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Prime Minister

If you have time to read the attached draft, the Chancellor would like to have a

Treasury Chambers, Parliament Street, SW1P 3AG word about-
01-233 3000 it. He will

need to circulate before the weekend.

PRIME MINISTER

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TAX AND PUBLIC EXPENDITURE - CABINET ON 23 JULY

In my minute of 25 June I sketched out what might be included in my paper for Cabinet on 23 July, and your Private Secretary's letter of 6 July broadly endorsed this. You may now like to have sight of the papers which the Chief Secretary and I propose to circulate by the end of the week.

2. As you will see, only the Chief Secretary's paper seeks any operational decision - this in relation to local authority current expenditure in 1982-83. All that is looked for in my own paper is an endorsement, or rather re-endorsement, of the need in the forthcoming Public Expenditure Survey to come out with totals below those derived from the March Public Expenditure White Paper. But I have sought to put this squarely against the background of the present excessive tax burden and what we could do if we could reduce this burden especially in relation to our employment policies.

3. I know how very difficult our colleagues are going to find it to restrain public expenditure. But that is why I think it is important that the need for this is put to them firmly in terms of the tax reductions that are within our grasp and are at risk. No doubt there will be those who will argue that it would be quite ambitious enough simply to stick with the present public expenditure plans, which would at least permit some tax reductions. But in my view we must try to do better; the margin between the scope for tax reductions and the need for

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tax increases is narrow, and once the totals start sliding we shall be lost. And we need to bear in mind that although these possibilities of tax reductions are justified by my view of our medium-term economic prospects which I describe in my paper, these themselves are vulnerable; they are subject to forces outside our control and could worsen.

4. In my minute to you I also mentioned that I was considering how, from the point of view of mechanics, we might make improvements in the way we bring the public expenditure discussions in the autumn to a conclusion. I am still giving thought to this, but as you say we need not settle the matter now.

5. I am copying this to Sir Robert Armstrong.

A handwritten signature in black ink, appearing to be "G.H.", written over a faint "CONFIDENTIAL" watermark.

G.H.

July 1981

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TAX AND PUBLIC EXPENDITURE

DRAFT PAPER FOR CHANCELLOR OF THE EXCHEQUER TO PUT TO CABINET

Our general approach

At our meeting on 17 June we endorsed the objective of maintaining our present economic strategy.

2. We also agreed to consider further in the context of the 1981 Public Expenditure Survey the balance to be struck between taxation and public expenditure. We noted that during our term of office so far the burdens of tax and public expenditure have both increased, directly contrary to our expectations and our promises.

Taxation

3. The present burden of tax is far too high. It is one of the main factors hindering the growth of new employment opportunities. It is higher as a percentage of output than it was in Labour's last year. Although the basic rate of income tax has been reduced, there has been a substantial increase in indirect taxes, the starting point for income tax is lower in real terms, and National Insurance contributions have been increased. As a result, 48½% of the income of a married man on average earnings is now taken in direct and indirect tax and contributions; when we first took office it was 45%. Many more lower paid people have been pulled into tax. And although we have made some useful changes in the structure of company taxation, the real burden on industry has not been appreciably reduced; the rates of Corporation Tax and National Insurance Surcharge (NIS) are unchanged.

4. To help reduce unemployment, and for other sound social and economic reasons we must do better. A priority must be to raise substantially the starting point for income tax. This is essential in order to widen the gap between incomes in and out of work, to improve incentives for the lower paid and to ease the poverty trap. Raising the income tax threshold would also encourage greater restraint in pay bargaining. We also need to reduce the tax burden on business; a cut in the National Insurance Surcharge would

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directly reduce labour costs, encourage firms to take on more people, and improve profitability. Tax reductions of this kind are a better way of stimulating ^{real} employment, and likely to do to greater effect and with better long term consequences, than additional public expenditure which further increases the size of the public sector.

5. It follows that a reduction in the burden of taxation is central to the achievement of our objectives and must have a very high priority.

The economy

6. As explained when we discussed economic strategy on 17 June, the background against which we have to look at our tax and public expenditure strategies is one in which the world economy will be slowly recovering from the present recession and our own economy adjusting to a lower rate of inflation and the effects of North Sea oil.

7. The fall in output appears now to have come to an end. But the pace of recovery is uncertain, as the wide array of forecasts indicate. The crucial question is the speed at which inflation adjusts to declining monetary growth. On this much will depend on what happens on pay settlements this autumn and winter. Partly owing to the recent fall in sterling, inflation may not fall as fast as previously expected this year, with something of a pause in coming months.

8. Our policies for public expenditure, taxation and reducing inflation are not exempt from the judgment of the markets. Until recently that judgment, by raising the exchange rate, has been helping us to secure a rapid reduction of inflation; and to shelter our interest rates and hence British industry and employment from the full effect of US interest rates, to which our Community partners have been more exposed. If however the view takes hold in the markets that our determination is weakening, we could find ourselves increasingly exposed to US interest rates and to damage to our efforts to reduce inflation. This is something we must have in mind in taking our expenditure decisions.

9. Provided expectations of lower inflation are maintained, there should be some increase in output in 1982, and a rather bigger increase in 1983 that should halt the rise in unemployment in that year. But given the likely

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world environment, and with business profitability still under pressure, it would be unrealistic to expect any strong resurgence of the economy in the next two years.

10. In all the circumstances, and consistently with our decision on 17 June, we must stick with the medium-term financial strategy and the path of the declining PSBR (as a proportion of GDP) set out there. This should bring inflation down well into single figures and permit a fall in interest rates over the medium-term. But holding to that strategy will require some tough decisions. The way we may be affected by factors we do not control only means we must make sure we stick to policies where we do.

Public expenditure

11. The key to making tax reductions lies in public expenditure. The Government's record on this is so far a disappointment, to ourselves and to our supporters. We said in the March White Paper that the planned public expenditure totals there indicated are higher than we should wish, and that this requires most serious attention in the current Survey. We must now implement that.

12. Even just to make good the reduction in real personal tax allowances imposed in the last two Budgets, and to provide some tax relief to ease the financial pressures on business requires that our total public expenditure plans are no higher than in the March White Paper.

13. But expenditure at this level would still mean an overall tax burden higher than when we came to office (at the moment if we exclude the North Sea it is 39½% of GDP; it was 35% when we came into office; and the March White Paper plans would imply 37%). A broad ready reckoner is that each £1 billion cash reduction in public expenditure would enable us to reduce taxes by £1½ billion. To get the overall tax burden back by 1982-83 to the level at which it stood when we came to office requires a substantial reduction in the White Paper public expenditure plans. But it would, for example, make possible a real stimulus to employment by enabling us to restore the starting point for income tax to the 1979-80 level and ease

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substantially the burden of the NIS. We could also begin to make progress towards fulfilling other long-standing pledges such as an easing of the burden of the capital taxes.

14. Yet it is clear from the Survey so far that there are going to be serious problems even in holding the March White Paper totals. For next year, 1982-83, bids for additions to programmes exceed £6 billion in cash. Of this some £2½ billion is for additions to nationalised industries EFLs. There is a bid of £1.4 billion for employment measures [part of which was recently discussed in E]. There are bids for increases in the majority of other programmes too. Increases will also result from unemployment forecasts worse than were assumed in the White Paper.

15. We have the problem of overspending by local authorities. The overspend in the current year will be substantial despite the counter action taken. We should do all we can to contain this, including timely guidance as suggested by the Chief Secretary in C(81) about plans for current expenditure in 1982-83.

16. There are good arguments in favour of some shift within programmes in favour of capital rather than current expenditure. It is disappointing that most of the bids for additions are for current expenditure, or in the case of the nationalised industries to make good reduced internal finance.

17. Public services pay accounts for some 30% of the public expenditure planning total. The lower we can get pay, the better the services we can provide. But we must not be unrealistic. It would be quite wrong to base our plans for other expenditure on an assumption about pay which we cannot fulfil. This is the difficulty about the otherwise attractive suggestion of linking pay with capital projects, which is discussed in the annex to this paper. There may be some possibility of doing this in certain fields. I should welcome, not later than September, any suggestions from colleagues responsible for particular pay negotiations and capital programmes how the idea might be developed in their areas, e.g. the NHS, the armed forces.

18. But our overwhelming concern must be with the totals. For these it is not necessary at this stage to propose a precise objective, nor do I intend to do so. Amongst other things I would expect that before this is done, the Chief Secretary will examine individual programmes. But the proposals

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now emerging would lead to higher totals than the cash equivalent of the March White Paper. Within them the proportion of capital would be lower. This is the opposite of what both we and our supporters think right. Far from enabling us to reduce taxes, it would mean that we would have to increase taxes even further in the remaining Budgets of this Parliament. To go down that road would be economically damaging and politically impossible.

19. It is against this background of political, economic and social considerations all pointing to restraint of public expenditure plans below those derived from the March White Paper that we must approach the present Survey and the current nationalised industries investment and financing review. Whatever the case for increases in certain areas of special priority, our overriding aim must be to get the overall expenditure totals down below those derived from the White Paper.

Conclusion

20. I invite Cabinet to endorse the general approach to the public expenditure Survey indicated in this paper, and in particular the overriding aim in paragraph 19 so as to make possible within our overall economic strategy the tax reductions necessary for fulfilling our economic and employment objectives.

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PAY AND CAPITAL PROJECTS

It has been suggested that the provision for pay should be reduced to make room for an increase for capital projects.

2. It is possible to make this trade-off to some extent for public expenditure in total. But we must not make plans for capital (or other) expenditure which depend on provision for pay which is unrealistically low.
3. And it would be difficult to introduce the trade-off between pay and capital investment into the negotiation of public sector pay at this level of aggregation. The link between pay for, say, doctors and investment in, say, roads or in the public sector as a whole is too indirect.
4. The best opportunity to link capital spending to the outcome of pay negotiations, and to make it an element in these negotiations, is where all the following conditions are fulfilled:
 - (a) there is a clearly defined cash limit within which both pay and capital expenditure have to be found, so that the trade-off is clear eg the EFL for a nationalised industry, the cash limit for the NHS;
 - (b) the pay negotiations within that cash limit are self-contained, and within the control of the Minister or manager responsible for the cash limit;
 - (c) either the unions have a direct interest in a higher level of investment, because it means higher employment, or the continued viability of the industry, or moral and political suasion can be applied by the Government saying "we would have liked to have had more investment but the money went as pay instead";

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(d) additional investment in that area is desirable on merits;

(e) it is practical to arrange that the capital expenditure is not committed until the savings on pay are secured.

5. This approach has been used for some nationalised industries. For example the Government has linked investment with pay and productivity for the railways. It is for consideration whether it could be introduced for other areas eg the National Health Service, the Armed Forces and Defence.

6. But it would be difficult to apply to:

(a) local authority pay. While the Rate Support Grant is a cash limit, local authority pay is not directly controlled within a cash limit. How would the Central Government be sure enough of savings on pay to increase the cash limit on local authority capital until too late in the year? It would be difficult to make the capital/pay trade-off an effective element in a particular negotiation;

(b) Civil Service pay. The combination of central negotiations on pay and many cash limits including Civil Service pay would make it difficult to establish a trade-off.

7. Nevertheless we should not lose sight of the possibility over time of achieving more on civil service and local authority pay, perhaps by differential treatment of different groups, the introduction of regional pay variations, etc.

LOCAL AUTHORITIES' CURRENT EXPENDITURE 1982-83

Note by Chief Secretary, Treasury

The Chancellor's paper C(81) discusses our general approach to the public expenditure Survey. This note is about an immediate decision concerning local authorities' spending plans.

2. It will be helpful to give local authorities early guidance as to our intentions for their current spending next year 1982-83, which will be reflected in the Rate Support Grant negotiations later. Guidance given before the summer holidays will have more influence on actual spending next year than would a statement delayed until the autumn. For England and Wales the Consultative Councils on 30 and 31 July are suitable opportunities.

3. Despite the conditional reductions in Rate Support Grant, local authorities are likely to overspend the March White Paper plans for relevant current expenditure for the current year 1981-82 by at least £1 billion. Political opposition to further cuts is increasing. The further powers to influence local authority expenditure which we have discussed in E Committee will not take effect before 1983-84.

4. In consequence of this overspend in the current year, if local authorities are to keep their cash spend next year 1982-83 to the provision in the March White Paper revalued on the present formula, they will have to spend no more

cash next year than this year. This would imply that on present estimates they should reduce their current spending next year in volume terms by some 7 per cent compared with what is now expected for the current year. This 7 per cent comprises elimination of the 3-4 per cent volume excess in 1981-82, the Government's already intended volume reduction of 1 per cent between 1981-82 and 1982-83 as shown in the White Paper, and the carry forward of the cash squeeze of 2-3 per cent now expected to develop in the current year 1981-82.

5. The 2-3 per cent cash squeeze just mentioned occurs in the current year because actual pay and price increases between 1980-81 and 1981-82 are proving to be more than the cash limit factors for this year. The cash planning system is intended to carry forward such a cash squeeze unless it is specifically decided to admit a bid to make it good. The greater part of this year's squeeze for local authorities will result from pay settlements which they have made, accepting the consequent squeeze for this year. It is right to carry this squeeze forward.

6. While in general we ought to be aiming below the March White Paper figures, in the case of local authorities current spending I doubt whether specifying now a further cut in the White Paper figures beyond the carry forward of this year's squeeze would help to get actual spending down. Indeed a 7 per cent volume reduction on this year's expenditure will be tough.

7. I accordingly propose that local authorities should now be told that, except for police pay (see below), they are expected to hold their total cash current expenditure in 1982-83 to the cash equivalent of the provision in the last White Paper, revalued on the present formula, with minimal variations in the service pattern within existing programmes. The revaluation would be on the basis agreed by Cabinet for starting this year's survey : that is, conversion from autumn 1980 prices to 1981-82 prices using the factors (11 per cent and 6 per cent) used for this year's RSG and cash limits, and then revaluation forward to cash provision for 1982-83 using for the present the single 7 per cent factor provisionally adopted. This would be confirmed or revised in the autumn in the light of any general revision of inflation factors for 1982-83 which may then be decided by Cabinet on grounds of realism.

8. Particular services should in general not be exempt from this approach. There is, however, a case for special allowance for the extra cost of the prospective 1981 police pay settlement (say £90 million) and of allowing police forces to recruit up to complement (£25 million). This would recognise our priority for the police service without abandoning the discipline of cash planning.

Conclusion

9. I therefore invite Cabinet :

- (i) to agree that the Government's plans for local authorities relevant current expenditure in 1982-83 should be held to the cash equivalent of the March White Paper revalued as in para 7, except for police pay as in para 8;

(ii) to ask the Secretaries of State for the Environment and for Wales to give guidance accordingly at the Consultative Councils on 30 and 31 July, and the Secretary of State for Scotland to give comparable guidance to Scottish local authorities.