Cabinet Bundle
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Qa 05164

TO: PRIME MINISTER
FROM: J R IBBS

PUBLIC EXPENDITURE

1. You agreed that the CPRS should prepare a note to bring together the main points that need to be considered by the Cabinet when the reductions in public expenditure are discussed in the context of economic prospects and policy.

2. I attach the paper which,given your approval,I propose to circulate. The purpose is not to guide the Cabinet to particular decisions but to set out for Thursday's meeting of the Cabinet the main arguments and suggest where some additional information might be helpful.

JRI

28 October 1980

Attachment

Prime Minister.

Tim and I saw an earlier draft of this paper this afternoon, and we told the Cabinet Office that we thought that it was so written that it would encourage those members of Cabinet who are inclined to argue for a relaxation of the money supply and PSBR targets. The Cabinet Office have sought to strike a better balance in this latest draft which, I think, does help to focus on the issues. But you should bear in mind that if Cabinet takes up the suggestions of assessments of the economic and employment consequences of both adopting and of not fully accepting the Treasury's proposals which are made in paragraphs 9 and 10 of the paper, this will delay decisions on public expenditure. Are you content for this paper to be circulated to Cabinet?

[initials]
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DRAFT CABINET PAPER

THE ECONOMIC PROSPECT AND ITS
IMPLICATIONS FOR POLICY

Note by the Central Policy Review Staff

1. The Cabinet has for consideration three Treasury papers: C(80) 59, 58 and 60. A brief summary of the key facts in these papers and of the main decisions required is given in the Annex to this paper, the purpose of which is not to guide the Cabinet to particular decisions, whether those proposed by the Treasury or otherwise, but to draw the Cabinet's attention to the magnitude and implications of the issues involved. Before addressing themselves to these specific questions Ministers may find it helpful to consider the underlying questions given in paragraph 14 of this paper.

2. The Chancellor of the Exchequer in his paper (C(80) 59) on economic prospects states that -

i. The proposals in the Chief Secretary, Treasury paper (C(80) 58) are required to bring public expenditure volumes back as nearly as possible within published planning totals (the White Paper of last March) for 1981-82.

ii. These reductions in public expenditure would do little more than "validate the assumptions in the forecast" and little to reduce the Public Sector Borrowing Requirement (PSBR) below the present forecast of over £11,000 million for 1981-82.

iii. To get back to a PSBR equal to about 3 per cent of Gross Domestic Product (GDP), as implied by the medium-term financial strategy (MTFS), would require the PSBR to be reduced by about £4,000 million; to create conditions in which interest rates can fall requires a reduction of at least £2,500 million from the current forecast figure.

3. It is apparent that the Chancellor of the Exchequer envisages the need for fiscal measures (although the magnitudes of these are not yet defined) as well as all the reductions in public expenditure proposed by the Chief Secretary, Treasury, in order to create monetary conditions in which interest rates can fall and the upward pressure of interest rates on the exchange rate be eased.

BACKGROUND

4. The Government's strategy gives priority to the reduction of inflation through control of the money supply. This policy is having considerable success. If recent good performance on prices is sustained, the rate of inflation year on year is expected to be down to 11 per cent by late 1981.

5. There is in particular evidence of changed pay expectations in the private manufacturing sector. A major contributor to this change has been the liquidity squeeze caused by a combination of world recession, high interest rates and the strength of sterling. The effects have been particularly severe for those United Kingdom companies whose prices, whether in the home market or in export markets, are set by international competition. It

is important to maintain the pressure leading to improved attitudes and greater efficiency but not, the Central Policy Review Staff (CPRS) suggests, at an intensity which would put at risk fundamentally viable companies which are an integral part of the economic structure and whose survival is likely to be indispensable to economic recovery.

6. The liquidity squeeze on the corporate sector contrasts with continuing high liquidity in the personal sector. The substantial wage increases that prevailed until recently have increased personal earnings at the expense of company profits. It is desirable to reverse and not to exacerbate the disparity between the financial position of the personal and corporate sectors.

THE MAIN ISSUES

7. In considering the Treasury papers the Cabinet will want to consider not only what effects the proposals will have on the monetary strategy, but also their effects on the level of economic activity, industry and employment.

8. Within the overall strategy of reducing inflation by controlling money supply, one objective is to release to the private sector resources which on present forecasts are likely to be pre-empted by the public sector. To what extent and in what timescale will the Treasury's proposals meet this objective?

9. All reductions in public expenditure in the first instance reduce demand on private industry, either directly through reduced purchases or indirectly through reduced personal incomes.

In conditions of full or near-full employment the private and overseas sectors take up the slack. But we are now in a recession both at home and abroad. Even if interest rates and the exchange rate fell, it might be longer than usual before demand from the private and overseas sectors increased sufficiently to fill the gap resulting from the reductions of public expenditure. In that event the cuts might result in a temporary additional drop in output and a temporary further rise in unemployment. The Cabinet may wish to consider whether an assessment should be made of the economic, industrial and employment consequences of the Treasury's proposals, including the possible effect on particular sectors on geographic areas.

10. On the other hand, if public expenditure in 1981-82 is not reduced by the amounts proposed, and the shortfall is not offset by additional tax increases beyond those which the Chancellor of the Exchequer may already be contemplating, then the PSBR is likely to be well outside the ranges envisaged in the MTFS. For any given desired level of money supply interest rates (and therefore probably the exchange rate) will have to stay higher than they would otherwise need to be, and will perhaps even go higher than at present. If in order to avoid that consequence a higher rate of growth of money supply than that envisaged in the MTFS were accepted in 1981-82, that would presumably be reflected in the levels of inflation and output in 1983 and 1984. The Cabinet may wish to consider whether an assessment should be made of the consequences for industry and employment of making only part of the reductions now proposed.

11. Thus the dilemma which faces the Cabinet is that reductions of public expenditure on the scale proposed by the Treasury, together with whatever fiscal measures may be envisaged, may exacerbate the recession and make unemployment higher in the shorter term than it would otherwise be. However, not to make reductions on that scale could entail either higher interest rates and a higher exchange rate - making the liquidity squeeze on the corporate sector still tighter - or a relaxation of the MTFS, which in the medium term could reduce the rate at which inflation is brought down and postpone economic recovery.

12. Whatever total amount of reductions in public expenditure the Cabinet agrees upon, it will wish to consider whether the distribution of the cuts should be adjusted to take account of the potential impact on particular industries. For example, cuts on capital programmes fall with special severity on the construction and capital goods industries; cuts on defence equipment fall on the shipbuilding, vehicle and aerospace industries; while at the other extreme the impact of cuts in transfer payments which reduce the spending power of beneficiaries of social security is distributed over a wide range of consumer goods industries.

13. There is of course scope for further improvements in efficiency in the public sector. It is extremely important to obtain these if better attitudes and a sense of economic reality are to prevail. But the savings required go far beyond what can be achieved by improved efficiency.

14. The Cabinet will wish to consider the impact of reductions in public expenditure on its political commitments: including the commitments on defence (the North Atlantic Treaty Organisation target of 3 per cent annual growth and the commitment to implement the recommendations of the Review Body on Armed Forces Pay); the commitments on maintenance of standards of education and health care; the commitments to maintain the value of social security benefits; and, on the other side of the account, the commitment on taxation.

QUESTIONS FOR MINISTERS

15. The CPRS suggests that Ministers will want to address the following basic questions -

1. Taking account of the present state of the economy and of the Government's economic objectives, are the reductions proposed by the Chancellor of the Exchequer in the PSBR and in public expenditure for 1981-82 appropriate, or should some higher or lower figures be considered?

2. What monetary target for 1981-82 is implied by the reductions proposed? The outturn for 1980-81 will at best be at the top of the 7-11 per cent range proposed in the MTFS, perhaps a little outside it. Do the Treasury proposals imply an objective of returning to the centre of the range implied in the MTFS for 1981-82 (ie 8 per cent)? If so, is that practicable? What would be the consequences of a more gradual return to

the path (eg to 9 or 10 per cent as the central figure for 1981-82)? What would be the political consequences of modifying the government's strategy at this stage? Very roughly, each percentage point on the money supply is about £$\frac{3}{4}$ billion. A higher monetary target would accommodate a higher PSBR for any given level of interest rates - though the size of the increase would depend on its distribution.

3. Is the Cabinet content with the broad balance between reductions in public expenditure and fiscal measures in the Treasury proposals?

4. What are the likely consequences for industry, for employment and for inflation of the Treasury's proposals, both in the short and longer term?

5. Within the general framework of the MTFS, and the objective of making possible a fall in interest rates and the exchange rate, is there sufficient scope in the Treasury's proposals (or some redistribution of them) for mitigating immediate damage to industry and employment, without jeopardising longer-term objectives?

Cabinet Office

28 October 1980

ANNEX

For their discussion of the economic prospect and public expenditure on 30 October Ministers may find it helpful to have a brief summary of the main figures and points for decision arising from papers C(80)59, C(80)58 and C(80)60.

I - The Economic Prospect: C(80)59

GDP: likely to fall by 2½% in 1980 (as in Budget forecast); and by about the same amount in 1981. The Medium-Term Financial Strategy (MTFS) assumed an average GDP growth rate after 1980 of 1% a year.

Inflation: the year on year increase is currently around 16%. If recent good performance on prices is sustained, the increase is expected to fall to about 11% by late 1981.

Earnings and Profits: the year on year increase in earnings is currently well over 20%. Thus real earnings have still been rising at the expense of profits.

PSBR: latest forecast for 1980-81 is over £10 bn (£8½ bn in Budget forecast).

forecast for 1981-82 over £11 bn (on assumptions in paragraph 11 including full July cuts, full indexation of personal tax allowances and public service pay rises of 9%). This would be equivalent of 4½% of GDP (compared with illustrative figure of 3% in MTFS). To get back to MTFS would need cut of £4 bn. Chancellor proposes £2½ bn.

Points for Decision

(1) Do Ministers accept that target reduction in PSBR should be £2½ bn?

(2) Do Ministers accept the need for public expenditure cuts on the scale now proposed by the Chancellor and the Chief Secretary, given

(a) that increased tax revenue will still be required;

(b) that a substantial reduction in external financing requirements for nationalised industries is assumed, involving large price increases and cuts in capital expenditure;

(c) that the PSBR gap would be even larger if the July cuts were not already assumed.

II - Public Expenditure Programmes: C(80)58

Prospective excess over White Paper for 1981-82 £2.7 bn

of which:

nationalised industries	£1,070m (£600m on top of £470m proposed in July)
changed economic assumptions	£ 700m
industry and employment measures	£ 150m
reserve/shortfall	£ 550m
miscellaneous	£ 250m

Points for Decision

(1) Do Ministers accept the specific cuts proposed in Table 2 first column?

(2) Do they accept an additional 2% volume cut on cash limited programmes (excluding local authority current expenditure) for 1981-82; and provisionally to carry these forward to subsequent years?

(3) Do they accept a 1% cut in local authority current expenditure for 1981-82 and subsequent years on top of the 2% cut shown in the White Paper and confirmed in August? Can this be achieved?

III - Cash Limits for 1981-82: C(80)60

Points for Decision

(1) Pay

Do Ministers accept the suggested 6% increase for public services (including Armed Forces, NHS etc)? Can it be effectively imposed?

(2) Prices

Do Ministers accept a price factor of 11% between 1980-81 and 1981-82?

IV - Announcements

Points for Decision

(1) Do Ministers with to make a general announcement in the near future of their overall position?

(2) What specific announcements should be made, and when, on

- public service pay and cash limits
- additional local authority cuts
- changes in other programmes
- the Industry Act forecast?

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SECRET

PUBLIC EXPENDITURE 1974-75 to 1981-82

	1974-75	75-76	76-77	77-78	78-79	79-80 Provisional outturn	1980-81 White Paper revalued, adjusted for transfers from reserve to programmes	1980-81 Forecast outturn	1981-82 White Paper revalued	1981-82 Including likely increases and agreed cuts	1981-82 Including remaining proposed cuts
1. Central Government (1)	53,735	54,479	54,011	52,546	55,144	55,468	57,305		57,080	57,900	57,150
2. Local authorities	24,358	24,262	22,910	21,533	21,415	21,714	20,360		19,426	19,250	19,150
3. Nationalised industries' borrowing	3,040	2,624	2,266	908	1,335	1,527	1,124		-146	625	625
4. Reserve	-	-	-	-	-	-	575		1,400	2,000	2,000
5. Special sales of assets	-	-	-	-697	-	-998	-500		-50	-150	-150
6. Shortfall	-	-	-	-	-	-	-1,120		-840	-640	-640
7. EC refunds	-	-	-	-	-	-	-	-545	-	-670	-670
8. Planning total after shortfall	81,133	81,365	79,187	74,290	77,894	77,711	77,744	78,100	76,870	78,300	77,450
9. % change on previous year	+8.5	+0.3	-2.7	-6.2	+4.9	-0.2	-	+0.5	-1.1[2]	+0.3[3]	-0.8(
10. Debt interest	1,400	1,693	2,179	2,472	2,847	3,845	3,500	3,900	3,500	4,000	4,000

(1) Including public corporations other than nationalised industries, and grants to nationalised industries, but excluding Government lending to nationalised industries (included in line 3).

(2) Change on White Paper revalued for 1980-81.

(3) Change on forecast outturn for 1980-81.