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Ref. A03326

PRIME MINISTER

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Cabinet: Public Expenditure

The three Cabinet memoranda by the Chancellor of the Exchequer and the Chief Secretary, Treasury, are being circulated this evening. Arrangements are in hand with the Treasury for the "enlarged bilaterals" between the Chancellor, the Home Secretary and the Chief Secretary on the one hand and certain individual spending Ministers on the other to be held in the period between this week's Cabinet and next week, though we shall not "go public" on these arrangements until after tomorrow's Cabinet, and subject to agreement at that Cabinet.

2. I suggest that the right place for inserting this subject into tomorrow's agenda is as an introduction to the last item, Civil Service Manpower, after the discussion of The Queen's Speech on the Opening of Parliament.

3. You might open the discussion on the last item by saying that, before you invite the Lord President to speak to his paper (C(80) 56), you would like to draw the attention of your colleagues to the three important Treasury papers which have been circulated for discussion next week, and you think that it would be helpful if, in preparation for that discussion, the Chancellor could say a preliminary word this morning about the economic prospects and their implications for policy, particularly on public expenditure and cash limits.

4. The object of the discussion will be to get a sufficient degree of reaffirmation of the economic strategy, and specifically of July's decision that public expenditure totals in 1981-82 and later years should be held within the figures set out in the March White Paper, so as to provide a framework for the "enlarged bilaterals" and for next week's discussion of the detailed proposals on public expenditure. You will therefore want to keep the discussion away from the detailed public expenditure proposals and on the strategy and the expenditure targets.

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5. The advantage of coming to this subject relatively late in the agenda, but with one big item still to deal with, is that Ministers may be in a frame of mind not to pursue the subject at inordinate length on this occasion, and may be prepared to postpone a full discussion until next week. You could perhaps encourage this by intervening as soon as the Chancellor has said his piece, to say that Cabinet will of course be returning to a full discussion of this next week, but that in the meantime the Chancellor and the Chief Secretary, together with the Home Secretary, will during the next seven days be seeking to discuss with the spending Ministers most seriously affected the very difficult decisions that are called for. You would go on to urge Ministers each to go as far as possible, in this very difficult situation, in agreeing the reductions proposed by the Chief Secretary.

6. The Ministers concerned will include the Secretaries of State for Defence, Social Services, Education and Science, the Environment, and Scotland, and the Ministers of Agriculture and (probably) Transport. They may also need to include the Secretary of State for Employment, who will not readily accept the reductions in his special employment measures which the Treasury are proposing.

7. The ideal outcome would thus be

- (i) provisional reaffirmation of the strategy, and in particular of the decision to stay within the public expenditure totals in the March White Paper;
- (ii) agreement to continue discussion at next week's Cabinet;
- (iii) endorsement for the "enlarged bilaterals".

8. But it may not go as smoothly as that. You may encounter expressions of dissent on two counts.

9. Some Ministers (e.g. the Secretary of State for Industry) may accept the strategy and the overall targets, but want to see the cuts decided and distributed so as to minimise the damage to industry. As we saw yesterday, the implications of this would be:

- (a) not to make further cuts in capital programmes;
- (b) not to make further cuts in defence equipment projects;
- (c) to go as far as possible on public sector pay and numbers;

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(d) to consider deeper reductions in transfer payments.

10. That makes obvious sense; the difficulty is to make up the numbers required on that basis. If this strand of thought did emerge in the discussion, you might sum up by saying that:

- (a) if public expenditure is to be held within the totals in the March White Paper, we need reductions totalling the £1,850 million or so indicated in the Chief Secretary's paper;
- (b) if capital programmes, or defence, are to be spared, in order not simply to push the squeeze on to industries already very vulnerable, then other current expenditure, especially transfer payments, will have to find more;
- (c) in his "enlarged bilaterals" the Chancellor should take account of the effects of the proposed reductions on industry and employment and of the views expressed and should endeavour to see how the "mix" of the package of reductions can be adjusted to reflect them.

11. The dissent may go beyond that, to questioning whether the strategy continues to be valid in the present circumstances. The argument will be that industry is already under unprecedentedly heavy pressure with the combination of recession, high interest rates and the high exchange rate; that the recession is deeper and the levels of interest rates and the exchange rate are higher than was forecast or foreseen at the time when the strategy was decided upon; that industry is in no position to absorb the consequences of reductions of public expenditure proposed; and that we should therefore look either to more reliance on fiscal measures - increases in taxation - and less on public expenditure cuts or, more drastically, to a modification of the strategy: an easing of the pressures that the strategy is placing upon the economy and in particular upon industry, even at the cost of slowing down the rate at which inflation is being reduced.

12. If this line of thought were to emerge in discussion, you would have to judge whether it was sufficiently strongly and widely held to make it necessary to change the handling plan. It might be possible for you to say that that was something which the Cabinet would need to discuss when it took the papers next

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week, but that in the meantime the Chancellor should go ahead with his "enlarged bilaterals", on the basis that the reductions would be needed if the strategy and the March public expenditure totals were to be adhered to, and the results of the "enlarged bilaterals" could be very relevant to next week's discussion. But you might judge that the disquiet was so profound and so wide in the Cabinet, that there was no point in pursuing the public expenditure proposals and holding the "enlarged bilaterals" until the major questions had been resolved. In that event you would presumably have to conclude that the Cabinet would be having a full discussion next week of the economic prospects and their implications for policy, and that further consideration of the Chief Secretary's public expenditure proposals would have to wait until after that discussion. But that is an outcome you will want to avoid if it is possible to do so.

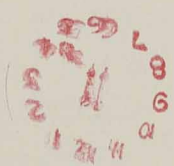
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ROBERT ARMSTRONG

22nd October, 1980

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