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CABINET

PUBLIC EXPENDITURE: THE ECONOMIC BACKGROUND

Memorandum by the Chancellor of the Exchequer

1. This paper sets out the economic background against which we must consider our future public expenditure plans.

2. It is now clear that the early 1970s saw a major turning point in the development of the world economy, with a dramatic fall in the ability of economies to grow at a satisfactory rate without excessive inflation. The heightened risk of inflation and the problems of energy supply impose severe constraints on growth over the next five years. For most of this period, it is true, this country should be self-sufficient in energy. We cannot, however, escape the deflationary effects of the energy shortage on the world economy. And we will have to contend with the deep-seated domestic problems of low productivity growth, poor trading performance and strong pressures for higher real wages.

3. The economy is currently in a weak condition. Inflation has acquired a considerable momentum and (quite apart from the once-for-all effects of indirect tax increases) is accelerating. Our external competitiveness has worsened seriously in the past three years. The current account is weak, despite North Sea oil. Industrial output and profitability are low. Money supply has been growing at, or above, the top of the old target range of 8-12 per cent, necessitating increased interest rates. The full effects of many of these developments have yet to be felt. If the next five years are to improve on the poor performance of the last five, there is an urgent need to bring about major improvements in inflation, productivity and competitiveness. This has to be done in a world environment that, to say the least, is unlikely to be favourable.

4. Governments themselves cannot regenerate industry. But they can create the conditions in which the market economy can function more effectively. The Budget was the first step in this process. The major objective in this year's public expenditure decisions must be to ensure that this strategy can be continued by leaving sufficient room both for progressively reducing the growth of money supply and for making further real tax cuts. This means that we will need to be very tough in our expenditure decisions.

INFLATION AND GROWTH

5. Our first priority must be to bring down the rate of inflation. Without this, all our other objectives for the economy will remain unfulfilled. To this end it is essential to hold to the guidelines we have set for money supply, and, over time, progressively to reduce them. And we must do this without driving interest rates higher or severely restricting credit to the private sector. This means that we must reduce the public sector's deficit, at the very least as a proportion of Gross Domestic Product (GDP).

6. These policies will entail accepting a loss of output and employment in the short-term. How severe these losses will be, and how long they will last, will depend partly on how quickly our policies change the climate of expectations in which price and pay decisions are made. There is no past evidence here on which we can draw. Obviously, the more resolute we show ourselves in pursuing our policies, the more quickly will the public build these policies into their expectations. But it would be unrealistic to expect very quick responses. Though there is good reason for hoping that GDP and employment will be rising towards the end of the Survey period, we cannot look for much growth over the period as a whole.

7. The Treasury's latest projections, which are broadly in line with the underlying assessments made by many outside forecasters, indicate a fall in output and a steep rise in unemployment in the early part of the period, with a recovery in the later part as inflation moderates. These projections assume a growth in world trade at about half the pace recorded in the decade to 1973. This itself could be optimistic, particularly for the years immediately ahead. The projections also assume that public expenditure is cut on the scale envisaged in the Chief Secretary's earlier paper (C(79) 11), with an adjustment to social security spending to allow for higher levels of unemployment than the working assumptions used for the Survey and shown in Annex D of C(79) 25; and that tax allowances, bands and specific duties are fully indexed. The growth of money supply is assumed to be progressively reduced, to 7 per cent in 1983. On these assumptions the projections show the economy eventually moving on to what should be a sound and sustainable growth path. The speed at which this takes place will depen on how quickly our policies lead to a change climate of expectations. But the intervening period is bound to be a very difficult one, in which we will have little room for manoeuvre.

8. The poor prospects for growth over the next three years or so reflect the combination of a number of adverse developments:

a. World trade is depressed, and is likely to remain so for some considerable time. The latest oil price increases seem certain further to curtail world growth.

b. Productivity in United Kingdom industry is extremely low. On the latest evidence it looks as though the estimates of productivity growth included in the last Government's public expenditure White Paper, though substantially lower than earlier estimates, were not low enough. Our tax reductions, and other measures to restore incentives, should in time help to improve productivity. But in the next few years these beneficial effects are likely to be more than offset by the impact of falling output and investment. Excluding North Sea oil, we cannot count on output per head rising at more than half the $2\frac{3}{4}$ per cent averaged in the years 1964-74.

c. The trading performance of our manufacturing sector is poor, and its cost competitiveness has been seriously weakened by increases in pay far in excess of productivity. In the short run this loss of competitiveness has been increased by the appreciation of the exchange rate.

d. The need to reduce inflation will entail tight fiscal and monetary policies that will reduce the pressure of demand.

In time, the adverse factors should be overcome; but it seems clear that the next three years are going to be a very difficult time.

PROSPECTS FOR THE PUBLIC SECTOR BORROWING REQUIREMENT AND TAXES

9. These poor prospects for growth together with the likelihood of differentially high pay increases in the public services in the next two years as a result of comparability awards mean that substantial reductions in the volume of public expenditure will be necessary if the Public Sector Borrowing Requirement (PSBR) is to be contained. Increased pay is a particularly important element in 1980-81: it is assumed in the projections, on the basis of existing commitments and a judgment on the likely outcome of the Clegg reviews, that earnings in the public services will be $18\frac{1}{2}$ per cent higher in that year than in 1979-80 (implying an increase of £$4\frac{1}{2}$ billion in the public service pay bill). Earnings in the private sector are assumed to be about 14 per cent higher and retail prices about $13\frac{1}{2}$ per cent higher. These assumptions for earnings are of course highly uncertain, but given the commitment to honour comparability awards it would be imprudent to count upon a significantly more favourable outcome for the public services. Increases in pay and prices thus add enormously to the projected total of expenditure at current prices in that year.

10. The table below summarises the Treasury's projections of the PSBR (on the fiscal assumptions noted above of full indexation of taxes and public expenditure cuts on the scale envisaged in C(79) 11.

Public Sector Accounts
(£ billion at current prices)

	1979-80	1980-81
General Government receipts	76.2	87.7
General Government expenditure	85.1	97.0
Public Sector Borrowing Requirement	8.3	9.2
PSBR as % of GDP at market prices	4.4%	4.2%

11. For later years, the margins of uncertainty are of course enormous, but the projections suggest that the PSBR would remain around its 1980-81 proportion of GDP in the following year (implying a rise to about £10 billion in current prices) and would decline quite sharply in the final year of the Survey.

12. The implication of these projections is that the levels of public expenditure implied in C(79) 11, which would involve cuts from the inherited plans of about £6½ billion in 1980-81 (at 1979 Survey prices), would leave no room for real tax cuts in the 1980 and 1981 Budgets.

13. Progress towards our objective of reducing the basic income tax rate to 25p would require further cuts in public expenditure (or a further switch to indirect taxes, which would put up prices). The size of the additional cut would depend partly on its composition, but if the cut were wholly on goods and services, as a rough rule of thumb every 1p off the standard rate in 1980-81 would entail a cut of £0.7 billion in expenditure at 1979 Survey prices.

CONCLUSION

14. We face a very difficult economic prospect over the next few years. There is little hope of any significant growth of the economy until inflation has been substantially brought down. To this end, it is vital to hold to our policies of containing the PSBR and reducing the growth of money supply and to establish a firm conviction that we intend to do so.

G H

Treasury Chambers

6 July 1979