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Seen by PM
Copied to Dom. Monetary Policy

PRIME MINISTER

PUBLIC EXPENDITURE

This minute is to give you warning of further serious problems over our future public expenditure plans, especially for 1981-82. These will have to be brought out in the paper which John Biffen and I will be putting to the Cabinet planned at the end of the month. We urgently need to discuss the issues, both because of their intrinsic difficulty and because they are relevant to our discussion on Monday of monetary policy. Hence this interim note.

2. The main reasons why the prospects looks worse than in July are:

(i) Discussions with the nationalised industries about their external financial limits for next year show that their financial prospects have worsened further. Clearly we must do all we reasonably can to get the industries themselves to take measures to offset their increased bids. John Biffen has made some proposals to this end. We may have to insist on further cuts in investment. The position will not be clear for a few more days. At the moment we cannot be sure whether the increase in the provision for nationalised industries can be held to the £½ bn envisaged in July or will have to be increased, perhaps to £1 bn (at late 1979 prices).

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(ii) Meanwhile changes in the prospects for unemployment, inflation and interest rates call for increased spending for unemployment and other ~~social security~~ benefits, housing subsidies and export credit subsidies. Other recent developments also point to further adverse changes.

3. In addition, Keith Joseph and Jim Prior are formulating proposals for industrial support and employment measures which could come to £0.4 bn.

4. In July we decided that public expenditure plans for 1981-82 and the subsequent years should be held within the totals published in our March White Paper, adjusted downwards for the EC settlement, which would make the planning total for 1981-82 about 1⅓ per cent lower in volume terms than the plans for the current year. I regard it as critical to the credibility of our public spending policies that we hold to this decision, keeping the figures within our own published planning totals.

5. It would be helpful if we could get it lower. For now there is a further reason for a tough line. The latest Treasury forecast points to a public sector borrowing requirement approaching £11 bn (in cash) in 1981-82, which would be incompatible with our objectives for reducing monetary growth and getting interest rates down. So we have to find ways of bringing it down. We can in theory, do so in 3 broad ways: higher taxes; reductions in the cost of given spending volumes; or lower expenditure volumes. In practice the cost is, of course, largely the pay element.

6. I am examining what contributions might come from the tax side, including further revenue from the North Sea, employees' national insurance contributions, and

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perhaps not revalorising to the full extent the personal tax allowances. It is nether desirable nor easily conceivable to look to this source for a major contribution. Public expenditure must contribute in one way or another.

7. Pay is a critical element. Each 1 per cent more, or less, on public services pay is about £¼ bn on the PSBR. We are considering in E the provision to be made for public services pay next year. A draft paper is coming to you separately. All I need say here is that the lower we set that provision and - the real imperative - achieve pay settlements within it, the less the cuts in services forced upon us.

8. But we do have to consider cuts in services in any event - as we foresaw in July and as I indicated in my minute to Cabinet last month. If we were to close the gap by further reductions in volume the implications look like being as follows.

9. Even if there were no net increase on employment and industry measures, in order to achieve the target agreed in July we should probably need cuts of between £1¾ bn and £2¼ bn (at late 1979 prices) on programmes other than the nationalised industries. John Biffen and I will be considering further over the next few days what proposals we must make. I should say now that I have sympathy with what Michal Heseltine has been saying about spreading the cuts widely and doing enough to minimise the risk of having to come back yet again for more late

10. We shall certainly need most of the £0.9 bn specific cuts which John Biffen has so far been discussing in bilaterla with our colleagues. But those discussions show that many of the proposals already on the table

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are difficult and will be strongly resisted. This has more important implications for how we might proceed now.

11. These are the kinds of proposals we shall have to consider if we are to do more on volume. I am looking at the possibility of trying for a further reduction in local authority current expenditure beyond what was announced in August. I am also considering adding to the specific cuts a general 2 per cent cut in all cash controlled programmes. This would in effect carry forward into next and subsequent years the benefit from the current year's cash limits squeeze, which in the plans so far was carried forward only in civil service numbers.

12. All of this involves political difficulties. In particular the further volume cuts would mean moving away from commitments made previously, for example in looking for significant savings in the very large programmes for health, defence and social security.

13. I fear cuts would be needed in gross spending on health, which we have hitherto sought to protect.

14. We would also have to look for a further contribution from defence, while respecting Francis Pym's concern both about national security and about relations with our NATO allies. I understand his wish to be able to say that we have at least stopped the decline in defence spending which occurred under our predecessors, even though I think significant increases may now need to be deferred until later in our period of office.

15. Social security accounts for a quarter of total public expenditure, and by far the largest single element within that is retirement pensions. I regard it as essential

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to effect a step change here in the light of our exceptional problems, in order to put the programme on a more realistic basis. Such a change would only be defensible in a year when the increase in incomes generally has to fall behind that in prices, as has to happen next year. We should have to think extremely carefully about presentation in the light of our pledges. Were we to proceed the kind of change needed would be to abate the increase in retirement pensions and other benefits in November 1981 to, say, 3 per cent less than the expected increase in RPI. The same would apply to public service index-linked pensions.

16. This is a forbidding menu. But the overall arithmetic will persuade you, as it has pursuaded me, that we have to think in this kind of way. I hope we may have a chance of talking together about the central problems, quite briefly - perhaps on Sunday evening, at any rate separately from the meeting on Monday about monetary matters.

(G.H.)

10 October 1980