

25 July 1980

Policy Unit


Original returned to
J Hoskyns
P.M. [signature]

PRIME MINISTER

IS PUBLIC EXPENDITURE SELF-INDEXING?

I attach a copy of a letter to Geoffrey, together with a paper we have prepared on this subject. This is only for information, as I understand that you have yourself suspected that there is a dangerously large amount of self-indexation in public expenditure.

It is not necessary to read the paper, which is inevitably long and rather detailed.



JOHN HOSKYNS



10 DOWNING STREET

25 July 1980

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON SW1

Dear Geoffrey,

IS PUBLIC EXPENDITURE SELF-INDEXING?
- And does it matter if it is?

You will remember that we referred, in the table of contents for the "Long Campaign" paper (now in the process of serialisation, as agreed!) to the "auto-indexing muddle". We have done some more thinking about this and have the suspicion - I wouldn't put it stronger than that - that public expenditure is effectively self-indexing to such an extent as to threaten quite seriously the achievement of the financial strategy.

Accordingly, we have tried to set down our thinking in the attached paper. I would stress that we don't pretend to know the answer to the questions posed by the paper; we are really not qualified to do that. The paper therefore simply raises the underlying questions and tries to explain why we are worried about them. If we are sounding a false alarm, then there is no harm done. If there is anything in what we say, then, with so much at stake, the problem needs further thought by those properly qualified to tackle it.

Indexation, whether as a policy or as a phenomenon, is a very elusive subject as we found working in Sir Douglas Wass' small group last winter. I think most of us got fairly confused at various stages during that exercise. It is this elusiveness which makes it such treacherous ground; hence our concern and hence the paper.

I am copying this letter, and the paper, to the Prime Minister, Keith Joseph, and also to Robin Ibbs.

*Yours ever
John*

JOHN HOSKYNs

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● IS PUBLIC EXPENDITURE SELF-INDEXING?

- And does it matter if it is?

1. INTRODUCTION

1.1 In earlier papers on public sector pay, we have emphasised the danger that the process of Transition from high to low inflation could end with further resources transferred from the private sector to the public, rather than vice versa.

1.2 We have a nagging suspicion that public expenditure may be to a large extent self-indexing so that, even if inflation is brought down, this switch of resources is extremely likely. A natural response to this suggestion may be to say that, given the will to set the right cash limits and stick to them, there cannot be a problem. But self-indexing could still take place despite the system of cash limits because:

- (1) Only about two-thirds of all expenditure is cash-limited.
- (2) Cash limits could in the event be set to accommodate full indexation in order to avoid the embarrassment of (3) below.
- (3) Powerful economic and institutional forces could ensure that cash limits are exceeded (eg B.Telecoms).

2. ARE WE THINKING STRAIGHT ON PUBLIC EXPENDITURE DURING TRANSITION FROM HIGH TO LOW INFLATION?2.1 It is Transition which makes self-indexation a potential problem

2.1.1 As we have stressed in earlier papers, Transition is different from Stable State. It poses distinctive problems, calling for different solutions, because it requires deceleration in the nominal increase of public expenditure as well as real cuts. With the present balance of the economy, we would still need to cut public expenditure and reduce the PSBR as a percentage of GDP, even if we had zero inflation. (Of course, there are, in the real world,

all sorts of aggravating causal links between high public expenditure, high PSBR and the rate of inflation. But they should not be allowed to obscure the crucial systemic difference between Transition and Stable State.)

2.1.2 If public expenditure lags in accommodating to the MTFs, while the private sector leads, then the private sector will be damaged in several ways:

- Higher PSBR with both interest rates and exchange rate higher; or PSBR on target, but higher taxes.
- Higher nationalised industry prices.
- Cuts in public sector capital spending.
- Public sector pay knock-on encouraging private sector to damage itself further with high settlements.

2.1.3 This passing of the bill from the public to the private sector deepens the private sector recession, so that a larger bill for unemployment is passed back to increase public expenditure and reduce revenues still further.

2.1.4 We have heard it argued that no problem arises, provided the PSBR target is met; and that buoyant tax revenues will ensure that this is the case. We may have misunderstood this argument, but it seems to us that, if our fears are correct, the public sector will lag behind the private in adjusting to the MTFs. One of two things can then happen: either the private sector is damaged, via the PSBR, by recession (as described in Section 2.1.2 above) because the monetary contraction prevents the hoped-for buoyancy; or the buoyancy is provided by monetary accommodation - so that in effect both sides of the PSBR equation are multiplied by some higher GDP deflator. In other words, the struggle against inflation is relaxed

2.2 Are we clear who should bear the burden of monetary deceleration?

2.2.1 The Government urges people to settle for pay increases which are well below the current inflation rate because, if they do not, transitional unemployment will be unnecessarily high. The

Government has accepted in principle that it must practise what it preaches as regards the Civil Service. But it is worth remembering that, only a few weeks ago, the Chancellor had to push hard to get this principle accepted. Although we have now established the right principle for the Civil Service, can we make it stick throughout the public services, with their 11-month pay round?

- 2.2.2 There is still an implicit suggestion in some of the public expenditure papers that inflation is something beyond Government's control, something which (even though it is caused by Governments) simply "happens" to the Government (just as it happens to, say, a medium-sized engineering company) making the fulfilment of its programmes unnecessarily difficult. It is a short step from that assumption to the further assumption that Government should therefore be free to adjust its own nominal spending to take account of inflation. Government is the only party to the whole economic process which can lead the way, by cutting its own spending and thus reducing the money supply without forcing the private sector into the vicious circle of high interest rates serviced by indexed revenues*. And yet it treats itself as the one party which can effectively escape from the effects of the inflation it has helped to cause. In doing so, it either perpetuates the inflation or increases the damage of Transition.
- 2.2.3 All this is obvious enough, and the simple answer is that we must cut public spending. But we need to dig a little deeper. About £34bn of the total public expenditure of £98bn (1980/81 cash) is formally indexed (transfer payments and defence) and there are other less firm commitments to index other large parts of public expenditure. What will be the result of this in the eventual pattern of public expenditure, as planned in the White Paper, at present expressed in constant prices? Will that pattern itself affect the chances of achieving the PSBR target? By how much more must we reduce the pay outturn for the public services in order to compensate?
- 2.3 Even if we are clear that "public expenditure must bear its share", what does that really mean?
- 2.3.1 What are the effects of selective indexation? The Public Expenditure White Paper shows all categories of expenditure in constant

* and secured on indexed debtors, to meet indexed pay awards!

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prices. Does the real eventual distribution reflect any advantage in being indexed rather than un-indexed? How do the White Paper plans, expressed in constant prices, reflect the difference in outcome between public services pay settling at, say, 9%, and transfer payments being indexed on a forward-looking basis at, say, 16% for this year and with similar differentials for following years? (This raises further questions addressed in Section 3.1 and 3.3 below.)

- 2.3.2 What is to be learnt from past experience? Social security was effectively indexed on an ad hoc basis from the early Seventies until about 1975, and thereafter formally indexed. During that period, total social security expenditure rose significantly as a percentage of public expenditure. Is there a connection between the indexation and the increase? Did indexed transfer payments lead the way during the acceleration of inflation, just as we fear that it may trail behind during deceleration? Do we expect this to happen again over the period of the MTFs? Are the figures in constant prices adjusted to show that? (See also 3.1.1 below.)
- 2.3.3 If we believe that the MTFs will reduce inflation to negligible proportions, should there really be any fully-indexed exceptions to the rule? Should not everything within Government's control be de-indexed (or, to be precise, consistently and partially indexed) in line with our exhortations to the private sector and in line with the monetary deceleration to which the whole of the economy must in the end accommodate? After all, when we have no inflation, everyone enjoys a stable pound; there are no exceptions then. If we mean to end inflation, should we be so worried about protection of particular groups, as if inflation is going to continue for ever? Why, at this point of all points, are we about to commit ourselves to full indexation of child benefit, rather than a deliberate ad hoc increase if that is called for, followed by a partial indexation in line with MTFs and the monetary targets? Our thinking does seem confused. Either we wish to increase transfer payments by deliberately indexing them fully during Transition; or we are tacitly assuming that the rest of public expenditure, in aggregate, will in the event index itself fully in the same way - in which case, the whole question of the resulting damage to the private sector rears its ugly head.

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3.4 Is indexation (both as policy and as phenomenon) confusing our thinking about public expenditure cuts? Are we cutting in order to get the real cuts called for in the White Paper? Or to get the monetary deceleration called for by the MTFs? Are we cutting to get the desired switch of resources from the public to the private sector, or to avoid the perverse switch in the other direction caused by the sheer momentum of self-indexing behaviour within the system? The underlying problem is obvious the moment you bring together the White Paper and the PESC Report. For example, in 1981/2, our total expenditure is expected to be £73bn, instead of £74½bn in the current year (1979 survey prices) - a fall of 2%. But the GDP deflator and RPI are expected to rise by 12.1%, and 10% respectively, during the same period (Annexes H and M of 1980 PESC). Is it possible to do PESC in cash terms, even if this forces early disclosure of cash limits?

2.4 Where do we go next?

2.4.1 The questions asked so far either have simple answers which show that there is no real problem, or else they lift the veil off a deeper problem and expose further underlying questions. On the assumption that it is the latter, the next section looks at some of those underlying questions.

3. UNDERLYING QUESTIONS WE NEED TO ASK

3.1 How different are the processes of inflationary acceleration and deceleration?

3.1.1 Can self-indexing public expenditure be a problem when inflation is accelerating? Will it tend to make the acceleration faster? Perhaps it makes no difference because, by definition, inflation means that all prices, all pay, all expenditures, are rising in money terms and public expenditure is no different from anything else. In that situation, the social reason for ad hoc indexing is understandable, even though it may end up by helping to perpetuate the very process which made it necessary. Perhaps the problem only emerges when one faces deceleration, the Transition downwards, as we are now doing. If we look at social security spending as a percentage of total public expenditure, over the period of the Healey deceleration, we see that it rose from 21.1% in 1975/6 to

25.3% in 1978/9. Was this the result of indexation, or rising unemployment, or deliberate changes in programme volumes? In the Public Expenditure White Paper, the proportion is expected to rise from 26% in 1980/81 to 27.5% in 1983/84. Again, is this the result of the indexation process, or a planned increase in volume? Or both?

- 3.1.2 What is the effect of inflation coming down quicker or slower than anticipated in PESC? What is the relationship between the GDP Deflator/RPI paths in PESC and the monetary targets in MTFs? If faster, does that increase the squeeze on the private sector, or does the nominal increase in public expenditure simply grow more slowly, so that the effect as between the two sectors is neutral? If slower, does that ease the squeeze on the private sector (although obviously at great inflation cost in other ways) or does the public sector simply absorb the extra money in the system by indexing its own expenditures?
- 3.1.3 We should, however, be clear that even if inflation comes down in line with the MTFs, public expenditure could still trail the deceleration process, with greater consequent damage (through the processes described at Section 2.1.2).
- 3.1.4 Is it possible to calculate the impact of inflation falling by, say, 3 percentage points less each year than was assumed? Is it possible to work out the effect of zero average growth over the next three years? Just so that we know what we might be up against.

3.2 Dealing with the different bits and pieces

- 3.2.1 Once we are clear about the processes at work, then we can decide how to deal with the different parts of public expenditure.
- 3.2.2 Fully-indexed expenditure. This includes most transfer payments, defence spending, possibly health spending, police pay, and armed forces pay. How far are these indexed on a forward-looking basis? Does the relationship between the monetary targets, cash limits and inflation rate, make this a satisfactory basis? Is it indeed a self-fulfilling prophesy? What happens with such indexed expenditures if the inflation rate falls more, or less, slowly than

expected? Would a partial and backward-looking basis be better? Or even partial and backward-looking or forward-looking, whichever is the smaller? (This should not present any political problems, once people realise that the indexation process is part of the Transition to a stable currency, not a device for living with perpetual inflation, which is the way many people at present see it.)

3.2.3 Pay which is negotiated and "de-compared". In the light of this discussion, what sort of outturn are we aiming for? Do we really know what we're up against in trying to achieve such an outturn on a case-by-case "do the best you can" basis with dozens of different groups negotiating in a virtually unending succession over the 12-month period? What percentage is compatible with the MTFS after we have satisfied those parts of public expenditure which are formally or effectively indexed, or better-than-indexed? (This question was examined more fully in our paper of 18 July on "Public Sector Pay".)

3.2.4 The remainder. How far can we go in de-indexing other current expenditures? What is the effect of a defence budget which is fully-indexed and then increased in real terms by 3%? How far should we resist the easy solution of further cuts in the public sector's capital spending? Has any work been done to estimate the long-term costs - political and economic - from such cuts? How do we prevent monopoly, trade union-controlled nationalised industries - Coal, Gas, Rail, Post Office, Electricity - from acting like a home-grown (but at least recycled) mini-OPEC exacting special levies by way of prices, increased subsidies, broken EFLs and reduced investment leading to lower future value for money?

4. CONCLUSION

4.1 This paper suggests that the very way in which we are conditioned to think about public expenditure may contain some dangerous optical illusions. In particular, we may not yet appreciate just how large the cuts in public service pay will have to be. Our fear is that it will not be possible to get a pay outturn which is sufficiently low, and, because it is difficult to shed manpower

in the way that the private sector would have to do in such circumstances, the cash limits will be simply broken or expanded. The probability is therefore that the public sector will help itself to a greater proportion of the available cash in the system, passing the consequences, as already described, to the private sector.

4.2 All the thinking at present, from the original reluctance in some quarters to publish an MTFIS at all, through to the present reluctance to publish early cash limits, suggests an implicit assumption that what must be endured by the private sector simply can't be endured by the public. Achieving the MTFIS demands an approach to the public expenditure arithmetic which displays absolute commitment to results.

4.3 If we are roughly right in the foregoing analysis, perhaps we should consider turning the present process upside down: doing all the forecasting in cash terms, based on forecast inflation; forecasting cash limits, in exactly the same way as the MTFIS; adjusting cash limits downwards only, if inflation turns out to be lower; but not upwards if inflation turns out to be higher.