



cc Mr. Whitmore
Mr. Dwyer

Prime Minister

To note.

MCS 13/11

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

PRIME MINISTER

MS

PUBLIC EXPENDITURE

You have received the Home Secretary's MISC 62 report. To follow up our brief talk the other day, I send you this note about the issues which it raises for our general economic policy.

2. You have in mind yourself now to hold a series of small meetings with the spending Ministers whose programmes have still not been settled. This looks the best way forward now.

3. It is highly desirable to complete these discussions within the next week, so that the final results of the whole Survey can be brought to full Cabinet for ratification on 26 November, and announced during the following week. Any further slippage could cause increasing trouble, both political and practical (in relation eg to the Estimates for next year).

The results so far

4. I must express to you my deep concern about the public expenditure picture which is emerging.

5. The results of MISC 62 are summarised in table 1 of Annex A. Many of the differences concerning individual programmes have been resolved, but those which remain, in addition to the major remaining issues concerning housing capital expenditure and local government which we were discussing at Cabinet on Thursday, involve some large amounts.

attached
at May A



I am especially worried about defence.

6. The MISC 62 figures do not allow for the further increase in his bids half-threatened by the Defence Secretary in his minute of 3 November to the Home Secretary.

7. On economic grounds, we should have aimed at an outcome close to the White Paper revalued, or below it; but the Chief Secretary and I recognised that this was unrealistic politically. Our proposal to Cabinet was therefore for an increase of $\pounds 3\frac{1}{2}$ bn over the White Paper revalued in 1982-83. We recognised that it might be necessary to go a bit higher, but when Cabinet agreed to aim to arrive at planning totals "as near as possible" to what we had proposed, we hoped, as I am sure you did, for an outcome quite close to that. I had in mind perhaps an extra $\pounds \frac{1}{2}$ bn.

8. The outcome now will be at best about $\pounds 4\frac{1}{2}$ bn over the White Paper. At worst, even without the additional defence threat, it could be over $\pounds 6$ bn above the White Paper.

9. Every extra \pounds on public expenditure will mean at least an extra \pounds on tax. We cannot load more onto interest rates.

10. Much can occur in the next four months to change the detailed prospects for the PSBR and interest rates. If public expenditure is $\pounds 4\frac{1}{2}$ bn above the White Paper revalued, the present guess is that, with no change in taxes beyond revalorisation of allowances and specific duties, and the increase in National Insurance Contribution about which I minuted you yesterday, we would on present forecasts not exceed the PSBR envisaged for 1982-83 at the time of the last Budget, and in fact would be not far off what I envisaged in my 20 October Cabinet paper. But, even so, I might still have to consider increasing taxes in the Budget in order to help with interest rates.



11. An excess of over £6 bn over the White Paper would not be compatible with our economic and tax objectives. Public expenditure as a proportion of GDP would be higher than its already unacceptably high level of 45½ per cent this year (41 per cent in 1978-79 and 1979-80). It would be seen, rightly, as a major change of policy, at odds with our statement in the Queen's Speech that "plans for public expenditure will reflect the importance of restricting the claims of the public sector on the nation's resources".

12. It would shake the markets with ill consequences for interest rates, and the exchange rate.

13. To give spending colleagues the programmes they are now seeking could require up to £3 bn of extra taxation. This is the yield from 3p extra on the basic rate. I should want to avoid doing it that way if I could. But there are no easy options for raising significant amounts of revenue. Failing to increase personal allowances, at least to meet the Rooker-Wise requirement, would worsen the poverty trap. Raising indirect taxes beyond revalorising the specific duties (including petrol) would add to the RPI. We ought to be relieving industry of taxation, not adding to it.

14. The problem is not just for 1982-83. If we do not hold expenditure in the later years, the chances of tax reductions in the 1983 Budget will vanish.

Defence

15. I am particularly worried about defence. You saw the Defence Secretary's minute of 3 November and the Chief Secretary's of 9 November. The Defence Secretary is in effect asking to be exempted from much of our public expenditure control system. We cannot allow arguments based on the NATO target of 3 per cent real growth to justify further postponement of decisions on defence when we are taking

SECRET

ANNEX A TABLE 1

		£ billion			
		1981-82	1982-83	1983-84	1984-85
1.	White Paper revalued and adjusted.	104.62	109.96	114.28	119.98
2.	Chief Secretary's proposals in C(81)51*	107.24	113.45	118.01	124.43
3.	Changes agreed (for programmes now fully agreed) since Chief Secretary's proposals	-	+ 0.55	+ 0.39	+ 0.13
4.	Range of outcomes for programmes not yet agreed	-	+ 0.28 to + 2.14	+ 0.43 to + 3.12	+ 0.44 to + 3.54
5.	Resulting total	107.24	114.28 to 116.14	118.83 to 121.52	125.00 to 128.10

* Adjusted for corrections since 20 October.

SECRET

ANNEX A TABLE 1