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ACNO

Treasury Chambers, Parliament Street, SWIP 3AG
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6 October 1983

Andrew Turnbull Esq
10 Downing Street
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Dear Andrew,

PUBLIC EXPENDITURE: EXPERIENCE ABROAD

One of the enclosures to Michael Scholar's letter of 27 September was a note by Ferdie Mount putting our public expenditure experience in an international context. Michael asked for our comments on it: I am sorry that these have been delayed while we checked some points with overseas posts. They are now set out in Annex I to this letter.

You may find Annex II more useful, for in it we have tried to emulate Ferdie by producing some constructive material both on general fiscal and budgetary policies abroad, and on particular expenditure policies, arranged by subjects. I have however to add one caveat: monitoring the progress through their legislatures of measures proposed and announced by foreign governments is difficult, and it would make sense for you to check with us the status of a particular measure before public reference to it is made.

You told me that the Prime Minister had expressed particular interest in Chancellor Kohl's plan to freeze public employees' salaries for 9 months. This plan is mentioned on page 4 of Annex II, but our embassy at Bonn advises that it applies only to those public workers who have 'no strike' agreements - equivalent to $1\frac{3}{4}$ million people or a third of all public workers. These include some, but not all, civil servants. Other public workers, who are not covered by 'no strike' agreements, are receiving pay increases by three stages between March 1983 and August 1984. You also mentioned that the Prime Minister had asked whether in the Netherlands private sector employers were ready to follow the example set by government

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of 3½ per cent cuts in civil service salaries (also mentioned on page 4 of Annex II). Unfortunately neither our embassy in The Hague, nor the Dutch embassy here, is able to confirm that the private sector are indeed coming into line.

Yours ever,

John Kerr.

J O KERR

ANNEX I

COMMENTS ON THE MOUNT MEMORANDUM OF 26 SEPTEMBER

Paragraph 1: Japan/Germany/Switzerland

It is important to note that over the past 20 years general government borrowing in Japan has on average taken a very similar share of GDP as in the UK, and welfare spending is probably lower in Japan than here. German welfare spending is indeed higher than ours, but OECD estimates suggest that public spending as a whole in Germany accounted for a higher share of GDP than in the UK in 1981. On Switzerland, the point to watch is that the Swiss growth rate since 1960 has been lower than that of any industrial country other than the UK and New Zealand.

Paragraph 3: Particular Current Examples

i. Italy The Craxi government is indeed proposing to means-test pensions, but only for non-contributors.

ii. Sweden The Palme government announced early this year a 7 per cent increase in wages for 1983, which was indeed expected to reduce real wages by 4 per cent. However Swedish inflation has been lower than expected, and the real wage cut now seems likely to be only some 2½-3 per cent.

iii. France The comparison between the Mitterand package and previous UK austerity packages going back to the 1945 government is best dropped. OECD calculations - which we do not entirely accept - suggest that fiscal measures taken in the UK since 1979 have reduced our own underlying general government deficit by 5½-6 per cent of GDP. The Mitterand package falls well short of this. And it is not certain that the comparisons between his current experience, and ours in 1968 or 1976, work out quite as the memorandum suggests.

Other countries' public expenditure experience

Budget deficits

(i) Overseas governments are continuing to take firm measures to hold down budget deficits. More than half OECD members have been seeking to cut their planned public spending during the current year. Many of them have also raised taxes. In other countries where public spending cuts have proved impossible, taxes have also had to be raised. This broad process is continuing in the budgets now being announced for 1984.

(ii) The average general government financial deficit of the major seven industrial countries (US, Canada, Japan, Germany, France, Italy and the UK) has risen from 2 per cent of GDP in 1979 to an estimated 4½ per cent this year - but the OECD calculates that this increase is more than accounted for by the effects of the world recession. Once allowance is made for this, the major countries have reduced their underlying deficit by about 1 per cent of GDP - in contrast to the experience after the 1973-74 oil shock when inflationary measures boosted underlying deficits by 1 per cent of GDP. Progress in reducing structural deficits since 1979 has been particularly marked in Japan, Germany and the UK. So, we have been in good company.

Social security

(i) The US government appointed the bi-partisan Greenspan Commission to enquire into ways of closing the deficits projected in the social security fund. Now, following its recommendations, Congress has agreed to cuts in planned expenditure and increases in contributions of about $165 billion over the next 7 years. Currently benefit increases are delayed six months.

(ii) In France and Germany the governments have delayed pension increases for five and six months. In its draft 1984 budget the German government has also announced plans to reduce some unemployment and maternity benefits. The French government plans to cut unemployment benefits relative to earnings.

(iii) In Italy the government has proposed that those with an income above 600,000 lire per month (£250) should no longer be eligible even for the minimum pension unless they have paid the necessary contributions. The government also intends to stop paying disability pensions to those with an income of above 900,000 lire (£380) per month.

(iv) The Japanese government has proposed not to increase pensions this year.

(v) The Belgian government has cut family allowances and unemployment benefits.

(vi) The Danish government plans to reduce some unemployment benefits and introduce a means-test for recipients of basic old-age pensions aged up to 69.

(vii) In the Netherlands some family allowances have been reduced and pensions are only being increased by 1 per cent this year. In addition the Dutch government's latest budget has announced a 3½ per cent cut in planned social security expenditure from the start of 1984.

(viii) The Australian government plans to make retirement pensions subject to a wealth test as well as an income test.

De-indexation

The Danish government has de-indexed social security benefits until 1985. Flat rate increases will be paid. In Belgium social security benefits have been de-indexed. In France pensions are to be indexed to the expected inflation rate over the coming year rather than the increase in salaries over the past year. In Canada benefits are only being indexed to the government's inflation targets.

Health costs

(i) The US Congress last year passed a package of health expenditure economies and revenue increases worth about $4 billion in 1984. The Administration's budget for fiscal year 1984 proposed further savings of $2 billion.

(ii) In Germany the government plans to charge hospital patients for board and lodging on the first 14 days rather than the first seven. Some drugs are also no longer available under sickness insurance and prescription charges are to be increased. A board and lodging charge has been introduced for hospital patients in France.

(iii) In Italy payments for prescriptions have been introduced for drugs unless they are essential or for emergency treatment. The government has also proposed doubling the maximum prescription charges. Prescription charges have also been increased in Belgium and the government has imposed a temporary freeze on doctors' and health workers' fees

Public sector costs

The US government has proposed a 12-month freeze in Federal pay and pensions. In Japan most central government employees did not receive a pay increase last year. The German government has proposed a 9-month freeze in salary increases for 1¾ million public sector employees. The Danish government has suspended public sector comparability. In the Netherlands the government's 1984 budget proposes a 3½ per cent reduction in civil services salaries from January 1984. The government also hopes to cut the number of civil servants by 2 per cent. The Irish civil service has been cut by 3,500 (5 per cent) over the last two years.

Social Security Contributions

US employer and employee social security contributions are to be increased and federal employees are to begin paying social security contributions. In Germany, France and Italy contributions have also been increased. In Belgium the government has levied a 'solidarity' contribution for all employees earnings over the minimum wage. The French government has added an extra 1 per cent levy to the civil service scheme. The Dutch government has also increased unemployment and old-age contributions.

WITH PM

PRIME MINISTER

Public expenditure: experience abroad

The Treasury have conducted a trawl through overseas posts to gather together interesting material on public expenditure developments abroad. These are set out in the attached annex.

The Treasury have made two caveats to the reports you received during your visits to Germany and the Netherlands.

(i) Chancellor Kohl's plan to freeze public employees' salaries for nine months applies only to those public workers who have "no strike" agreements - equivalent to $1\frac{3}{4}$ million people or one-third of all public workers. These include some, but not all, civil servants. Other public workers who are not covered by "no strike" agreements are receiving pay increases by three stages between March 1983 and August 1984.

(ii) It is indeed the case that the Netherlands Government is proposing a $3\frac{1}{2}$% reduction in civil service salaries from January 1984 but neither our Embassy in the Hague nor the Dutch Embassy here is able to confirm that the private sector are coming into line.

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7 October 1983