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CABINET

THE LONGER TERM

Note by the Chancellor of the Exchequer

1. The issues we are to discuss on 9 September are among the most important we shall consider at any time in this Parliament. The way we handle them will crucially affect the policies we put forward at the next election, and the performance and shape of the economy for many years to come.

THE PROBLEM

2. We came to power in 1979 with a firm commitment to reduce the share which the State takes of the nation's income. We argued in the manifesto that when the State spends and borrows too much, "taxes, interest rates, prices and unemployment rise so that in the long run there is less wealth with which to improve our standard of living .....". Our experience since 1979, and all experience abroad, has demonstrated how well-founded that judgment was. The report by officials (C(82) 32) shows, however, how far we still are from fulfilling our manifesto commitment: indeed, if we maintain our present policies, with the expenditure to which they commit us, we could well move in the opposite direction.

3. Since 1979, prospects for the world economy have worsened substantially. It is clear that no one can now confidently predict more than a fairly modest world growth during the rest of this decade. In addition, the United Kingdom economy has faced the particular problems of the pay explosion of 1979-80 and the rise in the exchange rate resulting from the petro-currency status of sterling. The resulting loss of competitiveness will take some time to remedy.

4. It is against this difficult background that the official report describes two "scenarios" for the development of the economy to 1990. Neither is a forecast: they simply illustrate what might happen if we maintain our present expenditure policies against two economic backgrounds, one rather more favourable than the other. On the low-growth Scenario B, the report shows that public expenditure might rise to nearly 47 per cent of Gross Domestic Product (GDP) in 1990-91 - a higher proportion than at any time since the

dismantling of the war economy. This level would be nearly 6 percentage points above that of our first year of office and 3 points above what we have agreed for 1982-83. Such a major departure from one of our central aims for the economy would, surely, be altogether unacceptable.

5. On the somewhat more optimistic assumption of $2\frac{1}{2}$ per cent growth in Scenario A, public expenditure would still be nearly 40 per cent of GDP by 1990. This is somewhat below the level of 1979-80 and about 4 points below that planned for 1982-83. But we cannot be reassured by this. In real terms, public expenditure would still be higher in 1990-91 than in 1979-80 or 1982-83. Moreover, some of the assumptions on which the projections are based are, if anything, over-optimistic. They make little allowance, for example, for the increases in expenditure which public opinion might expect in a period of higher growth. And they ignore "creep" - the apparently inexorable tendency for the planning total for any future year to be added to as it comes closer to the present because new and compelling policy commitments are entered into, or for other reasons. (The effect of this in recent years is clearly illustrated by the chart at Annex A.)

6. Moreover, the projections in the officials' report, showing as they do significant increases in the social security, health and defence programmes, imply a degree of restraint in the provision of other public services which may in the event prove politically unacceptable. We need to give ourselves some room for manoeuvre in public expenditure.

7. I accordingly believe that -

a. We must find new ways of permitting some of the demands to be met, both by encouraging people to make extra provision for themselves, at least at the margin, and by finding ways in which those extra services demanded can be supplied without burdening the Exchequer.

b. We must consider carefully the extent to which we are denying ourselves room for manoeuvre by past pledges and commitments. We must review these, questioning both the objectives and, in some cases, the underlying assumptions. Where priorities have changed, we must be prepared to drop commitments or modify them, perhaps drastically.

c. We must look much more closely at the efficiency of our spending programmes. This means in practice not only policy reviews, scrutinies and stringent control of manpower, but also opening up more of the business of central Government, local government and the National Health Service to private sector competition, as is already being undertaken with local authority direct labour organisations.

d. Last but not least, it is essential that we get across to the country at large the nature of the longer-run problems of public spending and then seek its support and understanding for sensible ways of solving them.

TAXATION AND GROWTH

8. I attach at Annex B a note by the Treasury which considers what the expenditure projections in the officials' report (C(82) 32) could mean for taxation.

9. On the face of it the gap between revenue and expenditure in Scenario A in C(82) 32 does not look too bad. But the better growth of output and productivity reflected in this Scenario is based on an expansion of the private sector encouraged by reductions in interest rates and in taxes, especially taxes and charges on business, such as Corporation Tax, National Insurance Surcharge or other National Insurance charges. It will also be important if we are to achieve this better growth performance, to reduce personal taxation so as to improve incentives. We cannot secure the lower interest rates that the private sector needs if we do not hold the Public Sector Borrowing Requirement down firmly. The way forward to better economic performance can therefore only be through reducing expenditure.

10. The rates of tax implied by the low growth Scenario B and related expenditure projections would plainly be quite unacceptable. They would be seriously damaging to industry and crippling in their effect on personal incentives. Moreover, the increases which would be needed are if anything understated, partly because the expenditure projections make no allowance for "creep", but also because such high rates of tax would create major problems of evasion and enforcement. They would almost certainly run into diminishing returns and lead to a further growth in the black economy.

OVERSEAS EXPERIENCE

11. The United Kingdom is not alone in having to take hard decisions on public spending. Other countries, too, have had to rein back spending plans. They include both rich and poor. Among our major industrial partners, the United States, Germany and Japan have all sought spending economies. The French Government, too, is now seeking stringent cuts in its previously ambitious plans. Even among the Scandinavian countries, with a long tradition of high public spending, economies are being made. In many cases, previously sancrosanct programmes such as social security, health and education have had to share in the reductions. In developing countries in Africa, Asia and Latin America, reductions in public spending plans form a vital part of many of the adjustment programmes agreed with the International Monetary Fund. Mexico is the most recent to join the list.

CONCLUSION

12. The record of the past two decades has shown all too clearly the dangers of formulating or accepting policy commitments on the assumption of a continuing economic growth which in the event has not been achieved. It has been a failure of successive Governments that they have assumed growth in the economy without taking the steps necessary to make it possible. Successive expenditure reviews have thus followed a dreary cycle of over-optimism followed, inevitably, by retrenchment.

13. As a Government we need a more robust strategy than this. We must not make the mistake of assuming that faster growth will float us over the rocks. We need to create the conditions for a freer and more prosperous society, in which the public sector is smaller and taxation is lower. This calls in my view for some thorough study and new insights, leading at a later stage to radical decisions affecting most if not all of the major programmes. We cannot neglect any possible approach.

14. I am not now proposing some kind of long-term total for public expenditure, still less specific cuts or changes of direction in any particular area of expenditure. I do, however, invite my colleagues to agree that the prospects suggested by the officials' reports are unacceptable, and that we need to take a new and fundamental look at levels of public spending. More specifically, I seek their agreement -

a. that (except where work is already in hand) we should as a first step commission further studies along the lines identified by the Central Policy Review Staff in their paper (C(82) 31) (and in the Annex on minor options) as well as any other possibilities which colleagues may care to suggest. These studies should be completed and reported back to the Cabinet in the spring of 1983;

b. that meanwhile, to allow ourselves freedom of manoeuvre, we should agree to make no further public commitments which would add significantly to expenditure beyond 1985-86, and that we should avoid repeating former pledges which would otherwise expire;

c. that in considering this year's public expenditure Survey we should have particular regard to the longer term implications of our decisions, especially, for the "new" year 1985-86; and

d. that we should consider further how these difficult issues might best be presented to our supporters in Parliament and to the country at large.

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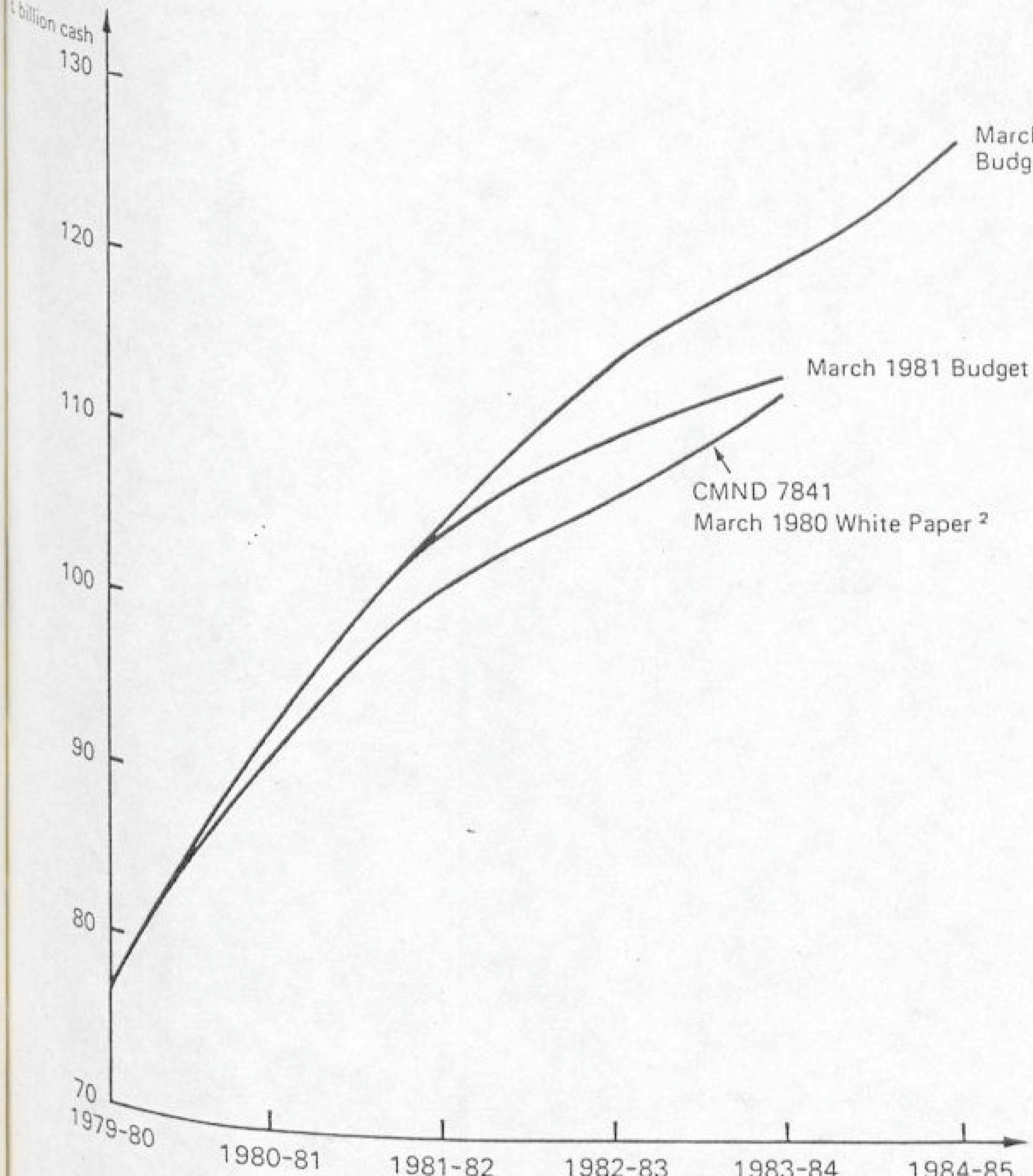
Treasury Chambers

3 September 1982

PUBLIC EXPENDITURE PLANNING TOTALS

£ billion cash



Notes:

[1] Converted into cash from the plans in 1980 Survey Prices.

[2] Converted into cash using the same inflation assumptions as used for converting the MARCH 1981 BUDGET plans.

PUBLIC EXPENDITURE IN THE LONGER TERM
FISCAL IMPLICATIONS

The longer term public expenditure exercise has projected expenditure to the end of the decade on two illustrative macro-economic scenarios, the main features of which are shown at Annex 1 of the Public Expenditure Paper. This note describes a similar projection of tax revenue on each of the same scenarios, and goes on to look at the balance between revenue and expenditure that is implied. Like the expenditure figures, these projections are dependent on the scenarios assumed: they are not forecasts. The margin of error is inevitably wide when looking so far ahead.

Assumptions

2. Like expenditure, taxes have been projected on the basis of unchanged policy. This has been interpreted to mean that income tax thresholds and specific duties are raised in line with prices, that tax rates are unchanged and that existing allowances and reliefs are continued. Local authority rates and National Insurance Contributions are calculated from the projections of local authority expenditure and expenditure from the National Insurance Fund, respectively, on the assumption that an unchanged proportion of such expenditure is met from general taxation. For North Sea taxes the real sterling oil price is assumed to rise by about a third between 1980 and 1990. (This reflects both a rise in the $ price and a fall in the exchange rate.) Even though some new fields are assumed to come on stream, total production is assumed to be a little below its peak level, which is reached in mid-decade.

The projections

3. If scenario A were to be fulfilled, the projections suggest that tax receipts would rise by about 20 per cent in real terms. This is a rather smaller increase than that assumed for GDP in this scenario so that taxes as a percentage of GDP fall from 39½ per cent to just over 37 per cent. (See table A). However, this mainly reflects a fall in local authority rates and National Insurance Contributions as a percentage of GDP: this would only occur if local authority spending and benefit payments from the National Insurance Fund were in fact held to the levels assumed in the Expenditure projections. Income tax and consumption taxes fall slightly in relation to GDP, the former because the scenario assumes a falling wage share, the latter because the evidence is that a 10% rise in income leads to less than a 10% rise in consumption of goods that bear specific duties. The yield of capital taxes also declines in relation to GDP, largely because of the indexation of CGT. Corporation tax and North Sea taxes, on the other hand, rise somewhat as a percentage of GDP.

4. On scenario B projected tax receipts rise by only 6% in real terms - a good deal less than on scenario A. But GDP also rises more slowly and taxes remain roughly constant as a percentage of GDP at just below 40% (see table A). Local rates - derived from the Expenditure projections - fall in relation to GDP as in scenario A, but NICs remain a roughly constant proportion of GDP because the limited growth in benefit expenditure matches the limited growth in GDP. Capital taxes again fall in relation to GDP. Against this North Sea taxes and income tax rise as a percentage of GDP. (Corporation tax is about constant). The reason why income tax rises in relation to GDP on scenario B, unlike scenario A, is that wages and salaries rise as a share of GDP. 80-90% of the yield of income tax comes from wages and salaries. Consumption taxes, however, fall as a percentage of GDP because of the tendency for expenditure on goods bearing specific duties to rise less fast than income.

Implications

5. On scenario A the projected gap between expenditure and revenue narrows to about 2 per cent of GDP by the end of the decade - no smaller as a percentage of GDP than the target figure set for the PSBR in the last year of the Medium Term Financial Strategy. Moreover, the tax projections make no provision for raising income tax thresholds in real terms or for cutting tax rates to help personal incentives, or to ease the disincentive effects of the poverty trap. Nor do they allow for any reduction in the rate of business taxation*. Corporation tax payments are projected to rise as a percentage of GDP. Without tax reductions to improve incentives and increase net company profitability it is doubtful whether the economic growth postulated could be achieved.

6. If the economy develops less favourably as in scenario B the problem of financing public expenditure is likely to be much more severe. The projections show expenditure - which is little lower than in scenario A - exceeding revenue by 7% of GDP. If this gap were bridged by borrowing the implication is a reversal of progress so far made in reducing the PSBR. Indeed, as a percentage of GDP, borrowing approaches the levels which precipitated the 1976 crisis. But if borrowing were to be restrained to 2% of GDP without cuts in expenditure , taxes would have to be raised by the equivalent of £15 bn at today's prcies. The tax burden would rise from 40% to 45% of GDP (having already risen from 35% to 40% since 1978-79. See Chart J).

7. If the £15 bn came from income tax alone, the yield would have to be raised by about half. If it came from the consumption taxes (VAT and specific duties) their combined yield would similarly have to be increased by half. (Raising £15 bn in VAT only would require the VAT yield to be doubled). The response of

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* Though if the expenditure projections in this scenario are fulfilled, the combined National Insurance Contribution rates of employers and employees taken together could fall by something like 1½ per cent. (There could also be some fall in local authority rate poundages).

taxpayers to changes on this scale cannot be predicted with any precision. But in crude "ready reckoner" terms what is implied is, at the least:

- raising the basic rate of income tax to about 45p (more if the tax base were reduced through evasion or disincentive effects). Deductions of tax and NIC together would then be over 50 per cent on a marginal £ of income for nearly all taxpayers.

or - abolishing all allowances other than the single allowance (e.g. the married man's allowance, mortgage tax relief, relief for pension contributions and life assurance) <u>and</u> raising the basic rate to perhaps 33p.

or - raising VAT to 25% and doubling the real level of all specific duties.

or - levying VAT at 25% on goods which now bear the 15% rate <u>and</u> those now zero-rated (food, fuel, etc.).

Conclusions

8. The projections are, as stressed above, subject to a wide margin of error. But they demonstrate the difficulty of financing the levels of public expenditure implied by the continuation of current policies. If the economy grows very slowly, as in scenario B, the consequences for taxation and/or borrowing are very serious. The economy would need to grow steadily and strongly, as in scenario A, to permit the sort of expenditure levels envisaged. It is doubtful whether this growth could arise without any further Government action to improve work incentives or to improve businesses' profitability through tax cuts. But if taxes <u>were</u> cut borrowing could not be restrained to 2% of GDP and the inflation and interest rate assumptions would begin to look implausible.

Table A: Tax yields at constant (1980-1) prices and as a percentage of GDP

	£bn 1980-1 prices.			% of GDP		
	1982-3	1990-1 Scenario		1982-3	1990-1 Scenario	
		A	B		A	B
Income Tax	25.7	32.3	29.4	11.1	10.9	12.0
NIC's	16.4	18.6	17.5	7.0	6.3	7.1
Consumption taxes (incl VAT and specifics)	26.6	32.7	27.3	11.4	11.1	11.1
LA Rates	10.5	9.3	9.2	4.5	3.2	3.7
Corporation Tax, North Sea taxes and NIS	11.1	16.0	13.1	4.8	5.4	5.3
Capital Taxes	1.8	1.1	1.1	0.8	0.4	0.4
TOTAL	92.1	109.9	97.4	39.4	37.2	39.7
Public Expenditure (incl debt interest)	103.0	116.0	115.0	44.0	39.3	46.8

Note: Columns do not add exactly to totals because of rounding

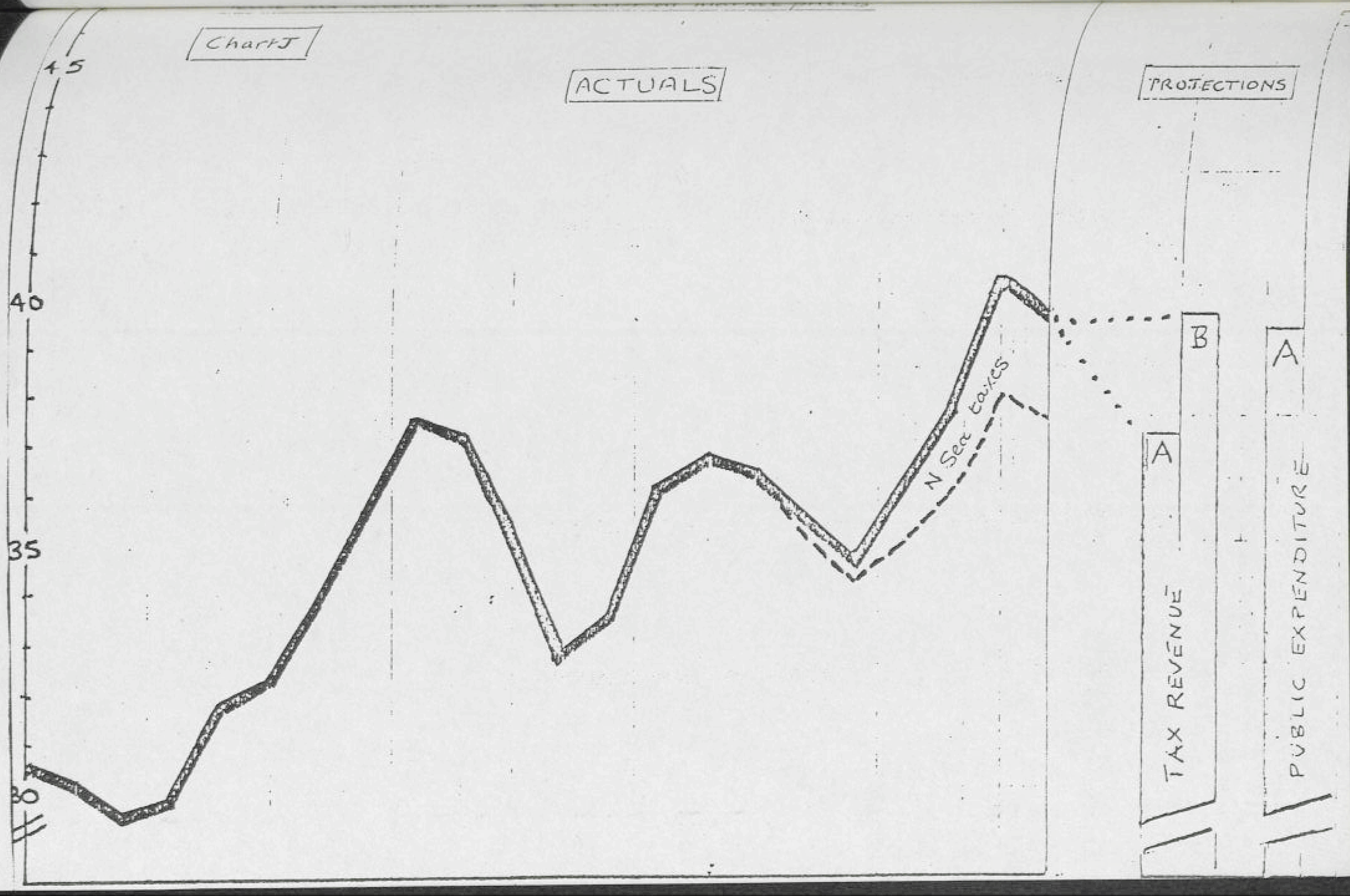

Chart J
ACTUALS
PROJECTIONS
45
40
35
30
N Sea taxes
B
A
A
TAX REVENUE
PUBLIC EXPENDITURE