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Strategy

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PRIME MINISTER

The Economic Outlook and Public Expenditure
Brief for Ministerial Meeting, 9.00 am 7 December

BACKGROUND

There are four papers for this meeting:

(i) The Chancellor's minute of 27th November, copied to those attending the meeting, covering a draft paper on 'the Economic Outlook', originally intended for Cabinet.

(ii) The Chancellor's paper on 'Pay and Price Provisions for the 1980-81 Cash Limits' which he sent to you at the end of last month (undated). He is recirculating this to the Ministers attending the meeting at your request; it is intended for Cabinet on 13th December.

(iii) The CPRS paper on 'the Economic Outlook' which, as you asked, was circulated with Mr. Lankester's letter of 3rd December to the Ministers attending the meeting.

(iv) A redrafted paper on 'the Economic Outlook and Public Expenditure' which is a condensed version of the first paper, extended with some paragraphs on public expenditure, suggesting postponement of the Public Expenditure White Paper and a fresh public expenditure cuts operation in the next month or two. The Chancellor proposes specific targets of £1 billion for 1980-81 and £2 billion reductions in the later years. If approved, this paper is intended for circulation to Cabinet for discussion on 13th December.

2. The CPRS paper ((iii) above) should serve as a brief on the substance of all this. I will not attempt to duplicate it. This note deals only with handling and procedure, and with a couple of points which were not covered by the CPRS.

3. The object of this meeting is to secure the approval of a few key Ministers before the Chancellor launches his proposals on the full Cabinet. The balance of the group was intended to cover both the Chancellor's natural allies and some potential critics. It is already clear that Mr. Prior feels he

has been outflanked (he and Mr. Jenkin are in a minority). He has told the Chancellor, during the NEDC briefing meeting, that he disagrees with the whole approach. This was before he had seen the Chancellor's detailed proposals either on cash limits or on further cuts. His line seems likely to be that forecasting is an inexact science; that the forecast £10 billion plus PSBR in 1980-81 may be an overstatement; that the outturn may be quite a bit better and that we should wait and see; that further public expenditure cuts will be damaging in themselves, and politically dangerous.

4. If the Ministerial Group on Friday agrees with the Chancellor, the next step will be for him to circulate his revised paper ((iv) above), with any further modifications to reflect the discussion, for discussion by Cabinet on 13th December. The Cash Limits paper ((ii) above) would be taken at the same time. Thereafter, you would establish a small 'star chamber' group of Ministers, rather on the lines of MISC 11 which met during the summer, to conduct the cuts operation and make recommendations to Cabinet. Final decisions would be needed some time before the Budget. The Group might need to start work early in January. I shall submit further advice about membership and mode of operation later.

5. There is a particular problem over the position of the Secretary of State for Defence. These papers have not been copied to him. He is away in Brussels, at a NATO meeting, on Monday, Tuesday and Wednesday of next week. The first he will hear of the cash limits proposal will be when he reads his Cabinet papers on Wednesday night. This, as Mr. Le Cheminant warned Mr. Lankester in an earlier note, may cause considerable difficulty for the Ministry of Defence because it implies a substantial squeeze on the volume of defence spending next year. In addition, the Chancellor wants to leave open the possibility of further cuts in the Defence programme. His new paper ((iv) above) deliberately does not mention this. The CPRS paper does. He had intended to speak privately to the Secretary of State for Defence before Cabinet. It is not now clear that there will be time for this. You may want a word with the Chancellor about the best way to handle the problem. Otherwise, there is a risk that the deal which the Chancellor struck with the Secretary of State following the previous Cabinet discussion will come unstuck.

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6. There is a further problem over cash limits, not brought out in the CPRS paper (which was circulated before the cash limits paper was available). It concerns only 1980-81. The Chancellor says that the PSBR for 1980-81 would 'exceed £10 billion'. The latest figure is, I understand, £10.3 billion. But this is on the assumption that cash limits are set to accommodate the expected rate of inflation (17 per cent) rather than the 14 per cent which the Chancellor suggests in his separate cash limits paper. If cash limits were, in fact, set at 14 per cent, and inflation turned out to be 17 per cent, there would thus be an automatic squeeze of £450 million even before any further cuts were explicitly sought. If Ministers were minded to endorse the Chancellor's target of £1 billion reduction in 1980-81 it would be important to establish whether the cash limit volume squeeze was included in this total, or additional to it. (We have asked the Treasury to ensure that the Chancellor is ready to deal with this point). In any case, there is no one-for-one relationship between a cut in the volume of public expenditure and a fall in the PSBR. Other factors, including shortfall, complicate the calculation. The Chancellor's £1 billion is only a very rough indication of the scale of the problem - not a precise target.

HANDLING

7. I imagine you would want the Chancellor to introduce his paper, and you may then wish Sir Kenneth Berrill to say a word. The Chancellor may at some point wish to take a list of possible ways of meeting his target of £1 billion. Thereafter the discussion could be, as the CPRS suggest, structured round the series of questions listed in their paper. The point about cash limits arises on paragraph 13 of their paper, and you may want to bring it out clearly at that stage. The separate problems about Defence are best handled in a private word with the Chancellor.

CONCLUSIONS

8. The outcome of the meeting will, presumably, be agreement that the Chancellor should revise his paper - and possibly also his cash limits paper - in the light of discussion and circulate it to Cabinet at the beginning of next week. You may want to reserve a decision on the subsequent steps until you have heard the Cabinet discussion.

ROBERT ARMSTRONG

(Robert Armstrong)

6th December, 1979

6/12/79

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Strategy

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.