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10 DOWNING STREET

THE PRIME MINISTER

Not Sent

Personal Minute

No.

CHANCELLOR OF THE EXCHEQUER

Public expenditure is too high; has tended to rise faster than the growth of the economy, and has risen by 5 per cent in real terms since we took office; and on existing policies is likely to go up by a further 10 per cent in real terms by the end of the decade. That would mean a vicious circle of high taxation - and ours is already much higher, at 40 per cent of the national product, than any of our main industrial competitors except the French - leading to inadequate incentives, continuing poor industrial performance and low growth, and a still higher tax burden.

The action required to break out of this circle plainly ought to command public support. And I believe that our decision to plan to keep expenditure broadly constant over the next 3 years was widely welcomed. Yet in the present climate of public opinion, action on individual programmes to reverse the trend over the decade would be unpopular. So we need to change the climate; and to press home the argument that the higher growth the country needs will not happen, on a lasting basis, unless we first succeed in reducing the burden of spending, taxes and borrowing. We need to demonstrate the link, through lower taxation, between lower public spending and more jobs.

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The Chief Secretary will be reporting to Cabinet next month on his discussions with colleagues on the implications of this year's Survey decisions for the later years 1987-88 and 1988-89. But we need not wait until then to start working collectively to change the climate of public opinion. Our aim should be to make press and public face up to the problem, recognising the demographic and other trends causing some elements in public expenditure to rise; and the damage if the overall rise were not reversed. We need not argue for specific solutions at this stage: these can be allowed to emerge from the debate; and it will be easier for us to identify and implement solutions if it becomes generally accepted that public expenditure savings are inherently desirable.

As the next step in our work on longer term public expenditure, on which I undertook on 21 July to reflect, Cabinet colleagues may find it useful to have the enclosed background briefing, at Annex A, on the longer-term consequences of current public spending policies (and their tax consequences), illustrating how high public spending, far from stimulating growth and job opportunities, damages both. I intend myself to speak along the lines of the text at Annex B, and Treasury Ministers will be speaking on similar lines. We must all take every opportunity to get this message across - in our own speeches and statements, and by encouraging Parliamentary colleagues (and possibly the Treasury Select Committee), party spokesmen at all levels, and sympathetic correspondents, academics, and commentators, to address the issues, and help change the climate. The Chief Secretary will be glad to arrange more detailed briefing for any Minister who would find this useful.

Copies of this minute go to all members of the Cabinet, and to Sir Robert Armstrong.

3.41 cc F.B.

ANNEX A

PUBLIC EXPENDITURE TRENDS, PAST AND FUTURE

a. Public expenditure in the past

i. It has risen by 319% in cash, or 13.9% in cost terms (ie after allowing for inflation) in the last ten years - from £28.5 billion to £111.6 billion

ii. Since 1978-79, it has risen by 82% in cash, and 5.4% in cost terms. As a proportion of GDP, it has risen from 40.9% in 1978-79 to 43.6%.

iii. Though part of the increase under this government is due to deliberate decisions to spend more on defence (+24% in cost terms) and law and order (+29%), some is the result of extraneous factors such as demographic trends and recession (which have combined to produce an increase in social security spending of 22% in cost terms). Health, too, has risen by 14% in cost terms.

iv. As a result, taxation is a bigger burden in the UK than in most industrial countries. It has shot up from 36% of GDP in 1980 to 40% in 1982.

v. But we can ill afford such a high level of taxation. Worth noting that Germany, with a much higher GDP per head, takes only 37% of GDP in tax. France has 43.75% and is desperately trying to reduce this.

b. Current plans

i. Total public expenditure will rise from £119.6 billion - this year - to £132.3 billion in 1985-86. In cost terms, making an estimate of future inflation, this is roughly constant.

ii. As a ratio to GDP it will be about 43½% this year, falling in future as the economy starts to grow again.

iii. Within this, defence and health will grow slightly; other programmes should remain constant or fall slightly.

iv. So the plans up to 1985-86 contain the growth in public expenditure.

c. But if current policies continue, the underlying upward trend of expenditure will begin to reassert itself, for demographic and other reasons.

Supposing the economy grows at 2½% a year, then by 1992, on realistic assumptions of further growth in programmes:

i. total expenditure might increase by 12½% in cost terms

ii. it would still take 40% of GDP - compared with 43½% now.

And if the economy only grew at ¾% a year from next year on, roughly our experience in the last 10 years, then

i. expenditure might grow a bit more slowly - 11½%

ii. but it would take an even larger share of GDP - up to 47%

All these totals are based on projections of current policies and plans, without any new developments. We may have overestimated some, and underestimated others. So have not given figures for individual programmes. But broad picture probably right. If so, some rethinking is clearly needed.

Implications for taxation (if one were to assume that borrowing levels off at 2% of GDP): at best no reduction (in the high-growth case) but in the low-growth case, a large increase - from 40% to 45% of GDP. That could mean, eg, doubling the basic rate of income tax; or significantly reducing personal allowances; or doubling VAT.

Of course expenditure cannot be allowed to grow as fast as that - very unlikely we could get 2½% growth unless we did cut taxes; and cannot cut taxes without reducing expenditure.