balance, 20 is somewhat better, unless she is prepared to see us set up star chamber before Cab: (therewith the rumours etc before the Conf re any of them). NL

CHANCELLOR

"AUTUMN STATEMENT"

See Mr Norgrove's minute of 1 September, below. The important decision sought is not in fact about the date of the Autumn Statement - which can't be decided at this stage - but about the date of the first public expenditure Cabinet.

2. We were planning for 27 October. At Mr Bailey's urging, the proposal now is to go for 20 October.

3. The argument for the switch is that the Chief Secretary's "bilaterals" wind up on 29 September; and that before he starts a second round, bashing the heads of the recalcitrant, his arm will have to be strengthened by a collective discussion, with Prime Ministerial homilies. So, it is argued, the second round can't effectively start before the October Cabinet, which should therefore be as early in the month as possible - ie the 20th, since the week of 10-14 is ruled out by the Party Conference.

4. The arguments against the switch are:-

(a) that 20 October is the date of the Mansion House speech;

(b) that the Prime Minister will not much like the idea of having the crunch in the week immediately after the Party Conference (even if papers don't go round until the Conference is over, rumours will fly);

(c) bureaucratically, it will be difficult to prepare and clear your paper, on the economy, post-Washington and pre-Conference.

5. I've tried to think of a middle course. But the obvious one - starting star chamber before Cabinet - doesn't really work, because

it would also mean starting the rumours/rows before the Conference.

6. I conclude that the least bad option probably is 20 October. If you agree, the Cabinet Office will not object to the switch, but I think that we would do well to put it to No 10 on paper, and quite soon, given the Conference complication.

J O KERR

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

13 September 1983

The Rt Hon Sir Geoffrey Howe QC MP
Secretary of State for Foreign and Commonwealth Affairs
Foreign and Commonwealth Office
Downing Street
LONDON SW1A 2AL

Dear Geoffrey

We had a word about Defence and the Survey, and our offices have arranged a short private meeting for 15 September. It occurred to me that you might find it useful to see before then the attached copy of a letter which Peter Rees sent to Michael Heseltine last week, and some extracts from the DM briefing for Treasury Ministers.

As you will realise, these papers are a bit sensitve: I should be grateful if you could ensure that they don't go outside your Private Office.

Yours ever
Nigel

NIGEL LAWSON

12/9

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Michael Heseltine MP
Secretary of State
Ministry of Defence
Main Building
Whitehall
London SW1A 2HB

8 September 1983

Dear Michael

PUBLIC EXPENDITURE SURVEY 1983

At its meeting on 21 July, Cabinet agreed that our objective for this year's Public Expenditure Survey should be to keep to the planning totals for 1984-85 and 1985-86 published in the last White Paper, and to maintain expenditure at about the same level as this in cost terms for 1986-87. We are to meet at 4.30 pm. on 20 September to discuss how your expenditure programme might be adjusted to help in meeting this overall objective in each of the Survey years.

Cabinet is likely to discuss the provision to be made for pay in 1984-85 on 15 September. In the meantime, I suggest we should prepare for our bilateral discussion on the basis that there will be a single standard assumption about pay increases for the Civil Service and related groups, the Armed Forces and the NHS, that it will be rather lower than the 5 per cent and the agreed assumption will, like last year, be removed from all programmes before final decisions are taken.

Our current commitment is to increase defence expenditure by 3% per annum in real terms up to 1985-86. For our discussion I am prepared to take this commitment as our starting point. Defence provision in 1983-84 is £15,715.4 million. On the basis of the cash factors and an assumption that a 3 per cent pay factor is adopted for 1984-85, 3 per cent growth up to 1985-86 (Falklands exclusive) would be met by the following provision:-

	1984-1985	1985-86
£million	16,908.3	17,933.7

I could not agree to any growth in excess of the NATO aim.

The provision above will necessitate reductions in the current cash baseline for defence. This means, of course, that I cannot accept your bids for the first two years. I must also emphasise that the objectives set by Cabinet for the Survey are very stiff ones. If I am unable to make sufficient progress towards these objectives in my round of discussions with colleagues it may be necessary to look again at all programmes, which would mean that for defence I might have to seek a contribution which would lead to provision lower than in paragraph 3 above. But the overall position is unlikely to be clear by the time we meet on 20 September.

You are seeking two further additions for 1986-87 - another year of 3 per cent real growth and provision for extra Falklands costs. For the non-Falklands budget my view, based on the Cabinet's overall objective, is that we should not plan for any real growth in 1986-87 or the later years of this Parliament (see the Prime Minister's minute of 5 August). Although I naturally realise that provision must be made for extra Falklands expenditure in 1986-87, my hope is that we can agree a figure substantially below your present bid of £623 million, and in line with Parliamentary and public expectations that the burden of extra Falklands expenditure will continue on a declining trend after the published figure of £684 million for 1984-85 and £552 million for 1985-86.

Manpower

Our discussion should also cover the civilian manpower aspects of your programme up to 1 April 1988. You have proposed for civilian manpower:

	1/4/84	1/4/85	1/4/86	1/4/87	1/4/88
Baseline	200,000	198,000	197,000	197,000	197,000
Net change		-13,966	-13,926	-14,972	-15,142
Proposed requirement		184,034	183,074	182,028	181,858

As you know, Cabinet agreed on 21 July that we should secure rather larger reductions to the present total than those so far identified by departments. The 1982 PES exercise showed a run-down to 197,000. The Government cannot claim the planned change in status of the Royal Ordnance Factories as a new saving. Without the ROFs the baseline is 178,500, so the present bid adds 3,358. I hope that the development of MINIS and a continued search for savings can produce substantial reductions. You will have your own views on what can be achieved and how, but I would regard a reduction to 170,000 at 1/4/88 as a reasonable initial target at this stage, with an expectation that greater savings will be identified when MINIS becomes fully operational.

Yours ever, Peter

PETER REES

ANNEX E

1986-87: MAINTENANCE OF 3 PER CENT REAL GROWTH

The Government's commitment to plan to increase defence spending by 3% per annum in real terms expires in 1985-86. The Defence Secretary has bid for a further 3% growth in 1986-87.

2. This bid must be rejected. The eventual cost will be far higher than the £568m claimed in this survey. Any "volume" commitment carries on its coat-tails a host of other bids to underwrite price increases and preserve "volume".

3. MOD will argue that the bid is needed to meet the NATO aim and will stress that this aim was reaffirmed in June by NATO Heads of State and Government, including the UK. But when proposing this, Mr Heseltine:

(i) accepted that "a firm commitment on defence expenditure to the end of the NATO planning period would cause us difficulties (as it would most of our allies)";

(ii) explicitly emphasised that "the 3% formula is, of course, a target, not a binding commitment"; and

(iii) referred to "the UK's good record on 3% and our public commitment to meet it to 1985-86".

A copy of Mr Heseltine's minute to the Prime Minister is attached (Appendix A).

4. The aim is only an aim, like the UN aim that 0.7% GDP be devoted to overseas aid, whether it can be achieved must depend on economic circumstances. (Annex J explains the optimistic economic forecasts behind the 3% aim.)

5. NATO exhortations are a dubious way of approaching public expenditure planning. The 3% aim is crude and meaningless. All defence expenditure (however wasteful or non-operational) counts.* Simplistic year on year arithmetic applies (not, for example, absolute levels of expenditure). It concerns only inputs.

6. MOD may make a play of the diplomatic or transatlantic repercussions, should the UK excuse itself from the 3% target three years hence. We should be sceptical about such claims. As

/ Mr Heseltine

* This includes all types of Falklands-related expenditure

Mr Heseltine himself has pointed out, the UK has a good record; but economic considerations cannot continue to be ignored and other European NATO allies adopt a much more pragmatic approach to the 3% aim. See, for example, the public comments of the German Chancellor last December (Appendix B).There may be some criticism but the diplomatic consequences abroad are unlikely to be as serious as the political ones at home, if the economic strategy is blown off course. Also,there is increasing evidence that public opinion will not accept that defence expenditure should continue to grow at the expense of pensions, the NHS and other social services.

7. Of the major Allies, the UK contribution to NATO is already second only to the US in absolute terms, per capita, and as a proportion of GDP. For example, the proportion of GDP the UK devotes to defence is half as much again as Germany (5.1% against 3.4%). MOD ought to be striving to reduce the unfairness of the UK defence burden, not to increase it. (Further details of comparative performance in Annex B.)

8. MOD's other ploy will be to dramatise the operational (and possibly industrial) consequences of not continuing to increase defence expenditure by 3%. Such forebodings can be discounted:

a. MOD's internal plans last year assumed no growth at all after 1985-86. Mr Heseltine ought to revert to the force projections that satisfied his predecessor.

b. Real growth in military effectiveness can be achieved without an equivalent increase in input cost. MOD must exploit the substantial scope for increasing defence <u>output</u> by greater efficiency and value-for-money.

c. MOD have cried wolf before (notably in the 1981 Survey: even after making over £1000m of cuts in his 1982-83 programme, Mr Nott foresaw a "programme gap" of £200m - but the real problem in 1982-83 was to avoid a massive underspend). MOD costings are notoriously inaccurate. The margin of error for 1986-87 is too great to attach much reliance to cries of gloom and doom at this stage.

d. Substantial scope exists for economies that do not damage the front line. For example, the civilian manpower economies we are proposing are worth £120m per annum; over £1200m a year is spent on Service training; over £700m on social and welfare expenditure; the value of defence stocks at major depots is £7 billion.

DM Division

CONFIDENTIAL

APPENDIX A
TO ANNEX E

C

MO 25/2/28/2

Ch of Ex dealt

PRIME MINISTER

NATO MINISTERIAL GUIDANCE

The NATO Defence Planning Committee will be meeting in Ministerial session on 1st/2nd June. On present plans I shall not be present during the plenary discussion of the Ministerial Guidance, when we shall be represented by our Ambassador Sir John Graham - we need to decide the line he is to take.

2. As you know, the Ministerial Guidance is the document produced every other year to set the framework for national and NATO planning for the next five year period - in this case 1985-1990. The draft has been under discussion at working level in Brussels for some weeks and is to be considered by Permanent Representatives on 24th May prior to submission to Ministers. The resource guidance section draft is attached. You will see that, in respect of the 3% target for annual real increases in expenditure, it reads as follows:

> "notwithstanding economic and financial constraints, the standing Alliance commitment to the 3% formula guidance is confirmed."

This is a repeat of the 1981 formula which John Nott endorsed on behalf of the Government.

3. A firm commitment on defence expenditure to the end of the NATO planning period would cause us difficulties (as it would most of our allies). But the 3% formula is, of course, a target not a binding

commitment. In view of this, the UK's good record on 3% and our public commitment to meet it to 1985/86 (when the Ministerial Guidance will come up again for review), I believe it would be wrong and unnecessary to mount any opposition to a repeat of the formula to which we subscribed in 1981. Internationally, this would provoke an unhelpful transatlantic row in a crucial year for the Alliance. Domestically, the likelihood of the row becoming public could be politically very damaging in present circumstances. On the other hand, there may be US pressures to toughen up the 3% formula to stress it as the minimum required (the US are, of course, planning annual average increases in defence spending of 7% over most of the NATO planning period). But the FRG have already made clear that they would not support any substantive strengthening of the 1981 formula and I believe the UK should lend them support in resisting any such US pressures.

4. I therefore propose that the UK should go along with a repeat of the 1981 3% formula but should support the FRG in resisting any US pressures to go beyond this. Additionally, if the opportunity arises, I am content that we should - as suggested by Treasury officials - support any move by others in seeking deletion from the 1981 formula of the phrase 'notwithstanding economic and financial constraints'.

5. Subject to any views of my colleagues, I propose that Sir John Graham should be instructed to proceed accordingly at the meeting of Permanent Representatives on 24th May and subsequently at the Ministerial session.

6. I am copying this minute to the Chancellor of the Exchequer, the Foreign and Commonwealth Secretary, the Chief Secretary to the Treasury, and Sir Robert Armstrong.

Approved by the Defence Secretary & signed in his absence

Ministry of Defence
20th May 1983

Specific promises have been made, eg, that Nato countries should spend in real terms 3% a year more on defence—do you think you will manage that? General Rogers has suggested that 4% will be necessary.

We have had a good record on this in previous years. We will have to see how it turns out next year. Then you have to ask, what is 3%? What does it include? All these percentages have their own significance—you can do anything with statistics. If the Nato supreme commander says he needs 4% that doesn't mean that the Germans—the two chambers in parliament, the government, business and so on—will all meet and declare that this will be carried out. I am a partner in an alliance, and in my view a partnership means that you talk to each other and not about each other. I may add that from my talks with General Rogers I gained the impression that he sees the matter in exactly the same way.

That raises a philosophical question: how can western countries increase their Nato commitment and defence expenditure when they are facing such economic difficulties, with choices necessary between social and military spending?

That is an important question, an elementary political question, and it needs a political answer. This has to be very drastic: the German chancellor must do all he can to stimulate the economy. I must do all I can to reduce unemployment, youth unemployment above all. But it would all be a waste of time if I could not guarantee peace and freedom for our country.

But then the question arises: how do you set which is your priority?

You have to do both. I cannot say: I am going to cut down the army and cut down military service because I have to combat unemployment first. You have to take the middle route.

But there is only so much in the kitty.

Yes, of course, and so I have to spread the sacrifices as best I can. I don't really see this as a problem. Perhaps I am rather old-fashioned. Politicians have to behave as people do in their private lives; in my view a bad housekeeper makes a bad politician. You can't simply eliminate certain areas of expenditure altogether. We must remain capable of defending ourselves. And we will not do that if we adopt a policy of "either-or". Our young people must realise that there is a point in what they are doing, when they are being asked to defend our country. They must come to see that they are defending freedom and peace. It must be a freedom that appeals to them, that makes sense to them. The principle of social justice and the will to defend are closely related.

ANNEX G

ACCOMMODATING REDUCTIONS IN THE DEFENCE PROGRAMME

Treasury Ministers will be arguing that even if defence provision is reduced by some £400m in each year of the Survey, the 3% growth commitment up to 1985-86 will be met; their further aim will be to prevent real growth in 1986-87. The Defence Secretary may try to make capital out of the alleged gravity of the penalties this would inflict on defence plans and policy.

2. It is not the Treasury's job to prescribe where cuts can be made: it is primarily for MOD to order priorities within the defence programme. The paragraphs below suggest how MOD assertions might be countered; and indicate some of the areas in which fruitful savings might be found.

3. MOD invariably overdramatise the effects on the defence programme and Fleet Street defence correspondents and the defence lobby have a field day. During the 1981 Survey, Mr Nott claimed that his plans for 1982-83 were some £1300m above baseline provision. On this basis he secured substantial cash additions. He also instituted over £1000m of cuts before reporting to OD colleagues in early 1982 a residual "programme gap" (an excess over agreed provision) of £200m. In the event, MOD's problem in 1982-83 was to avoid a £1 billion-plus underspend; they instituted addback measures and advanced £500m worth of bills from 1983-84. The underspend on non-Falklands expenditure was still £400m. Are current MOD complaints any more reliable than Mr Nott's a couple of years ago?

4. Accurate estimating on the defence programme is very difficult - partly because of the nature of the programme, partly because of deficiencies within MOD. The margin of error can exceed 5% (£300m on the annual equipment spend alone) in the estimates year - and is greater thereafter. This explains the ease with which MOD are accommodating the 1983-84 cash limit cut of £240m (Appendix A is how they presented it to NATO); and the determination with which they sought end-year flexibility. Estimating errors could facilitate the absorption of further cuts; they certainly make it impossible to foretell dire consequences.

/ 5.

5. Mr Nott was, apparently, content to make forward plans on the basis of no growth after 1985-86. MOD's internal forward planning is undertaken on their annual long term costing (LTC), and last year's LTC - endorsed by the Defence Secretary - assumed that the defence budget would not grow after 1985-86. This year's LTC - completed in June - may have made more ambitious assumptions (ie 3% growth in 1986-87); but why cannot Mr Heseltine revert to the plans and capabilities envisaged by his predecessor?

6. A number of possiblities exist for making economies in defence spending without damaging the front line. Most notably:

a. the civilian manpower targets Treasury are proposing would yield savings of some £120m per annum;

b. Mr Heseltine's MINIS system will presumably facilitate substantial economies across the department.

7. A great deal of the defence budget is currently devoted to social and welfare expenditure(1):

	£m
family and personnel services in UK	240
education	170
married accommodation	90
medical services	210

Is there no scope for non-operational savings here?

8. There remains vast potential for economies on the annual spend in other areas(1):

	£m
BAOR	1700
General RAF support	460
RAF stations	420
Service training	1230
Storage and supply	400
Whitehall organisation	220
Other support services	300

9. None of this is necessarily to suggest that any of these functions can be entirely discarded. But savings should be possible without

/ damaging

(1) Source: 1983 Statement on the Defence Estimates

damaging the front line. MOD has made great claims of its quest for greater efficiency and economy. A 1% efficiency gain on the defence budget would realise some £170m each year. If MOD can deliver this minimum, complaints about the effects of programme cuts are ill-founded; if MOD currently believe themselves unable to achieve this sort of efficiency gain, greater intervention by Defence Ministers is warranted.

Lower prices on defence contracts

10. The independent Review Body on Non-Competitive Government Contracts is due to complete its triennial review in the autumn. The Government has been pressing for substantial changes in the way profit is calculated. If successful these should lead to a substantial reduction in profit rates (currently, on average, 20% on historic cost capital employed - a rate set when inflation was anticipated to be some 15%). An overall five per cent reduction in the profit rate would reduce the cost of defence contracts by some £75m per annum. This would be a saving in input costs with no reduction whatsoever in output - a classic example of the value for money improvements that ought to be pursued throughout defence activities.

DM Division
August 1983

14/7/1983

NATO RESTRICTED

C. UNITED KINGDOM DEFENCE EXPENDITURE REDUCTIONS (NU)

The United Kingdom Member reported that the previous week his Government had announced a plan to trim the budget estimates of Goverment departments, including a reduction of 240 million in the current year's defence expenditure which represented a reduction of approximately 1.5%. He said that even after this reduction, planned expenditure this year would still be 1,300 million higher than last year, and would still be an increase in real terms of more than 3%, quite apart from provision for the Falkland Islands. The decision related only to the current year and the Government remained committed to a 3% increase target up to 1985/86, the last year for which expenditure had been currently published. His Authorities believed they could meet this reduction by careful cash manqement without affecting the front line, the major equipment programmes, and training and activity levels. At the same time the Government had agreed that in future the Ministry of Defence would be permitted to carry forward funds underspent on capital programmes from one year to the next. He said that this was a very important change which greatly increased the flexibility in planning and which his Authorities had been seeking for many years.

THE COMMITTEE TOOK NOTE.

NATO RESTRICTED

D. REPORTS ON NUCLEAR ARMS CONTROL NEGOTIATIONS (NU)

The Deputy Chairman briefed the Committee on the current status of nuclear arms control negotiations and said that a written summary of the NAC consultations on INF negotiations would be provided in due course(5).

THE COMMITTEE TOOK NOTE.

NOTE
(5) Subsequently distributed under cover of DCMCM-EMJ-33-83, 19 Jul 83 (NS).

FROM: J O KERR
DATE: 14 September 1983

CHANCELLOR

MEETING WITH THE FOREIGN SECRETARY: 4.30 ON 15 SEPTEMBER

There are two aims at this meeting.

2. First, <u>we</u> want to carry on nobbling on <u>Defence</u> - and counteract any Heseltine nobbling. We have in fact done GH proud by sending him, with yesterday's letter, the CST's letter to Mr Heseltine, and the two (very good) DM texts. I think that you will want to concentrate on persuading him:-

a. that 3 per cent in 1986-87 is not on, and we are in no way committed to it; and

b. that carrying forward this year's cash limit cut is feasible and does not conflict with the 3 per cent aim.

My personal view is that he will need no persuasion on (a); and that he will be reasonably receptive - and much more receptive than his officials would be - to (b).

3. He wants also to use the meeting to compare notes on what should be said to the Americans later this month on economic issues. He will be seeing Shultz at the United Nations while we are in Washington; and will be having further talks with him and the President and others when the Prime Minister follows us

... into Washington. Mr Lavelle has produced the attached charge-sheet.

4. The Defence aim is clearly the more important; and I suggest we should talk Defence first. If we get pressed for time for adequate discussion on the US, you could always hand over the charge-sheet.

5. No officials other than Private Secretaries will be present.

J O KERR

SECRET AND PERSONAL

10 DOWNING STREET

EXCHEQUER
3 OCT 1983
3/10
ACTION: Ms Seamen
COPIES TO: PS/FST, PS/MST, Mr Bailey, Mr Watson

From the Private Secretary

30 September 1983

PLP.

Dear Steve,

Redundancy Payments and Supplementary Benefit

The Prime Minister's attention has recently been drawn to the argument for qualifying in some way the treatment of redundancy payments in connection with the payment of supplementary benefit. It is argued, on the one hand, that there might be a case for spreading payment of redundancy money over, say, five years, to avoid the situation in which these large capital sums are spent to little lasting effect, with the recipient then moving directly on to supplementary benefit; a solution to this problem might, for example, be to deem a redundancy payment recipient as having an income of an appropriate size, such deeming to be disregarded if the recipient had lost his redundancy money in setting up his own business. It is argued, on the other hand, that the size of the capital sum is in itself highly useful in achieving otherwise difficult, but necessary, redundancies. The Prime Minister would be grateful if your Secretary of State could let her have a note on whether the entitlement to supplementary benefit should be qualified for those recently in receipt of redundancy payments, in the light of these arguments.

I am sending a copy of this letter to Margaret O'Mara (HM Treasury) and Richard Hatfield (Cabinet Office). I would be grateful if you and they would restrict access to this letter to the maximum extent possible.

Yours sincerely,

Michael Scholar

Steve Godber, Esq.,
Department of Health and Social Security.

SECRET AND PERSONAL

10 DOWNING STREET

Dear John

[illegible]

[illegible] the [illegible] way the treatment of redundancy payments in connection with [illegible] supplementary benefit [illegible] on the one hand [illegible] there might be a case for spreading payment of redundancy money over, say, five years, to avoid the situation in which those [illegible] capital sums are spent [illegible] with the [illegible] supplementary benefit [illegible] to this [illegible] might, for example, be [illegible] reduced [illegible] payment [illegible] as having [illegible] income [illegible] rate [illegible] the recipient [illegible] his redundancy money in setting up his own business [illegible] the other hand [illegible] highly [illegible] raise [illegible]. The Prime Minister would [illegible] supplementary benefit should be [illegible] of redundancy payments [illegible].

I am sending a copy of this letter to Margaret [illegible] (Employment) and [illegible] and they would [illegible] this letter [illegible].

[illegible]

As you see, I agree with your three points below. The third (ATI) would of course affect para 2 (as well as para 4(b)) of the ~~draft~~ CST's draft minute, & enable us to eliminate the last sentence, which would tend to [illegible] unnecessary differentiation as it stands. I have spoken to you about a possible compromise deal with P. Jenkin on end-year flexibility. (Like you, incidentally, I don't understand X in Miss Noble's submission of 14/10: this must be sorted out.) I am not happy about the phrasing of 4, which plays Sir GH's game, it seems to me, by focussing exclusively on bilateral aid, without putting it into the ~~[illegible]~~ total aid context (thus [illegible] prominence to [illegible] in the briefing – although even here it is not all that clear [illegible] EC and [illegible] not [illegible], from which we draw greater strength.

NL

SECRET

FROM: J O KERR
14 OCTOBER 1983

You & JOK were right!

CHANCELLOR

PUBLIC EXPENDITURE SURVEY

The best guide to the latest position is the new draft (below) of the Chief Secretary's minute. Comparing it with the 7 October version, also below, one can see that, because of Blackpool, not much progress has been made. Indeed we have gone backwards with Mr Walker - see his letter today (gas prices "Action" folder) - while we have failed to settle with Mr Jenkin on local authority capital because he wants 5 per cent, rather than 2 per cent, carried forward (see his letter of 13 October, below). Even the crucial deal with Mr Fowler seems in some danger, for his officials say that he is showing some signs of having second thoughts. And, to add insult to injury, Sir G Howe has reverted to his earlier, and larger, bids on aid.

2. I expect that all this was pretty inevitable, given the loss of momentum because of the Conference. We now need to stoke it up again. The Prime Minister is getting started by seeing Sir K Joseph on Monday at 6.00 pm on the basis of the note sent to her last week. Mr Turnbull is advising the Prime Minister that the Chief Secretary should be asked: we could suggest that you join in, but I have not done so, for I think it is probably best that it should be her meeting, and tri-lateral. If there are 4 of you, it could turn, damagingly, into the Treasury versus the rest! But, in case you think I am wrong, I attach a copy of Mr Faulkner's brief for the Chief Secretary. The Prime Minister will also see Sir G Howe on Tuesday. The present plan is that neither you nor the Chief Secretary will be invited.

I agree

3. As for Chief Secretary activity on Monday, he will be

seeing Mr Jenkin, to try to sort out the ~~India~~ end-year flexibility point, and the problem of local authority current expenditure in the later years. I advise you not to join them. He may also have to see Mr Fowler, though nothing has been arranged as yet. Again, I think you should hold back: a meeting with you, or with you and the Prime Minister, might be the next move if a meeting with the Chief Secretary shows that he is in fact welching on the deal.

I agree

4. Apart from defence, agriculture and energy - on none of which there seems any point in further negotiation pre-Star Chamber - the other outstanding programme is Industry. Here, for obvious reasons, nothing has happened since you last saw the papers. My hunch is that:-

a. the Prime Minister, and Cabinet, would back the DTI line on Innovation, rather than ours; and

b. Mr Parkinson's successor is likely to want, for very obvious reasons e.g. vis-a-vis his DTI Ministerial team - to settle for no less than Mr Parkinson would have got.

I therefore conclude that we ought to concede, and quickly, and get para 6 b. out of the paper for the Prime Minister and Cabinet.

I agree

5. You will wish to compare notes with the Chief Secretary at "prayers". Your reactions to the draft minute - which seems to me pretty good, though FERB will no doubt think it a bit long - could be fed in then, or on paper. But I have kept a slot at 5.00 pm for a meeting between you and the Chief Secretary, with Middleton, Bailey, Scholar, Battishill and Hart, in case there is a major problem - eg a Fowler welch - requiring substantial discussion and re-drafting.

J O KERR

FROM: A M W BATTISHILL
DATE: 24 October 1983

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Mr Middleton
Mr Bailey
Mr Littler
Sir T Burns
Mr Cassell
Mr Wilding
Mr Scholar
Mr Evans
Mr Watson
Mr Norgrove
Mr Ridley

I agree Ms. This will do. C.

Nothing here to change our provisional view on Friday that sticking to the 10th is probably best; and that the Topling/walker problems are for them to solve. JOL.

PUBLIC EXPENDITURE CABINET AND THE AUTUMN STATEMENT

Yes – and they've put it on an arrangement notice – below.

I understand the Cabinet Office are suggesting Thursday 10 November for Cabinet to take the report of MISC 99, and finally settle the public expenditure figures. This is on the basis that MISC 99 will complete its work within about 10 days, and that it will not be absolutely necessary for you to attend the Ministerial Council in Athens on 10 and 11 November. We have taken a quick look at the implications for publication of the Autumn Statement of this and possible alternative dates for Cabinet. In what follows we assume that only one further Cabinet on public expenditure will be required; a second Cabinet would extend the timetable. Details are shown in the Annex.

OF agrees with this

Some general points

2. The key considerations for the timetable are these:

- Ministers will presumably wish to publish the public expenditure figures as soon as possible after they are agreed, and with only one weekend intervening between decision and publication (Cabinet was specifically put back a few days last year to avoid a second weekend intervening when the previous Chancellor had to go abroad);
- the critical date, therefore, for the Autumn Statement is the date of the final Cabinet;

- if the outcome of Cabinet is reasonably predictable, we can plan on publishing 7 days later (a weekend plus the minimum 5 working days required for final drafting of the Statement, including the expenditure paragraphs; completing the figures; and for the printers);

- by the Cabinet outcome being reasonably predictable we mean:

  (a) that, on the basis of the MISC 99 recommendations, known a few days before, a reasonably confident prediction can be made of the final public expenditure outcome, including, within a small margin, the probable 1984-85 planning total and the size and treatment of the planning reserve (so that these can be taken into the forecast in advance);

  (b) that there are unlikely to be significant changes affecting the size or presentation of next year's fiscal adjustment;

  (c) that decisions on NIC and NIS have already been taken, and cleared with the Prime Minister in advance, are mentioned at the expenditure Cabinet, and not disturbed; this allows the minimum 3 clear days needed by the Secretary of State for Social Services to finalise other National Insurance decisions; and for the Government Actuary to put together the report on the National Insurance Fund which accompanies the announcement; and

- that, finally, there are no unexpected decisions on particular programmes, the presentation of which in the Autumn Statement cannot be settled within a day or so.

3. To the extent that any of these things go wrong, and particularly if changes affect the forecast or the fiscal adjustment, there is a risk of slippage in publication; and with a Thursday Cabinet, the possibility of slippage beyond a second weekend. (A Tuesday Cabinet obviously provides a larger safety margin against that).

MISC 99

4. The plan, as you know, is for MISC 99 to conclude its meetings with Spending Ministers if possible by one week today, Monday 13 October; and to complete its report by the end of the week, Friday 4 November (with the possibility of some intervention by the Prime Minister in that interval). It is on that basis, we understand, that 10 November has been suggested as the date for Cabinet.

10 November Cabinet

5. The first point to note about a 10 November Cabinet is that you will be in Bonn with the Prime Minister for bilateral meetings for the immediately 2 preceding days (the afternoon of the 8th and the whole of the 9th). So there would be virtually no time at all to influence matters between the MISC 99 report and discussions in Cabinet. You will also need to plan to have settled all other outstanding issues on the Autumn Statement, excluding the final public expenditure figures, by Tuesday 8 November. This includes next year's National Insurance Contribution rates and earnings limits with Mr Fowler and the Prime Minister; substantially the whole text of the Industry Act Forecast; and, in particular, the treatment of next year's forecast fiscal adjustment, consistent with the probable final decisions on public expenditure (both the totals and the handling of the planning reserve).

6. Assuming that Cabinet then ratifies the MISC 99 recommendations, we should have until Friday evening 11 November to settle with you any outstanding points on the text for the printers; though relatively small changes could be made at proof stage after the weekend. This can be a fairly intensive period and might mean that it would be prudent to ask another Treasury Minister to attend the ECOFIN meeting arranged for 14 November. It should then be possible to publish the Autumn Statement, if all goes well, on Thursday 17 November.

OF are entirely happy about that.

7. On this timetable the forecasters should be able to take account of the CGBR figures (though not the PSBR) for October, which become available in the first week of November.

8. This is clearly not an ideal timetable; it assumes very good progress early on, and there are risks if decisions come unstuck at Cabinet of the Autumn Statement being delayed over a second weekend. It will only work at all if your presence is not required in Athens (which OF regard as an acceptable risk so long as the Foreign Secretary attends), and if Cabinet can settle public expenditure in the absence of other Ministers concerned (the Foreign Secretary and the Secretary of State for Agriculture unless he chooses to attend Cabinet and send another Agriculture Minister to Athens; and possibly the Secretary of State for Energy who is due to be in China on the 10th). And it is a fairly tight timetable because of your 2 days in Bonn in the crucial run-up to Cabinet. But it is certainly not impossible, so long as MISC 99 does its job fairly quickly, and there is then a good prospect of a satisfactory outcome at Cabinet.

15 November Cabinet

9. This is probably the earliest next practicable date if you or other key Ministers could not be spared from Athens. In those circumstances, an extra Tuesday Cabinet could be explained by Ministers' overseas commitments, and the need to settle the expenditure figures as quickly as possible and publish the Autumn Statement. That said, the overall timetable would be no easier from your point of view if you were out of the country for most of the previous week. So, as with a 10 November Cabinet, it would only be safe to plan on the basis of settling most of the other outstanding issues on the Autumn Statement by 8 November before you left for Bonn. With a 15 November Cabinet, the earliest date for the Autumn Statement would probably be the following Tuesday, 22 November, though this could, if necessary, slip back a day or two to 23 or 24 November without risk of another weekend intervening.

10. If you decided anyway not to go to Athens, deferring the expenditure Cabinet until 15 November would give you a little extra time in which to work on the rest of the Autumn Statement decisions, and prepare the ground for Cabinet (whether or not you attended the ECOFIN meeting on the 14th). This could be useful; for example, if it proved difficult to reach agreement on NICs. A 15 November Cabinet, with publication of the Autumn Statement a week later, would also give the forecasters time to take on board the October PSBR figures.

11. However, we understand the Prime Minister leaves for New Delhi on 21 November, so that she would be abroad when the Statement was made.

17 November Cabinet

12. This is the third possibility. It has the advantage of avoiding the need for a special Cabinet, and of being well clear of your absence abroad. Its disadvantage, of course, is that it lengthens still further the interval between MISC 99 completing its work and final decision by Cabinet, prolonging speculation and increasing the risk of leaks. It also begins to look a little late if there has to be a third Cabinet to settle outstanding issues. With a 17 November Cabinet the earliest date for publication would be Thursday 24 November. It has the same risks as to slippage beyond a second weekend as Thursday 10 November.

Conclusions

13. Cabinet on 10 November seems to provide the fastest practicable timetable: it looks to be just manageable provided all goes well with MISC 99 and at Cabinet; but it is all rather tight and depends critically on which Ministers need to go to Athens. It is the only timetable which allows the Autumn Statement to be published before the Prime Minister leaves for New Delhi. Provided you can decide now to stay away from Athens (and there are no unsuperable problems for other Ministers) 15 November has quite a lot to be said for it: above all it provides a little extra room for manoeuvre, either if a third expenditure

Cabinet is needed (say on the 17th), or if a little more time is needed after Cabinet to finalise the Autumn Statement. But it does mean that the Prime Minister will be out of the country when the expenditure decisions are announced, and the Autumn Statement published. Cabinet on 17 November would be clear of all international meetings, but prolongs the uncertainty on public expenditure, and risks a rather late Autumn Statement if a third Cabinet proves necessary. Again, the Prime Minister would be out of the country on the date of publication.

Wed. 14. It may be worth taking the Prime Minister's mind on these options when you next see her. But whatever her preference, there is clearly everything to be said for pushing on with as much preparatory work as possible on the Autumn Statement in advance of the public expenditure decisions.

AMB

A M W BATTISHILL

ILLUSTRATIVE TIMETABLES FOR AUTUMN STATEMENT

Cabinet	10th	15th	17th
Mon 31	←	MISC 99 finishes meetings	→
Tues 1			
Wed 2			
Thurs 3			
Fri 4	←	MISC 99 reports	→
Sat 5			
Sun 6			
Mon 7			
Tues 8	to Bonn pm	to Bonn pm	to Bonn pm
Wed 9	Bonn	Bonn	Bonn
Thurs 10	**Cabinet**	[Athens	[Athens
Fri 11		Athens]	Athens
Sat 12			Athens]
Sun 13			
Mon 14	[Ecofin]	[Ecofin]	[Ecofin]
Tues 15		**Cabinet**	
Wed 16			
Thurs 17	AS		**Cabinet**
Fri 18			
Sat 19			
Sun 20			
Mon 21			
Tues 22		AS	
Wed 23		[AS]	
Thurs 24		[AS]	AS
Fri 25			
Sat 26			
Sun 27			

24/10/83

CABINET AND AUTUMN STATEMENT: TIMING

MISC 99 starts today: WW hopes for deal in margins with Howe; and deal round table with Jopling. Deal with Gowrie already struck. But problems expected with Joseph, Walker, and Heseltine, and WW doubtful about chances of agreement with these three in MISC 99.

2. MISC 99 will complete operations on Monday. Perhaps sensible to envisage discussions with these three at No 10 before a report is made to Cabinet. (May also be need for further discussion on local authorities.)

3. This suggests that earliest date for Cabinet is 10 November: as now planned. Certainly keen to press on as fast as possible - with a view to publication of Autumn Statement (5 working days needed after decisive [ie ? second] Cabinet) before PM leaves for New Delhi. (21) Would mean my not attending Athens Special Council: no problem, GH can cope; though his absence from the Cabinet would be a pity. Also potentially absent - Jopling and Walker (China): latter potentially very serious.

4. If 10 November plan proves infeasible, or if second Cabinet required, ? case for going for 15 rather than 17 November. Even 15 November would however be too late to permit publication before PM's departure for New Delhi. But there would still be the 17 November slot for settling any still outstanding issue - eg Defence? - before ~~PM's~~ her departure.

CONCLUSION

5. 10 November looks best, despite the problems. But perhaps worthwhile clearing the decks, on a contingency basis, also for 15 November?

CONFIDENTIAL

FROM: J O KERR
DATE: 25 October 1983

MR BATTISHILL

cc Chief Secretary
Economic Secretary
Mr Middleton
Sir T Burns
Mr Bailey
Mr Littler
Mr Cassell
Mr Scholar
Mr Evans
Mr Watson

PUBLIC EXPENDITURE CABINET AND AUTUMN STATEMENT: TIMING

The Chancellor was most grateful for your minute of 24 October, and agrees with your reasoning throughout. He has noted that the Cabinet Office have now circulated a provisional agenda showing that public expenditure would be discussed on 10 November; and he is inclined to think that we should take no steps to change that plan, even though it would involve his not attending the Special Council in Athens. (The problems which the timing would create for Sir G Howe, Mr Jopling, and Mr Walker are perhaps for them, not us, to raise.) And whether Cabinet's discussion in the end falls on 10, 15, or 17 November, the Chancellor agrees that we should press ahead as fast as possible with Autumn Statement preparations, and that he should plan not to attend the ECOFIN meeting on 14 November.

2. The timing is of course very much subject to the Prime Minister's views; and the Chancellor will raise the matter with her at their meeting tomorrow.

JOK

J O KERR

PERSONAL AND CONFIDENTIAL

PW will go to Cabinet, but a good day's work there, nonetheless. Disappointed on Agric: was only £13.6 mn. We shall have to get what we can out of X. And what about research? N.

FROM: J O KERR
DATE: 27 October 1983

we spoke

CHANCELLOR

STAR CHAMBER TODAY: ENERGY AND AGRICULTURE

The following is my understanding of how MISC 99 got on today.

Energy

Mr Walker came offering a package of cost reductions on gas and electricity of £130 million/£100 million/£100 million, but saying that he could offer nothing on prices. MISC 99 bought his package (which actually is slightly more than we asked for on cost reductions), but said that he would need to offer something on prices as well. He refused, overplaying his hand.

In the subsequent restricted session the jury made it clear that they agreed with the Treasury proposals on electricity and domestic gas prices. (If they are as good as their word, that means another £250 million off Mr Walker.) But they don't like our idea of insisting that future industrial gas prices should be set as if the freeze had not been extended ~~till~~ to 31 March 1984. We have been asked to put in a note about that; but I guess that we shall lose it (price tag: £30 million).

On coal, Walker argued that he should not lose his £100 million for NCB investment, on the grounds of unripe time (MacGregor) and red rag (Scargill). The Committee have asked for a Treasury paper exploring how the NCB could be given conditional access to the £100 million without it being shown in the White Paper.

Agriculture (record below)

This was a hurried meeting; but Mr Jopling seems to have put up a skillful performance. He conceded £20 million a year of capital grants, through changing the eligibility rules. But that was all;

and he used the Euro-argument to fend off larger cuts. The Lord President pursued his suggestion that the rate of capital grants for agriculture should be brought in line with those for industrial investment; and we have been asked to put in a short paper on that. It will in fact show that the grants should come down from £100 million to £12 million; which clearly is pie in the sky. But we may conceivably get a recommendation for cuts of slightly more than Mr Jopling's £20 million.

JOK.

J O KERR

LORD PRESIDENT OF THE COUNCIL

PRIVY COUNCIL OFFICE

WHITEHALL, LONDON SW1A 2AT

31 October 1983

CHIEF SECRETARY
REC. 1-NOV 1983
ACTION MR Bostock
COPIES TO PPS
MR Bailey
MR Anson
MR Lovell
MR Scholar
MR Hart

x = a small further cut on top of Mr J's offer.

Dear Michael

Following our discussion this afternoon about the agriculture and fisheries programme, I promised to write to you setting out the recommendations which MISC 99 are disposed to put to the Cabinet.

We discussed the revised proposals which you put to the Group on 27 October and which are set out in detail in MISC 99 (83)10. These would entail the following totals: £878.5 million for 1984-85; £884.2 million for 1985-86; and £895 million for 1986-87. The Chief Secretary's proposals for the corresponding years were £855 million, £860 million and £865 million. At our meeting we explored various ways of reconciling your position and that of the Chief Secretary but were not able to identify the basis of an agreed settlement.

After the meeting MISC 99 discussed the position again and reached the following conclusions. As compared with your revised proposals we would ask you to find additional savings amounting to about half the total of your additional bids, ie £8 million in 1984-85, £9.2 million in 1985-86, and £10 million in 1986-87. This would produce the following totals: £870.5 million in 1984-85, £875 million in 1985-86 and £885 million in 1986-87. Although the Group appreciated your wish to retain flexibility in identifying the source of any additional savings, we would look to you to achieve them mainly by savings on capital grants and to do so, inter alia, by ensuring that no capital grant is paid at a rate greater than 50 per cent and by not introducing grant aid for tourism and craft industries. Finally, the Group would wish to stress that, in making these proposals for savings falling short of those sought by the Chief Secretary, Treasury they have very much in mind the uncertainties and difficulties which you fear may arise over support for agriculture when the post-Stuttgart negotiations in the European Community are finally resolved.

The Rt Hon Michael Jopling MP

The Group are most grateful to you for the help and co-operation which you have given to us already in our effort to secure the planning totals approved by the Cabinet. Although the proposals set out in this letter will not be welcome to you, we very much hope that you will be able to accept them.

I am sending copies of this letter to the Secretary of State for Scotland, the Lord Privy Seal, the Secretary of State for Trade and Industry, the Chancellor of the Duchy of Lancaster, the Chief Secretary, Treasury and Sir Robert Armstrong.

Yours ever

Willie

LORD PRESIDENT OF THE COUNCIL

PRIVY COUNCIL OFFICE
WHITEHALL, LONDON SW1A 2AT

CHIEF SECRETARY	
REC.	1 - NOV 1983
ACTION	Mr Robson
COPIES TO	PPS
	Mr Bailey
	Mr Anson
	Mr Burgner

Mr Scholar
Mr Hart

31 October 1983

C,
This takes more off Mr Walker than HMT sought.
[signature]

ENERGY INDUSTRIES

Before we meet again tomorrow, I thought that it might be helpful to set out briefly where our thinking has got to, following the Group's discussion with you on 27 October, on the recommendations which MISC 99 might put to the Cabinet.

The starting point for our discussion on 27 October was a gap of £400 million in 1984-85, £300 million in 1985-86 and £75 million in 1986-87 between your proposals and those of the Chief Secretary. During the discussion you offered efficiency savings in the electricity and gas industries worth £128 million in 1984-85 and £100 million in each of the two succeeding years. The Group were most grateful to you for this offer.

The remaining areas of disagreement concern the provision to be made for investment by the National Coal Board (NCB), the path of electricity prices over the next three years, and the amounts of the increases in domestic gas prices in January 1984 and in industrial gas prices in the quarter starting 1 April 1984.

NCB Investment

On NCB investment the position is as follows:

	£m 1984-85	1985-86	1986-87
Your proposals	839	884	848
Chief Secretary's proposals	739	784	748

The Rt Hon Peter Walker MBE MP

SECRET

The Group fully appreciates the points which you made at our discussion about the sensitivity of the published NCB investment figures. They noted however that it would be in accordance with the treatment of the NCB in the current Public Expenditure White Paper if an investment figure were published only for 1984-85, that there is as yet no published figure for that year, and that the only basis of public comparison would be the published figure for 1983-84 of £800 million. The Group would therefore be inclined to recommend a figure for investment for 1984-85 of £800 million, which would be published, and figures for investment in the two succeeding years of £784 million and £748 million which, as last time, would not be published. As it seems likely that the investment figure for 1984-85, like that for 1983-84, will be undershot, the Group would be disposed to recommend that the NCB's External Financing Limit should be calculated on the basis of the Treasury figure for investment of £739 million in 1984-85 as well as on the Treasury figures on investment of £784 million and £748 million for the two succeeding years.

Electricity Prices

The Group felt unable to support your proposal for a freeze on electricity prices in 1984-85. Their preference is for a smoother path of price increases over the next three years along the lines put forward by the Chief Secretary, Treasury, providing savings of £210 million in 1984-85, £90 million in 1985-86 and £30 million in 1986-87.

Gas Prices

Taking into account the points made in discussion, as well as the earlier exchanges among Ministers and with the Prime Minister, the Group favour a 6 per cent increase in domestic gas prices in January 1984. This would provide further savings of £39 million for 1984-85, £28 million in 1985-86 and £31 milli in 1986-87.

2 minor defects"
(a) no "backdating" tex.
(b) no increase on top of 6% for domestics to compensate for 'no backdating'.

On industrial gas prices the Group were disposed, taking account of efficiency savings which you have offered, to accept your proposal for an increase of 3 per cent in the April quarter and to forgo savings of £30 million sought by the Chief Secretary in each of the three years.

The proposals set out in his letter are intended to form part of a total package, and we shall be grateful to know if you would be able to accept them on this basis.

I am sending copies of this letter to the Secretary of State for Scotland, the Lord Privy Seal, the Secretary of State for Trade and Industry, the Chancellor of the Duchy of Lancaster, the Chief Secretary and Sir Robert Armstrong.

VISCOUNT WHITELAW

SECRET

PRIVY COUNCIL OFFICE

WHITEHALL. LONDON SW1A 2AT

CHIEF SECRETARY	
REC.	1 - NOV 1983
ACTION	Mr Faulkner
COPIES TO	PPS
	Mr Bailey
	Mr Wilding
	Miss Kelley
	Mr Scholar
	Mr Hart

31 October 1983

C.

See student grants para: p.2.

Dear Keith

MINISTERIAL GROUP ON PUBLIC EXPENDITURE (MISC 99): EDUCATION AND SCIENCE PROGRAMME

I promised at the end of our discussion with you on 26 October to write outlining the recommendations on the education and science programme which MISC 99 were minded to put to the Cabinet as part of our eventual report. I should like at the outset to express to you the Group's thanks for the very clear and helpful way in which you outlined your proposals and the arguments for them. We have also been much assisted by your letter of 28 October about student grants: as was recognized in the discussion, all the packages under consideration assume that there will be reductions in the cost of student grants of £20 million in 1984-85, £40 million in 1985-86, and £50 million in 1986-87.

The following paragraphs set out the Group's views on the issues which we discussed with you on 26 October.

Local Authority Capital Expenditure

In view of the many other pressures on public expenditure in general, and the need to reduce local authority expenditure in particular, the Group do not feel able to support any increase in the provision for capital expenditure on schools, and colleges of further education.

Universities - Capital

The Group do not feel able to recommend any increases here. They consider that priority expenditure should be accommodated within the existing programme.

The Rt Hon Sir Keith Joseph Bt MP

SECRET

Universities - Current

Again, the Group do not feel able to recommend any increase. They agree with the Chief Secretary that it should be possible to find efficiency savings by 1986-87; and indeed, I believe that you share this view, though you regard the Chief Secretary's proposals as over-ambitious. Subject to what is said below in the context of student grants, the Group intend to recommend savings of £50 million in 1986-87.

Science

After considering the arguments which you put forward for additional expenditure on science, and having regard to the conclusions of the Prime Minister's meeting on 19 October, recorded in her Private Secretary's letter of the same date, the Group do not feel able to recommend any increase here.

Student Grants

I am afraid that we do not think it likely that the Cabinet would endorse the proposals in your letter of 28 October. It is therefore necessary to look for other measures producing equivalent savings. There seem to be two possible approaches, which we should like to discuss with you.

The first would be a less severe package of savings on student grants, coupled with further savings on university current expenditure. I understand that some suggestions regarding student grants have been put to your officials by the Chief Secretary's.

The second would be to find the whole of the savings from further reductions in university current expenditure.

We realise that neither of these alternatives will be welcome to you; but we regard it as essential to find savings on the scale I have mentioned.

Changes Already Agreed

In earlier discussions you and the Chief Secretary had reached agreement on the following changes.

	1984-85	1985-86	1986-87
Additions			
Student grants	+ 40	+ 50	+ 45
Science (International subscriptions	+ 6	+ 8	+ 7
Reductions			
Grant-aided institutions	- 5	- 7	- 10
Student grants	- 20	- 40	- 50
Net effect	+ 21	+ 11	- 8

It transpired at our meeting that you had regarded these changes as involving agreed additions to the baseline in 1984-85 and 1985-86, whereas the Chief Secretary was expecting you to find offsetting savings in those two years. In view of the difficulties which you face in your programme, MISC 99 intend to recommend that you should not be required to find such savings. It would, of course, follow from what is said earlier in this letter that, to the extent that proposals for savings on student grants were not accepted, they would have to be replaced by savings on university current expenditure.

The net effect of these recommendations is to increase the baseline by £21 million in 1984-85 and £11 million in 1985-86, and to reduce it by £58 million in 1986-87. I realise that you will regard them as to some extent disappointing; but they are as far as MISC 99 felt able to go if we are to achieve the Cabinet's objective of sticking to the planning totals. I hope you will be able to accept them on that basis.

Once again, let me say how grateful I and the other members of MISC 99 are for your help.

I am sending copies of this letter to the Secretary of State for Scotland, the Lord Privy Seal, the Secretary of State for Trade and Industry, the Chancellor of the Duchy of Lancaster, the Chief Secretary and Sir Robert Armstrong.

Yours ever
Willie

A v. good submission. ~~[illegible]~~

If PM doesn't buy it, the CST shd withdraw all concessions ~~[illegible]~~. If so, no more concessions

In any event must be made. N.

CHANCELLOR OF THE EXCHEQUER

C

Stop Press

That is intolerable

The scorecard below, and my comments on it, assumed that the Energy offer to Walker would stick. It hasn't, and the CST has tonight conceded

(a) 5% rather than 6% domestic gas price increase

(b) only 39, not 100, off NCB investment in 84/5.

2. The effect is that we lose

84/5	85/6	86/7
100	28	30.

3. We end up

84/5	85/6	86/7
23 down	10 down	150 up

on our bids on Walker – which only shows that they were too modest.

clearly determined to get a deal with him before he left; and Walker argued that he couldn't deliver the Gas or Coal Boards on the 2 points at issue. So the heat was turned on the CST, and he crumbled — despite your evidence that Macgregor would have take a cut on investment — not of course evidence that he could use — and the evidence, known to all, that the PM favoured 6% on Gas.

Totally untrue

Bad.

(Perhaps W.W. will feel a bit guilty, and be heavier with AH.)

Bsc +87 +408 +241

FROM: T A A HART
DATE: 1 November 1983

CHIEF SECRETARY

VN

cc Chancellor
Mr Middleton
Mr Bailey
Mr Scholar
Mr Donovan - for file

SURVEY SCORECARD

I attach a scorecard showing the present position on the Survey. As usual, it sets out changes from the White Paper baseline in £ million. The scorecard shows:-

i. the position as at Cabinet on 20 October (ie the bottom line of Annex A of your minute of 18 October to the Prime Minister);

ii. the effect of the provisional decisions reached so far by MISC 99 (assuming that all their packages are accepted);

iii. the effect of other decisions, on local authority current expenditure in the later years and Arts and Libraries. This gives us

vi. the outstanding difference from the White Paper (ie the gap still to be bridged) and, set against this,

v. the Treasury position on defence.

2. I also attach a note which gives this information in summary form. It shows in addition:-

a. the overall change from the White Paper if the Treasury carried the day on defence and

b. a comparison between the provisional decisions of MISC 99 and your own proposals. As you will see, they come quite close to you in the first year, but fall short of your targets by about £50 million in the second year and exceed them by about £100 million in the third year. All this is, of course, subject to the major questionmark over defence.

3. On the energy industries in 1986-87, they have exceeded your target by £186 million. But this is heavily offset by the concessions made to the FCO, MAFF and DES which together are worth £79 million compared with your original position.

4. It is clear that (assuming a satisfactory result on defence), our major problem will be in the second and third years. The gap in those years could be bridged by either adding less to the reserve or by additional sales of assets or by a mixture of both. The reason for the particular difficulty in 1985-86 is partly that we started off about £150 million light. MISC 99 have given away another £50 million and the decisions on LA current etc added £180 million. Thus we are now around £380 million short for that year.

AJH

T A A HART
GEP 1

5.55

SECRET

ie whether we need to reduce the 'reserve' in order to 'hold the totals' seems likely now to depend entirely on the battle with MOD

SUMMARY OF SCORECARD

[no longer true: given the Energy outcome.]

	Change in relation to WP(£m)		
	1984-85	1985-86	1986-87
Agreed as at 20 October	+575	+929	+1083
Effect of MISC 99 provisional decisions	-326	-866	-1693
Effect of other decisions (LA current; OAL)	+6	+598	+660
Outstanding difference from White Paper	+255 +355	+661* +689	+50* +80
Defence (unsettled): Treasury position	-268	-281	+161
MOD position	+ 152	+ 337	+1603
Net change from WP if Defence carried	-13	+380*	+211*

*Assumes addition to reserve of £0.5bn in 1985-86 and £2bn in 1986-87.

MISC 99 provisional decisions so far compared with CST proposals

	1984-85	1985-86	1986-87.
	-14	+47	-107

Note: Defence not included.

ie the agreed 86/7 Falklands bid, less our (c £300m) cut

ie for 85/6 the PEWP fig of £3B is increased to £3.5B
(if we win on Defence we could perhaps revert to £3B to show the overall total coming out below the PEWP figure)
for 86/7 the Survey Protocol does talk £3B + 3% = £3.09B
and that would be increased to £5B
(if we win on Defence it might again be sensible to come down to £4.5B)

NB These were the whittled down bids (whittled down from £6B, plus re-agreed baseline changes)

	1984-85			1985-86			1986-87		
	(1)	(2)	(3)	(1)	(2)	(3)	(1)	(2)	(3)
	Agreed	Department	CST						
20th October Cabinet Adjustments by MISC 99	+575	+535	-580	+929	+829	-778	+1083	+1437	-1024
FCO-ODA	0	[+ 46]	[- 20]	0	[+ 73]	[- 30]	0	[+ 108]	[- 30]
FCO-OTHER	+ 6	[+ 10]	[0]	+ 9	[- 10]	[0]	+ 21	[+ 23]	[+ 9]
MAFF	- 4	[+ 27]	[- 20]	- 24	[+ 11]	[- 39]	- 38	[+ 7]	[- 53]
DES	+ 21	[+130]	[0]	+ 11	[+136]	[0]	- 58	[+ 140]	[- 80]
Energy Industries	-349	[+128]	[-272]	-862	[-544]	[-844]	-1618	[-1357]	[-1432]
	-326	[+341]	[-312]	-866	[-314]	[-913]	-1693	[-1079]	[-1586]
Other decisions									
LA current later years	-	-	-	+588	[+753]	[+418]	+ 647	[+ 833]	[+ 418]
OAL	+ 6	[+ 12]	[0]	+ 10	[+ 20]	[0]	+ 13	[+ 25]	[0]
Outstanding difference from White Paper	+255			+661			+ 50		
Defence (not settled)	-	+152	-268	-	+337	-281	-	+1623	+ 161

FROM: J O KERR
1 NOVEMBER 1983

CHANCELLOR

Ld W has done impressive so far. N.

MISC 99

... You should see the attached letters from the Lord President to Sir K Joseph, Mr Jopling, and Mr Walker. All pretty satisfactory.

2. The Lord President's meeting with the Foreign Secretary (and the Chief Secretary) took place this morning. Sir G Howe bought an offer of £6 million/£8 million/£12 million for the FCO Vote (ie BBC and British Council) but did not agree figures for Aid. The Lord President offered him the baseline, and not a penny more; he has retired to consider his position. He is to give the Lord President an answer by tonight: if it is other than acceptance of the baseline for Aid he will go to MISC 99 tomorrow.

3. Other remaining MISC 99 engagements are with Mr Walker this afternoon, Sir K Joseph tomorrow morning, and of course Mr Heseltine tomorrow afternoon. I have spoken to Mr Turnbull about possible attendance at any No 10 meetings with Mr Walker and Mr Heseltine.

J O KERR

SECRET AND PERSONAL

PWA

FROM: J O KERR
DATE: 2 November 1983

CHANCELLOR

MISC 99

Education

Earlier this evening I sent you the record of the meeting with Sir K Joseph. He has this afternoon seen the Prime Minister, who is said - by No 10 - to have agreed to the revised student grants package. (But Mr Turnbull warns me that it could still come up at your bilateral tomorrow, because she is still a bit uneasy.)

Defence

2. The position, after a two hour meeting this afternoon, and with another to follow at 9.30am tomorrow, is very confused. The only thing which seems clear is that Mr Heseltine has dropped his AFPRB compensation bid (as we knew he would). He also seems to be dropping his "defence RPE" bid, but is retreating behind a smokescreen of insisting on a Treasury guarantee that if inflation exceeds the 4 per cent and 3 per cent allowed for in the survey baseline, he'd get some more money. Such a guarantee is not of course on offer.

3. Mr Heseltine of course rejects our post 7 July baseline. As expected, his main grounds are that it is politically inept, and personally impossible, to publish figures for 84-85 and 85-86 below those in the last PEWP. Lord Whitelaw is apparently persuaded that this is bunkum, and that he will have to take lower figures; but I gather that Lord Whitelaw also thinks that our demand for these two years (-268 and -281) is a little too steep, and that Mr Heseltine should be offered an addback of £75 million in each year. The Chief Secretary has not agreed. /Every penny of addback of course means an increase of more than 3 per cent in the defence programme/

4. On 1986-87, Mr Heseltine seems to have indicated that he would settle for something less than 3 per cent, and Lord Whitelaw has told the Prime Minister tonight that he thinks an offer will appear tomorrow morning. The Chief Secretary has not offered his £100 million. But Mr Heseltine has also argued that MISC 99 is the wrong place to take the key political decision of whether or not to come off the "3 per cent commitment", and Lord Whitelaw is disposed to agree with him. A possible outcome, failing an acceptable Heseltine offer, is therefore that no MISC 99 recommendation for the last year will be put to Cabinet.

5. The 9.30am meeting tommorow will be with the Chief Secretary but without Mr Heseltine. If Mr Heseltine has indicated to Lord Whitelaw over-night that he would settle for the Treasury bid plus £75 million in each of the first two years, the Chief Secretary is inclined to buy that. If no Heseltine offer for the last year has appeared, the Chief Secretary is inclined to keep his £100 million for that year in his pocket.

6. There is clearly a very difficult judgement here. At your meeting you told the Chief Secretary that he could offer the £100 million only if we had got our bids approved for the two preceding years. So he has followed your instructions to the letter so far. But if he buys the £75 million in the first two years, he will have exceeded them. Not necessarily wrong, I think: the problem is to judge whether:-

(a) Cabinet would swing behind the MISC 99 recommendation for these two years, seeing off Heseltine protests, or instead regard the MISC 99 recommendations as a new floor above which the bargaining with Heseltine starts; and

(b) Cabinet would be more likely to give us a good deal on year three, where a £1.6 billion gap could be on the

CHANCELLOR OF THE EXCHEQUER

table, if we had made a conciliatory offer for the earlier two years.

My instinct would ~~be~~ and show that the Chief Secretary should not buy the £75 million in the first two years unless Mr Heseltine has. But I'm not certain.

7. The Chief Secretary will be in his office at 9.00am for a meeting with his defence briefers. You could therefore have a word with him on the 'phone then. And you are of course seeing Lord Whitelaw before MISC 99 meets.

8. I think that you ought also to plan to have a word with the Chief Secretary later in the day, but before your bilateral with the PM.

9. On the overall arithmetic, see the up-dated scorecard below. Even including the defence £75 million in each year, we would, with contingency reserves of £2.5 billion and £3 billion, still be able to say that we had reduced the overall totals. A key decision before your bilateral is whether you want to explain that to the Prime Minister. It is what she would most like to hear, I am sure, but it might of course reduce her willingness to resist the £75 million (or £75 plus) awards!

10. On the FCO and Energy, see the confirmatory notes below.

J O KERR