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Ref No. A05732

PRIME MINISTER

Economic Policy and Public Expenditure

C(81) 50 and 51

BACKGORUND

When the Cabinet discussed the economic strategy on 23 July they agreed that, before reaching a view on the balance to be struck between the Government's taxation and public expenditure objectives, they would need a much fuller evaluation of the options than Treasury Ministers had then offered. The Chief Secretary's paper setting out the Treasury's public expenditure proposals (C(81) 51) is therefore introduced by a paper by the Chancellor of the Exchequer (C(81) 50) which discusses the broad policy options open to the Government on the level of the PSBR, and the balance between tax and expenditure, and the effect which different options would be likely to have on inflation and unemployment.

PSBR £9 bin.

2. The Chancellor's main proposals are: (a) that the Government should continue to aim for a PSBR in 1982/83 no greater than that envisaged in this year's Budget (£9bn); (b) that public expenditure should be limited to levels which will avoid a real increase in the tax burden in the next Budget; (c) that unless public expenditure totals are reduced below those recommended there will be no scope for real tax reductions in the next Budget or a reduction in the National Insurance Surcharge and (d) that, while the recommended totals should leave some scope for tax reduction in 1983 and 1984, the Government should not count on this yet.

The proposed public expenditure totals are:

	£ billion	
	1982-83	1983-84
1981 White Paper (revalued and adjusted for Gas Levy etc)	109.9	113.9
Total bids	117.1	124.5
Proposed	113.5	118.1

For 1984/85 there is a figure of £124.8 bn which results from carrying through to that year the Chief Secretary's proposals for earlier years. However he considers that this total is too high and will have to be looked at again by officials in the interdepartmental Public Expenditure Survey Committee before he is ready to put proposals to the Cabinet; he would hope to do this in late November, so that a figure can be included in the Public Expenditure White Paper.

3. The Chief Secretary has arrived at these totals in the following way:

(a) For local authority expenditure he has assumed, pending a final decision, that the maximum feasible volume cut in 1982-83 is 3 per cent, followed by further volume cuts of 2 per cent in each of the succeeding years, together with some allowance for overspend; this involves increases of £1.4 bn in each of 1982/83 and 1982/84.

(b) For nationalised industry external financing limits he has proposed a figure which implies an excess of £1.18 bn over the 1981 White Paper revalued, compared with the original excess bid of £2.5 bn.

(c) For demand-led programmes which are affected by the level of unemployment, higher interest rates and higher prices there is an additional "estimating allowance" of £1.6 bn in 1982/83 and £3.3 bn in 1983/84.

(d) For departmental programmes he has proposed reductions (as against bids) of £3.6 bn in 1982/83 and £6.3 bn in 1983/84.

4. The details for departments are set out in Annex A to C(81) 51. Apart from defence, universities and prisons, on which policy decisions have already been taken, the proposals are for programmes to be cut by at least 2 per cent compared with the White Paper revalued. This includes a 2 per cent cut in all staff and general administrative expenditure, and is additional to the 1 per cent volume squeeze which will result from the worsening in the prospects for

inflation since the factor of 9 per cent was fixed for non-pay elements in September. For many departments their savings towards the 630,000 civil service manpower target had not been settled at the time of the last White Paper, and their savings towards the target will therefore count for the purposes of the 2 per cent cut in staff expenditure now being sought. Any detailed problems for departments can be fully resolved when the Estimates are settled, and a discussion at this meeting should be avoided.

5. For many Ministers the proposed reductions will be very difficult. The Chancellor of the Exchequer sent to you on 9 October (but not to other Ministers) two lists - List A showing the difficult cuts proposed and List B showing those difficult cuts which would be necessary if further reductions were to be required. For ease of reference these two lists are attached. The following points should be noted in particular:

(a) There is a major dispute over defence expenditure concerning the extent to which allowance should be made for price changes this year and in future years; the sum involved amounts to around £0.5 bn in 1982/83 and around £0.7 bn in 1983/84.

(b) There are some contentious proposals for the DHSS, notably the 5 per cent abatement (to be mentioned orally) of "unpledged" benefits (sums involved: £165m in 1982/83 and £490m in 1983/84) and new health charges for road accidents, hospital beds and exempt groups (£95m in 1982/83 and £205m in 1983/84).

(c) The housing proposals will involve substantial council house rent increases which will have some effect on the RPI (sums involved £50m in each year).

(d) A substantial increase is proposed in parental contributions to student awards (sums involved £40m in 1982/83 and £100m in 1983/84).

(e) The uncommitted road programme is to be cut by half in 1982/83 and substantially thereafter (£50m in 1982/83 and £75m in 1983/84).

(f) There are some potential legal problems over refusing Regional Development Grant for Sullom Voe and Flotta (£122m in 1982/83).

(g) The Foreign and Commonwealth Secretary is likely to see difficulty about the 3 per cent real cut in overseas aid (£30m in each year).

(h) The Minister of Agriculture will be seriously concerned about the proposed cuts in capital grants for farmers (£30m in 1982/83 and £50m in 1983/84).

6. Several of the proposals will involve legislation in the 1981/82 session. It is already clear that primary legislation would be required for the new health charges and for making school leavers ineligible for supplementary benefit, and affirmative resolution orders would be required for some proposals relating to agriculture, regional development grants and Home Office fees; in addition legislation may be required to increase National Insurance contributions so as to balance the National Insurance Fund.

MAIN ISSUES

Outlook for the economy

7. Ministers are likely to be keenly interested in the Chancellor's assessment of the prospects for unemployment and inflation (paras 10-12 of his paper). On unemployment he expects the rise to be slowed in 1982 but not to be reversed. On inflation he sees a lower rate before the end of 1982 but expects progress to be less rapid than assumed in September. He may be willing to offer some quantitative estimates in discussion. Although he sees better prospects for 1983 and beyond, his assessment for 1982 will prompt some Ministers to probe carefully to see whether there is any action which could be taken to improve employment prospects in the short term, particularly bearing in mind the political points which the Chancellor has made in para 3 of his paper.

Level of the PSBR

8. The difficult public expenditure discussions summarised in para 5 above, and the Chancellor's view that no real tax reductions are likely in 1982, follow from his proposal on the PSBR. He argues that the Government should aim for a figure in 1982/83 no greater than the £9 bn announced at the time of this year's Budget. This would assume a reduction in the PSBR as a percentage of GDP from $4\frac{1}{4}$ per cent this year to $3\frac{1}{4}$ per cent next year. Since there is said to be no reason at present for revising the view of the level of output next year from that taken at the time of the Budget, the Chancellor feels that he cannot justify an increase in the PSBR. In para 18 he estimates that an increase in the PSBR of £1 bn would be likely to cause a rise in interest rates of $\frac{1}{2}$ to 1 per cent, and some increase in inflation. Any benefits to employment which would follow from the tax reductions or higher expenditure made possible by this increase would be eroded by the end of 1985. He also argues that an increase in PSBR for 1982/83 beyond that announced would be likely to have a bad effect on market confidence.

9. Some Ministers may argue that the Government should have more regard to the timing. They may prefer to see benefits in 1982/83, even if these are eroded later. On market confidence some may argue that there is no easy option. If

the Government gets into political difficulty by adhering to its plan to reduce the PSBR as a percentage of GDP, this could also affect market confidence. The Chancellor will however no doubt stress the additional constraints which international developments, and particularly those in the United States, place on the Government's freedom of action.

Tax v. expenditure

10. If Ministers agree that the PSBR target should be maintained, they will nevertheless wish to consider whether the Chancellor is proposing the right balance between tax and public expenditure. The argument may turn on the benefits to output and employment which can be expected for a given level of expenditure or tax reduction even in the short term.

11. The benefits from expenditure are discussed in paras 18 to 20 and Annex B of the Chancellor's paper. He argues that, even allowing for savings in unemployment benefit and increased tax receipts, additional public expenditure over time affects the PSBR adversely. Moreover the additional employment which might result from substantial extra expenditure on procurement (at a level which would increase the PSBR by £1 bn) is surprisingly small (eg 30,000 by end of 1982 and 50,000 by end 1983). Some Ministers may nonetheless argue that in political terms the Government cannot afford not to do something on these lines.

12. Other Ministers may argue that this strengthens the case for tax reductions. with P.M. — The Secretary of State for Industry wrote to the Chancellor on 12 October proposing a cut in the National Insurance Surcharge, as favoured by the CBI. The Chancellor has implied in paras 31 and 32 of his paper that this is the kind of tax reduction which he would hope to make in 1983 or 1984. Moreover he argues that, as compared with an equivalent increase in public expenditure, a tax reduction of this kind is preferable because it would tend to bring down inflation. However in terms of reducing unemployment he says that it would have much the same limited effect as an expenditure increase.

13. In considering the case for a reduction in the National Insurance Surcharge (NIS), Ministers will need to bear in mind that, in line with his stance of not altering the real burden of taxation in 1982/83, the Chancellor is proposing (para 27) that National Insurance contributions should rise to balance the National Insurance Fund. This is mentioned only briefly; but it is important that Ministers should be fully aware of it. In relation to the proposal for a reduction in NIS, it cuts both ways. It could be argued that a reduction in NIS is even more desirable to mute adverse reaction from industry to the increase in contributions; on the other side it would be argued that the increase in contributions would cancel any political and presentational benefit from reducing NIS.

14. If Ministers accept that the merits of tax reductions as against expenditure increases (or vice versa) are finely balanced in terms of the effect on employment, they will want to consider whether the particular balance proposed by the Chancellor and the Chief Secretary for 1982/83 and 1983/84 is the right one. Given no change in the PSBR target, failure to achieve the totals proposed by the Treasury is likely to make a real increase in the tax burden inevitable; but tax reductions in 1982 could be achieved only by adopting even more difficult expenditure cuts than those proposed (for example abatement of uprating the "pledged" benefits).

TIMETABLE

15. Treasury Ministers are looking for decisions on the public expenditure totals, and on 1982-83 in particular, by 'mid-November'; that is, in practice, by Cabinet's meeting on 19 November at the latest, and preferably by the 12 November meeting. This is to enable the nationalised industries' EFLs and the RSG settlement to be announced, the work on the Estimates and on the preparation of the March 1982 Budget to go ahead, and decisions on increases in the National Insurance Contribution to be taken. You will need to consider how best within this timescale to deal with the major decisions on the economic strategy, and on particular public expenditure programmes, which now need to be taken. After the meeting on 20 October there are, on present plans, meetings of Cabinet on 29 October, and 5 November as well as on 12 and 19 November.

16. Your aim on 20 October might be to complete a preliminary and provisional discussion of the overall approach proposed by Treasury Ministers. Although Departmental Ministers will undoubtedly make points on their programmes, there will probably not be time to enter into definitive discussions of particular programmes - and in any case it would probably be as well to give the lessons from this discussion time to sink in before going on to the discussion of particular programmes. If the Cabinet were to endorse the aim of entering into further discussions with a view to securing net savings sufficient to bring public expenditure totals down to those proposed by the Chief Secretary, that would not commit spending Ministers to sign up on particular cuts - and it is unlikely that many of them would be prepared to do so at this stage - but it would give the firm steer which is necessary if the further discussions, some of them not in full Cabinet, are to be effective.

17. You could indicate that, in the light of the meeting, you will make arrangements for further discussions of individual programmes. You will wish to do so in consultation with the Chancellor of the Exchequer before you leave for Cancun on 21 October. You might also indicate that the Cabinet would return to discussion of the overall strategy in the light of the outcome of the further discussions on individual programmes and with a view to examining the overall package.

18. The proposals for some programmes, notably social security, are politically contentious and of sufficient general interest to call for discussion in full Cabinet. Others might be dealt with by the Economic Strategy Committee and others might be left either to further bilateral discussions between Treasury and Departmental Ministers or, in cases where it is thought that this would not be worthwhile or where it is tried and agreement cannot be reached, to a small group under you or the Chancellor of the Exchequer. Provisionally the plan might be as follows:

(a) Cabinet on 29 October and 5 November might:

(i) Confirm the local authority current expenditure totals and, either not later than 5 November, agree on the Rate Support Grant percentage and other details. (NB The overall total has already been provisionally agreed by Cabinet; the split of that total between services has now been agreed by the Home Secretary's MISC 21 Group; MISC 21 will make recommendations to Cabinet, following the meeting of the Group on 22 October, on the RSG settlement though it is not yet clear whether they will be able to do so in time for discussion on 29 October rather than 5 November.)

(ii) Discuss the options for the Social Security and Health programmes, perhaps on the basis of a paper by the Secretary of State for Social Services. (NB The Chancellor of the Exchequer's Sub Committee on Public Sector Pay (E(PSP)) will consider further the provision for NHS pay at a meeting on 27 October.) It might also be necessary at the same time or more probably on 12 November to consider the recommendations of the Chancellor of the Exchequer and of the Secretary of State for Social Services for increases in the National Insurance Contributions: depending on their level, these increases could require urgent legislation; they are relevant to any discussion of decreases in the National Insurance Surcharge.

(b) Ministerial Committee on Economic Strategy

(i) On 2 November E Committee is already planning to consider papers by the Secretary of State for Employment on employment and training schemes. At the same time they can deal with the Chief Secretary's proposals for some offsetting savings, mainly by way of reduced allowances.

(ii) In the week beginning 9 November E could deal with:

- the proposals for Regional Development Grants on the basis of a paper by the Secretary of State for Industry. (Note that the Scottish and Welsh Secretaries are likely to be opposed to any percentage reduction and that Treasury Ministers want a bigger reduction than the Secretary of State for Industry will propose; the Attorney General may need to be brought into the discussion on Sullom Voe and Flotta.)

- Any remaining issues on the nationalised industries' totals, though the aim should be for the Chief Secretary and the sponsor Ministers to deal with this in bilaterals.

(c) Either bilaterals or small group

(i) Given the current deadlock between Treasury Ministers and the Secretary of State for Defence on the cash provision for 1981-82 and for the later years, you will wish to deal with the Defence budget yourself; this might be in a small ad hoc meeting with the Chancellor of the Exchequer, the Secretary of State for Defence, the Foreign and Commonwealth Secretary, and (perhaps) the Secretary of State for Industry, who has a legitimate interest.

(ii) On the remaining programmes the Chief Secretary may be able to make further progress in bilaterals between 20 and 29 October. He could then report the outcome to you and the Chancellor of the Exchequer on your return from Cancun. You might then wish either to deal with any outstanding problems in a small ad hoc meeting under your chairmanship or (perhaps preferably, in view of the other pressures on you during this period) to ask the Chancellor of the Exchequer to convene a small group. In either case it might be desirable to have two or three "neutral assessors" (eg the Home Secretary, the Lord President and perhaps the Paymaster General or the Chancellor of the Duchy of Lancaster). The outcome from the bilaterals and/or discussion in a small group would be reported to Cabinet by 5 or 12 November for endorsement or, in the event of continuing disagreement, resolution.

HANDLING

19. The two papers hang closely together and, before opening up the discussion, you will wish both the Chancellor of the Exchequer and the Chief Secretary to speak. You might then yourself suggest that the best course at this meeting would be to discuss Treasury Ministers' analysis and proposals in general terms with a view to preparing the way for more detailed discussion of individual programmes later. The intention would be for Cabinet to return to discussion of the overall economic strategy and the emerging package at later meetings in the light of progress on reaching agreement on particular programmes with a view to getting final and overall agreement by mid-November.

20. Most Ministers will then wish to speak; those whose programmes are mainly affected by the proposed cuts are the Secretaries of State for Social Services, Industry, Education and Science, Environment, Transport, Scotland and Wales and the Minister of Agriculture. The Secretary of State for Employment's programme will be discussed in detail by E on 2 November. The Secretary of State for Defence is unable to attend the meeting because of a NATO commitment. You might ask the Chancellor of the Duchy of Lancaster to deal with any questions on the proposed 2 per cent cut on general administrative expenses.

CONCLUSIONS

21. On the assumption that the Cabinet will not wish at this meeting to reach conclusions on all the recommendations in the Chief Secretary's paper (C(81) 51), you will, in the light of the discussions, wish to record conclusions:

1. Taking note of the general considerations affecting public expenditure set out in C(81) 50 and 51.

2. Agreeing to further discussions of individual programmes with a view to securing reductions sufficient to bring public expenditure totals down to £113.5 bn in 1982-83 and £118.1 bn in 1983-84 as proposed by the Chancellor of the Exchequer and the Chief Secretary in C(81) 50 and 51.

3. Noting that arrangements have already been made for the Economic Strategy Committee to discuss employment and training measures and Regional Development Grants and that you will make arrangements for discussion of other programmes in full Cabinet or elsewhere, in which cases the outcome would be reported to Cabinet.

4. Inviting the Chief Secretary to arrange for officials in the Public Expenditure Survey Committee to consider further the totals for 1984-85.

5. Agreeing to resume discussion on 29 October and at further meetings in November.

D J Wright

Robert Armstrong

(approved by Sir R Armstrong and signed on his behalf).

16th October 1981