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PRIME MINISTER
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PUBLIC EXPENDITURE

It is hoped that Members will find the following notes helpful in the debate on Wednesday, 7th May 1980.

Contents

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I. EXPENDITURE PLANS

1. The Government's Strategy

Publication of the Public Expenditure White Paper on Budget day enabled the Chancellor of the Exchequer this year for the first time to review both together in his Budget statement. Presentation with the Budget of the Medium Term Financial Strategy was another new departure, setting out the central element of the Government's economic policy around which policies for spending and taxation will be shaped for the rest of this Parliament.

The Chancellor said:-

> "At the heart of the medium term strategy is the need to return to a sensible level of public spending and to see taxes and Government borrowing reduced. The spending plans which this Government inherited were too high and were set to grow considerably faster than production. Most aspects of public spending are worthwhile if the nation can afford them. But, too often, we have endorsed plans for rising expenditure that we cannot afford. In the last 20 years the ratio of public expenditure to GDP has risen by a quarter.
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> It would be all too easy for this ratio to go on rising indefinitely, unless we addressed ourselves to fundamentals. This is what we have done in the most far-reaching review of medium-term expenditure plans since they began 20 years ago. This review is crucial to the strategy. Crucial to success in reducing the PSBR, lowering interest rates, and bringing down inflation. And crucial if we are to find room for lightening the tax burden and so to provide scope and encouragement for enterprise and initiative.
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> ... In today's circumstances any Government would have to check the size and growth of public spending. This does not mean, and has not meant, that public expenditure should be cut indiscriminately. Our choices have been guided by the belief that Government should provide efficiently and realistically those services which it alone is able, and best fitted to provide. The role of the State can sensibly be reduced when it has taken over what private initiative can better achieve; and where it has been reducing incentives increasing bureaucracy and distorting markets" (Hansard, 26th March 1980, Col. 1451-3).

Expenditure on defence, law and order and health will, therefore, continue to grow - health exactly as planned by the Labour Government, the cost being partly offset by an increase in charges. Provision for private and nationalised industries, for housing, and for education is reduced - the latter by less than the decline in the school population. Spending on social security will increase by nearly 4 per cent between 1979-80 and 1983-84, despite some reductions.

2. Curbing Public Expenditure - The Third Round

In his June Budget, Sir Geoffrey Howe announced the steps to be taken after the Government's first, rapid review of public expenditure. It resulted in proposals to cut spending by £1½ billion and in eliminating the Labour Government's planned increases for 1979-80 to hold total spending at about the same level as in 1978-79.

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The White Paper published on 2nd November (Cmnd. 7746) carried this process further. It eliminated planned increases of £3½ billion, to hold total spending for 1980-81 at approximately the same level as in the previous two years, at 1979 prices.

Since November further net reductions of £900 million have been made to take account of the worsening economic situation here and abroad. £325 million of this will be set aside for the contingency reserve. Actual spending will be reduced by at least £575 million at current prices.(The £1bn. contingency reserve for 1980-81 is precautionary: the aim is to leave as much as possible unspent.)

The overall effect will be to reduce public spending by over £5 billion in 1980-81 compared to Labour proposals - equivalent to 7p on the basic rate of income tax.

By 1982-83, the last year for which the Labour Government published plans, spending will be 11½ per cent, or some £11 billion at today's prices below the level proposed in their last White Paper (Cmnd. 7439 January 1979).

By 1983-84, the last year covered by the present White Paper, expenditure will be some 4 per cent lower in real terms than in 1979-80. This will be, as the Chancellor said, "for the first time ever, a progressive reduction in total expenditure throughout the lifetime of this Parliament" (Col. 1452).

3. <u>The Medium Term Financial Strategy</u> (published in the Financial Statement and Budget Report - the Red Book)

The objectives for the medium term are "to bring down the rate of inflation and to create conditions for a sustainable growth of output and employment". To this end the growth of the money stock is to be progressively reduced from the target range of 7-11 per cent for growth in M3 set for the 14 months February 1980 to April 1981, to 6 per cent (mid-point of a 4-8 per cent range) in 1983-84. The Government does not intend to achieve this reduction by excessive reliance on interest rates: to avoid doing so the aim is progressively to reduce the public sector borrowing requirement as a percentage of GNP from the 4¾ per cent estimated for this year to 1½ per cent in 1983-84. This would be a little below the average ratio in the 1960s.

As Mr. Nigel Lawson, Financial Secretary to the Treasury, emphasised to the Finance Committee on 22nd April, the financial strategy for the reduction of inflation is the essential element in the Government's policy. Proposals for public spending, borrowing and for taxation are shaped around it. The cuts in public expenditure are the key element in the strategy for reducing the level of Government borrowing and so for relieving pressure on interest rates and on resources for the private sector.

4. <u>Effect of public expenditure cuts on the cost of living</u>

Exaggerated estimates have been put about by Labour Members and others of the effects of the spending cuts on the cost of living. The Chancellor of the Exchequer gave the official estimate in his evidence to the Select Committee on 14th April. Only 16 per cent of the £4 billion reduction in public spending in 1980-81 is derived from increases in charges. <u>In total, decisions on public expenditure taken by the present Government have to date added less than ¼ per cent to the Index of Retail Prices</u>.

5. <u>Public Expenditure as a percentage of GNP</u>

There were, during the years of the Labour Government, four re-definitions of public expenditure. Its relationship to national output was also changed quite substantially by the revaluation of production onto a 1975 base instead of 1970. The effect of these

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changes has been to reduce the apparent share of GNP accounted for by the public sector from a peak of 59 per cent on an earlier definition in 1975 to approximately 42 per cent at the present time
Changes over the past six years on present definitions, are shown in the following table:-

Ratios of public expenditure to GDP at market prices (1)

	Total public expenditure including debt interest	General government expenditure on goods and services
1973-74	41½ (2)	24½
1974-75	46½	26
1975-76	46½	27
1976-77	45	25½
1977-78	41	23½
1978-79	42½	23
1979-80 (estimated)	42	23

(1) These ratios are based on the expenditure figures in the White Paper including debt interest, net overseas and market borrowing by nationalised industries and special sales of assets. The expenditure totals also include non-trading government capital consumption, to make them comparable with gross domestic product (expenditure estimate) at market prices.

(2) Excluding nationalised industries' short term borrowing and capital value of leased assets.

(Source: Government Expenditure White Paper 1980-81 to 1983-84, Cmnd. 7841).

It is expected that there will be a further reduction in the ratio of public expenditure to GNP over the period covered by the White Paper.

6. Labour cuts, plans and criticisms

The Labour Party have been loud in their condemnation of the Government's spending proposals over the past year. The criticisms must be set against the Labour Government's own record in office. After an 8.5 per cent increase in spending in its first year, at the behest of the IMF it cut expenditure by 2.5 per cent in 1976-7 and 6 per cent in 1977-8 (at constant 1979 survey prices). This compares with the Government's proposals in the present White Paper to cut spending by 4 per cent in real terms over 4 years: to a total of £67.1bn. in 1983-4 compared to the estimated £69.9bn. in 1979-80.

By far the greater part of the cuts are being made against the inflated spending plans left by the Labour Government. The 5.6 per cent increase in 1978-9 would have been followed by a further increase of over 2 per cent a year over succeeding years. The plans were clearly based on the assumption of a rate of growth in GNP of 3 per cent a year made in the Labour Manifesto - following on the achievement of barely ½ per cent a year over the Labour Government's five years in office.

Mr. Healey had himself warned that cuts in spending would be necessary to offset the cost of comparability wage increases (Hansard 25th January 1979). The Clegg awards are expected to cost £2 billion in 1980-81, and the full year effects of the staged settlements for civil servants and local authority white collar workers will add about a further £1 billion (Cmnd. 7841, para. 33 page 10).

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Mr. Healey frequently blamed his inheritance for the problems he faced in office. In particular it may be remembered that, in answer to a question from Lord (then Mr. Robert) Carr on 30th December 1975 on the increase in the rate of inflation over 3 months from his own 8.4 per cent statement in September 1975 to 23 per cent in November, said:

> "The main reason for this change is that in the last three months the index has reflected 11 threshold payments which had to be made under legislation introduced by the Conservative Government". (Hansard, Col. 600)

The pay commitments entered into by the Labour Government have been substantially larger.

7. Public Sector Pay

Much currency has been given to the figure of 25 per cent for the year-on-year, 1979-80/1980-81, increase in the central government paybill. As the Chancellor emphasised to the Select Committee, the figure (25 per cent covering the civil service, the national health service and the armed forces; 23 per cent over the whole of the public services including local authority employees) relates to the total increase in cost, not to settlements. About a third of it results from delayed 'catching up' awards from commitments entered into by the last Government.

Cash limits on central government expenditure in the present year provide for an annual increase in the pay bill of 14 per cent through new settlements from their due settlement dates. Rate support grants and transport supplementary grants provide for a 13 per cent increase in local authorities' costs between 1979-80 and 1980-81 for price increases and new pay awards.

The 18¾ per cent Pay Research award to the civil service will be brought within the 14 per cent cash limit by reducing manpower by some 2½ per cent and by delaying implementing the award from 1st April to 7th May, so that it is paid for less than a full year. The 16½ per cent award to the armed forces is of a similar order.

Manning levels in the civil service have already been substantially reduced. There were 25,000 fewer in post in April than when the Government took office: and establishment levels (to which manning levels will be reduced over the next year) have been set at 60,000 lower than they were then.

8. Nationalised industries

There has been considerbale discussion, in the Select Committee and in the press, of the turnround in nationalised industries' finances envisaged in the White Paper of £2½ billion in external finance; and the £3½ billion increase expected in internally-generated finance by 1983-4.

The Chancellor pointed out to the Select Committee that the forecast drop of £2½ billion was smaller than the fall of £3 billion in total external finance of the nationalised industries in the 3 years from 1974-5. The improvement in the industries' finances was expected to come:

a) from removal of underpricing, especially in energy industries. Achievement of the gas and electricity industries' medium term financial targets (set in January 1980) would provide about 25 per cent of the turnround.

b) from improvements in efficiency and cost-cutting. About 40% of the turnround should come from improved performance in the main loss-makers -shipbuilding, steel, coal and rail.

c) the remaining third of the turnround would come from a variety of factors - the unwinding of the Post Office billing delays of 1979-80; and increased profitablity from cashflow from BNOC.

II SPENDING PROGRAMMES

1. Nationalised Industries

For too long the nationalised industries have been a drain on the profitable, private sector of industry, through the taxation levied to subsidise operating losses and under-used investment, through higher interest rates and through the process of "crowding out". This the Government is determined to reduce. Consequently total net borrowing by the nationalised industries is projected in Cmnd. 7841 to fall from £1900 million in 1979-80 to £550 million in 1983-4. The industries covered will be expected to generate their own internal resources and indeed move a substantial net repayment at the end of the period.

The ways in which this turn-around should be achieved were set out by the Chancellor of the Exchequer (see above paragraph). First by economic pricing policies adopted in order to see that nationalised industries act, in so far as possible, subject to market, commercial discipline; secondly by improvement in performance by industries which, like British Steel, have in the past generated heavy losses, will be required. It is worth noting that already most of the nationalised industries have been set performance targets.

Total net borrowing in Cmnd. 7841 is £100 million less than the figure given in Cmnd. 7746. This is because of a number of factors: principally the removal of British Aerospace borrowing (British Aerospace is being turned into a limited company with about half the shares sold to the private sector), improved BNOC receipts, a change by the NCB from borrowing to grants and a reduction in the short-fall allowance to £100 million. Apart from British Aerospace, the sale of assets has not been taken into account in these figures.

2. Industry Department Spending Programmes

There has been growing concern that the effect of much "aid" given to industry, under the 1972 Industry Act, through the NEB and by other means, has in fact chanelled resources away from profitable growth centres of the economy to other less successful areas, aborting perhaps as many jobs as it destroys. By curbing the powers of the National Enterprise Board and continuing regional aid in areas of most need the Government has shown its recognition of this problem.

Provision for Department of Industry spending thus falls by about 50 per cent by 1983-4 from the 1979-80 level of £1,017 million, and most of this reduction comes from spending on the NEB and on Regional Development Grant. However, the policy is a gradual one and sudden, disruptive changes have been avoided. The Government's flexibility has been shown by its willingness to give assisted status to areas with special problems, such as Corby.

The Government has also made clear its priorities within the reduced budget for spending on industry by continuing with support for Research and Development (principally through the Product and Process Development Scheme, the reduced Micro-Electronics Industry Support Programme and the Micro-Processor Applications Project).

SOCIAL SECURITY

The social security programme will cost £19,354 in 1980-81 (Cmnd. 7841, March 1980; figures at 1979 survey prices), which will be about one quarter of all public expenditure. As the Chancellor told the House of Commons in the budget statement:

> "Its volume has grown by about 50 per cent in the last ten years, allowing both for inflation and the switch from family allowance and child tax allowances to child benefit. That rate of growth is more than three times the 15 per cent increase in GDP over the same period". (Hansard 26/3/80 Cols. 1457-8)

As the Chancellor acknowledged, part of this increase has been due to demographic factors (for example, in the last seven years the number of pensioners rose by 1 million) and to the increase in the number of disabled people. However the social security budget has also been affected by real increases in benefits in anticipation of a growth in output which was not actually achieved.

The main reductions in expenditure are as follows:

1. The reduction of earnings-related supplements for the unemployed, sickness and injury benefit and maternity allowances in 1981 and their abolition in 1982.

2. A 5% cut in unemployment benefit, sickness benefit, industrial injury benefit and invalidity pensions (i.e. to be achieved by raising these benefit by 11½ % in November compared with a 16½% expected increase in prices) Additional cuts of 5% in these benefits may be made in 1981, with a further 5% cut in 1982, under the provisions of the Social Security (No. 2) Bill.

3. Responsibiltiy for providing an income for the first eight weeks of sickness will be transferred from the state to the employer.

However it should be noted that supplementary benefits - the "safety net" - are being increased fully in line with prices and those on very low incomes are therefore being fully protected.

One reason for singling out unemployment benefit and sickness benefit for cuts is that both are tax-free and this confers an unexpected bonus on the recipients. Both Parties are committed in principle to taxing them and the Government intends to do so in 1982. Mr. Jenkin has also announced that when invalidity pensions are brought into tax the Government would wish (resources permitting) to restore them to the level of the retirement pension.

Mr. Jenkin has emphasised that:

"Even after making the savings that I have announced the social security budget is still programmed to grow at about 2 per cent a year". (Hansard 31/3/80 Col.49).

This will go towards meeting the expected increase in the number of pensioners and the unemployed.

Mr. Jenkin concluded:

"If I am supposed to be murdering the Welfare State I am setting about it in a pretty rum way". (Hansard 31/3/80 Col. 54).

NATIONAL HEALTH SERVICE

The Conservative Election Manifesto confirmed that

"It is not our intention to reduce spending on the Health Service".

and this was re-affirmed by Mrs Thatcher during the General Election campaign.

The Public Expenditure White Paper shows that total expenditure on health services (excluding the personal social services) will rise from £7688m in 1978-9 to £8140m by 1983-4.

The Labour Party has criticised the increase in prescription charges to £1 later this year, but:-

1. As early as 1976 Conservatives warned that:-

   "When the service is short of funds for priority tasks, there is no case for holding down prescription and other charges". (The Right Approach 1976).

2. The last Labour Government increase dental and optical charges on a number of occasions.

3. Six out of ten prescriptions do not carry a charge because the recipient is exempt - e.g retirement pensioners, children under 16 those receiving supplementary benefits and others.

HOUSING

From the financial year 1981-82, all housing grants from central government will be allocated on one block. Total public expenditure on housing (including central government grants and local contributions) in 1980-81 will be £4,700m at 1979 survey prices. (£1,916m capital and £2783 current). This is £672m less than the 1979-80 estimated outturn of £5,372 and most of the reduction will be capital expenditure. In real terms, public expenditure on housing will fall gradually to £3840m in 1981-2, to £3,250 in 1982-83 and to £2,790m in 1983-84.

EDUCATION

The Government's expenditure plans provide for a fall of about nine per cent in expenditure on education over the five years 1979-84.

This reduction reflects the fall in the school population which will total 1½ million over this period, school meals which will amount to one-third of the savings and full-cost tuition fees for those overseas students who begin courses in September 1981.

Provision for special education has been protected, expenditure on colleges of further education, which have a critical role to play in supplying skilled man power and technicians, has been increased by seven per cent over the next year and allowances for the improvement of school buildings have been increased by nearly 50% to encourage the adaption and more efficient use of existing facilities.

These savings will not directly affect the provision of education in the classroom. The Government remains committed to improving basic standards of achievement, and despite the restraints on public spending has given local authorities every opportunity to concentrate resources on the essentials of the education service.

LAW, ORDER AND PROTECTIVE SERVICES

Expenditure on this programme is planned to increase reflecting the Conservative Government's priority for law and order services. This was foreshadowed in the 1979 General Election Manifesto which specifically exempted law and order programmes from the general policy of cutbacks in public spending. Total spending in 1980-81 is expected to reach £2,530 million at 1979 survey prices against a projected ultimum of £2,446 million for 1979-80 , again at 1979 survey prices. It should rise to £2,670 million in 1982-3.

The main additions are for the running of the police and supporting services (£1,469 million in 1980-1 against £1,426 million in 1979-80), and the prisons (projected to increase from £284 million in 1979-80 to £301.2 million in 1982-3). Figures for the prisons in Cmnd. 7841 do not take into account the recommendations of the May Committee Report on prisons.

Extra spending (£90 million in 1983-4 against £76 million in 1979-80) is projected for the probation and after-care services. The number of probation officers should rise to 5,200 by 1983-4 against 4,800 in 1979-80.

Numbers of police officers available should also rise. The full implementation of the Edmund Davies recommendations on police pay by the Government has meant a substantial rise in police man power. The programmes allow for an increase to 133,800 by the end of March 1984.

Capital Expenditure:

It has been alleged that these reductions will mean an end to further capital expenditure on local authority housing, but several factors must be borne in mind.

1. Block Allocations

   As funds are to be treated as one block, local authorities will be free to spend their allocations as they wish. If they consider long scale council housebuidding necessary, the government has no policy to stop them.

2. Housing need

   The levels of expenditure on housing reflect the overall economic background and the need to reduce the massive burden of public expenditure. Also housing policies and expenditure need to recognise the significant general improvement in housing conditions over the last 30 years. Not only has the condition of our housing stock improved tremendously, nationally the demand and supply of housing are in better balance (there is an overall surplus of approximately 400,900 dwellings households.)

   The emphasis of public sector policy should shift to meeting particular needs such as those of the elderly and single people. Both in the public and private sectors there needsto be a better use made of our existing housing stock.

3. Cost saving Schemes

   Since there will be severe restraints on local authority expenditure on housing, the Government has suggested cost saving schemes to lower the cost of priority homes while encouraging home ownership.

   a) Building stata (one bedroom) homes for sale to single people.

   b) Selling council houses.

   c) Securing land release for private builders and encouraging partnerships schemes between local authorities and private builders.

   d) Low cost building for sale

   e) AIM (Acquisition Improvement and Sale) schemes eligible for exchequer background.

   f) Shared ownership schemes.

   g) Help with mortgages for priority homebuyers using the mortgage guarantee powers in the housing bill.

4. Use of capital recipients

   In future local authorities will be able to supplement their capital allocations by keeping 50% of the capital receipt from sale of assets, repayment of principle on loans etc. The remaining 50% will be distributed at a national level through the HIP allocators. Selling local authority assets will enable local authorities to spend more on capital projects, yet it it is Labour local authorities who are rejecting this policy and at the same time complaining about cuts in government growth.

5. Other opposition criticisms

Opposition criticism has concentrated on the extent of the reduction and whether comparison with free cost outturns is misleading. The main defensive points are:

- It is usual to compare allocations with outturn in earlier years. The last government's Public Expenditure White Paper of January 1979 did this.
- The housing policies of the last Labour Government were unrealistically high. The budget cuts of the present government remained £300m from the 1979/80 allocators yet the lower cash limit will not be reached even though inflation of building costs was higher than expected last year.
- In real terms, reductions in HIP allocators for 1980-81 against the cost outturns for 1979-80 are 21% (31% against Labour's original provision).
- Net capital expenditure on housing fell under Labour from £4,202m in 1974-5 to £2,077m in 1979-80. The present reduction reflecting the trend started under Labour.

Current expenditure

Levels of current expenditure in 1980-81 are expected to fall by £45m from the estimated outturn for 1979-80. In November 1979 the government announced a rent increase guideline of £1.50 per week on average for 1980-81 and a supplementary net increase guideline of 60p a week for the second half of 1980-81. This averages up to £1.80 per week increase over the whole year and is a 28% increase ofer the average local authority rent of £6.50 a week. This brings rent into line with the Labour Government stated intention to keep the rise in local authority rent broadly in line with increased earnings. This will ease the burden on the rate payer and will enable local authoritiesto use more funds for capital investment.

LOCAL GOVERNMENT SERVICES

The Government has called for reductions in local government spending in 1980-81 of 1% in addition to the cuts requested in 1979-80. This will represent a cut of 4 per cent over four years from the increased local government expenditure levels advocated by Peter Shore in the autumn of 1978.

Since 70% of local government spending goes on wages and salaries and related expenditure it is vitally important that the local authorities emulate the example of central government and reduce staff levels. The latest quarterly returns for the quarter ended December 1979 show a fall of only 0.3% over the quarter ended December 1978. It is clear from the figures published this time for individual authorities that Labour councils are less willing to reduce staff numbers than Conservative councils.

The consequence of continuing overmanning in local government coupled with substantial pay awards to local government staff will be increased costs borne by ratepayers. The Government has made it clear that no additional money will be available to pay for the recent Clegg award to teachers, should the employers agree to pay it in full.

Rate increases are already running ahead of the rate of inflation. According to the report in the Times of 10 March 1980 average rate increases in 1980-81 are 22%. As with control of staff numbers, Conservative councils are shown to be more prudent than Labour authorities. There are no Conservatives among the 20 highest rate increases in England and Wales and no Labour councils among the 20 lowest.

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