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NOTE FOR THE RECORD

cc Sir Robert Armstrong

The Prime Minister held a meeting this afternoon to discuss public expenditure and nationalised industry finance. The Home Secretary, the Chancellor of the Exchequer, Chief Secretary, the Secretaries of State for Social Services, Industry and Trade, Sir Anthony Rawlinson, Sir Robert Armstrong, Mr. Ibbs, Mr. Hoskyns, Mr. Wolfson and Mr. Whitmore were present.

The following is a summary of the main points of the discussion.

The Chancellor said it was essential, for the attainment of the monetary strategy, to get the volume of spending in 1981/82 back to the planned levels of Command 7841, and also to achieve a reduction in the relative cost of public expenditure. In achieving the Chief Secretary's volume cuts, it was important to minimise the damage to private sector industry - though there was no way of insulating the latter altogether. The arithmetic he was working on was roughly as follows. The latest Treasury forecast suggested a PSBR of £11¼ billion: this was after allowing for the revalorisation of all taxes and it assumed that the planning total in Command 7841 was achieved. It thus assumed that all of the Chief Secretary's proposed cuts, or some variation on them to reach the same total, were achieved. He felt it would be necessary to provide about £½ billion of tax relief to industry, which would bring the PSBR to about £11¾ billion. He was considering the following revenue measures to reduce this figure: a temporary increase in VAT on imports (£½ billion), an increase in the national insurance contribution paid by employees (£½ billion), increased take from the North Sea (£½ billion), and less than full indexation of personal taxes (£½ billion). These measures might produce a PSBR of £9¾ billion, nearly 4 per cent of GDP. This was higher than the plan in this year's Red Book; so the achievement of the Chief Secretary's cuts was a minimum.

As for the cost of programmes, the key here was the pay assumption. He was proposing a figure of 6 per cent for the public services, which if anything was on the low side in terms of its attainability. The majority of the nationalised industries,

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after nudging by Treasury and sponsor Departments, were assuming 10 per cent or less, which again was the best which was likely to be achievable. The experience of the last year showed that there was no point in assuming cash limits for the nationalised industries that could not be achieved. The Prime Minister commented that there was an equal danger of being under-ambitious on the pay assumptions: she went along with the 6 per cent on public service pay, but was sceptical of the nationalised industries' assumptions. The Home Secretary, after explaining MISC 21's conclusions on the RSG grant percentage and distribution, said that the Committee were doubtful that a pay figure of less than 8 per cent could be achieved - though the option of 6 per cent was being put to Cabinet.

The Chief Secretary explained his preference for volume cuts achieved by reducing the programme figures, rather than by imposing a repetition of this year's cash limits squeeze. (There was no dissent.) He went on to say that, if industrial damage was to be minimised, much of the burden of the cuts would have to be concentrated on transfer payments.

Mr. Ibbs said he was very concerned about the consequences for industry of the Chief Secretary's proposals. Without a proper assessment of their impact, there was a risk that what was intended as a cure for industry would actually do harm. Mr. Nott argued that the Chancellor was trying to reduce inflation too fast and that the monetary strategy was too ambitious (though he would support the Chancellor in Cabinet). Sir Keith Joseph said he supported the need for further cuts, but he hoped they would be chosen as far as possible so as not to add further to the pressures on industry. Mr. Jenkin said he would like to know what the tax options were before final decisions were taken on expenditure. Sir Anthony Rawlinson said that it was a fantasy to believe that the necessary cuts could be achieved simply by reducing the pay and numbers in the public services: there had to be substantial other cuts which were bound to hit the private sector.

/On the specific

On the specific proposals in the Chief Secretary's paper, the following points were made:

(i) Defence

The Chief Secretary said that Mr. Pym was likely to offer some reduction, but nothing like the £500 million he was proposing. He did not believe that the Government could credibly achieve the further substantial overall cuts without significant economies from MOD. In any case, the argument no longer seemed to be about our commitments, but rather about what we could afford. Moreover, we were already spending more than our allies in relation to GDP, and we did not seem to be getting value for money. The Prime Minister commented that MOD must be made to obtain savings by improved efficiency - particularly in relation to their industrials. Sir Keith Joseph said he hoped defence would as far as possible be spared: Ministers should look at our NATO commitments, our security needs, the implications for the private sector, and at the possibility of cutting other programmes further (he mentioned further education). In addition, the floatation of British Aerospace shares had had to be deferred because of the Chief Secretary's proposals: this would lose the Treasury money and the Government a political prize.

(ii) Social Security

Mr. Jenkin said that the proposed 3 per cent cut in pensions was politically extremely difficult. It would cover all pensions: at the very least, the exclusion of, for example, war pensions, ought to be considered. Also, it would be worth considering alternative approaches so as to achieve the same saving - for example, full indexation up to "x" per cent on the RPI and partial indexation above that. The Chancellor suggested that, presentationally, we should not be talking about a pension "cut". The overall package might be presented as follows: pay up by 6 or 7 per cent, benefits by 8 or 9 per cent and the prices assumption for cash limits by 10 or 11 per cent. The Prime Minister said that, in view of the sensitivity of this proposal, it should not be mentioned in terms in the Chief Secretary's paper for Cabinet.

(iii) Health

Mr. Jenkin said that the real reduction proposed was about £200 million - because colleagues had turned down his proposal for a road accident scheme. The £200 million reduction would go against specific pledges in the Manifesto, and would - in his view - be even more difficult to present than a pension cut. Politically, increasing the tax on alcohol and/or tobacco, or increasing the "health stamp" would be a better option. The Prime Minister said that the Chancellor should discuss the "health stamp" alternative with Mr. Jenkin; he should also consider removing alcohol and tobacco from the social security uprating formula. This would remove one of the disadvantages of raising these indirect taxes, though there would still remain their RPI impact.

(iv) Scotland

Mr. Jenkin pointed out that the Scots were over-provided according to the Needs Assessment Study.

(v) Home Office

The Home Secretary said that he would find it easier to achieve the further £30 million cut (over and above the £10 million he had already agreed) if he had freedom to choose between local authority current expenditure and his cash controlled programmes: the £21 million cut in local authority current expenditure proposed by the Chief Secretary would involve asking the local authorities to reduce the number of policemen employed. The Chief Secretary said he should be able to go along with this.

On the nationalised industries, the Prime Minister said that somehow greater disciplines must be brought to bear on them. She suggested, for example, that the Government guarantee on NCB borrowing should be removed for any borrowing over the EFL. In relation to BGC's proposed EFL, she suggested that the decision to make BCG a co-financer of the gas gathering pipeline should be

/reconsidered

reconsidered: there was no reason why this project should not be financed wholly by the private sector.

The Chancellor said that the Government had to continue its attack on the monopoly practices of the nationalised industries; but Ministers should not deceive themselves that this would achieve all that much in the short run. EFL figures had to be realistic; otherwise, we would have a repetition of this year's experience.

Handling

The Prime Minister said that the Chancellor's paper on the economic prospect and the Chief Secretary's paper on public expenditure should be circulated in time for this week's Cabinet. There should be a second reading discussion on the general public expenditure position, and she would aim to get the re-endorsement of the planning totals in Command 7841. She did not wish there to be discussion at this week's Cabinet of the Chief Secretary's detailed proposals; but it would be helpful if Ministers had the Chief Secretary's paper by way of background. The paper should then provide the basis for further bilaterals between the Treasury and individual Ministers with a view to decisions being taken on individual programmes at Cabinet on 30 October. She asked the Chancellor to conduct these further bilaterals with the support of the Chief Secretary and the Home Secretary.

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21 October 1980