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DRAFT 20/10/80

PUBLIC EXPENDITURE

Memorandum by Chief Secretary, Treasury

Cabinet agreed on 10 July to keep public expenditure plans for 1981-82 and later years within the totals announced in the March White Paper (Cmnd 7841) less the benefit from refunds of EC contributions (CC(80) 28th conclusions). The separate paper now being circulated by the Chancellor (C(80)) shows the importance of sustaining that decision. Indeed, if it were practicable, it would be helpful to reduce public expenditure further in 1981-82.

2. But the prospects have deteriorated since July. We foresaw then that cuts in other programmes would be needed to offset increased provision for nationalised industries, then put £470 million* over what was provided in the March White Paper. Subsequent developments show very large prospective excesses over the March totals of the order of £2.7 billion in 1981-82, and more in later years. To offset these increases and get back to the March White Paper will now require larger and more difficult cuts in programmes, with serious difficulties, both practical and political.

The
3. / main reasons for the increases, set out in table 2 of Annex A, are:

* This, and all other figures in this paper, are at late 1979 prices.

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(i) The July increase would have allowed £1.2 bn for specific industries in 1981-82. The industries have now sought external financing limits totalling £2.5 bn. I propose in [E(80)] that their bids should be scaled down to £1.5 bn - £0.3 bn more than we allowed for in July. In addition increased provision of £0.3 billion is needed in the Reserve for next year, partly for the end-year flexibility scheme for nationalised industries. So £0.6 bn more is needed.

(ii) The changed prospects for unemployment, inflation and interest rates require increased provision of perhaps £0.7 billion in 1981-82, and more in later years, for benefits, housing subsidies and export credit subsidies.

(iii) In view of the recent discussion in E Committee, we need to allow something for the proposals put forward by the Industry and Employment Secretaries for "seed-corn" proposals for industry and measures concerning unemployment, particularly for young people. The original proposals amounted to £0.4 billion. I suggest that in present circumstances we can only allow for a net increase of £0.15 billion.

(iv) An additional £0.5 billion is needed in 1981-82 for a necessary increase in the Reserve together with a reduced estimate for shortfall.

(v) Certain other smaller items require a further £ $\frac{1}{4}$ billion.

4. To cover these changes action is needed on public service pay, and on expenditure programmes both by specific cuts as so far discussed in bilaterals with the Ministers concerned, ^{by} and/certain general cuts affecting a large number of programmes. The proposals in this paper need to be considered in conjunction with those in C(80) concerning cash limits.

(a) Public services pay

5. The Chancellor proposed in C(80) that the 1981-82 cash limits provide for a 6% increase in public services pay in the next pay round. Each 1% reduction in the pay settlements below 9% reduces the relative costs of the public sector below those allowed for in the Medium Term Financial Strategy by some £220 million and can justifiably be counted towards bridging the gap.

(b) Specific cuts

6. My proposals for specific cuts are in the first column of Table 3 in Annex A: the main ones are described in Annex B. They have been reduced in some cases to allow for the interaction with the general cuts described below. I have discussed them bilaterally with the Ministers directly concerned. So far I have secured agreement to £0.2 bn of the £1 bn proposed.

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7. The political difficulties of many of the/ ^{cuts} are evident. But we can only obtain the amounts needed to secure both our economic strategy and our specific commitment on public expenditure by significant savings in the very large programmes as well as in smaller programmes. This means moving away from certain commitments made previously, notably in relation to health, defence, education and social security.

8. Defence is one particular difficulty. I respect the Defence Secretary's concern both about National security and about relations with our NATO allies. My proposal would mean that we had at least stopped the decline in defence spending which occurred under our predecessors. But any significant increases now need to be deferred until later in our period of office.

9. Another key issue is social security. It accounts for a quarter of total public expenditure. The largest single element is retirement pensions. A step change here would not only give us a needed saving next year but put the programme on a more realistic basis for the future.

10. I propose that the increase in retirement pensions and other benefits in November 1981 should be abated to 3% less than the expected increase in the RPI. A similar abatement would apply to the increases in public service index-linked pensions. This would be in line with the fall in real earnings in the public service.

11. Legislation will be required. The way in which the cut should be expressed, and whether the legislation should give permanent enabling powers can be considered later.

(c) General cuts

12. On expenditure other than pay the Chancellor has proposed a cash limit factor of [12%].^{*} This is within the realistic range of expectations, but towards the optimistic end of that range, so it may still imply some degree of cash limits squeeze, if inflation turns out higher. Rather than reduce the factor further to produce a deliberate major cash limits squeeze, I propose a general volume cut in all expenditures subject to cash limits (excluding local authority current expenditure) of 2% in 1981-82, carried forward into the later years. The effect will be similar to that produced this year and last by the cash limits squeeze. It is simpler and better than such a squeeze, because it enables programme managers to plan for it now, and the volume figures published in the White Paper to represent more nearly the Government's intentions.

13. In addition, I propose that we seek a further 1% cut in local authority current expenditure, in 1981-82, and in subsequent years, to be shared out proportionately among the relevant programmes. This involves re-opening the earlier decision, announced in August to local authorities, to stick to the 2% reduction between 1980-81 and 1981-82 shown in the

*The Chancellor is considering this further.

March White Paper. The extra reduction would be explained as required by the economic climate. It may not be implemented in full, especially in 1981-82, but we cannot exempt the local authorities from this further effort.

Total effect

14. Annex A, Table 3 shows the combined effects of the various reductions on the main programmes. The figures for later years are on the basis of carrying forward the policy measures involved in the specific cuts, and the absolute amounts of the general cuts.

15. Even these proposals taken together will still leave our planned spending in 1981-82 above what we decided in July by more than £0.2 billion, as is shown in Table 2. There is a corresponding excess in 1982-83, although the totals for that year and the one after are provisional: the economic assumptions may need to be changed before the Budget. The excess will be more if the cuts are not implemented in full or if the other assumptions, eg on public service pay are not validated.

16. For public presentation we can obtain some easement by taking advantage of the EC refund, ie by presenting our decision as holding public expenditure from 1981-82 onwards below the March White Paper provision, but not to the full extent of the gain from the EC refund. But this does not help the problem with the PSBR.

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Announcement

17. We have first to reach decisions on the substance, need to but/keep in mind what requires to be said and when.

18. Specific announcements will be needed in the next month or so of:

(i) Cash limits factors, as proposed in C(80);

(ii) The additional cut intended in local authority current expenditure, which is relevant to the Rates Support Grant settlement next month;

(iii) Some changes in other programmes where operationally necessary;

(iv) The public expenditure policy assumed in the Industry Act forecast.

19. It will be for consideration whether some announcement about our overall plans in general terms will be appropriate in the near future. Subject to that, the occasion for comprehensive and detailed announcement will be the next public expenditure White Paper, which I propose we publish again on Budget Day next March.

Conclusion

20. I invite the Cabinet's approval of the proposals set out in this paper.

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ANNEX A

TABLE 1

CHANGES COMPARED WITH MARCH PUBLIC EXPENDITURE WHITE PAPER

£m late 1979 prices

	1981-82	1982-83	1983-84
I <u>Total public expenditure</u> Cmnd 7841 revalued			
Total programmes excluding nationalised industries	75,606	74,351	74,330
Nationalised industries' finance	754	167	-507
Reserve	1,350	1,700	2,200
Special sales of assets	-50	-50	-50
Shortfall	-840	-840	-840
	76,820	75,328	75,133
EC refunds	-680	-680	-680
II <u>Increases</u> (see table 2)	+2,724	+3,056	+2,967
<u>Reductions</u> proposed (see table 3)	-1,840	-2,117	-2,580
Net changes in total public expenditure volume (a)	+884	+939	+387
III <u>Effect of reduced public service pay</u> (b)	-650	-650	-650
Net changes (a & b)	+234	+289	-263
IV <u>EC refunds</u> (c)	-680	-680	-680
Net changes (a & b & c)	-446	-391	-943

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TABLE 2

INCREASES COMPARED WITH MARCH PUBLIC EXPENDITURE WHITE PAPER (Cmnd 7841)

£ million late 1979 prices

Nationalised industries

	1981-82	1982-83	1983-84
Anticipated in July	+470	+470	+470
Further increase for individual industries	+300	-	-
Increase in reserve (partly for end-year flexibility)	+300	+50	+50
	+1,070	+520	+520

Other programmes

Revised economic prospects (unemployment benefits, export credit, housing subsidies) (1)	+700	+1,100	+850
Industrial support)	+150	+185	+185
Employment measures)			
Reserve (not including provision for end-year flexibility for public services)	+350	+500	+250
Reduction in shortfall	+200	+340	+340
May CAP price-fixing	+40	+55	+60
Civil service manpower: extra redundancies	+64	+39	+47
Child benefit uprating by prices (proposed in C(80)40) (2)	+75	+250	+360
Changes agreed before July (incorporated in survey baseline)	+75	+67	+55

Total increases

	+1,654	+2,535	+2,447
	+2,724	+3,056	+2,967

NOTES:

(including DHSS staff)

- (1) Provisional Treasury estimates. Additions will be made to specific programmes in consultation with Departments.
- (2) Reduction proposed in Table 3 (3% off all social security benefits) will partially offset this.

REDUCTIONS COMPARED WITH MARCH PUBLIC EXPENDITURE WHITE PAPER

DEPARTMENTS (excluding nationalised industries)	-----81-2----- £m late 1979 prices				82-3	83-4
	Cuts already proposed (inc some agreed)	1% reduction in LA current expenditure	2% volume cuts in cash - controlled programmes	Total		
Defence	-317	-	-183	-500	-500	-500
DHSS (social security)						
- 3% off all benefits, less small bid	-162	-	-	-162	-498	-496
- child benefit: changed date of payment	-62	-	-	-62	-10	-15
Indexed public service pensions (3% off)	-10	-	-	-10	-30	-30
DHSS(health and PSS)	-	-12	-125	-137	-137	-137
DOE (housing)	-34	-1	-27	-62	-88	-83
(PSA)	-19	-	-8	-27	-23	-23
(other)	-62	-15	-18	-95	-89	-84
DES (gross)	-85	-61	-32	-178	-238	-243
Scotland (excl. DAFS)	-109	-17	-24	-150	-150	-150
MAFF/DAFS/WOAD	-26	-	-9	-35	-35	-35
OAL	-10	-2	-3	-15	-15	-15
Home Office	-10	-21	-9	-40	-40	-40
Transport	-15	-10	-17	-42	-42	-42
All other Departments:						
general cuts	-	-8	-118	-126	-126	-126
ECGD: shift to TSBs, less smallbid	-48	-	-	-48	+4	+4
Other changes						
EC unadjusted contribution: revision to fore- cast	-90	-	-	-90	-240	-490
Sales of assets (slippage from 80-81)	-100	-	-	-100	-	-
Other changes in C(80)40 and agreed in bilaterals	+39	-	-	+39	+140	-75
TOTAL	-1120	-147	-588	-1840	-2117	-2580

NOTES: (1) 2% volume cuts include savings resulting from reductions in civil service manpower proposed by Lord President (incl. 2½% manpower squeeze carried forward from 1980-81).

(2) "Formula" cuts for Scotland, Wales and N.Ireland are excluded and replaced by general cuts.

IMPLICATIONS OF MAIN CUTS PROPOSED

1. Defence

As part of the specific cuts proposed in September, defence were asked for a contribution "of the order of £400 million a year". The additional 2% volume cut now proposed would mean for defence a further reduction of £205 million. Since a total cut of nearly £600 million is clearly not feasible, this has been scaled down in the table to £500 million. The Secretary of State for Defence will be concerned that cuts of that order, on top of previous cuts built into the baseline, would damage operational capability and defence industrial capacity.

2. Social Security

The proposal is to uprate all benefits (including retirement pensions) by 3 percentage points less than the Budget forecast of the rise in prices up to November 1981. Main legislation will be needed. This is a very difficult decision politically, when the Government has just legislated to align long term benefits with prices, and when the published forecast is not expected to show a fall in average real earnings on the same scale. Nevertheless this measure will produce savings of £170 million in 1981-82 and £510 million in later years, which are central elements in reducing the total. Even with these measures the social security programme - the largest public expenditure programme - is likely to rise over the period.

3. Education

Cabinet in July decided on cuts of £85 million next year, mainly in local authority current expenditure (on schools and further education) to achieve education's share of the 2% target reduction for local authorities. Since education is nearly half of local authority current spending, a further £61 million is needed towards the further 1% reduction; and a 2% reduction in other programmes (universities, science) would yield a further £32 million. These cuts carried forward,

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with some further reductions, total (gross) £240 million a year for later years. The Secretary of State will be concerned about trebling the cut in his programme, when he regards what has already been agreed as putting at risk the Queen's Speech commitment to "maintain and improve" the quality of education.

4. Health

Following decisions not to pursue fully a number of proposals for additional charges which has been made (notably charging for accident treatment) the programme is already £100 million below current spending plans. A further £125 million (2 per cent) cut in volume would mean a total reduction of £225 million below present plans. Unless colleagues are prepared to reconsider charging on the necessary scale, gross NHS spending would have to be cut, not only below the planned level arguably implied in the Manifesto commitment but in fact below volume spending in the current year. Because of upward demographic pressures, this means an absolute reduction in level of service.

5. Scotland

The figures in the table show £109 million for specific cuts, plus £17 million for local authority current 1% and £24 million for the 2% on other programmes, giving a total of £150 million. The Secretary of State was originally asked for £150 million plus "formula cuts" and regarded this as poticially unacceptable. The equivalent figure is now £109 million since the £41 million for percentage cuts would take the place of "formula cuts". These cuts would mean that expenditure per capita in Scotland on comparable programmes would continue to be almost one-third higher than in England.

6. Home Office

The Home Secretary reluctantly accepted a cut of £10 million. The percentage cuts now proposed would mean a further cut of £30 million, mainly on local authority current spending (police, courts etc).

7. Environment

The proposal is for specific cuts of a further £50 million, including £10 million on PSA. The percentage cuts would be additional to these. The PSA contribution is likely to entail a reduction in departments' accommodation programmes and standards of service provided to them.

DRAFT CABINET PAPER 20/10/80

PAY AND PRICE FACTORS FOR THE 1981-82 CASH LIMITS AND VOTES

We need to decide now the inflation factors to be used in fixing cash limits for 1981-82. This is material to the RSG decision to be taken during the next month, and it will be useful to announce the factors generally in the near future.

2. These factors need to be considered at the same time as the volume programmes discussed in C(80). It is the cash limits which will ultimately determine how much money is available for the cash controlled programmes next year. Whatever figures we decide, it is central to our policy that the resulting cash limits should be rigorously observed.

3. The cash limits cover much of central Government expenditure including defence, the hospital and community health service and universities. They also cover the rate support grant (RSG) and local authority capital expenditure. Altogether this amounts to over £40 billion at late 1979 prices.

A. Pay

4. On pay, cash limits cover numerous public service pay groups including the armed forces, doctors, nurses, NHS ancillaries, teachers, local authority manual workers and civil servants.

5. I propose that the 1981-82 cash limits and Votes should provide for a [6%] annual increase in earnings from due settlement dates in the current pay round.

6. The 1981-82 cash limits and Votes must also include provision for a number of settlements in the autumn of 1981. These fall in the next pay round. I propose that the provision for these settlements should be two percentage points below the figure we decide on for the current pay round (i.e. 4% if the proposal of 6% above is agreed). It should be made clear that this is a provisional figure.

7. There are two other points on the pay provision. First, settlements in the remainder of the current financial year. The 1980-81 cash limit provide 14% for these. This is too high. I propose that the 1981-82 cash limits should only finance settlements in the remainder of 1980-81 (i.e. those agreed between 1 October 1980 and 31 March 1981) only to the same extent as the provision for new settlements in the current round (as in para 4).

8. Second, staging. The general policy from now should be to avoid staging whenever possible. In future cash limits should be set so as to prevent financial advantage to employees from staging.

9. Certain public service awards were staged in 1979-80; non-industrial civil servants, for whom staging increases earnings

between 1980-81 and 1981-82 by about 2% in the absence of any further pay increase; teachers, for whom the comparable figure is about 4%; and university teachers (about 5%). [Passage to be added in the light of E Committee discussion.]

B. Prices

10. For 1979-80 we set cash limits in such a way as to produce a deliberate 'cash limit squeeze', that is, deliberately lower, we we acknowledged, than would provide in full for expected price increases.

11. Apart from the saving in expenditure, such a squeeze is a useful incentive to efficiency. But for 1981-82 there is a better way than a fresh major cash limit squeeze of consolidating and carrying forward the savings from last year's cash limits squeeze and renewing the stimulus to efficiency. This is the proposal in C(80) for a general cut of 2% in the volume plans for cash controlled central government expenditure (capital and current) and in local authority capital expenditure. A further general cut of 1% is also proposed in local authority current expenditure, to be reflected in the RSG.

12. Provided that these proposals are agreed, I propose that in cash limits and votes we provide for an increase in prices of [12%*] between 1980-81 and 1981-82. This is within the range of realistic expectation, but towards the optimistic end of the range. So it may still imply some degree of cash limit squeeze,

*The Chancellor is considering this further.

but this should not be significant unless the current economic assessment turns out to be significantly wrong.

13. This figure would apply to all expenditure other than pay. There appears to be no significant difference in the price prospects in the different areas of expenditure, so it is not necessary to use a range of different price factors as in the past.

14. This would be the provision made for price increases in the RSG.

C. Conclusions

15. I invite Cabinet to:-

- a. consider whether the 1981-82 cash limits and votes should provide for a [6%] annual increase in earnings from due settlement dates in the current pay round and [4%] in the next pay round;
- b. agree that the 1981-82 cash limits should only finance settlements in the remainder of 1980-81 to the extent of the figure agreed as a. above for the current pay round.
- c. [conclusion on staging to be added]
- d. agree that for expenditure other than pay the 1981-82 votes and cash limits should provide for a [12%] increase in prices between 1980-81 and 1981-82.