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PRIME MINISTER

ECONOMIC POLICY, TAX AND PUBLIC EXPENDITURE

As you know, we now need to take decisions about public expenditure for 1982-83 and the two later years. We are due to begin discussing this in Cabinet on 20 October, and it is important that the process should be through by around the middle of November.

2. The decisions we take will be difficult and extremely important. They will affect the whole of our economic and political strategy for the rest of this Parliament. They must inevitably be seen in the light of a General Election within the next 2½ years.

3. I propose, therefore, that in putting proposals to our colleagues I should set these in the broad economic and political context. I attach a draft of the paper I propose to circulate together with a draft of a paper by the Chief Secretary which sets out the proposals for public expenditure in more detail. We are both still working on these.

My general message

4. The general message I shall want to convey to our colleagues, in my paper and orally, is broadly as follows:-

- what we are doing is well in line with the international environment
- our policy for getting inflation down and for stimulating industry is a long-term one, and gives grounds for guarded optimism



- unemployment is serious, but there are no realistic alternative policies which, within the life-time of this Parliament, would make any substantial difference to the way in which the numbers would move
- the public/private sector balance, which we sought to correct, has gone in the wrong direction. The private sector has borne virtually the whole brunt of the recession. Largely this is due to individual spending Ministers defending their corner at the expense of the wider picture. As a result our record on public expenditure and tax is a great disappointment.

5. None of this is particularly new. But it needs reaffirming, particularly against the sort of remarks that are going to be made at the Party Conference next week and elsewhere about the need for some change of course. It is because of these sounds that our colleagues will have been hearing, and in line with what I think was looked for at the 23 July Cabinet, that my paper is deliberately full. It is important for our colleagues to understand - particularly perhaps on unemployment - just what limitations and shortcomings alternative policies have.

My overall proposals

6. The core of the matter lies in the PSBR which we should seek for next year. There is no single demonstrably "right" figure we should look for. But a higher PSBR adds to pressures on interest rates and a lower one reduces them. In my view at this stage we cannot plan to go above the PSBR for 1982-83 which we looked for at the time of my last Budget, and even this points to serious risks on interest rates. But it is a known starting point, and I think it would be difficult to persuade our colleagues now that we should work from a lower figure.



*Imp. depends
on finance*

7. We now come to the tax and public expenditure picture. Our basic approach, of course, is that finance should determine expenditure, rather than vice versa. This would mean setting tax objectives, and, in the light of the chosen PSBR, determining public expenditure totals accordingly.

8. Such an approach, coupled with the need not to damage confidence in the markets and the political desirability of doing what we said we were going to do, would point to public expenditure totals at or below those implied by the last Public Expenditure White Paper (Cmnd 8175) - thus about £110 billion for 1982-83. However the Chief Secretary and I regard this as wholly impossible. There is no realistic way in which we can make cuts or reject bids on that scale. On the other hand, we cannot possibly afford - whether in economic or political terms - to accept all the bids which our colleagues have made. For 1982-83 this would make the totals some £8 billion above those implied by Cmnd 8175.

£113.5 bn.

9. In my view we should not look for a figure which would imply now the need for real tax increases in my next Budget. On the other hand we must go to our spending colleagues with proposals which we think are achievable. Balancing these desiderata, the Chief Secretary and I feel that the figure we should look for is some £113.5 billion for 1982-83, or some £3.5 billion above Cmnd 8175.

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10. Even this will require some tough decisions from the spenders. But against that, it assumes no real tax changes in 1982 - that is, merely the indexing of rates and allowances and increases in the National Insurance Contribution to balance the Fund. In particular expenditure at this level makes it most unlikely that we should be able to make any move on two areas where, from the point of view of our counter-inflation and industrial strategy, we ought to do something - some reduction in the National Insurance Surcharge and some restoration of the income tax



thresholds frozen in the last Budget. Against that, any higher public expenditure figures would almost certainly make tax increases necessary.

11. I am aware how disappointing this picture is. Market confidence will anyway be eroded by our failing to hold the Cmdnd 8175 totals, and the further off we are from them the greater the effects will be. And I should not even be able to sugar the pill by hinting at the possibility of any real reductions in the tax burden next March. On the other hand the figures I propose should give a reasonable prospect of real reductions in 1983 and 1984.

Public expenditure in more detail

(a) 1981-82

12. Public expenditure this year could turn out to be as much as £2½ billion higher than envisaged at the time of the Budget. That was £0.8 million higher than provided in the White Paper.

13. The main increase since the Budget is the prospective local authority overspend of about £1½ billion on their current expenditure. Changes in economic circumstances, particularly higher interest rates, have added some £0.3 billion. Finally, it now seems prudent to write down by about £½ billion the deduction for short-fall, so increasing the total.

14. The more directly controlled programmes are holding well; we should be able to keep increases in them within the Contingency Reserve, provided we take a consistently tough line with all further proposals.

(b) 1982-83 onwards - present position

15. The position is well illustrated by Table 1 attached to the draft of the Chief Secretary's paper.



16. The starting point is the White Paper revalued, and adjusted for items such as the Gas Levy, which are exactly matched by revenue and so have no PSBR effect. We have to add for agreed additions, the effect of changed economic prospects and higher local authority spending. So at the outset of these discussions the expenditure total is £4 billion higher than the starting point for 1982-83 and £6 billion higher for 1983-84. And we are faced with further bids for £3½ billion and £5½ billion in these 2 years respectively.

(c) 1982-83 onwards - proposals

17. The Chief Secretary and I fear that we have to accept some of the bids in whole or part - for example the carry forward of the Armed Forces pay award, the assistance with redundancy costs in the steel and shipbuilding industries, the introduction of the comprehensive Youth Opportunities Programme, some expenditure on prison building and staff. But we recommend rejecting just over half of the bids for 1982-83, and two-thirds of them for the following year.³⁻⁴ We also propose cuts in existing programmes of nearly £2 billion in 1982-83, and £2½ billion in 1982-83.

3-4?

18. We are still faced with bids for nationalised industry EFLs in 1982-83 of nearly £1 billion more than the £750 million increase we agreed to in July. We propose that the excess should be cut to £495 million, bringing the total increase to £1,245 million.

19. We are reasonably confident colleagues can be persuaded to accept in this difficult situation about half our proposals - mainly the ones at the fringes of programmes, which are small individually, but cumulatively significant.

20. In particular we hope to get agreement to a reduction in all cash limits including staff and general administrative expenditure. Taken with the carry forward of the cash limits squeeze resulting from this year's Civil Service pay settlement,



this will require a reduction in numbers (or in related expenditure) 3½ per cent greater than already allowed for in last year's White Paper figures. We are proposing a reduction in the NHS programmes for improved efficiency. Colleagues will justifiably consider these measures severe and in some cases difficult to achieve - they will be for my departments. But we think that it is right that we should be severe - the CBI evidence and recommendations point to it.

21. Some proposals will be much more difficult for the Ministers responsible for departmental programmes. They are set out in the attached List A. But we must secure agreement to virtually all of them if we are to avoid tax increases in the next Budget.

22. The most contentious proposal may be the reduction by 5 per cent in the uprating of the social security benefits on which there is not a specific pledge - including unemployment, sickness, child and short-term supplementary benefits. The justification for this cut is the fall in real incomes of those at work this year and next - which is expected to be greater than that.

23. Nor have we been able to spare capital programmes. We would have liked to spare them - or even to increase capital - but it is just not on in these circumstances. Our proposals for nationalised industry EFLs will mean that their investment in total will be little different from that envisaged in the last White Paper.

Further reductions

24. As I say, these proposals even if achieved would on present forecasts leave no prospects for tax cuts in the next Budget. We have therefore considered the possibility of further reductions. (List B attached gives some examples.) The only scope for really substantial further savings lies in either re-opening the decisions on Defence or in acting on the pledged social security benefits. If we could do either, or both, of those it could make a very real difference to the tax and interest rate prospect, or



possibly leave some room for a slightly more accommodating line on other expenditure programmes. But in spite of the help it would give on tax we would not wish to put these proposals to colleagues unless they had your full backing and we were reasonably confident of success.

Procedure

25. One thing you will wish to consider is how to pursue the discussions after the initial discussion on 20 October, which itself might have to spill over to the next meeting.

26. Copies of this minute go to the Chief Secretary and to Sir Robert Armstrong.

A handwritten signature in black ink, appearing to be 'G.H.'.

(G.H.)

9 October 1981