28 October 1980

Policy Unit

PRIME MINISTER

BRIEFING FOR CABINET

Following our discussion last Friday morning, this minute suggests the approach you and Geoffrey might take to the Cabinet discussion on public expenditure cuts.

1. THE PROBLEM

1.1 The problem you face is at two levels. Superficially, we have the natural and familiar problem: spending Ministers resisting the call for further cuts; more fundamentally, this problem itself provides, for colleagues who are opposed to Government strategy, the opportunity to frustrate that strategy, discredit it and thus weaken your authority.

1.2 It follows, therefore, that the role you play and the tone of voice you use is very important.

2. YOUR OWN ROLE IN THE DISCUSSION

2.1 We suggest that you put special emphasis on chairing, rather than participating in, what will be a difficult, maybe acrimonious, discussion between Geoffrey and his Treasury team on one side and some, though not all, of the spending Ministers on the other.

2.2 Your opening statement should therefore defuse the situation and create an atmosphere in which it is much more difficult for the hostile colleagues to escalate the discussion into a row. For example, show some sympathy for the spending Ministers, recognising the difficulties they face when the Treasury come back at them again for more cuts. Remind them that that is the Treasury's job.

- "We have a duty to get the answers as right as we can. It is easy enough for us - well-paid, owning property and land - to look at both recession and inflation with equanimity. But we have a duty to the small man with savings in cash, and to the private wealth-creating sector."

- "That duty requires us to bring inflation down, and then bring interest rates down, as far as possible without putting taxes up. That duty is a Manifesto duty and a national duty."

- "What we decide in the present round of cuts may well not be enough. All experience suggests that the situation will have deteriorated even further by the Spring and that we will then be having to make bigger tax increases than we had hoped would be necessary. (Each penny on the standard rate of tax is worth over £700m)."

- "We cannot put the problem off in the hope that it will get easier. We can't win the next Election with a phoney give-away Budget. We would simply be recreating a re-run of the 1979/80 problem for 1984/5 and neither the public nor the media would in any case be fooled."

3. GEOFFREY RECAPITULATES THE TREASURY PAPERS

3.1 "We now face an all-too-familiar problem. We did not, as a Government, achieve what we had hoped to achieve in our first year as regards public spending. We are therefore caught in the familiar box:

- We must ease the pressure on the private sector; but we can't do that by simply losing control of the PSBR because then whatever we do for the private sector will be cancelled out by higher interest rates.

- If we close the PSBR gap by higher taxes, then we reduce the very incentives we were pledged to restore.

- If we try to close the gap by relaxing control of money supply, then we guarantee a resurgence of inflation in the run-up to the next Election."

3.2 "We have to solve the problem now: that is, in the 1980 Budget and public expenditure plans. We have first to agree what level of PSBR we can tolerate for interest rate purposes; second, what cuts we can make without damaging the private sector; third, what tax increases will be needed to make good the difference."

3.3 "The better we can do on public service pay, then the smaller those tax increases will have to be. But for the present, we should not count our chickens on pay and we therefore have to make the biggest cuts possible. Each percent on public services pay is £220m."

3.4 I know that you feel very strongly about the inequity of monopoly unions in the public sector (especially nationalised industries) putting their fellow workers in the private sector out of jobs. I don't think that you need to labour this point as you have made it at previous meetings, and I think that all colleagues fully understand it.

4. GENERAL POINTS WHICH NEED TO BE MADE DURING DISCUSSION

4.1 It is important that colleagues understand the need to decelerate payments. Public services pay rose very substantially last year and the 6% for public services and the 8% for nationalised industries is essential if the public sector pay as a whole is to decelerate in line with the economy as a whole, as per the MTFS. Similarly with social security. It might be best for Patrick Jenkin to make this point himself:

> "There is no question of 'cuts in social security' in the way that pressure groups suggest. Next month, as we announce cash limits and EFLs which imply a 6-8% range for pay, and private sector pay is beginning to come down into single figures, social security will be uprated by no less than 16.5%. A year hence, in November 1981, we will no doubt be pressing for cash limits and EFLs which reflect pay increases in the 3-4% range. But, on present policies, social security will be uprated by about 11%. All we are proposing is that that should be reduced to 8% which means that social security will be increasing relative to pay.

(Our view is that it should be de-indexed by one-third of the backward-looking inflation rate, which would have meant an 11% uprating this November.)

4.2 You suggested in our discussion that if alcohol and tobacco were taken out of the index for the purposes of indexing social security, this would give the same effect as a 3% de-indexation. We think that this would be psychologically the wrong way to do it. The principle of de-indexing is fair once it is understood. It is not a selective cut, but ensures that social security decelerates like everything else. To fiddle about with the index would look mean or dishonest (as TPI did in our view) which is bad for the Government; and the opportunity to teach the meaning and importance of deceleration in all payments, to conquer inflation, would be missed - which is bad for everyone.

4.3 The impact of the monopoly nationalised industries on prices or taxes causes natural indignation, but at present the "rules of the game" do not allow us to do anything about it. But it is worth making the point that, if it was not for the nationalised industries' total overspending of £2.9bn, income tax could now be at 26p standard rate. It will be difficult to get realistic settlements until and unless trade union power, especially in those monopoly industries, is substantially reduced. In the meantime, we have to decide whether excessive pay awards should lead to reduced investment or higher prices. Each hits the different parts of the private sector in different ways. (One has only to read Geoffrey's recent minute to you on trade union resistance in the Post Office to see how futile it is to talk of solving the nationalised industry problem without further steps to reduce the bargaining imbalance. See, for example, how the mere threat of disruptive action does the unions' work for them!)

4.4 Increased expenditure on youth employment schemes etc can only be cosmetic. We may agree to doing a bit, but we must be clear that the more we spend soothing the symptoms, the longer it will take to cure the disease. Better to spend time removing trade union obstructions to youth employment.

5. HANDLING COLLEAGUES' OBJECTIONS

5.1 When hostile colleagues object to the cuts, or criticise the strategy, don't get directly involved in argument with them, don't let them cross-examine you or Geoffrey. We suggest that you cross-examine them.

this would give the same effect as a 3% de-indexation. We think that this would be psychologically the wrong way to do it. The principle of de-indexing is fair once it is understood. It is not a selective cut, but ensures that social security decelerates like everything else. To fiddle about with the index would look mean or dishonest (as TPI did in our view) which is bad for the Government; and the opportunity to teach the meaning and importance of deceleration in all payments, to conquer inflation, would be missed - which is bad for everyone.

4.3 The impact of the monopoly nationalised industries on prices or taxes causes natural indignation, but at present the "rules of the game" do not allow us to do anything about it. But it is worth making the point that, if it was not for the nationalised industries' total overspending of £2.9bn, income tax could now be at 26p standard rate. It will be difficult to get realistic settlements until and unless trade union power, especially in those monopoly industries, is substantially reduced. In the meantime, we have to decide whether excessive pay awards should lead to reduced investment or higher prices. Each hits the different parts of the private sector in different ways. (One has only to read Geoffrey's recent minute to you on trade union resistance in the Post Office to see how futile it is to talk of solving the nationalised industry problem without further steps to reduce the bargaining imbalance. See, for example, how the mere threat of disruptive action does the unions' work for them!)

4.4 Increased expenditure on youth employment schemes etc can only be cosmetic. We may agree to doing a bit, but we must be clear that the more we spend soothing the symptoms, the longer it will take to cure the disease. Better to spend time removing trade union obstructions to youth employment.

5. HANDLING COLLEAGUES' OBJECTIONS

5.1 When hostile colleagues object to the cuts, or criticise the strategy, don't get directly involved in argument with them, don't let them cross-examine you or Geoffrey. We suggest that you cross-examine them.

5.2 If, for example, they urge that nationalised industry investment programmes should not be touched, ask where the money is going to come from: from higher prices with the consequent effect that has on the private sector? From higher borrowing and thus interest rates (it's going to be difficult enough to bring them down as it is, and a high PSBR itself is inflationary)? From higher taxes - which amounts to subsidising nationalised industry prices? Or from printing more money, and thus creating higher inflation eighteen months to two years downstream? Each answer they give, press them further. Get them to display the inadequacy of their position in front of their colleagues. Put them in the hot seat. (To further defuse the situation, it may help to address them by their Christian names when cross-examining in this way. It makes it harder for them to be deliberately obstructive.)

5.3 After such questioning, you could probably sum up by saying:

> "If there really is a something-for-nothing solution to this problem, then of course we must look at it. But it seems to me that there is not; that whichever way we turn, we cannot get out of the box. The money has to come from somewhere. If the reality is inescapable and if it's going to hurt someone, whatever we do, let's at least make sure that the process is visible to the public, so that they can learn the economic realities and so that public opinion can be mobilised against public sector union monopoly and management incompetence. A big pay award leading to a large price increase leading to fresh bankruptcies does teach that lesson. A big pay award leading to reduced investment teaches that lesson slightly less directly. A big pay award leading to relaxed EFLs simply sustains the illusion that 'Government money' can solve every problem; the very illusion we have to shatter. And ends up with the dreamworld intact, and an electorate angry at higher taxes or else more inflation."

5.4 If the discussion threatens to end in disarray, you will obviously want to regain control by proposing a further meeting as soon as possible, or separate meetings with dissenting colleagues. What matters is that there is a clear "next step". What that step consists of is less important.

I have not copied this note to Geoffrey, but I am of course available for your meeting with him tomorrow evening if needed.

JOHN HOSKYNS

5.2 If, for example, they urge that nationalised industry investment programmes should not be touched, ask where the money is going to come from: from higher prices with the consequent effect that has on the private sector? From higher borrowing and thus interest rates (it's going to be difficult enough to bring them down as it is, and a high PSBR itself is inflationary)? From higher taxes - which amounts to subsidising nationalised industry prices? Or from printing more money, and thus creating higher inflation eighteen months to two years downstream? Each answer they give, press them further. Get them to display the inadequacy of their position in front of their colleagues. Put them in the hot seat. (To further defuse the situation, it may help to address them by their Christian names when cross-examining in this way. It makes it harder for them to be deliberately obstructive.)

5.3 After such questioning, you could probably sum up by saying:

> "If there really is a something-for-nothing solution to this problem, then of course we must look at it. But it seems to me that there is not; that whichever way we turn, we cannot get out of the box. The money has to come from somewhere. If the reality is inescapable and if it's going to hurt someone, whatever we do, let's at least make sure that the process is visible to the public, so that they can learn the economic realities and so that public opinion can be mobilised against public sector union monopoly and management incompetence. A big pay award leading to a large price increase leading to fresh bankruptcies does teach that lesson. A big pay award leading to reduced investment teaches that lesson slightly less directly. A big pay award leading to relaxed EFLs simply sustains the illusion that 'Government money' can solve every problem; the very illusion we have to shatter. And ends up with the dreamworld intact, and an electorate angry at higher taxes or else more inflation."

5.4 If the discussion threatens to end in disarray, you will obviously want to regain control by proposing a further meeting as soon as possible, or separate meetings with dissenting colleagues. What matters is that there is a clear "next step". What that step consists of is less important.

I have not copied this note to Geoffrey, but I am of course available for your meeting with him tomorrow evening if needed.

JOHN HOSKYNS