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CABINET

PUBLIC EXPENDITURE AND ECONOMIC STRATEGY

Memorandum by the Chancellor of the Exchequer

1. My earlier memorandum (C(79) 27) drew particular attention to the serious budget problem facing us in 1980-81. It showed that even with cuts of $\pounds 6\frac{1}{2}$ billion in the inherited expenditure plans the public sector borrowing requirement (PSBR) is projected to rise to around $\pounds 9$ billion. There would be no room for any real reductions in taxes; and, to contain the growth of money supply - which is the central feature of any policy to get inflation under control - interest rates would remain high.
2. There are, of course, wide margins of error around such projections. But the projection is constructed as a central one and it is therefore as likely that it will prove to be too low as that it will prove to be too high. It would be most unwise to proceed now upon the hope that the PSBR will in the event turn out to be lower than the present projections suggest. Indeed, there are some disquieting signs (for example the worsened outlook for world trade following the oil price increase) pointing to a higher outcome.
3. I was asked at last week's Cabinet to outline the consequences of failing to achieve the $\pounds 6\frac{1}{2}$ billion cut in the inherited plans. The answer clearly depends on the actual extent to which the cuts fall short of $\pounds 6\frac{1}{2}$ billion. But the budgetary prospect for 1980-81 is already tight. A significant reduction in those cuts would risk forcing us to abandon one or more of our other policy objectives, with all the unpalatable consequences. If we allow the PSBR significantly to exceed $\pounds 9$ billion the growth of money supply could not be held down without considerably higher interest rates. These we must avoid. Indeed, we need to create conditions in which interest rates can come down from their present levels. We certainly shall not do that if we are seen to be weakening in our determination to reduce public expenditure.
4. A reduction of $\pounds 6\frac{1}{2}$ billion in the inherited plans would imply a decline of about $\pounds 1\frac{1}{2}$ billion from this year's expected total. This would represent a volume reduction of about 2 per cent between the two years. Given the poor

prospects for economic growth and the sharp increase in the relative cost of public expenditure that is expected to result from comparability awards, a volume reduction of this order is required to prevent public expenditure rising as a proportion of Gross Domestic Product (GDP).

5. To illustrate some of these consequences more specifically the Treasury have made projections for 1980-81 with assumed expenditure cuts of only about half those envisaged in the Chief Secretary, Treasury's paper C(79) 26. These projections show, as one would expect, some temporary improvement in output and employment, but at the cost of higher inflation and an intolerable budgetary and monetary prospect. The ratio of public expenditure to GDP would be one point higher at 43 per cent. The PSBR would be around £12 billion, and money supply would be accelerating. To avoid this outcome, which would entail holding the PSBR to around the £9 billion shown in my earlier paper, would require substantial tax increases. Since the projections already assume that the specific duties will be increased in the 1980 Budget in line with retail prices, the scope for further raising indirect taxes is severely limited. But if the whole adjustment had to be made on income tax it would imply an increase equivalent to around 5p on the basic rate.

6. None of us could contemplate tax increases of anything approaching this size. We would be faced with having to modify our financial objectives and depart from the announced strategy of progressively reducing the PSBR and the growth of money supply. This would be a very serious move indeed. The financial markets, with good reason, see public expenditure cuts as the key to a progressive reduction in money supply growth. They are expecting a reduction in the volume of expenditure and the PSBR next year and the effect of announcing an increase - both in absolute terms and as a percentage of GDP - would be highly damaging to confidence. It would almost certainly cause interest rates to rise sharply.

7. In these circumstances the relief to output and employment arising from smaller expenditure cuts would be very short-lived, and purchased at the expense of output and employment in later years. We embarked in the Budget on a strategy aimed at restoring a better balance in the economy even if it implied a difficult path in the shorter term. It is imperative not to be driven off that strategy after such a short time by failing to take the public expenditure decisions necessary to make our fiscal policies match the rest of our strategy. This is precisely where the previous Government fell down and we committed ourselves to the task of reversing their failures. If we are seen to falter now the whole credibility of the Government will be called in question; and the result will be that the transitional problems of falling output and employment will be extended, and the prospects for inflation made much worse.

G H

Treasury Chambers
17 July 1979