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CABINET

THE ECONOMIC OUTLOOK AND PUBLIC EXPENDITURE

Memorandum by the Chancellor of the Exchequer

INTRODUCTION

1. I have been taking stock of the economic situation. The general strategy remains the only feasible one but the difficulties we face are greater than we had any reason to expect. I consider that we need to look again at our public expenditure plans and it was evident at our 15 November discussion (CC(79) 21st Conclusions, Minute 4) that many members of the Cabinet share this view. It is imperative to get our policies properly established in our first year of office.

RECENT DEVELOPMENTS

2. Three developments cause particular concern:-

i. With strong wage inflationary pressures, poor trading, productivity and competitiveness performance and the unpromising outlook for world trade following the further large increases in oil prices, the economy is inevitably moving into a recession from which there could well be only a slow recovery.

ii. Despite the action I took in the Budget, underlying monetary growth has been much higher than expected.

iii. Inflationary expectations, and hence pay pressures, remain high and intractable.

3. This outlook was reflected in the recent Industry Act forecast which brought out in particular the deteriorating prospects for output and for reducing the rate of inflation next year; and some of the assumptions underlying that forecast (eg on earnings and interest rates) could be over-optimistic. Recent non-Government forecasts, such as that prepared by the London Business School, point in very much the same direction.

ACTION SO FAR

4. The measures taken in the Budget established our credibility from the start by signalling our resolve to maintain strict monetary control backed by fiscal policies consistent with it. And the further measures of 15 November were dictated by the necessity of maintaining those policies in the face of the disappointing monetary and Public Sector Borrowing Requirement (PSBR) developments. The initial reaction in the markets was favourable and we have secured substantial gilt sales to help fund this year's PSBR. I hope that the other effects of the changes will now come through so that money supply growth comes into the target range, without even higher interest rates than those which we have had no alternative but to accept. But this will depend on a number of factors some of which we can influence - particularly the market's assessment of our determination to carry through our policies - and others which we cannot, eg developments overseas.

FUTURE ACTION

5. The overriding priority is to reduce inflation, as a necessary condition of resumed and sustainable growth. In parallel with this we must secure a major improvement in the supply side of the economy. To these ends our policies must embrace the following:-

i. Progressive reduction of the rate of growth of the money supply at tolerable interest rates.

ii. Further reductions in the burdens of income tax and capital taxation.

iii. Substantial reductions in the inherited public expenditure plans and in the size and role of the public sector generally.

6. No compromise is possible on i. Otherwise the credibility of any Government's strategy on inflation would be destroyed. Nor can we compromise on our objective of restoring incentives by reducing taxation. Our weakness on the supply side is still acute and we urgently need to take further measures to remedy this. The single most important contribution we can make is to reduce taxation at all income levels. But, with the worsening economic prospects, and the difficulty evident from Dublin of getting an acceptable reduction in our European Economic Community contributions, there is now little prospect of attaining our inflation and tax objectives on the basis of the public expenditure plans agreed so far by Cabinet.

7. Disappointment with the 1980-81 White Paper (whose plans were some £2 billion higher than the target the Chief Secretary, Treasury, and I set) contributed to the unsettled market conditions that necessitated the 15 November measures. Many in the markets were hoping for an unequivocal reduction in the volume of expenditure and the PSBR for 1980-81.

8. For the period immediately after 1980-81 a similar situation is in prospect. The Chief Secretary, Treasury, and I warned the Cabinet in September that even with the reductions we proposed it would be hard to hold the PSBR in the later years to around its present proportion of Gross Domestic Product (GDP) without some real increase in taxation. In the event the plans agreed by the Cabinet are more than £1 billion higher for most of the years concerned; and the economic prospect has worsened, as reflected in Government and independent forecasts. Thus on any prudent assessment of the economic outlook the present expenditure plans seem incompatible with slower money supply growth unless we have even higher interest rates or higher taxes, or both.

9. Chronic structural weaknesses in the economy - low productivity growth and poor trading performance as well as the tendency to higher inflation - appear to have intensified in recent years. These problems cannot be overcome quickly and given also the worsened prospects for the world economy after the further rise in oil prices the medium-term prospects for GDP growth are now poor. It is against this background that the Treasury's medium-term analysis has been carried out. It suggests that the policy conflicts are likely to be most acute in the next two years. For example, to bring inflation down well into single figures by 1983 entails getting monetary growth in that year down to 7 per cent (and the PSBR to $2\frac{1}{2}$ per cent of GDP, which should allow interest rates to fall). On present expenditure plans this would require tax increases equivalent to around 5p on the basic rate of income tax by 1981-82. There would be no prospect of any real reduction in personal taxes from today's levels before 1983.

10. Two key conclusions emerge. First, however difficult the short term, the centrepiece of our anti-inflation strategy - progressive reduction in monetary growth - remains the only feasible one. But second, stabilisation of our expenditure plans at their present levels is not enough. (And, depending on the treatment of debt interest, it is arguable whether we have even done that.) Unless we reduce plans further we shall not be able to avoid serious damage to our taxation objectives and the risk of even higher interest rates than those we have now. This is also becoming increasingly clear to the financial markets and without changes there is a serious risk of a series of tensions in the markets, of which that last month was only a first example. Most important, it is also becoming clear to our supporters in Parliament that further action on public expenditure is needed.

PUBLIC EXPENDITURE AND THE SECOND WHITE PAPER

11. I conclude that our public expenditure plans need to be reduced. It is difficult to say with confidence precisely what further reductions would be required to meet our monetary and tax objectives. On the Treasury's projections, the PSBR for 1980-81 would on present expenditure plans exceed £10 billion, and rise to around £13 billion in 1981-82, or over 5 per cent of GDP compared with the $4\frac{1}{4}$ per cent expected this year. A PSBR at this level

would be a major blow to confidence and it seems very unlikely that we could finance it without still higher rates of interest.

12. Our room for manoeuvre in 1980-81 is restricted. We have published our plans and they are being acted on by spending authorities. For example, it would be difficult now to ask local authorities to make further reductions in their current expenditure. But we need to hold the cash limits and to make whatever further savings we can. One important decision for 1980-81 not yet taken concerns the uprating of child benefit. There is also the question of further savings on housing investment. In all we ought to be looking for a total volume reduction of the order of £1 billion.

13. In 1981-82 a reduction of the order of £2 billion appears to be needed. If the total is not to rise again we must carry this reduction forward to the two subsequent years.

14. We can only make reductions of this order by fundamental new decisions on the major programmes. The social security programme which constitutes over a quarter of public expenditure will need to be a major source of the further savings.

SECOND WHITE PAPER

15. If the above is accepted it points to postponing the White Paper hitherto scheduled for January. We do not want to publish figures we are subsequently going to revise; and to do so would make the revisions more difficult to achieve. Any economic projections published with the figures would also reveal the inconsistencies I have described; but equally refusal to publish supporting economic material would lead observers to conclude themselves that the figures did not add up. We certainly would not publish any convincing or viable financial plan incorporating the present expenditure figures. So I conclude that we should postpone the White Paper.

16. The decision to postpone implies that we shall achieve the necessary reductions. To delay the White Paper and then publish plans that were still too high would be the worst of all worlds.

17. Nor could we let the uncertainty run on too long. We need to publish the White Paper not later than the Budget and preferably in March. This will require an intensive operation which we should aim to complete by the end of January.

CONCLUSION

18. I recognise the difficulty of the decision I am asking the Cabinet to make, and of the subsequent decisions necessary to implement it. But without this decision it will become widely apparent that our policies are

inconsistent and that our expenditure plans are incompatible with our monetary and taxation objectives; and that there is a serious risk that even more painful measures would become unavoidable.

19. I therefore propose that:-

i. We undertake an exercise, which we should aim to complete by the end of January, to identify savings of £1 billion in 1980-81 and £2 billion a year in 1981-82 and subsequent years.

ii. We postpone the next Public Expenditure White Paper and aim to publish it in March.

G H

Treasury Chambers

10 December 1979