Copies to Mr Wolfson
Mr Vereker
Mr Duguid
Cabinet Office

Prime Minister. PM seen
The Chancellor would like to stay behind after your meeting tomorrow morning on inner cities to discuss this. A note by Mr Vereker is at flag 'A'.

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

Econ Pol

PRIME MINISTER

INFLATION FACTORS FOR PUBLIC EXPENDITURE

I would like to discuss with you the paper which I shall be putting to Cabinet on this. We need to take a decision on 15 September on what factors we should use, if we are not to upset the whole timetable for public expenditure decisions, rate support grant and even the Budget.

... 2. I attach the present draft of the paper which has been put to me. The Chief Secretary and I agree with the conclusion that the factors for inflation between 1981-82 and 1982-83 should be 4 per cent for pay and 9 per cent for other prices, and with the general line of argument set out in the paper. I will, however, be reflecting further on the details of the draft.

3. I do not think that there will be much difficulty in persuading our colleagues to accept the 9 per cent factor for prices other than pay. The main argument will relate to the factor for pay.

4. I have been debating whether it might be more realistic to go for a factor of 5 per cent rather than 4 per cent. However, what the CBI told me on Tuesday convinced me that we should go for 4 per cent. They are looking for settlements in industry lying between 4 per cent and 8 per cent. But they think that if their members are to achieve this, it is important that the factor for the public sector should not be higher than 4 per cent. Although this argument is the critical one, I think it prudent to leave it to be put orally, rather than include it in the circulated paper.

/5.

5. Two alternatives may be put forward. Some may argue for using a pay factor of zero as a holding measure. I think that this would be wrong. We would be seen to be shirking an opportunity to give a lead on the desirable level of pay settlements. It will also distort all our public expenditure decisions. I would need to provide for another £1¼ billion claims on the contingency reserve, compared with those for a 4 per cent factor.

6. Michael Heseltine would advocate the use of a zero factor for a different reason; he thinks that we ought to be seeking settlements at that level, or close to it. The idea which he has been exploring with Leon Brittan is that the saving from using such a low factor for the public sector as a whole should be used to finance additional capital expenditure. Then to the extent that settlements actually proved higher, he would suggest reducing welfare payments to achieve the same PSBR. Michael Heseltine may want to put a paper suggesting this to Cabinet for discussion on the 15th.

7. While I see attractions in it, I am very doubtful about its practicability. I do not think that pay increases to public sector workers (including the mine-workers) are going to make it politically any easier to secure reductions in welfare payments. So the cost would in the end fall on the public expenditure totals and the PSBR. Then in the meantime, the public service unions are going to react very strongly against what they would claim to be blackmail.

...... 8. I also enclose a background for you only, a note by the Treasury economists on the inflation prospect.

[Approved by the Chancellor and signed in his absence.]

J[illegible] Kerr
4/ix

G.H.

4 September 1981

THE PROSPECT FOR INFLATION

Note by EA

Introduction and summary

The forecasters have just completed a re-assessment of the inflation prospect, as background to the Chancellor's paper on cash factors for 1982-83 and beyond for the Cabinet discussion on 15 September. This has been a quick exercise, which has used broadly the same policy assumptions as the June forecast and taken into account latest information directly relevant to the inflation prospect, but has not attempted to update the whole of the forecast.

2. The conclusion which emerges is that the outlook for inflation next year is a little better than we thought likely in June, despite a lower level for the exchange rate, mainly as a result of a further squeeze on profit margins, and thence on to domestic costs. Whereas the June forecast indicated inflation rates for the financial year 1982-83 of 10½-11%, our central estimate is now around 10%.

Latest developments

3. Since the June forecast was completed, there has been a further fall in the effective exchange rate, which in the third quarter of 1981 seems likely to be about 5% lower than forecast. The dollar, above all, has been stronger than expected and as a result sterling oil prices have risen several times in recent months. However, this has been the main factor pushing up prices in the private sector and otherwise recent monthly increases at the retail stage have been very low - with some components, notably clothing and footwear, showing no increase over the last year.

The forecast

4. The forecast takes account of the following changes from the June forecast:-

(i) A lower exchange rate - by an average of nearly 3% in 1982.

(ii) A level of private sector wage costs in the current quarter and thereafter over ½% lower than forecast in June. (This also implies that the gap between settlements and earnings in the 1980-81 pay round was not quite as big as we thought in June.)

(iii) A lower price of oil in 1982, as a result of the forecast continuation of the weak oil market: by the fourth quarter of 1982 dollar oil prices could be over 10% lower than previously forecast.

(iv) Both because of the greater squeeze on profits and because of the lower rate of price increases, we have shaded down the increase in pay: 7% on average for wage settlements; 8½% for earnings over the 1981-82 pay round. These figures are ½% lower than in the June forecast.

(v) In addition to these changes in costs, which on balance reduce the rate of inflation next year, we have allowed for some further intensification of the profit squeeze, in the light of the latest information on price trends in recent months. While the exchange rate has fallen, it remains high and recent evidence suggests that we did not make enough allowance for competitive pressures in the last forecast.

5. The resulting forecast is shown below:-

Price indices:
per cent increase between financial years 1981-82 and 1982-83

	September update	June forecast
RPI	10	11
GDP at market prices	10	11
Private domestic expenditure	9½	10½
General government procurement	9½	10½
General government investment	8	8
Whole economy average earnings	8½	9

The forecasts of the RPI and of GDP are probably more reliable than the forecasts of general government procurement and investment prices, which involve difficulties of measurement and where there are wide variations within the overall averages. These various inflation rates are all fairly similar, though the forecast for investment prices is for a lower rate of increase: this is because building costs (the major part of general government investment) have risen particularly rapidly in recent quarters and we see some slowing down in the course of the next year or so. Procurement expenditure is some four times as large as fixed investment.

Earlier forecast for 1982-83

6. The only previously published official forecast was given with the 1981 Budget, in the FSBR. This was for a rise of 8% in retail prices between the second quarters of 1981 and 1982, a view consistent with a 7½% increase between financial years 1981-82 and 1982-83, though the latter figure was not published. Since the budget, inflation prospects are generally perceived as having worsened, on account of the fall in the exchange rate and the rapid rise in industry's material costs in recent months. But the most recent monthly increases in retail prices have nevertheless been small and views on the inflation prospect are now tending to improve again.

Risks and uncertainties

7. Inflation forecasts made in the Treasury, and elsewhere, over the last eighteen months or so have generally been too pessimistic. In large part this is because the private sector has been forced to limit its price increases well below costs as a result of low demand, partly to sell off surplus stocks, and because of the pressures of foreign competition. The crucial question is how far can this process go: our judgement is that it may not go on much beyond early 1982, as the need to liquidate stocks disappears, and as the lower level of the exchange rate allows firms a little respite. But we could be seriously wrong in either direction. So too on cost pressures: apart from the usual uncertainties about the direction, let alone the extent, of exchange rate changes, our judgement of 7% wage settlements in the next pay round (for private and public sectors allows for a small fall in real earnings and for continuing effects from low profit margins on to wages. Even so, figures like that will do little to improve competitiveness. These uncertainties are reflected in sizeable error margins: the average margin of error of retail price forecasts, at about this time of year looking ahead to the next financial year, is of the order of 3% either way.

Earlier and later years

8. The inflation forecast for the fourth quarter of 1981 is now put at 11%, compared to 12% in the June forecast: this downward revision reflects continuing low profit margins, an inability to pass on the higher costs of imports (except in the case of oil) and a later increase in the mortgage rate.

9. With the exchange rate - very tentatively - not expected to decline further after 1982, and with continuing pressure of demand effects on wage increases and on the level of prices, substantially lower inflation rates are possible in 1983-84 and 1984-85. While our ability to forecast inflation rates two and three years hence is extremely limited, we think it quite possible that, if the pressures to reflate are resisted and interest rates kept high, then inflation rates could be some 7% in 1983-84 and a point or two lower the following year.

Outside forecasts

10. While published forecasts do not generally show figures for financial years, a good approximation for 1982-83 can be found in the increase to the fourth quarter of 1982. On the basis of forecasts of the RPI or consumers' expenditure deflator, outside forecasters span a range of 8% (LBS) to 12% (St James/Item), with many round 10%. Cabinet colleagues will be aware of these forecasts.

Industry Act forecast

11. An Industry Act forecast will be published before the end of November, and will include a forecast of the rise in the RPI between the fourth quarters of 1981 and 1982. Although not quite the same as the change between the financial years 1981-82 and 1982-83, and not for the same price index, the choice (and publication) of a price factor for use in public expenditure planning will constrain to some extent the Industry Act forecast. A difference of much more than 1% would need to be justified by some change in the inflation outlook.

REVISED DRAFT CABINET PAPER - 4 SEPTEMBER 1981

CASH FACTORS FOR PUBLIC EXPENDITURE SURVEY

Note by the Chancellor of the Exchequer

The starting point

1. On 7 May we agreed that, in order to conduct the survey in cash, we should adopt the provisional working assumption that all costs would rise on average by 7% between 1981-82 and 1982-83, and by 6% and 5% in the two following years.

2. It is now necessary to review that provisional decision and to settle the factors to be used for determining the cash programmes in the survey and, in due couse, for the 1982-83 Estimates and cash limits. We need to know what to assume for average costs, both to have a firm baseline against which to consider possible increases and decreases in programmes, and also so that the Ministers concerned can review the prospective costs in their field and reconsider their bids for extra provision and proposals for reduced provision.

3. The cost assumptions will also be the basis for the RSG settlement. The sooner we can settle these assumptions and let them be known, the better our chances of influencing local authority budgets and rates for next year, and of influencing public sector pay settlements, particularly the critical negotiation with the local authority manuals.

4. More generally, our decision is important. The cost assumptions used in preparing the public expenditure plans for 1982-83 and later

years will attract comment, from both the political and economic standpoint. They will be seen, correctly, as an indication of how successful we expect our anti-inflation policy to be, and as a measure of our determination to contain public expenditure.

Role of the factors

5. These factors will determine the "baseline" for our public expenditure decisions: the cash equivalent of the last White Paper. Apart from changes which we will make on policy grounds it will be possible to add or subtract a cash sum in the case of any particular programme if we decide that is necessary to make provision for that programme on a basis that differs significantly from what would be implied by these general factors. But decisions on any such adjustments can be left until October, when we consider the cash provision for particular programmes.

6. In general the cash provision for programmes decided this autumn will determine the corresponding cash limits and Estimates for 1982-83. In exceptional cases, the autumn decision may have to be reopened - any additional cash having to be found from within the Contingency Reserve. This procedure may be necessary to honour the Lord President's pledge to the Civil Service unions.

The proposal

7. I propose that we should now replace the single provisional factor of 7% average cost increase between this year and next, by:-

(i) an average increase of 4% in pay from due settlement dates from now on; and

(ii) an average increase, financial year on financial year, of 9% in other costs. (This would apply from uprating dates for social security benefits.)

I see no need at present to change the assumptions for inflation after 1982-83.

Two factors for 1982-83

8. It is now clear - as it was last year - that we need two factors, rather than one, for the change to 1982-83. Once again there needs to be a large gap - 5 percentage points or so - between what ought realistically to be provided for public sector cost increases other than pay and what is appropriate for increases in the wage bill, as I explain below.

9. With such a wide disparity, the use of a single cost increase factor would give rise to awkward distortions between programmes, in a direction contrary to our priorities, with over-provision for programmes with a large element of public service manpower. And there would be a danger that the continued use of a single figure, which would be significantly higher than what we can afford to pay, would set a damaging point of reference for unions in pay negotiations.

Prices

10. At Budget time, an increase in retail prices of 8% between the

second quarters of 1981 and 1982 was forecast, implying a similar increase between the averages for the two financial years 1981-82 and 1982-83. Inflation prsopects for the year ahead now look somewhate less favourable, because of the fall in the exchange rate, because oil prices in real terms are higher, and because the prospects for reductions in interest rates (which affect the RPI through the mortgage rate) have worsened as a result of the sharp increase in foreign rates. The present outside forecasts for the increase in the RPI from Q4 1981 to Q4 1982 vary between 8% (London Business School) and 12% (St James/Item). The Treasury internal forecasts for the RPI are at present at the middle of that range, about 10%. The latest signs are that there is still very considerable downward pressure on price increases. Some outside forecasters may have overreacted a month or two ago to the changes in the exchange rate.

11. Such indications as there are for likely relative price movements point to the average price increases for government spending on procurement generally and particularly on construction work, being somewhat below the RPI increase. This will partly offset a more rapid increase in the recent past.

12. We have to strike a balance in fixing the price factor in relation to these forecasts.

13. It must be reasonably realistic. It is no good using now a deliberately low figure for the uprating of social security benefits. We may decide to abate some of the upratings in November 1982; but the underlying basis will be the Government's forecast next spring of

of the RPI change, so we only risk deluding ourselves in the meantime about the cash cost.

For those programmes which will be cash limited, it is right to take a figure likely to be, if anything, slightly on the low side in order to ensure tight budgeting in Government departments and other public sector institutions, as a stimulus to efficiency and to holding down, where it is possible, the prices which they pay. But we should not go beyond that, reducing the factor in order to cut those programmes significantly: that should be done, if we so decide, by an overt squeeze.

14. We must also allow for the fact that the Government's forecast, and the assumptions which we ourselves use in framing our plans, inevitably have some effect on pay negotiators and price setters. Our efforts to reduce inflation depend on creating the right climate for expectations.

15. Balancing these considerations, I propose that the price factor should be 9%.

Pay

16. The temptation on pay is to defer a decision. But we need some working assumption so that we can look at expenditure commitments realistically. We cannot afford to give the impression that we are simply waiting to see what pay settlements emerge and will then validate them. And the timetable for the RSG settlement - together with the need for local authorities to know where they stand when negotiating with their manuals later this year - forces us to an early decision.

17. We must seek, and create expectations of, lower wage settlements in the coming round than in the last, and this points to a figure below the 6% we chose for cash limits in 1981-82. Indeed, it should be

"in low single figures".

18. Any figure on this basis will point to a further fall in real living standards of those in the public services, even allowing for some settlements being above the figure. Such a fall for wages generally is essential if we are to make worthwhile headway in restoring competitiveness. But we do not want to inflame the unions by announcing factors which significantly overstate the expected fall.

19. It would be imprudent to take a figure, as the basis of our current financial planning, significantly below what we think can be achieved. To the extent that the eventual outcome is higher than we allow for now, there will either have to be a squeeze on the programmes concerned, or to the extent that additional cash is provided by an allocation from the Contingency Reseve, a squeeze on programmes generally.

20. I propose 4%, which is, just, "a low single figure". In handling publicity, we should emphasise that this is a cash expenditure planning assumption. It does not, and is not designed to, force particular pay settlements to this precise figure. It does, however, indicate the broad measure of what the Government thinks reasonable to allow in its public expenditure plans and, where settlements in the event depart at all significantly from it, there will be necessary consequences - both ways - in public sector services and employment prospects.

Publication

21. The figures we choose now will need to be widely known in Government quickly and would be bound to leak. It will be better to announce

them, with the qualifications we want to get across.

22. I attach a draft statement which I propose should be made by press notice immediately following our decision. It will be necessary for defensive briefing to be ready on the implications for various public sector pay groups, and officials are preparing this.

Conclusion

23. I invite colleagues to agree that:

(i) The provisional inflation factors we chose in May should remain unaltered for inflation after 1982-83, but for inflation between 1981-82 and 1982-83 we should replace the working assumption of 7% for all costs by two factors: 4% for pay on average, applied to settlement dates, and 9% for prices on average, applied year on year.

(ii) We should announce these factors by press notice, as in the attached draft.

(iii) We should defer until October, when we come to consider individual programmes, consideration of any cash increases or reductions in respect of pay and prices.

REVISED DRAFT PRESS STATEMENT : 4 September 1981

PUBLIC EXPENDITURE PLANNING : CASH FACTORS

The Government has decided that, in preparing for the next stage of cash expenditure planning for 1982-83, when detailed decisions will be taken, it will allow for separate rates of increases of costs in respect of public service pay bills and other costs. For pay, the costs of programmes will be recalculated on the basis of an average increase of 4% at due settlement dates in the next 12 months. For other costs the basis will be an average increase of [9%].

2. This is a further stage in the arrangements announced by the Chancellor of the Exchequer in his Budget statement of 10 March 1981, under which the public expenditure survey this year is for the first time being conducted in terms of prospective cash expenditure, rather than in "constant prices".

3. This change requires that, as a starting point, the plans in the last expenditure White Paper (Cmnd 8175) should be put onto this prospective cash basis. At the beginning of the survey, it was decided to do this provisionally allowing for overall increases in costs of 7% between 1981-82 and 1982-83, and 6% and 5% respectively for the following two years. As then envisaged the prospects for the coming year have now been reviewed and the 7% average factor overall replaced by the separate factors of 9% and 4% referred to above. The weighted average of the separate factors now adopted is close to the provisional 7%: the change therefore has little effect on the resultant total for public expenditure, but it does affect the allocation between programmes.

4. The pay factor is not a forecast of pay settlements to be of particular amounts. It will contribute towards calculating the total cash planning figures for all programmes.

5. These assumptions on pay and prices only determine the starting point for this stage of the survey. The actual provision for individual programmes will depend on Ministers' judgements on that survey. Their decisions may include further adjustments to some, if not all, individual programmes. Cash limits for 1982-83 will follow from those decisions on programmes.

6. The Rate Support Grant paid to the local authorities for 1982-83 will be determined by Ministers' decisions on cash provision for local authority services, based on these factors of [4%] for the pay component and [9%] for other costs.

SUGGESTED REDRAFT OF PARAGRAPH 4

The pay factor does not carry the implication that all public service pay increases incomes will or should be 4%. There is no automatic entitlement to any particular pay increase: each must be justified on its merits. The pay factor is a broad measure of what the Government thinks reasonable to allow for the total increase in the public service wage bill.