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SECRET

MINUTES OF A MEETING AT 10 DOWNING STREET AT 9.00 AM ON 7 DECEMBER 1979

Present: Prime Minister
Home Secretary
Chancellor of the Exchequer
Secretary of State for Industry
Secretary of State for Employment
Secretary of State for Social Services
Secretary of State for Trade
Secretary of State for Energy
Chief Secretary, Treasury
Sir Robert Armstrong
Sir Kenneth Berrill
Mr P Le Cheminant, Cabinet Office
Mr P Mountfield, Cabinet Office

THE ECONOMIC OUTLOOK AND PUBLIC EXPENDITURE

The meeting considered a draft memorandum by the Chancellor of the Exchequer on the Economic Outlook and Public Expenditure, a further draft memorandum by the Chancellor of the Exchequer on Pay and Price Provisions for the 1980-81 Cash Limits, and a paper by the CPRS on the Economic Outlook.

THE CHANCELLOR OF THE EXCHEQUER said that, in his judgement, it was now necessary to reopen the Cabinet's previous decisions on Public Expenditure, and to seek savings of at least £1 billion in 1980-81 and of £2 billion in each year thereafter. He invited the Group to endorse this conclusion before he circulated his paper to Cabinet. All advisers in the Treasury agreed that there was no feasible alternative. He began from the imperative of maintaining the present monetary discipline. The position was worse than had seemed in the Autumn. Oil prices had risen, pay settlements had been higher than expected, we had still to secure a reduction in our contribution to the EEC budget, and the Cabinet had not agreed on public expenditure cuts on the scale he had proposed. The long term objective of a prosperous and vigorous economy would be at risk if as a result of a failure to take the necessary decisions on public expenditure high interest rates were maintained and taxes had to be increased in the next two years. The Parliamentary Party and outside commentators alike expected a further reduction in public expenditure, and it would be damaging to confidence if it were not achieved.

In discussion the following points were made -

a. It was argued on the one hand that the Government's monetary targets could not be achieved at reasonable interest rates without a reduction in the public sector borrowing requirement (PSBR) at least in real terms. If increased taxes were to be avoided, this meant that public expenditure had to be reduced. Against this, it was argued that the PSBR was a residual difference between two very large figures both subject to wide margins of error. Its forecasting was necessarily inexact, as were its effects on the money supply. Moreover, in a recession private sector demands would be declining, and it should be possible to finance the Government financing requirement at acceptable interest rates. It was too early to evaluate the impact of the most recent set of measures. There were cogent political and social, as well as economic, grounds for avoiding a further round of public expenditure cuts. It would be better to wait for the Budget. If further fiscal action was then thought necessary, consideration should be given to increases in some indirect taxes: there were, in any case, good social arguments for increasing the tax on tobacco and on drink, and sound energy arguments for increasing petrol tax, though all these would increase the Retail Price Index (RPI).

b. The economy paid a high price for the national obsession with the need to keep pace with the RPI. There was a good case for allowing some increases, notably the increase in world oil prices, to be passed on directly to the community, which could not be insulated from world trends. It might be possible to present the RPI in a way which distinguished these movements from others. Too much public expenditure was already related, directly or indirectly, to movements in the RPI. Many social security benefits, along with public sector pensions, were directly indexed. Indirectly, increases in prices led automatically to pressure on public sector pay, and therefore on public expenditure, and indeed on pay in the rest of the economy. There was a strong case for breaking out of this RPI trap. This would involve breaking the statutory and non-statutory protection of benefits, where this could be done without retreating from Manifesto commitments.

c. The social security programmes would have to make a substantial contribution to any future expenditure cuts. There was, however, a case for looking at rates of contribution as well as rates of benefit. These proposals could not

be separated from those on the taxation of short term benefits which were shortly to be considered by E Committee. A considered approach on those lines was preferable to any immediate cut in general benefits. In any case, unless the structure of the National Insurance Fund - which was supposed to be maintained in broad balance - was changed the impact in any increase in contributions on the PSBR would be small. Moreover, increased contributions merely drove up unit costs for employers and tended to reduce employment or drive up prices.

d. Economies would have to be sought in other areas of public expenditure as well as social security programmes. While the armed forces proper must clearly be exempt, there might be a case for looking again at the Defence 'tail'. The Law and Order programmes were too small to make any significant contribution, and in present circumstances it would be wrong to make any major reductions. But there were other Home Office services, like the Fire Services, which could be re-examined. A major contribution would also have to come from housing and rents, and it might be necessary to look again at tax relief for mortgages. It would also be desirable, within the overall constraints of a reasonable PSBR, to leave room for a package of incentives for small firms and for the encouragement of investment generally as well as to leave room for other contingencies, including British Leyland. Apart from cash limits, where the Chancellor's proposals would involve an overall 'squeeze', it would be wrong to seek further across-the-board reductions. The search should concentrate on specific policy changes. Discussions to this end would be better carried out bilaterally, between Treasury and spending Ministers, than in full Cabinet, provided that sufficient political endorsement could be found for the overall target.

e. More dramatic solutions might be considered. For example, it had several times been proposed that the standard rate of income tax should be brought down to a low figure, say 15 per cent, to be financed largely by the abolition of personal allowances. Schemes of this kind deserved further study. Alternatively, income tax could be abolished altogether and replaced by a

modified poll tax on the lines of the National Insurance Surcharge, collected direct from employers. The developing oil situation also provided a further major potential source of revenue. A steep increase in petrol taxation, could be entirely justified on energy saving grounds and rising oil prices gave scope for further increases in Petroleum Revenue Tax (PRT) which would not affect the RPI.

THE PRIME MINISTER, summing up the discussion, said that the Ministers present broadly supported the Chancellor's approach to public expenditure. He should now circulate his paper to Cabinet, for discussion next week, without at this stage indicating any firm figures for reductions. He should meanwhile discuss his proposals with some of the Ministers most directly affected. He should also circulate his paper on Cash Limits in the form at which it had been sent to her. He should circulate to Ministers present a note about the possibility of a 15 per cent standard rate of income tax with no personal allowances. He should arrange for a wide-ranging study to be made, by the Treasury and the CPRS, of the scope for 'de-indexation', covering wage bargaining, social security benefits, direct and indirect taxation, public sector pensions and the effect of world oil prices on the retail price index. This paper should be sent to her in the first instance.

The Meeting -

Took note, with approval, of the Prime Minister's summing up of their discussion, and invited the Chancellor of the Exchequer to be guided accordingly.

11 December 1979