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PRIME MINISTERThe Economic Outlook and Public Expenditure  
(C(79) 61)

## BACKGROUND

The Chancellor of the Exchequer has now circulated the paper which he discussed informally with you and others on Friday. At that meeting there was general support for the Chancellor's proposals, although Mr. Prior (who left before the end) is not wholly reconciled, and can be expected, I think, to voice his reservations in Cabinet. The Chancellor has not yet had the separate talks with Mr. Pym (who only gets back on Wednesday night) and Mr. Heseltine envisaged last Friday. Nor have any further approaches been made, so far as I know, to other members of the Cabinet. But the Chancellor's intentions have been well-trailed in the Press, and his move will come as no surprise. His paper contains the £1 billion target for 1980-81 and a £2 billion target for later years. But, at your request, it does not contain detailed proposals for individual programmes.

## HANDLING

2. I imagine you will want the Chancellor to introduce his paper briefly. You might thereafter like to take advantage of Friday's softening-up meeting by inviting some of the participants to speak. A possible sequence would be: Sir Keith Joseph or Mr. Nott (broadly allies); Mr. Prior (likely to be opposed); Mr. Jenkin or Mr. Whitelaw (supporters again). But after that, you will want to throw the discussion open, and give most members of Cabinet a chance to join in.

3. To judge by Friday's discussion, these are the points which may come up:-

- (i) The uncertainty of forecasting the PSBR. This is not an argument for inaction because the penalties of guessing wrong are too high. Most commentators now believe - with the Chancellor - that the

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PSBR is likely to be unacceptably high next year, and are expecting corrective action. It will be easier to compensate later for overkill now, than to fail to do enough now and have to cut expenditure or increase taxes by more later.

- (ii) In a depression, the Government will still be able to finance a PSBR of this kind at reasonable interest rates, and/or without adding to the money supply. The same arguments hold: the Government cannot afford to take a risk. Although there are some slight signs that the rise in interest rates is working through to bank lending, the Government borrowing requirement remains disturbingly high.
- (iii) In a recession, the appropriate response is to allow the PSBR to increase somewhat. This argument would be stronger if the PSBR was not already uncomfortably high. But the Chancellor has to finance the real PSBR, and not some hypothetical constant-employment PSBR, in the markets.
- (iv) If the PSBR must be reduced, the answer is to increase taxation not to cut expenditure. The scope for increasing direct taxation is severely limited, particularly if the Chancellor decides not to reverse the 'Rooker-Wise' amendments and increases would in any case be quite contrary to the Government's broad strategy. Because of the big VAT increases this year, there is no scope here - though the yield will rise with inflation. Petrol, alcohol and tobacco are the traditional remedies. A respectable case can be made for an increase in petrol duty, on energy saving grounds; the duties on alcohol <sup>and tobacco</sup> ought at least to keep pace with inflation. But all indirect taxation <sup>- particularly on beer and tobacco -</sup> affects the RPI, and it may seem odd to seek to counter inflation by deliberately - and again - increasing consumer prices. Other remedies - PRT, NIS, or increased Employee Contributions, are worth considering. But all except PRT feed through to industrial costs.

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- (v) If expenditure must take the strain, we should take credit for a reduction in the EEC Budget. Mr. Walker is bound to revert to this point but the only sensible answer is 'not until we are sure of it'.
- (vi) The Defence Budget should take its share. I have sent you a separate minute about the minefields in this area, through which you will need to step very carefully. You will need to bear in mind that the Cabinet does not yet know of the earlier deal between the Chancellor and the Secretary of State for Defence.
- (vii) Law and Order. Mr. Whitelaw has offered to find his share somewhere - possibly on the Fire Service. You may wish to ask him if that can be done without unacceptable damage to standards of fire cover. Cabinet will probably accept that the main Law and Order programme must be preserved.
- (viii) Social Security. The discussion on Friday of 'indexation' will help here - and there may be a little more to come when E has come to conclusions on the taxation of social security benefits. The Secretary of State for Social Services will, I think, argue on the latter point that the right course is to wait until benefits can be taxed. He will probably resist any attempt to cobble together an interim scheme for reduction of benefits meanwhile. Any action on indexation of course will require further and contentious legislation.
- (ix) Costs of Administration. The Cabinet's most recent discussion of Civil Service numbers was disappointing, and some may wish to reopen the question. The separate proposals on cash limits in C(79) 60 will impose their own general squeeze. Cabinet has decided against another general manpower exercise. Further pressure on this front is best brought to bear in the course of public expenditure reviews, and the right course is probably to pursue extra savings case-by-case, in the course of bilaterals

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with spending Ministers. You might invite the Chancellor to associate CSD Ministers with his studies where appropriate (leaving it to the CSD to suggest the appropriate cases).

- (x) Offsets. Mr. Heseltine made it clear, in an earlier discussion, that he would be more inclined to offer further savings in the housing and rents programme, if some part of the proceeds were recycled to 'accelerator' proposals. The discussion in E on Wednesday will have illuminated this problem. It seems unlikely that the two Heseltine schemes would work, and the Chancellor has grave reservations about finding room for any sweeteners of this kind at all. In the event, therefore, Mr. Heseltine may have to be told rather than asked to find more. He will be the less likely to be co-operative if he foresees the prospect of losing part of the Local Government Bill.
- (xi) Procedure hereafter. You were anxious to avoid any further negotiation in full Cabinet. Friday's meeting was not keen on reviving the idea of a 'star chamber' group on the lines of MISC 11 in the summer. I believe that on this occasion it is preferable for the discussions to be conducted bilaterally, extended as necessary on the lines I suggested in my earlier minute. You yourself should keep out of that stage of the exercise, so as to preserve your own freedom of action until final decisions come to be taken in Cabinet.
- (xii) Public Expenditure White Paper. If Cabinet approves these proposals, the publication of the 'later years' White Paper will have to be postponed from January until nearer the Budget. The discussion in Cabinet provisionally planned for 20th December would be correspondingly set back.

CONCLUSIONS

4. If the discussion goes the way you want, the conclusions might be:-

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- (i) To recognise that the prospects for the PSBR next year and in subsequent years require further savings of the broad order of £1 billion in 1980-81 and of £2 billion a year in 1981-82 and subsequent years - without any final commitment to exact numbers at this stage.
- (ii) To invite the Chancellor of the Exchequer and the Chief Secretary to open discussions with spending Ministers and to bring proposals, and options, to the Cabinet in January.
- (iii) To agree to postponement of the Public Expenditure White Paper until March.

BA

(Robert Armstrong)

12th December, 1979