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SECRET

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PRIME MINISTER

Public Expenditure and the Economic Outlook

(C(80) 3, 4, 5, 6 and 7)

BACKGROUND

Cabinet agreed in December (CC(79) 25th Conclusions, Minute 6) to aim at further reductions in the planned levels of public expenditure of £1,000 million in 1980-81 and £2,000 million in each of the subsequent years. The Chancellor offered at the same time to circulate a paper about the wider economic strategy, and about the role of monetary policy and the consequent need to keep down public expenditure and the PSBR.

2. Since Christmas, there has been the usual series of bilateral and multilateral talks, in which the Chancellor has been supported by the Home Secretary. He reported the first results of these talks to you at your private talk on 17th January, and again in his minute of 21st January. Since then he has made further progress. The main outstanding points now relate to housing and local government manpower, to the Defence Budget (on which I have minuted you separately), to employment measures and to certain parts of the social security programme. In addition, he wants Cabinet to endorse some of the bilateral agreements he has reached with spending Ministers, because of their wider political implications, and to get sufficient backing from Cabinet to be able to agree some other issues with spending Ministers before next week's Cabinet.

3. Cabinet thus has five papers in front of it. The first is the general economic and monetary background (C(80) 4) which will be convenient to take first. The second main paper, C(80) 3, is the public expenditure one: discussion of the three supporting papers (on special employment measures; on social security uprating; and on housing) can be fitted in as the Cabinet works through the main paper.

HANDLING

I. Economic and Monetary background

4. You might ask the Chancellor to introduce this paper (C(80) 4): as noted above, it was commissioned by Cabinet. It calls for endorsement rather than decision, and it should not require prolonged discussion provided that all your colleagues accept the underlying premise that there is no acceptable alternative to the strategy to which the Government has set its hand.

5. The Chancellor concludes that there is no 'alchemist's stone' which would allow him to dispense with the present monetary restrictions. Cabinet may grumble, but is likely to endorse this conclusion. You might run briefly round the table: the Ministers most likely to want to join in are the Secretary of State for Employment and the Minister of Agriculture (still grumbling) and the Secretary of State for Industry and Secretary of State for Trade (broadly in support of the Chancellor). The Home Secretary might also be ready to support the Chancellor. But the Chancellor's paper deals with all the obvious escape routes which Cabinet talked about last time: the hope that oil would float us off the rocks; the expectation that the Government's policies will take effect more quickly than the Chancellor reckons; the hope that interest rates will begin to turn down of their own accord; the possibility of reimposing the 'corset' in some tighter form; hire purchase and direct credit controls as an alternative or supplement to interest rate policy; going back on the exchange control decision; monetary base control. You will need to give some of these arguments a run if they are raised, but you might guide the Cabinet, fairly briefly, to agree with the Chancellor that there is no real alternative to the strategy on which it is already embarked.

II. Public Expenditure

6. You might start yourself by making five general points:

(i) Timing. It is essential that the Cabinet complete its discussion by next week. This is necessary both to give the Chancellor time to prepare his Budget, and to complete the printing of the Public Expenditure White Paper for publication ahead of the Budget.

(ii) There has already been a good deal of Press speculation. It is important to keep these discussions absolutely confidential until the decisions are announced. /NB: this may be before the publication date for the White Paper: see below. I suggest you do not get Cabinet involved in discussion of timing and presentation until they have taken the actual decisions./

(iii) The economic outlook is, if anything, even more forbidding than it appeared in December. (Oil prices, Afghanistan/Iran, etc.)

(iv) Yet the agreed savings listed here (Annex A), together with some of the other possibles, still do not add up to the Chancellor's - and the Cabinet's - original target. To some extent the short-fall may be made good by a volume squeeze, if inflation runs ahead faster than cash limits. But this is an unsatisfactory way of keeping the PSBR down, and the use of cash limits as an ex ante volume squeeze is liable eventually to discredit the cash limit system. Clear decisions on volume would be better - and those in the Chancellor's paper are the only ones on offer at this stage.

(v) Inevitably, discussion will focus most on 1980-81. But the short-fall is almost as serious in later years. Cabinet has agreed to publish full five-year public expenditure figures. But it may well have to return to the levels for later years next summer, when it looks at the 1980 Survey. Ministers may therefore want now or later to identify those areas where they think there is scope for still further savings, so that detailed work can be done on them during the Survey period. Some such points may emerge in discussion today and next week.

7. You should then invite the Chancellor to introduce the discussion, which he will do briefly. He will have three objectives: to get Cabinet ratification of the agreed cuts listed in Annex A; to get a favourable decision on Child Benefit, the biggest unresolved issue which is ripe for Cabinet decision this week; and to get sufficient guidance from Cabinet on the other issues to be able to conduct further bilaterals between now and next week. To do this it is important that Cabinet should complete a first run through the complete list at the first meeting.

8. You should then take the Cabinet through the individual issues in the sequence listed in the paper, bringing in related topics at the appropriate point (as shown below). The agreed figures are all listed in Annex A to C(80) 3, which also shows in brackets the Chancellor's original bid, for comparison.

(a) Social Security including Child Benefit. (Paragraph 5 and Annex C; also C(80) 6).

The proposal to abolish Earnings Related Supplement is agreed with the Secretary of State for Social Services. But it means reopening a decision taken by Cabinet as recently as 25th October (CC(79) 18th Conclusions, Minute 4) when it was agreed that the Government should not go back on the contractually-earned right to ERS. This is, however, the biggest single social security saving available, and if it is not acceptable substantial new savings will have to be found elsewhere. In judging this issue colleagues will especially need the judgment of the Leader of the House and the Chief Whip.

Mr. Jenkin has also agreed to cut the real level of short-term benefits (unemployment, sickness, maternity and injury benefits, widow allowances and long-term invalid), uprating them by 10 per cent less than is needed to keep pace with prices. At this point you will want to draw colleagues' attention to Annex C of the Chancellor's paper which makes it clear that what is proposed is a 10 percentage point shortfall, not a 90 per cent uplift. This is a major cut in the real value of these benefits. The Chancellor sees this as a 'change of gear' which would permanently shift the regular uprating on to a trend line below the present one. (The discussion at Wednesday's E on the taxation of unemployment benefit will be relevant). The Chancellor may also propose later - but not at this meeting - a similar 'change of gear' in relation to the Defence Budget and the NATO commitment. Cabinet has of course already accepted the need, wherever possible, to 'de-index' benefits and public sector wages. The Chancellor's proposals are not quite this - being a substitute for tax - but have much the same effect.

There is a quite separate problem over long-term benefits, which erupted at Question Time last Thursday, and is now dealt with in a joint paper (C(80) 6) by the Chancellor and Mr. Jenkin to which Cabinet could now turn. The question is whether, given the Manifesto commitment to make good the 1978 shortfall (which has been done), the Government should also make good the shortfall on its own 1979 uprating. If so, when should this be announced? Both Ministers agree that there is no obligation to put right the 1979 'earnings' shortfall. If Cabinet agrees (as I think they must), in what terms should the announcement be made, and when? Is the formula in paragraph 8 sufficient?

The unresolved issue concerns Child Benefit. The Chancellor wants to carry the de-indexation principle still further (and it should be easier, in principle, to do so for Child Benefit, which is not yet formally indexed). The Secretary of State wants to uprate in line with prices, because of the effect on incentives if this is not done. Whatever is decided on Child Benefit, he wants to keep children's supplementary benefit on a full uprating basis, arguing that this has very little effect on the in-work/out of work incentive problems. As you know, a fuller report on incentives is in preparation, but will not be ready in time for these Cabinet discussions. However, its tentative conclusions would, I understand, probably support Mr. Jenkin's case on both counts. Against this, the Chancellor feels that he must get the Child Benefit decision in his favour: £85 billion is at stake next year.

(b) Health (Annex A)

This is a convenient point at which to pick up the proposed reductions in the Health Service, which have been agreed with Mr. Jenkin. They are listed in Annex A as 'agreed' and described there. Mr. Prior complained last time that he had not realised prescription charges were to be increased. Is he content that they should be increased further this time? Does the Cabinet agree? What will be the effect on the RPI?

(c) European Community (paragraph 6).

At official level, there are signs that Departments feel their programmes are being cut unnecessarily, when there is a prospect of savings on the European Budget later in the year. If this argument emerges, you will probably want to ask Cabinet not to count its chickens. It is far from clear that we shall get the whole £1 billion reduction in the European Budget; even if we did, the Chancellor's strategy ideally requires even more savings than those Cabinet has agreed to find. The prospect of success in the EEC Budget negotiations is not an excuse for failing to take difficult decisions on domestic programmes.

(d) Cash Limits (paragraph 7)

Cabinet has already approved most cash limits for next year, building in a 14 per cent inflation assumption for central Government. The cash limits for the central Civil Service vote and for the defence budget, however, have yet to be agreed. If inflation were to continue next year at something like the present 17 per cent rate, there would be a quite sizeable volume squeeze implicit in these limits (yielding as much as £450 million); but, as the paper notes, obvious difficulties about publishing these. For the moment, Cabinet need only note the problems this would raise. Mr. Pym will probably keep quiet at this point, because these matters are under separate discussion; but such a squeeze (quite apart from any further squeeze on Armed Forces' pay) would make it even harder for him to maintain his 3 per cent volume growth rate. If anyone else challenges these assumptions, you should remind them that Cabinet has already decided the main cash limits and there is no going back on them.

(e) Local authority manpower (paragraphs 8-9 and C(80) 7).

As Annex A makes clear, Mr. Heseltine was asked to make much bigger cuts in the housing programme than he has in fact offered. The shortfall is £75 million in 1980-81 and £146 million, £85 million and £180 million in the subsequent years. His suggestion is that further economies in 'his' area could be found by further cumulative 1 per cent reductions in current expenditure on local authority services. But this is not in his gift. First it is not clear what base-line he proposes to apply this 1 per cent cut to: is it the figures which emerge from the Cabinet's decisions this month, or is it the earlier figures agreed by Cabinet but never announced? If the latter, local authorities will not know what they are supposed to be cutting. Next, how would he make it stick? The most he can do is to issue exhortation to local authorities, and to reduce the 'eligible expenditure' for RSG purposes. But local authorities would not necessarily reduce their expenditure correspondingly: they might choose to put up rates instead. Next, is such a percentage cut acceptable across the board, given the sizeable reductions already made in other local authority services? Finally, does it reflect the Government's own priorities? How could the present exemptions for the 'law and order services', and the relative protection of the Education budget, be continued? (The Chief Secretary has circulated some relevant figures as C(80) 7). All in all, this looks like a rather hastily-conceived gimmick, and the Chancellor will not wish to accept it. He will have some support for this line from the Secretary of State for Education. The Home Secretary will certainly oppose Mr. Heseltine's plan, and believes that more can be taken off the housing programme.

(f) Civil Service and other manpower cuts

The cuts listed in Annex A already take full account of the manpower reductions agreed by Cabinet before Christmas. The question is whether any further overall reduction should be made. Some Ministers may be disposed to argue that there is still plenty of administrative fat: and that the "Rayner" and similar exercises will sweat it off. They will want to take credit for these further savings. The Chancellor (and Mr. Channon, who you may wish to call at this point) will remind them that they were very reluctant indeed to come up with any further specific manpower savings last year. In addition, they are already being subject to an overall volume squeeze, of indeterminate size, through the operation of cash limits. It does not seem realistic to impose a further administrative 'super cut' across the board.

(g) Housing (paragraph 11)

Mr. Heseltine has agreed to reductions in the housing programme of £225 million in 1980-81, £364 million in 1981-82, £415 million in 1982-83 and £420 million in 1983-84 (listed in Annex A). But he is not prepared to say how this will be found. This presents some technical problems: how will the cuts be described in the White Paper? It leaves Government spokesmen a little exposed if they are asked to explain the figures. There is a general feeling in Cabinet (to which you have referred yourself) that Mr. Heseltine was too soft on council house rents last time. Can he be persuaded to firm up his proposals now? If so, he might be invited to discuss with the Chancellor between now and next week, and to come back with firm proposals. These should certainly include a statement of the effects on the RPI. The CPRS note that it might be possible to go further on housing subsidies than would otherwise be possible if the Government were prepared to consider a gradual elimination of housing subsidies, public and private.

(h) Defence (paragraph 12)

I have minuted you separately on this. For the moment, you need only take note simply that talks are continuing.

(i) Education (paragraph 13 and Annex A)

Although these cuts, largely in student grants and charges for nursery schools, have been agreed with the Education Ministers, they need ratification by Cabinet because of the political implications and the effect on the RPI (not quantified in the paper). You will note that the Home Secretary and other Ministers feel that there is scope for further reductions in the Education budget: does Cabinet wish the Chancellor to pursue these ideas bilaterally with Education Ministers before next week?

(j) Employment (paragraph 14, Annex A and C(80) 5)

The Secretary of State for Employment has accepted the reductions listed in Annex A, subject to consultation with the Manpower Services. They fall mainly on training. But he is not prepared to give up his additional bid for 'special employment measures' next year. These are described in his separate paper C(80) 5. They were the subject of preliminary discussion at E(EA) last week, but this was necessarily inconclusive because the Chief Secretary reserved his position. Mr. Prior's additional bids would amount to a maximum of £18 million in 1980-81, against which some receipts from the European Social Fund might be expected (figures in Annex 1 to his paper). The arguments are set out extensively in his paper. The decision is a straightforward one. In addition, a decision is needed on the taxation of the job release scheme allowance: the Chancellor wishes to tax it, in line with his proposals on short-term benefits. But because of existing undertakings, the payments would have to be correspondingly grossed up for tax, at a cost of £34 million, as well as incurring some additional administrative expenses. Mr. Prior proposes postponement of the tax decision for a further year. The sums involved are not large, and barely affect the PSBR at all. If the Cabinet does not decide the issue one way or the other this time, they might invite Mr. Prior to pursue the subject once again with the Chancellor, with a view to getting agreement before next week's discussions.

(k) Other agreed savings

At this point, you might ask Cabinet to confirm that the remaining savings listed in Annex A as 'agreed' can be taken as approved. The ones not so far discussed are those on page 2 of that Annex: Transport, FCO; Home Office; Energy; Legal Aid; and Export Credits. None of these seem to raise serious political problems which involve anyone beyond the spending Ministers concerned, who have already agreed to these cuts.

(l) Earnings rule

The CPRS note that, if it were desired to find additional savings for the later years, quite large provision is made (£35 million for 1982-83, rising to £125 million for 1983-84) for implementation of the Manifesto commitment to phase out the "ER" during this Parliament. It is arguable that deferring this commitment would be a good deal less painful than some of the measures already agreed. Indeed the objective of the commitment (to encourage retirement pensioners to go on working) may be open to question in present circumstances.

(m) Resulting figures

The results of these cuts, subject to any further bilateral discussions, are summarised in Annex B of C(80) 3. In his paper, the Chancellor proposes that publication in a Public Expenditure White Paper in March (just ahead of the Budget). But he is likely to suggest (next week, if not this) that, because of the risk of leaks, and the need to convince public opinion that the Government means business on public expenditure, he should announce the main decisions earlier than this, by way of a statement, Written Answer, or in some other form. All you need to do today, I suggest, is to get the Cabinet's agreement that, once final decisions have been taken, they should be announced between now and the Budget.

CONCLUSIONS

9. I think you might try to record agreement as follows:

(1) That Child Benefit should be uprated by /£1/, /50p/ in November 1980, with a premium of /£1/ for fourth and subsequent children.

(2) That Supplementary Benefit child allowance should be increased by /£1/ per week.

(3) That no decisions should be taken at this stage about the figures to be published for the United Kingdom contribution to the EEC Budget.

(4) That the possible implications of the 1980-81 cash limits for volume of public expenditure should be noted, without any final decisions this week.

(5) Either that the Secretary of State for the Environment should be asked to find further savings on his programmes in lieu of the suggested 1 per cent cut on manpower, and to agree them with the Chancellor; or that the Chancellor, in consultation with the Secretary of State for the Environment and others concerned, should examine further the 1 per cent reduction and agree on how it should be applied and enforced.

(6) In addition /possibly/ that the Secretary of State for the Environment should agree with the Chancellor of the Exchequer further identifiable potential reductions (of £X million, to be specified if possible) in the housing programme, to be considered by Cabinet next week.

(7) That no further general squeeze other than that implied by cash limits, should be imposed on central government expenditure.

(8) That the Chancellor and the Secretary of State for Defence should continue their discussions of the Defence budget.

(9) That the Education programmes should be reduced as shown in Annex A to C(80) 3, and that the Secretary of State for Education should agree with the Chancellor on the scope for further savings.

(10) That the new Special Employment Measures proposed by the Secretary of State for Employment in C(80) 5 be turned down. /Or alternatively, remitted to the Chancellor and the Secretary of State for Employment for further bilateral discussion./

(11) That the remaining cuts noted in Annex A should be approved.

(12) To invite the Chancellor to pursue with the Ministers concerned any further potential savings identified in discussion.

ROBERT ARMSTRONG

(Robert Armstrong)

23rd January, 1980

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Original of attachment on Pub. Expen. Pt 7.

PRIME MINISTER

Social Security Options

I attach at Flag A a list of all the social security changes which the Chancellor has agreed with Mr. Jenkin - together with the amount of money which would be saved against each one. At Flag B are some examples of what would happen to typical beneficiaries.

Points to note are:

i) Widows' allowance is not to be changed (annex A of the Cabinet Paper is wrong).

ii) The Chancellor agrees that Earnings Related Supplement cannot be abolished with effect before January 1981 without blatantly breaching the "contribution contract". ~~immediately~~.

iii) I think a distinction can be drawn between short term and long term benefits. Thus, it would seem reasonable to cut unemployment, sickness, maternity and injury benefits; but not invalidity benefits. Whether we can cut the short term benefits by as much as ten percentage points is another matter.

iv) The reductions in unemployment benefit and supplementary benefit could be justified perhaps as being in lieu of tax which will not start up until 1982. It is not proposed that other benefits will be taxed (except for ERS if it is continued).

v) Flat rate unemployment benefit lasts for twelve months and likewise sickness benefit. ERS lasts for six months.

/vi)

vi) All the measures proposed require primary legislation: the necessary changes could be made in the Social Security Bill which is now in committee.

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23 January 1980

SOCIAL SECURITY OPTIONS AGREED BY CHANCELLOR AND MR. JENKIN

	£m. at survey prices	
	80/81	81/82
Abolish ERS	-	260
Reduce up-ratings by 10 percentage points less than price inflation:		
Unemployment Benefit	22	65
Sickness Benefit	17	50
Invalidity Benefit	25	80
Maternity Benefit	4	10
Injury Benefit	2	5
Up-rating of short-term supplementary benefit by the lower of earnings or prices (assumed to be 2% point saving)	10	25
Postpone 1980 up-ratings by 1 week	40	40
Miscellaneous Changes: i) Abolish death grant ii) Abolish unemployment benefit for occupational pensioners with large incomes iii) Change "linking rule" (ie at present there are no waiting days if you fall sick or become unemployed within 13 weeks of last becoming sick or becoming unemployed. The proposal is to reduce this period to 8 weeks)	10	40
<u>Less</u> increased claims for supplementary benefit caused by above measures	20	70
	110	505

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EFFECT OF AGREED SOCIAL SECURITY CHANGES, ON AVERAGE EARNERS

1. The two key changes are:

   (i) put up sickness, invalidity, unemployment benefit 10% less than prices in November 1980.

   (ii) abolish the Earnings Related Supplement (ERS) to unemployment and sickness benefits in January 1981.

2. Examples

   A. Single man with average ERS of £11 to unemployment or sickness benefit.

(a) Now receives	£29.50
(b) With 15% uprating would in November get	£32.30
(c) With only 5% uprating will get	£30.45
(d) From January '81 with abolition of ERS gets	£19.45

   B. Married couple, with average ERS of £11 to unemployment or sickness benefit.

(a) Now receives	£40.95
(b) With 15% uprating would get in November	£45.45
(c) With only 5% uprating will get	£42.45
(d) From January 1981 with abolition of ERS will get	£31.45

   C. Married couple with two children, with average ERS £11 to unemployment or sickness benefit.

(a) Now receives	£52.35
(b) With 15% uprating and £2 child benefit increases would get in November	£57.35
(c) With only 5% uprating and £2 child benefit increase will get	£54.35
(d) From January 1981 with abolition of ERS will get	£43.35

Notes: 1. ERS lasts for a maximum of 6 months.
2. A person getting ERS when abolition occurred would continue to get it for that spell of sickness or unemployment, so he wouldn't have a cash cut.
3. Assumed throughout no entitlement to supp ben.

D. <u>Married couple with two children, on long-term Invalidity Benefit</u>

(a)	Now receives	£62.60
(b)	With 15% uprating would get in November (with £2 CB increase)	£70.75
(c)	With only 5% uprating will get (with £2 CB increase.	£66.70
(d)	From January 1981 will continue to get (ERS not having been in payment)	£66.70