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PRIME MINISTER

Economic Strategy
(C(81) 29 and 30)

BACKGROUND

In addition to the Chancellor of the Exchequer's main paper, C(81) 29, on the Economic Strategy the Cabinet have, as background for their discussion, two other papers by the Chancellor circulated under my covering note C(81) 30 - the paper on the Economic Impact of North Sea Oil and Gas Revenues which was briefly discussed by your Ministerial Group on Energy Prices (MISC 56), and a paper on pay in the coming year which has been circulated as E(81) 66 for discussion in due course by the Ministerial Committee on Economic Strategy.

2. In his main paper (C(81) 29) the Chancellor of the Exchequer takes stock of the last two years and of current economic problems. The Chancellor stresses the need to give continuing priority to the control of inflation, avoiding short term expedients; points to the need for public expenditure reductions, both to contribute to the reduction of inflation and to avoid entering the Election with a tax burden heavier than that inherited which the Chancellor sees as politically and economically intolerable (his paragraph 38); and calls for action to help on the supply side, notably by reducing the rate of pay increases and by improving productivity and competitiveness. The key paragraphs are 41, which warns against entering blind alleys (relaxing monetary controls, increasing public expenditure, introducing import controls and so on) and 43 in which he sets out some questions which might lead to action for changing the patterns of economic behaviour, particularly on the pay front, for improving the supply side of the economy, and for striking the right balance of fiscal policy.

3. The main gap in the Chancellor's paper is any indication of the forecasts of the main components of the economy on present policies: of money supply growth, the PSBR, output, employment and inflation, and the balance of payments. He may be prepared to give orally indications on these matters

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which he would prefer not to put in writing. It is not easy for the Cabinet to reach fully considered conclusions without some such indications.

4. The Chancellor of the Exchequer's main objective will be to get the Cabinet's broad endorsement of the need to maintain the Government's present general approach to the economy (his paragraph 45(i)). He also wants to prepare the way for the public expenditure discussions in July, and later in the year, by getting recognition of the need for reductions in public expenditure to enable cuts in tax. Thus, the most important of his questions is 43(i) - 'How much importance do we attach to securing significant cuts in the present tax burden? And how important are other commitments if we are to make room for tax cuts?' He will be looking for answers which will strengthen his hand when it comes to the discussion on public expenditure; and his colleagues may be chary of giving them.

5. Three Ministers have given indication of points they are likely to raise:-

- (i) The Secretary of State for Employment has given notice that he will wish to draw attention to the likely outlook on unemployment and pay and to ask Cabinet to consider three questions:-
 - (a) Whether, in 1983, unemployment at over 3 million - and possibly rising - is politically acceptable.
 - (b) Whether it is realistic on present prospects to expect non-inflationary pay settlements in 1983-84.
 - (c) Whether, without provoking a rise in the inflation rate, the Government can and should now take steps to bring forward and strengthen the upturn?
- (ii) The Secretary of State for the Environment wrote to the Chancellor of the Exchequer on 6th May, with copies to all Members of Cabinet, to call for additional capital investment in the public sector financed by savings on

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current account, and in particular by nil or very low cash limits for public sector pay. He agreed not to press this at the time of the Cabinet's discussion of the Guidelines for the Public Expenditure Survey on the understanding that he would do so in the economic strategy discussion. The Chancellor of the Exchequer has prepared for this in Annex B of C(81) 29 which discusses the mix of capital and current expenditure.

- (iii) The Minister of Agriculture has sent all Members of Cabinet, under cover of a letter of 11th June, a booklet published by the French Government on their aids to industry. His concern seems to be that the French, by vigorous marketing of an attractive package of incentives, are encouraging investment in France, both by French firms and by others (including, potentially, British firms) which will lead to increased competitiveness at the United Kingdom's expense, particularly in the food industry (turkeys are the main current example).

6. The discussion seems likely to cover the following questions:

- (i) How does the Chancellor of the Exchequer see the economy developing in the run-up to the Election? - specifically, what are his latest views on the money supply, interest rates, the exchange rate, output, employment and inflation? What are the prospects for the size and timing of the upturn?
- (ii) What if anything can and should be done to ease the way through the difficult period up to the date of the next Election? Is the balance of priorities in the present policy right?

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(iii) Is there any more to be done to help to bring about the Chancellor's objective of a steadily reducing level of pay settlements over the years ahead, defined (in paragraph 12 of his note on pay annexed to C(81) 30) as keeping the level of pay increases "well below the rate of inflation for two years or so"

7. It will not be the aim of Wednesday's discussion to take specific operational decisions but rather to prepare the way for those decisions in separate discussions later in the year. As the following paragraphs show there is already a 'home' for further discussion of nearly all the questions which the Chancellor of the Exchequer has raised and also those which are likely to be raised by other Ministers.

8. Cabinet's first substantive discussion of the 1981 public expenditure exercise has been fixed for 23rd July, and there is a programme for further discussions from September through to November. This will be the occasion for specific decisions on the balance between the Government's taxation and expenditure objectives, and on the balance within the public expenditure programme between capital and current expenditure. Thus it will cover the questions posed by the Chancellor in (h) and (i) of his paragraph 43; and the scope for further help to private sector firms, particularly small ones (his paragraph 43(d)), and for dealing with proposals for further capital investment, turns largely on how much room can be made by public expenditure cuts.

9. The Economic Strategy Committee is due to consider:-

(i) In the near future, the Chancellor of the Exchequer's memorandum on pay in the coming year (E(81) 66): this covers (b) and (c) in his paragraph 43.

(ii) Early in July, a paper by the Secretary of State for Employment on improvements to training schemes and the problems of youth unemployment - this is partly in response to the CPRS' work earlier in the year on these questions and partly following your meeting with him and other Ministers on 13th May (recorded in Mr. Lankester's letter of that date) - the Chancellor's paragraph 43(f).

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- (iii) Later in July, a paper by the Secretary of State for Employment on the outcome of the consultations on his Green Paper on Trade Union Immunities which, as Cabinet has already noted, is likely to lead to legislation next Session - part of the Chancellor's paragraph 43(g).

10. The Chancellor of the Exchequer's Steering Group on Government Strategy, MISC 14, already has work in hand on removing obstacles to mobility and efficiency, and has commissioned a further paper from the Secretary of State for the Environment (the Chancellor's paragraph 43(e)). The Chancellor of the Exchequer may say that he wants to use this forum for carrying forward his ideas on improving the supply side of the economy. This may well be useful, but it is a very small group - the only Ministerial members are the Secretaries of State for Industry and for the Environment, although other Ministers are sometimes invited. If the Cabinet is disposed to use MISC 14 for following up these matters, you may want to think of adding one or two Ministers to it. Alternatively, it might be better for operational decisions to be passed directly to the appropriate Ministerial Committees - either E or to E(DL), for privatisation proposals, or to E(EA) for more general questions.

11. The Chancellor of the Exchequer, together with the Chancellor of the Duchy of Lancaster, may wish to give some further thought on how to carry forward his paragraph 43(a) - 'how can we secure much wider understanding of the scale of our problems and of their real causes?' It may well be that a good deal could be done by using the information and charts available in C(81) 29.

HANDLING

① 12. You may wish to open the discussion by saying that the aim is not to take specific operational decisions but to take stock and to prepare the way for discussions and decisions later in the year. If asked, you could confirm that you have it in mind that there should be another general discussion of the economy in October, and a further one in January, preparing the way for the 1982 Budget; but you may prefer not to commit yourself on this, if you can avoid doing so.

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13. After the Chancellor of the Exchequer has introduced his paper, you have agreed that the Secretary of State for Employment should speak next. You might then give the Secretary of State for the Environment an early opportunity to put his points. If the Secretary of State for Industry were to come in at this point he could usefully give his reactions to their proposals and provide the Chancellor with some support. No doubt all your colleagues will want to speak. The main aim in the $1\frac{3}{4}$ hours available will be to ensure that the Cabinet are satisfied that they have had a wide-ranging discussion and that each has had the opportunity to say his piece.

CONCLUSIONS

① 14. You will want to record endorsement of the need to maintain the Government's general approach to the economy (paragraph 45(i) of C(81) 29), and to note the points made in discussion as background to later specific decisions. You may be able to record decisions to follow up specific points in the appropriate ways (see paragraphs 8 to 11 above).

② 15. You may also want to agree with the Cabinet the line to be taken with the Press - and to invite them to resist the temptation to embroider it.

RA

(Robert Armstrong)

Inflation - has to come down.
- resources for much ado
where majority of people
work
Small prop: to go to TAX.
Social Security Prop. Pay / Benefit.
Fed. del. pay settlement

16th June 1981