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PRIME MINISTER

The Economic Situation and Public Expenditure

(C(80) 58-61, 64 and 65)

On these papers the Cabinet has to address itself to decisions on a number of crucial questions for economic policy and public expenditure in 1981-82:

(1) The volume total of public expenditure: in other words, the total amount to be sought by way of reductions.

(2) The distribution of that amount among Departmental programmes.

(3) The percentage figure and the inflation factors for the RSG settlement.

(4) The cash limit factors for pay and prices.

BACKGROUND

2. The Chancellor of the Exchequer's paper on the economic prospect and implications for policy (C(80) 59) sets out the reasoning which leads the Treasury to propose the reductions set out in the Chief Secretary's paper (C(80) 58). The presentation is (as the Treasury are themselves now saying) a little confusing, because some of the figures are in 1980 Survey price terms and others in 1981-82 cash terms; I gather that the Chancellor may circulate at the meeting a page of figures which straightens out the confusion (and incidentally updates some of the numbers). But the gist is clear enough. In order to get the Public Sector Borrowing Requirement (PSBR) next year back to the current forecast of about £11,000 million, we need the full amount of the cuts in public expenditure proposed by the Chief Secretary; that will still leave a need for fiscal measures to bring the PSBR down further, in order to leave room for reductions of interest rates (and thus, it is to be hoped, the exchange rate).

3. Some of your colleagues may nonetheless want to argue that, because of the depth of the recession and the depressed state of industry (confirmed by the CBI figures announced today), there should now be a modification of the strategy which would permit smaller reductions in public expenditure and a higher PSBR next year. This line of argument requires them to accept that on that proposal: either interest rates must go higher to enable the Government to finance the higher PSBR without an increase in money supply - which would intensify the present liquidity squeeze on industry, and thus reduce output

and increase unemployment in the short term;

or money supply is allowed to increase at a faster rate (printing more money), which could mean higher inflation, greater uncompetitiveness, lower output and higher unemployment two years out than can be expected if the present strategy is maintained.

There may be requests for more information about the possible effects on industry and employment of the Treasury's proposals. That would be for the Chancellor of the Exchequer to answer: I believe that the answer is in fact that the overall effects would not be very great, but that (depending on the distribution) there could be more serious consequences in particular industries or geographical areas.

4. If this sort of argument looks like emerging, I suggest that the right course is to have it out, and to re-establish the collective commitment of the Cabinet to the present strategy. That is the only way to provide a sound and secure basis for agreement on the total amount by which public expenditure in 1981-82 is to be reduced. Once that is established, then it becomes a question of distribution: the Chief Secretary's proposals provide a starting-point, from which discussion can proceed on the basis that, if one programme is to be cut by less than is proposed, that will have to be made good by larger reductions in other programmes.

5. The other line of argument which you might get - it surfaced in E last week from the Secretary of State for Social Services - is that it would in present circumstances be better to effect more of the required reduction in the PSBR by increasing taxation and less by reducing public expenditure. The Chancellor's argument in reply will presumably be that, even if the whole amount of the proposed reductions in public expenditure are agreed and put into effect, he will still be left with a substantial amount to recover by increased taxation. By tradition it is for the Chancellor - consulting only the Prime Minister - to decide what he can and should raise by way of taxation and by what means, and that has not usually been discussed in the Cabinet - for reasons of Budget security. But Ministers in charge of spending Departments are being asked to make very large and very painful cuts, and in order to convince them of the need to persist in them the Chancellor may need to expose rather more of his general thinking on the size and shape of his Budget.

6. Once you have established a collective commitment to the strategy, and to the size of the reductions required, the next question will be how to get them. In my judgment some discussion of that should precede the discussion of cash limit factors and the RSG, not least because there is a trade-off between the proposed 1 per cent volume cut in local authority current expenditure and the percentage figure for the RSG; if the 1 per cent volume cut can be made to stick, then it would be reasonable to accept a figure of 61 per cent for the RSG, whereas if the 1 per cent cut cannot go forward, that will strengthen the case for 60 per cent for the RSG.

7. The Chancellor will be reporting on the outcome of the enlarged bilaterals; but they have not produced very much by way of firm commitments, and there remain pockets of stout resistance. The Secretary of State for Defence has undertaken, without commitment, to look at a reduction of £188 million, on the understanding that there would be a commitment to return to 3 per cent a year real growth thereafter; he can probably be got that far, but in his present frame of mind no further. The Secretary of State for Education and Science considers that the 1 per cent cut in local authority current expenditure would mean not only abandoning the Manifesto commitment on standards of education but also at least a moratorium on teacher recruitment, if not making some teachers redundant. The Secretary of State for Scotland will go along with the Scottish share of whatever cuts are agreed on a Great Britain basis, but declines to go further. The Secretary of State for Employment will argue for much more than the Chief Secretary is prepared to allow on measures to tackle rising unemployment.

8. There is, I think, no possibility of agreement round the table tomorrow on reductions adding up to the total proposed by Treasury Ministers. Once the Cabinet agrees on the total, there will have to be a further process of "brokerage", which is bound to turn primarily on the large spenders: defence, education, health, and social security. At this meeting you might seek a second-reading sort of discussion, in which Ministers might comment in general terms on the shape and direction of the reductions, in the hope that it might be possible to extract from the discussion some generalisations to guide the process of identifying where cuts should fall.

9. You have yourself said that you would like to minimise cuts in capital programmes and equipment programmes which would bear especially hard on certain industries which are especially vulnerable. You may wish to see whether there is any disposition to accept this as a general proposition. If there is, the implication must be that greater reductions should fall on public service manpower and current expenditure, and on transfer payments. You will wish to see if there is general readiness to cut deeper into the area of social security benefits, which account for a sizeable proportion of total expenditure.

10. If the discussion does establish some degree of agreement about where the cuts should fall, the next step should presumably be for the Chancellor and the Chief Secretary, together with the Home Secretary and the Lord President, to have another go at the spending Ministers who are going to have to bear the main brunt of the reductions, supported by whatever general conclusions have emerged at this meeting.

11. The discussions on cash limit factors and on the RSG are separable from the main issues of strategy and public expenditure; but final decisions cannot be recorded until those issues have been resolved. If time permits, you could have some discussion of cash limit factors and the RSG settlement; but I am inclined to think that those could and should be held over for a later meeting.

Timing

12. Decisions on the whole range of issues need to be reached before the State Opening of Parliament on 20th November. Between then and now there are three further meetings of the Cabinet: on 6th, 13th and 19th November. I should think that the aim should be to complete the process not later than 13th November. We have provisionally allowed time for an extra meeting of Cabinet on Tuesday, 4th November; so you have this up your sleeve if you need it. We could use it to discuss cash limit factors and the RSG, so as to be able to revert to the public expenditure questions on 6th November; but that is very rushed, and I suspect that it may make better sense to take cash limit factors and the RSG on Thursday, 6th November, so as to leave a fortnight for the process of brokerage on public expenditure, and then hope to be able to confirm decisions on all the issues on Thursday, 13th November.

HANDLING AND CONCLUSIONS

13. It is more than usually difficult to make recommendations to you about how to handle this discussion, because of the uncertainties about how it may go. Clearly you should invite the Chancellor of the Exchequer to open the discussion with a "scene-setting" presentation of the economic background to and reasons for the Treasury's proposals on public expenditure and cash limits. You may like to ask the Secretary of State for Industry to come in behind the Chancellor, to support him on the case for freeing resources from the public sector for the private sector. Other Ministers who may want to enter the discussion at this stage are the Secretaries of State for Trade, Employment, the Environment, Social Services, and the Minister of Agriculture.

14. The objective in this phase of the discussion will be to rally the Cabinet round the strategy, and record a conclusion accordingly. That done, it should be possible to proceed to the public expenditure proposals. You could invite the Chancellor or the Chief Secretary to open this part of the discussion, reporting on the present state of the bilateral discussions. I have suggested that this might be a second-reading discussion, leading to general conclusions which could provide a framework and direction indications for a second round of bilaterals, with a view to reporting agreements and resolving outstanding differences on 13th November.

15. If there is time, you could then proceed to take the papers on cash limit factors, and a first go at the RSG; but that makes for a very large mouthful at this meeting, and you could let those two papers stand over either until Thursday, 6th November or, if you want to force the pace, until a special meeting of the Cabinet on Tuesday, 4th November.

RA

(Robert Armstrong)

29th October, 1980