

Gran Pd.

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Mr Burns
Sir Kenneth Couzens
Sir Anthony Rawlinson
Mr Rylie
Mr Bailey
Mr Littler
Mr Middleton
Mr Battishill
Mr Bridgeman
Mr Cassell
Mr Evans
Mr Monck
Mrs Gilmore
Mrs Stamler
Mr Folger
Mr Ridley
Mr Cropper

CABINET ON 23 OCTOBER: THE ECONOMIC PROSPECT

The three papers by yourself and the Chief Secretary on the economic prospect, public expenditure, and pay and price factors for next year's cash limits are being circulated today as background to tomorrow's Cabinet. They will not be on the agenda but it was agreed at the meeting with the Prime Minister yesterday that you should make an oral statement relating to them.

2. Your objectives will be:-

(i) to secure Cabinet reaffirmation of the necessity of keeping as closely as possible to the public expenditure totals in Cmnd 7841, less the benefit from refunds of EC contributions;

(ii) accordingly, to secure acceptance in principle of the quantum of cuts proposed in the Chief Secretary's paper;

(iii) to set up immediate procedural arrangements for reaching as much agreement as possible with your spending colleagues prior to Cabinet on 30 October when the above papers and others will formally be considered.

3. The purpose of (iii) above is, of course, to meet the Prime Minister's wish that as much disagreement as possible should be cleared out of the way before Cabinet considers the issues collectively.

4. I attach accordingly:-

Flag A: Some speaking notes which might form the basis of your opening statement. These do not cover the procedural proposal for a "star Chamber" consisting of yourself, the Home Secretary and the Chief Secretary. I understand from Mr Lankester that the Prime Minister will want to put this forward herself provided you supply the cue. But it may be as well to raise this with the Prime Minister when you see her at 9 am tomorrow so that tactics are fully coordinated.

Flag B: An updated and more detailed note on the underlying arithmetic to replace that attached to my minute of 20 October on which you drew at yesterday's meeting. Although this is as reliable a guide to the magnitudes as we can at the present assess them, I do urge again caution in putting undue weight on specific figures. Among other things:-

(i) Our assessment of the economic prospects will change before the Budget, and some of the numbers correspondingly. We are not Budget making now.

(ii) When we come to the process of Budget making we shall need to pay particular attention to the implications of specific PSBR reducing measures for the money supply and interest rates. I have not attempted such an analysis in the present rough guide.

(iii) Many crucial decisions remain to be taken on the tax side. Not least, from the point of view of its effect on the PSBR, what is going to be possible on PPT.

5. Nevertheless, subject to these commonsense caveats, I hope this further analysis will help in focusing on the central problems we now face.



J B UNWIN
22 October 1980

SPEAKING NOTES: CABINET 23 OCTOBER

Encouraging signs that Government's strategy beginning to pay off. Picture on inflation particularly encouraging - both on pay and prices. Therefore more than ever vital to build on this by taking all steps necessary to maintain momentum and stick to financial strategy. Only sure way of getting inflation and interest rates down.

2. Always thought 1981-82 would be most difficult year. Said so in Budget and in presentation of MFFS. But, as my paper on economy shows, prospect even tighter than anticipated. This partly reflects effects of world recession, but also - very important - our own failure to control borrowing and spending as we had intended. In particular, on present outlook faced with very severe problems on PSBR (forecast at over £11 bn even assuming White Paper totals restored). Unless this reduced substantially, little prospect of any significant fall in interest rates. This damage inflation prospect and make prospect of easing of exchange rate more difficult.

3. Precise numbers (see my paper) not certain at this stage. But indicate right directions and orders of magnitude. All past experience shows we cannot afford to take risks. Key points to emerge are:-

(i) Absolutely vital to get back as closely as possible to what Cabinet agreed in July - ie Cmnd 7841 totals less benefit of EC refunds. This now harder than we thought in July as result of further excesses now revealed. CST's proposals designed to offset those excesses.

(ii) But even restoration of White Paper totals would do relatively little to reduce PSBR below present forecast. Rather, position is that if we fail to secure cuts of size proposed, we shall face prospect of PSBR even higher than that now forecast. Forecast not unreasonably assumed we would achieve public expenditure objective that Cabinet in July decided. Present prospect for PSBR is incompatible with interest rate and inflation objectives.

(iii) This means that in Budget I shall have to look for large tax increases (even greater to extent that room found for some relief to industry). Am considering possibilities (including N Sea) and will consult with colleagues concerned in due course. But further increase in real burden of personal taxation probably unavoidable (to add to increase in this year's Budget).

(iv) Stress again that above prospect, unattractive though it is, depends on accepting CST's proposals and holding close to White Paper totals. To extent that this not achieved, even greater weight will fall on tax side. Difficult to see how could avoid putting even greater tax burden on persons.

4. Recognise that to extent that worsened PSBR prospect reflects deeper than expected recession it would be perverse to cut back expenditure, or raise taxes, to restore early forecast of PSBR. Not proposing to do that. But serious deterioration in PSBR both this year and next only partially accounted for by revised view of course of economy. Indeed this year economy is moving much as expected in Budget, but PSBR is forecast to be about £2 billion more than expected. This reflects among other things higher public sector pay than allowed for, higher defence spending, and higher local authority spending and borrowing. Interest rates are thus now likely to have to remain higher than we had hoped.

5. Recognise concern about transitional effects of policies on industry. Accept further that any cuts in public expenditure work through to industry - those on transfer payments and pay indirectly, other cuts (not only on capital expenditure) more directly. This is regrettable. But overriding priority, and best way of helping industry in longer run, is to attack inflation by sticking to present financial strategy and getting interest rates down. This strongly endorsed recently by Pennock and Beckett who in particular press case for more public expenditure cuts.

6. Therefore ask Cabinet to:-

(i) reaffirm July objective of keeping to Cmnd 7841 totals less EC contributions;

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(ii) cooperate in securing quantum of cuts proposed by
CST.

This is absolute minimum if to maintain credibility, secure progress on inflation and interest rates that is so vital, and avoid very damaging tax cuts in next Budget.

7. [Accordingly propose arrangements for taking this forward before Cabinet on 30 October. Cue for Prime Minister to speak on 'star chamber' proposals].

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1981-82 £ billion

	expenditure effects (where relevant) 1980 Survey prices	PSBR cash terms
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(4) Brought forward: PSBR resulting from full adoption of proposals in C(80)58		12.05
<u>Other spending possibilities</u>		
(5) social security savings, including consequential on public service pensions	- .2	- .3
(6) public service earnings increases of 6% instead of 9% assumed in forecast	- .6	- .4
(7) PSBR after all spending adjustments		<hr/> 11.35 (say)
<u>possible discrete tax measures</u>		
(8) North Sea package to yield revenue of 1 in 1981-82		-1.1
(9) $\frac{1}{2}$ % point increase in employee NIC		- .5
(10) change accounting date for VAT on imports		- .6
<u>but</u> (11) cost of corporation tax changes (with stocks index and credit restrictions)		+ .3
(12) PSBR after all spending adjustments and discrete tax measures		<hr/> 9.45 <hr/> <hr/>
<u>Memo items</u>		
... each 1% under-indexation of income tax structure (allowances and thresholds)		- .15
... each 1% under/over-indexation of specific duties (inc VED)		± .08



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fiscal position 1981-82 £ bn

	expenditure effects (where relevant) 1980 Survey prices	PSBR cash terms
(1) PSBR in forecast (assumed Chief Secretary's July package for return to Cmnd 7841 would be achieved and that EC refunds would be a further bonus. But allowed for .5 excess spending (Survey prices) over Cmnd 7841 in demand-determined programmes and shortfall taken together)		11.25
(2) PSBR benefit of adhering to Cmnd 7841: adjustment arises because forecast foresaw higher spending in some areas than allowed for in Cmnd 7841	-.5	-.5
(3) excess over Cmnd7841 less EC refunds implied by CST proposals in C(80)58 (which provide for 2.3 at Survey prices for the nationalised industries - ie EFLs of 1.5, Reserve element of .8). Effects of the major C(80)58 spending items are:-	+1.1	+1.3
	expenditure, 1980 Survey prices	PSBR, cash
a) defence	-.5	-.6
b) 2% cut in cash-controlled programmes, excl defence	-.4	-.5
c) 1% cut in l.a. current	-.1	-.1
d) effects of revised economic assumptions and other changes on social security programme	+.2	+.3
e) probable increase in housing subsidies and export credit owing to revised economic assumptions, less cuts	+.4	+.5
f) increase in nationalised industries finance (incl Reserve provision)	+1.1	+1.4
(4) PSBR resulting from full adoption of proposals in C(80)58		

 12.05