cc Econ Pol PT7
Public Expend

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

6th December, 1979

Dear Tim,

THE ECONOMIC OUTLOOK, PUBLIC EXPENDITURE AND CASH LIMITS

On 27th November the Chancellor minuted the Prime Minister, with copies to other members of a small group of Ministers, with a draft Cabinet paper on the economic outlook, to be discussed at the group's meeting on 7th December. He indicated that a further Cabinet paper would be prepared on re-opening public expenditure.

The Chancellor has now decided that it would be better to combine discussion of the outlook, general economic policy and the implications for public expenditure in a single paper for Cabinet, a draft of which I now enclose for discussion by Ministers on Friday. Also enclosed for discussion at that meeting, as requested by the Prime Minister, is a draft Cabinet paper on 1980-81 cash limits.

Copies of this letter and of the enclosures go to John Chilcot (Home Office), Ian Ellison (Department of Industry), Ian Fair (Department of Employment), Don Brereton (Department of Health and Social Security), Stuart Hampson (Department of Trade), Bill Burroughs (Department of Energy) and Martin Vile (Cabinet Office).

Yours ever,

Tony Battishill

A. M. W. BATTISHILL

T. Lankester, Esq.,

PAY AND PRICE PROVISIONS FOR THE 1980-81 CASH LIMITS

DRAFT MEMORANDUM BY THE CHANCELLOR OF THE EXCHEQUER

The 1980-81 cash limits on the rate support grant (RSG) and the external financing limits on the nationalised industries were announced on November 16th. We now need to take decisions on the pay and price provisions in the Main Estimates for 1980-81 and in the other remaining cash limits.

A. Expenditure concerned

2. These are the limits on central government expenditure and on local authority capital expenditure. They cover over £25 billion (at 1979 survey prices). The main areas of central government expenditure include defence, the hospital and community health service and the universities. The limits cover numerous pay groups principally the armed forces, doctors, nurses, NHS ancillaries and university staff.

3. At this stage, we can leave on one side civil service pay: a global provision for the civil service pay settlement is to be made in a single Vote which need not be decided until February.

B. Provision

4. I propose that provision should be made for a 14 per cent increase between 1979-80 and 1980-81 in current costs covering both new pay awards and other current expenditure. This differs from past practice when a separate factor was used for pay and two other factors for the remainder of current expenditure but it follows the approach we agreed, for the RSG. The advantage of the RSG approach is that it avoids publishing

an explicit figure for pay which could become a starting point for negotiations.

5. I propose continuing past practice of using separate price factors for capital expenditure. Separate provision would be made for the outstanding comparability awards for the university teachers and for nurses. All the proposed factors are shown in Annex A.

6. These factors are based on the Industry Act forecast which showed a 14 per cent increase in the retail price index (RPI) between the fourth quarter of 1979 and the fourth quarter of 1980. They are also broadly in line with the figures supplied to the Government Actuary; these showed the same increase in the RPI and a 14 per cent increase in earnings between 1979-80 and 1980-81 for the economy as a whole (see Annex B).

7. As part of the RSG settlement, the local authorities were given a figure of 13 per cent for increases in the costs of their current expenditure generally. This cash limit represents a maximum contribution from the Central Government. We can justify the slightly higher figure of 14 per cent for Central Government cash limits on the grounds that for each Central Government service the cash limit is an absolute constraint whereas local authorities have greater flexibility and, in the last resort, their own balances to fall back on if inflation turns out higher than expected.

C. Implications for public expenditure plans

8. We cannot, consistently with our own published forecasts, make a higher provision than now proposed. And it is essential, in our first full year, to hold expenditure within the cash limits we set.

9. The effect of the cash limits on services will depend both on inflation generally and on public service pay settlements. If these costs increase faster than provided for, the cash limit will be bound to result in further reductions in the volume of expenditure. The size of these will depend on the mix of different types of expenditure on each service.

10. Any forecasts of inflation are inevitably subject to a wide margin of error, but it would be unrealistic if my colleagues do not allow for the possibility that the cash limits will require some further reduction in the volume of the services for which they are responsible in 1980-81. All spending authorities must manage their resources throughout the financial year in such a way that they keep within the cash limits even if costs rise faster than provided.

Conclusion

11. I invite the Cabinet to agree the pay and price provision proposed in Annex A.

ANNEX A

Provisions proposed for 1980-81 cash limits (based on the Industry Act forecast)

	% increase 1980-81 on 1979-80
i) New pay awards and price increases on current expenditure *	14.0
ii) Capital Expenditure:-	
Construction	
- Housing	15.8
- roads	16.4
- other	15.5
Land	15.0
Other capital expenditure	15.9

iii) Outstanding comparability awards

a) nurses in the range 20-25 per cent annual increase in earnings. This assumption will be replaced by the actual figure if the Clegg Report is available in time.

b) university teachers in the range 15 - 20 per cent annual increase in earnings.

* Apart from the global provision for civil service pay which will be settled later.

ANNEX B

Published figures

a. Assumptions given by the government to the Government Actuary for use in his report on the National Insurance Fund:

- Economy wide increase in earnings (including outstanding public sector comparability) of 14 per cent between 1979-80 and 1980-81

- RPI increase 14 per cent 1979 (Q4) to 1980 (Q4).

b. Industry Act Forecast:

- No earnings figure. Refers to "a progressive reduction in the rate of settlements over the coming year" by implication from the underlying increase of 15-16 per cent mentioned for this year.

- RPI increase 14 per cent 1979 (Q4) to 1980 (Q4).

c. RSG cash limit:

- increase in costs of 13 per cent between 1979-80 and 1980-81.

 CC Econ Pol Public Expenditure PE7 6/12/79.

THE ECONOMIC OUTLOOK AND PUBLIC EXPENDITURE

Memorandum by the Chancellor of the Exchequer

Introduction

I have been taking stock of the economic situation. The general strategy remains the only feasible one but the difficulties we face are greater than we had any reason to expect. I consider that we need to look again at our public expenditure plans and it was evident at our 15 November discussion that many members of the Cabinet share this view. It is imperative to get our policies properly established in our first year of office.

Recent Developments

2. Three developments cause particular concern:-

(i) With strong wage inflationary pressures, poor trading, productivity and competitiveness performance and the unpromising outlook for world trade following the further large increases in oil prices, the economy is inevitably moving into a recession from which there could well be only a slow recovery;

(ii) despite the action I took in the Budget, underlying monetary growth has been much higher than expected;

(iii) inflationary expectations, and hence pay pressures, remain high and intractable.

3. This outlook was reflected in the recent Industry Act forecast which brought out in particular the deteriorating prospects for output and for reducing the rate of inflation next year; and some of the assumptions underlying that forecast (eg on earnings and interest rates) could be over optimistic. Recent non-government forecasts, such as that prepared by the London Business School, point in very much the same direction.

Action so far

4. The measures taken in the Budget established our credibility from the start by signalling our resolve to maintain strict

monetary control backed by fiscal policies consistent with it. And the further measures of 15 November were dictated by the necessity of maintaining those policies in the face of the disappointing monetary and PSBR developments. The initial reaction in the markets was favourable and we have secured substantial gilt sales to help fund this year's PSBR. I hope that the other effects of the changes will now come through so that money supply growth comes into the target range, without even higher interest rates than those which we have had no alternative but to accept. But this will depend on a number of factors some of which we can influence - particularly the market's assessment of our determination to carry through our policies - and others which we cannot, eg developments overseas.

Future action

5. The overriding priority is to reduce inflation, as a necessary condition of resumed and sustainable growth. In parallel with this we must secure a major improvement in the supply side of the economy. To these ends our policies must embrace the following:-

(i) progressive reduction of the rate of growth of the money supply at tolerable interest rates;

(ii) further reductions in the burdens of income tax and capital taxation;

(iii) substantial reductions in the inherited public expenditure plans and in the size and role of the public sector generally.

6. No compromise is possible on (i). Otherwise the credibility of any government's strategy on inflation would be destroyed. Nor can we compromise on our objective of restoring incentives by reducing taxation. Our weakness on the supply side is still acute and we urgently need to take further measures to remedy this. The single most important contribution we can make is to reduce taxation at all income levels. But, with the worsening economic prospects, and the difficulty evident from Dublin of getting an acceptable reduction in our EEC contributions,

there is now little prospect of attaining our inflation and tax objectives on the basis of the public expenditure plans agreed so far by Cabinet.

7. Disappointment with the 1980-81 White Paper (whose plans were some £2 bn higher than the target the Chief Secretary and I set) contributed to the unsettled market conditions that necessitated the 15 November measures. Many in the markets were hoping for an unequivocal reduction in the volume of expenditure and the PSBR for 1980-81.

8. For the period immediately after 1980-81 a similar situation is in prospect. The Chief Secretary and I warned the Cabinet in September that even with the reductions we proposed it would be hard to hold the PSBR in the later years to around its present proportion of GDP without some real increase in taxation. In the event the plans agreed by the Cabinet are more than £1 bn higher for most of the years concerned; and the economic prospect has worsened, as reflected in government and independent forecasts. Thus on any prudent assessment of the economic outlook the present expenditure plans seem incompatible with slower money supply growth unless we have even higher interest rates or higher taxes, or both.

9. Chronic structural weaknesses in the economy - low productivity growth and poor trading performance as well as the tendency to higher inflation - appear to have intensified in recent years. These problems cannot be overcome quickly and given also the worsened prospects for the world economy after the further rise in oil prices the medium term prospects for GDP growth are now poor. It is against this background that the Treasury's medium term analysis has been carried out. It suggests that the policy conflicts are likely to be most acute in the next two years. For example, to bring inflation down well into single figures by 1983 entails getting monetary

growth in that year down to 7% (and the PSBR to 2½% of GDP, which should allow interest rates to fall). On present expenditure plans this would require tax increases equivalent to around 5p on the basic rate of income tax by 1981-82. There would be no prospect of any real reduction in personal taxes from today's levels before 1983.

10. Two key conclusions emerge. First, however difficult the short-term, the centre piece of our anti-inflation strategy - progressive reduction in monetary growth - remains the only feasible one. But second, stabilisation of our expenditure plans at their presentlevels is not enough. (And, depending on the treatment of debt interest, it is arguable whether we have even done that.) Unless we reduce plans further we shall not be able to avoid serious damage to our taxation objectives and the risk of even higher interest rates than those we have now. This is also becoming increasingly clear to the financial markets and without changes there is a serious risk of a series of tensions in the markets, of which that last month was only a first example. Most important, it is also becoming clear to our supporters in Parliament that further action on public expenditure is needed.

Public Expenditure and the Second White Paper

11. I conclude that our public expenditure plans need to be reduced. It is difficult to say with confidence precisely what further reductions would be required to meet our monetary and tax objectives. On the Treasury's projections, the PSBR for 1980-81 would on present expenditure plans exceed £10 billion, and rise to around £13 bn in 1981-82, or over 5% of GDP compared with the 4¼% expected this year. A PSBR at this level would be a major blow to confidence and it seems very unlikely that we could finance it without still higher rates of interest.

12. Our room for manoeuvre in 1980-81 is restricted. We have published our plans and they are being acted on by spending authorities. For example, it would be difficult now to ask local authorities to make further reductions in their current expenditure. But we need to hold the cash limits and to make whatever further savings we can. One important decision for 1980-81 not yet taken concerns the uprating of child benefit. There is also the question of further savings on housing investment. In all we ought to be looking for a total volume reduction of the order of £1 billion.

13. In 1981-82 a reduction of the order of £2 bn appears to be needed. If the total is not to rise again we must carry this reduction forward to the two subsequent years.

14. We can only make reductions of this order by fundamental new decisions on the major programmes. The social security programme, which constitutes over a quarter of public expenditure, will need to be a major source of the further savings.

Second White Paper

15. If the above is accepted it points to postponing the White Paper hitherto scheduled for January. We do not want to publish figures we are subsequently going to revise; and to do so would make the revisions more difficult to achieve. Any economic projections published with the figures would also reveal the inconsistencies I have described; but equally refusal to publish supporting economic material would lead observers to conclude themselves that the figures did not add up. We certainly would not publish any convincing or viable financial plan incorporating the present expenditure figures. So I conclude that we should postpone the White Paper.

16. The decision to postpone implies that we shall achieve the necessary reductions. To delay the White Paper and then publish plans that were still too high would be the worst of all worlds.

17. Nor could we let the uncertainty run on too long. We need to publish the White Paper not later than the Budget and preferably in March. This will require an intensive operation which we should aim to complete by the end of January.

Conclusion

18. I recognise the difficulty of the decision I am asking the Cabinet to make, and of the subsequent decisions necessary to implement it. But without this decision it will become widely apparent that our policies are inconsistent and that our expenditure plans are incompatible with our monetary and taxation objectives; and that there is a serious risk that even more painful measures would become unavoidable.

19. I therefore propose that:-

(i) we undertake an exercise, which we should aim to complete by the end of January, to identify savings of £1 bn in 1980-81 and £2 bn a year in 1981-82 and subsequent years;

and (ii) we postpone the next Public Expenditure White Paper and aim to publish it in March.