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✓ Mr Walker
✓ Mr Hargrave

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

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PRIME MINISTER

MS.

PUBLIC EXPENDITURE PROSPECTS

Particularly in the light of our forthcoming discussions of the defence programme, and in due course of public expenditure more generally, I feel you would wish to be kept aware of my continuing concern about the prospects for public expenditure.

2. In Cabinet on 18 June we shall be talking about the general prospects for our economic strategy, and for public expenditure as one element in that. It is too soon to determine a precise target for public expenditure, that is better left until July. But there can be no doubt that our economic and financial objectives call for a reduction in the public expenditure plans represented by our last White Paper (turned into cash).

... 3. The attached note, recently done in the Treasury, surveys the whole public expenditure field. As it indicates, one of the major problems is the pledges surrounding certain major programmes. The political difficulties here are only too evident. But we are also pledged to our economic strategy as a whole, not least as regards the burden of taxation.

4. This is the sombre context of the defence decisions and of the rest of public expenditure discussion later in the year.

/I am circulating



5. I am circulating to OD a paper about the defence problem. I fully recognise the difficulties here. John Nott's radical approach is greatly to be welcomed. Even so the proposed bill is frightening. We must contain it.

6. The formula I suggest in my paper will commit more money to defence than on economic and financial grounds one would wish. Some of our other spending colleagues may have difficulty in accepting the implication for their programmes of allowing so much for defence.

7. It is crucial to be sure that we go no further.

Ans
for (G.H.)
4 June 1981

(Approved by the Chancellor & signed in his absence.)

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PUBLIC EXPENDITURE PROSPECTS

1. As background for further discussion of Defence expenditure in advance of the main Survey, this note summarises the prospect for public expenditure in 1982-83 and 1983-84, as it appears in early June before the assembly of the detailed and updated Survey material, including Departments' considered bids and options for reductions.
2. The table annexed shows the programme figures in the March White Paper (Cmnd 8175) roughly converted into cash, using the inflation assumptions recently approved by Ministers. (More refined calculations will be provided for the main Survey, which will thus use numbers different in detail.) These figures do not allow for the effects in the later years of the decisions on the NCB and fuel prices taken in March.
3. The White Paper said that the level of future spending shown in it was higher than the Government "would wish in the light of their financial and economic objectives". Nothing has happened to modify that. On economic and financial grounds the aim should be lower totals than those implied by the last White Paper. But present policies and prospects point the other way.

The prospect for the main programmes

4. The four programmes largely protected from cuts in public expenditure reviews so far were shown in the White Paper as growing in total by 5 per cent in volume over the next 2 years. They would then account for half the total.
5. These programmes are:
 - (a) Defence (13 per cent of the total). The White Paper allowed for 3 per cent annual volume increases. So far from a reduction, Mr Nott is currently proposing a larger increase. The future application of cash planning, especially as to armed forces' pay and other differential price movements, remains to be settled.

- (b) Law and Order (4½ per cent of total) : the smallest of the four. Pressure is expected for further increase to meet commitments.
- (c) Health (and personal social services) (15 per cent of total). Health is growing in accordance with the pledge not to cut inherited (volume) plans. Also included are personal social services, which are not pledged; but it will be difficult to reduce local authority spending on them to the White Paper level : it is currently nearly 10 per cent higher.
- (d) Social Security (pledged elements) (17 per cent of planning total) : this is pensions and related parts of social security expenditure (rather more than 60 per cent) covered by Ministerial statements about maintaining real value.

6. Other social security expenditures are not covered by pledges, notably supplementary benefit, child benefit and unemployment benefit (11 per cent of planning total). The White Paper had the total of these falling by 1983-84, but only because of the expected saving to the public expenditure total (but not the PSBR) from the ESSP scheme. The unemployment assumptions in the White Paper (2.5 million in 1981-82, 2.7 million in each later year, compared with actual 2.5 million in May 1981) may need to be revised upwards, leading to increases here (£0.15 bn for every 100,000 extra unemployed) and in some other programmes.

7. Four programmes intended to yield, over the life of this Government, most of the savings from inherited plans were shown in the White Paper as reducing by 23 per cent in volume over the next 2 years (from 25 per cent to 19 per cent of the total) :

- (a) Industry, Energy, Employment (4 per cent of total). In the event these programmes rose in the last 2 years, notably because of employment schemes, redundancy payments, and aid to BL. There are signs of some (but not all) of these programmes exceeding estimates again, and of pressures to extend them. The programme does not include

provision for British Leyland in 1983-84, which will be a bid for the Contingency Reserve.

- (b) Housing (4 per cent of total). The reductions shown in the White Paper require a continuation of cuts in public sector capital expenditure and increases in rents over the 4 years. For England, for example, capital will need to be cut to half the 1979-80 level and council house rents to rise from 6½ per cent to 11 per cent as a percentage of average earnings. So little scope for further cuts.
- (c) Education and Science. Most of this programme is subsumed in local authority current expenditure - discussed below.
- (d) Nationalised Industries also discussed below.

8. Finance for the nationalised industries was shown in the White Paper as reducing to a modest net total in 1982-83 and a very small net amount in 1983-84. In the review just beginning the industries' opening bids for 1982-83 totalled some £2 bn in cash more than in the White Paper, without allowing for any increases for BSC, or for the spring decisions on the NCB's finances. Nor do they allow for any energy package. It should be possible to reduce these opening bids, but not to the point where the increase remaining can all be met by an allocation from the Contingency Reserve. Of these bids only £400m is for additional capital investment.

9. The remaining public expenditure programmes account for only some 15 per cent of the total. They have already been cut by nearly 10 per cent and are due to be reduced by a further 4 per cent over the next 2 years. They include some capital programmes, such as roads, and some local authority current expenditure.

10. Local authority current expenditure presents an obvious difficulty. It represents 20 per cent of the total. Measures at present available (including reductions in the Rate Support Grants) can exert a downward pressure, but cannot deliver any specific level of cuts in expenditure. After the intervention

now agreed, expenditure may perhaps turn out about 5 per cent above the cash equivalent of the White Paper figure for 1981-82. It is unlikely that in practice cuts will be achieved across the whole field of local authority current expenditure more ambitious than those in the White Paper for 1982-83 and the later years. Even these will be difficult.

11. The Contingency Reserve provision included in the White Paper was tight. Some of the increases in respect of industry and employment programmes and nationalised industries might fairly be offset against it, but it is not enough to cover all the increases which may be pressed in these programmes.

Assessment

12. Full assessment must wait for the bids and options for cuts being assembled for the survey.

13. The present prospect is disturbing. There are potential bids for increases in at least two of the major programmes. The reductions in housing and some minor programmes should be secured, but the scope for further reductions looks small. The revised economic assessment may lead to a further increase in the figures for unemployment related payments. It will be difficult to secure all the reductions planned in two of the main programmes intended to provide substantial savings, nationalised industries and industry, employment etc, and in local authority current expenditure, including education.

14. The other programmes and the periphery of some of the programmes already mentioned provide a narrow base for further cuts. The options exercise will identify the potential more precisely : but in virtually every case of any significance cuts will involve actions specifically rejected last autumn.

15. There are already signs of a repetition of last year, with general and painful reductions required simply to hold the total against increases for nationalised industries, for industry generally and for unemployment related programmes, let alone reduce the total.

16. The relative size of the hitherto protected programmes is such that it could well prove impossible to reduce the totals unless substantial reductions can be made in one or more of these. It will certainly be difficult to hold the totals if any significant increase is made in any of these programmes.

2 June 1981

MARCH WHITE PAPER FIGURES REVALUED (2)

£ billion cash

	1979-80 (outturn)	1981-82 ⁽¹⁾	1982-83	1983-84	% change over 4 years
1. Total	77.1	104.2	109.6	113.4	+ 47
2. Protected programmes					
Defence	9.2	12.3	13.5	14.8	+ 61
Law & Order	3.1	4.3	4.7	5.1	+ 65
Health & Personal Social Services	11.1	15.5	16.9	18.1	+ 63
Social Security (pledged elements)	12.6	17.1	18.7	20.0	+ 57
	<u>36.0</u>	<u>49.2</u>	<u>53.8</u>	<u>58.0</u>	
3. Other Social Security	7.1	11.3	12.4	12.7	+ 80
4. Programmes which have been cut					
Industry, Energy, Employment, Trade	3.3	5.8	4.9	4.3	+ 30
Housing	6.0	5.5	5.2	4.5	- 25
Education & Science	11.2	14.1	14.8	15.4	+ 38
	<u>20.5</u>	<u>25.4</u>	<u>24.9</u>	<u>24.2</u>	
5. Other Programmes	13.0	16.0	16.6	17.5	
6. Nationalised industries borrowing	1.5	1.2	- 0.1	- 0.1	
7. Special sale of assets	- 1.0	- 0.2	- 0.2	- 0.2	
8. Contingency Reserve Fully Allocated		2.5	2.8	3.0	
9. Shortfall	-	- 0.9	- 0.7	- 0.8	

(1) includes budget measures

(2) The above figures follow the structure of the public expenditure White Paper. This is the structure used for control. It differs slightly from the definition used in the national accounts and hence in the MTFS. The adjustments to move from the above figures to the national accounts basis are

add debt interest	10.4	13.7	14.6	15.2
other adjustments	1.9	2.0	2.1	2.5