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*MF*PRIME MINISTERTax and Public Expenditure

C(81) 37 and 39

BACKGROUND

In C(81) 37 the Chancellor of the Exchequer invites the Cabinet to recognise the need to reduce the burden of taxation and, to that end, to make substantial reductions in public expenditure. The intention is that this discussion should set the scene for the more detailed discussions that will follow after the Recess; the programme for these meetings is annexed to this brief and has been circulated to all Members of Cabinet. My note (C(81) 39) covers a paper by the Central Policy Review Staff (CPRS) on the strategic public expenditure issues, and some questions which need to be considered.

2. On 17 June (CC(81) 23rd Conclusions) the Cabinet endorsed the objective of maintaining the Government's present general approach to the economy and agreed to consider further, in the course of their discussions of the 1981 Public Expenditure Survey, the balance to be struck between the Government's taxation and public expenditure objectives and the balance, within the public expenditure programme, between capital and current expenditure. The Chancellor's present paper is addressed primarily to the balance between taxation and expenditure objectives.

3. The Chancellor of the Exchequer repeats the argument which he put to Cabinet on 17 June that the present burden of tax is too high and must be reduced for both political and economic reasons. In particular, he sees reductions in tax rather than higher public expenditure as the way through to providing permanent jobs. He warns that any weakening of resolve could upset the financial markets and jeopardise the objective of bringing inflation down to single figures and allowing for a fall in interest rates. He argues that the key to tax reductions lies in reducing the present prospective totals of public expenditure. Simply to keep the totals

at the levels in the last Public Expenditure White Paper would allow him to do no more than make good the reduction in real personal tax allowances imposed in his last two Budgets and to provide some limited tax relief to business (paragraph 12). To get the overall tax burden back by 1983-84 to 1979 levels, and to open up the possibility for significant reductions in tax including the national insurance surcharge, would require 'a substantial reduction' in the White Paper totals (paragraph 13).

4. The Chancellor invites the Cabinet to endorse this general approach to Public Expenditure Survey and in particular the overriding aim of getting totals below those derived from the White Paper, so as to make possible, within the overall economic strategy, the tax reductions necessary for fulfilling the Government's economic and employment objectives. He is not at this stage putting forward any specific target figure for public expenditure reductions. His aim for the moment is to secure a general recognition of the problems and of the objectives and to set the tone for the Chief Secretary's bilateral meetings after the Recess leading to Cabinet's further discussions of the 1981 Public Expenditure Survey in the autumn. The approach is also crucially relevant to the discussion by the Economic Strategy Committee next Monday, 27 July, of the nationalised industries' investment and financing review.

5. Even to get the totals down to White Paper levels is a large order. Returns to the Treasury at present indicate an excess in the order of £6½ billion in cash. Of this, around £2½ billion is for the nationalised industries' External Financing Limits, and will be discussed by E next week; £1.4 billion is for the unemployment measures proposed by the Secretary of State for Employment, which are now under separate discussion. The rest is spread around most of the programmes, with a good part of it attributable to the additional provision which Departments claim is necessary to make good inadequate re-valuation by the presently agreed factors for pay and for prices. (The Cabinet will review the inflation factors on 15 September: if they were then to be increased that would reduce the level of additional bids over the base line but it would not, of course, make any difference to the grand total of the cash requirement.) The CPRS pose the question: can the case for these bids be overridden in the interests of achieving the tax objective?

6. Some Ministers will argue that, although tax reductions would obviously be welcome, the Chancellor of the Exchequer is not being realistic in seeking the massive public expenditure reductions which he appears to have in mind. The present crude overrun of £6½ billion may well be reduced, but it would be very difficult to eliminate it because (so they will argue) -

i. Some programmes, such as Education, have also been cut severely and it is politically unrealistic to look for more; and Defence has already been settled in volume terms.

ii. The Government is pledged on the indexation of retirement pensions; there would be considerable political difficulty in limiting annual increases in supplementary benefit, child benefit and unemployment benefit and so on; and there is a commitment to maintain previously planned spending levels for the Health Service.

iii. Some forms of cut would be inflationary if they led to increases in the rates, or price increases by the nationalised industries; and cuts on capital investment would be damaging to employment.

iv. Pay increases in the public sector should be kept as low as possible; but, as the Chancellor of the Exchequer acknowledges, it is important not to base plans on unrealistic assumptions on pay.

The CPRS discuss this problem in Sections II and III of their paper, and put the questions how can further cuts be found and in particular can the public sector be made to yield a dramatic further cut in current spending?

7. The objective of Treasury Ministers will be to use the detailed bilateral discussions with Departments to form a view on what is practicable, and on what proposals they should make on 20 October for overall totals. In the meantime, Ministers may be reluctant to sign up in any meaningful way on the Chancellor's proposition that the Cabinet should now endorse the overriding aim of getting the overall expenditure totals below those derived from the White Paper. If they do not, the Chancellor will be very anxious to avoid any precise counter-proposition, such as that the aim should be to stick to

the White Paper totals. The least unsatisfactory outcome might then be for Cabinet to agree that, against the background of the prospects explained by the Chancellor and the objective of reducing the tax burden, the aim should be to cut public expenditure substantially and as much as is practicable.

8. The Secretary of State for Employment will probably refer to his wish to make a comprehensive statement before the Recess on the special employment measures which he has proposed. Mr Moore's minute to Mr Lankester of today summarises the progress made so far by the Chancellor of the Duchy of Lancaster's Group, MISC 59; you are discussing this issue yourself with the Secretary of State for Employment and other Ministers today.

9. Ministers may refer to the point you made, in your summing up of the discussion in the Committee on Economic Strategy of the employment measures, that each Minister should consider further, before the Cabinet met to discuss the 1981 Public Expenditure Survey, whether there was scope for changing priorities within their proposed programmes to give greater weight to employment generating projects. On present plans the MISC 59 Group will be considering a paper by the Chief Secretary on the relative merits of investment and fiscal measures in terms of generating employment; beyond that - and subject to what the Chief Secretary might say to Cabinet - I think that the practicable way to take account of proposals for employment generating projects is for the Chief Secretary to examine them in his bilateral discussions. In practice, every spending Department can produce a shopping list and the fairest and most sensible method would be to look across the board at all the possibilities. The further work which the Chief Secretary has in hand for MISC 59 is also relevant to the question raised by the CPRS in Section I of their note of whether Ministers will need more information on the employment trade-off when they consider particular tax and expenditure options.

10. In paragraph 17 of his paper the Chancellor of the Exchequer refers to the Secretary of State for Environment's idea that it might be possible to secure some trade-off between pay and capital investment when negotiating public sector pay. This question is discussed in more detail in the Annex

to his paper. The Chancellor is not optimistic that this is a very practicable way forward but he invites the Ministers concerned to put forward by September specific proposals for developing the approach in, for example, the National Health Service and for the Armed Forces.

HANDLING

11. You will wish to ask the Chancellor of the Exchequer to introduce his paper. Since the Chancellor is putting forward very general propositions, the discussion is likely to be wide-ranging and all Members of Cabinet will want an opportunity to comment.

12. A good deal of the discussion is likely to focus on the practicability of achieving massive public expenditure cuts on the lines envisaged by the Chancellor. Your objective, and the Chancellor's, will be to ensure that, before the detailed discussions of programmes get under way, there is full recognition of the need to reduce the burden of taxation and the greatest possible degree of commitment to go hard for the maximum public expenditure savings which can be made.

13. In the light of your discussions today you, and the Secretary of State for Employment, may wish to say something on employment measures. Substantive discussion of nationalised industries' programmes can be left to E next Monday; the spending of the local authorities will be discussed in more detail under the next item on the Agenda.

CONCLUSIONS

14. In the light of the discussion you will wish to record conclusions -

either accepting paragraph 20 of the Chancellor of the Exchequer's paper C(81) 37 - that is, endorsement of the general approach he puts forward and in particular of the overriding aim of getting overall expenditure totals down below those derived from the Public Expenditure White Paper

or, if Cabinet is not prepared to sign up on the Chancellor's objective, endorsing the objective of reducing public expenditure totals substantially (that is, without reference to any particular number or bench-mark).

22 July 1981

RIA
Robert Armstrong