PART 14

MT

Confidential Filing

Public Expenditure and Cash Limits

ECONOMIC POLICY

Part 1: May 1979

Part 14: February 1981

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~18.2.81~~		~~7.8.81~~					
19.2.81		~~4.9.81~~					
~~24.2.81~~		~~9.9.81~~					
~~26.2.81~~		16.9.81					
~~10.3.81~~		— Pt 14 — ends					
18.3.81							
~~2.4.81~~							
~~24.4.81~~							
29.4.81							
~~6.5.81~~							
~~7.5.81~~							
~~21.5.81~~							
~~29.5.81~~							
~~1.6.81~~							
~~7.8.81~~							
~~22.7.81~~							
23.7.81							
~~13.8.81~~							

PREM 19/419

PART 14 ends:-

Extract from mtg record 16 Sept

PART 15 begins:-

Public Expenditure Papers 9.10.87

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
C(81) 10	19/02/81
CC(81) 8th Conclusions, Item 6	24/02/81
C(81) 20	01/05/81
CC(81) 18th Conclusions, Item 5	07/05/81
MISC(56) 10	05/06/81
MISC 56 (81) 3rd Conclusions, Item 4	10/06/81
C(81) 37	17/07/81
C(81) 39	20/07/81
CC(81) 29th Conclusions, Item 4	23/07/81
C(81) 44	10/09/81
C(81) 45	11/09/81
CC(81) 31st Conclusions, Item 4	15/09/81

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed OWayland Date 24 February 2011

PREM Records Team

Extract from meeting record between the Prime Minister and the Chancellor of the Exchequer on Wednesday 16 Sept 1981 at 1715hrs

Econ Pol

Public Expenditure

Top copy:
Govt Mach, Pt 4
Future of CSD/HMT.

(v) Public Expenditure Decisions in October

The Chancellor said that he had been thinking of getting together a group of senior Ministers to try to persuade individual spending Ministers of the need for cuts in their budgets. However, in the light of the Cabinet reshuffle, he had now concluded that it would be better for Treasury Ministers to tackle them themselves.

Econ Pol
a R Lankester.

10 DOWNING STREET

16 September, 1981.

Cash Factors for the Public Expenditure Survey: Guidance for Ministers

You were kind enough to agree to coordinate Treasury clearance of the enclosed drafts - a letter from the Lord President to his colleagues, and a speaking note - which are designed to encourage Ministers generally to put across the pay message on the basis of yesterday's announcement of the provisional 4% and 9% cash factors.

I have deliberately left these drafts until after the announcement, both to give Treasury Ministers (and Bernard Ingham here) a clear run in briefing the media, and in order to be able to respond to any problems in the way it has come across so far. It is apparent this morning, both in the newspapers and, for instance, in Alan Fisher's interview on the Today Programme, that there is a good deal of confusion over the application of the pay factor to the nationalised industries, so I think the speaking note must bring out their entirely separate position (and our Press Office will be briefing the media accordingly).

I would like to get this to the Lord President by Thursday lunchtime so that, if he agrees, the guidance can be sent out to Ministers in time for their weekend speeches, so I should be grateful for comments by midday tomorrow. For your convenience I am sending copies of this letter and enclosures to Chris Kelly and Rosalind Gilmore.

J. M. M. VEREKER

M.S. Buckley, Esq.,
HM Treasury.

DRAFT LETTER FROM THE LORD PRESIDENT TO ALL GOVERNMENT MINISTERS

The New Pay Round

As you know, we announced on Tuesday the pay and price factors that will be used for planning purposes in this year's Public Expenditure Survey. As we expected, public and media attention has focussed on the pay factor, which has been widely interpreted as a 4% limit on public service pay.

Our success as a Government depends on getting unemployment down and output back up again. The lower the rate of wage increases, the more room for new investment and new jobs. So this coming pay round is crucial. In announcing the decision, which was necessary for our move to the cash planning of Public Expenditure, we had very much in mind the need to lower public expectations about pay in the pay round just beginning, and to explain the relationship between pay and employment.

I must look to all my colleagues in the weeks ahead to help with this task. With our newly reformulated team, we are in a better position than ever before to market our policies aggressively, both in our speeches and - equally importantly - in our private discussions with employers, whether in the public or private sectors. I hope you will find the enclosed speaking note helpful. I cannot stress too strongly that our policies can succeed only if they are widely understood.

F.P.

THE NEXT PAY ROUND

Points to make

1. The 4% pay factor announced by the Treasury on 22 September is a broad measure of what the Government thinks reasonable and can be afforded as a general allowance for increases in public service pay.

2. It's not a norm; still less an incomes policy. Some public service pay increases may be more, and some may be less; and it covers the public service only, not the nationalised industries - nor, of course, the private sector.

3. The financial framework for individual nationalised industries, within which pay costs will have to be accommodated, will be the subject of separate decisions later.

4. And employers in the private sector will make up their own minds what they can afford - the CBI has already said that in many cases it will be <u>less</u> than 4%. First indications, particularly in the engineering industries, are that private sector pay rises will be significantly lower than last year, and a number of companies have made it clear that they cannot afford any increase at all.

5. So there is no automatic entitlement to a particular pay increase. Both in the public and the private sectors, pay rises have to be justified on their merits.

6. The Government is absolutely committed to getting inflation under control. That is essential if we are to regain our ability to compete and lay the foundations for more jobs. The higher pay rises are, the greater the level of unemployment.

/ 7.

7. So we hope that union members, who have made clear their concern about unemployment, will recognise that the fall in living standards implied by the 4% pay factor is a contribution they must make in order to get unemployment down.

8. Higher wages in the public services simply mean more taxes, more borrowing or higher rates. Any group which makes selfish demands on its own behalf risks its own job security and puts a burden on the community as a whole.

9. We believe that this is widely understood across the country, whatever the rhetoric union leaders may use. We certainly see no need for confrontations with public service groups this coming winter. We expect that the progress we are making towards lower costs, higher productivity and a more competitive economy will continue.

SUGGESTED REDRAFT OF PARAGRAPH 4

The pay factor does not carry the implication that all public service pay ~~incomes~~ rates will or should be 4%. [Some will be less + some may be more +] There is no automatic entitlement to any particular pay increase: each must be justified on its merits. The [increase of 4%] ~~pay factor~~ is a broad measure of what the Government thinks reasonable to allow for the total increase in the public service wage bill.

within the 4%.

~~within the 4%~~ some more + some less.

according to - -

~~but~~

Tim,

Something like this — v. difficult to explain or expand why some will be less + some more ... [i.e. "according to the nature of individual groups" isn't very helpful.]

J.

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File

10 DOWNING STREET

From the Private Secretary

15 September 1981

Dear John,

Cash Factors for Public Expenditure Survey

In her summing up at this morning's Cabinet of the discussion on cash factors for the public expenditure survey, the Prime Minister invited the Chancellor of the Exchequer, the Chief Secretary and the Secretary of State for Employment to redraft the press notice which had been circulated along with the Chancellor's memorandum C(81)45. They were asked to take into account the various points that had been made in discussion.

The Chancellor, Chief Secretary and Secretary of State accordingly met immediately after Cabinet and agreed the text which I enclose with this letter. It is intended that it should be put out at 1530 hours today.

Cabinet did not discuss the position of the Pay Review Bodies. The Chancellor believes, in the circumstances, that it would be best, in dealing with enquiries about the position of the Review Bodies, merely to use the following form of words:-

> "The pay of groups of staff currently dealt with by Pay Review Bodies will be considered at the relevant time."

This form of words should be substituted for the briefing which at present appears as items 2 and 3 under "specific pay groups" in the briefing already circulated to the departments principally concerned under cover of Rosalind Gilmore's letter of 14 September.

I am sending copies of this letter and enclosure to the Private Secretaries to the members of the Cabinet and to David Wright (Cabinet Office).

Yours ever,

Tim Lankester

John Halliday, Esq.,
Home Office.

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TREASURY PRESS NOTICE

(For release 3.30 pm, Tuesday, 15 September)

PUBLIC EXPENDITURE PLANNING: CASH FACTORS

1. The Chancellor of the Exchequer announced in his Budget statement on 10 March, 1981 that the Public Expenditure Survey this year would, for the first time, be conducted in terms of prospective cash expenditure, rather than in terms of "constant prices". For this reason, the plans in the last Public Expenditure White Paper (Cmnd 8175) were, at the outset of the Survey, put onto a prospective cash basis, which included an allowance for cost increases between now and future years.

2. In the spring a provisional allowance was made for general increases in costs of 7 per cent between 1981-82 and 1982-83 and of 6 per cent and 5 per cent respectively for the following two years.

3. In now preparing for the main decisions on the cash totals for each programme, the Government has reviewed the provisional allowance for 1982-83 and has decided to use separate factors for pay and for other cost increases. These factors will be, for earnings, an increase of 4 per cent from due settlement dates in the coming year, and for other costs an increase of 9 per cent between this financial year (1981-82) and next (1982-83). This change has little net effect on the overall cash total of public expenditure, but it does affect the distribution between programmes.

/4. The

4. The pay factor does not imply that all public service pay increases will or should be 4 per cent. Some may be less, and some may be more. There is no automatic entitlement to any particular pay increase: each must be justified on its merits. The pay factor is a broad measure of what the Government thinks reasonable and can be afforded as a general allowance for increases in pay, at this stage of fixing the programme from which the public service wage bill has to be met.

5. All public service wages are paid for from rates, taxes or borrowing. Excessive wage increases can only mean higher rates or taxes or further cut-backs in public sector capital investment, which will cost jobs in both public and private sectors. The lower the level of pay settlements, the more there could be available for job creating investment throughout the economy.

6. The cash expenditure figures arrived at by applying these pay and price factors provide a framework for the further Ministerial decisions to be taken later. The final cash provisions for individual programmes, and where appropriate cash limits for next year, will follow from those further Ministerial decisions to be taken subsequently.

7. The Rate Support Grant paid to the local authorities for 1982-83 will be determined by Ministers' decisions on the cash provision for local authority services which may themselves be affected by overspending in the current year. But the

/framework

framework will be the plans revalued using these factors of 4 per cent for pay increases and 9 per cent for increases in other costs.

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PRIME MINISTER

CABINET: CASH FACTORS FOR THE PUBLIC EXPENDITURE SURVEY

You asked the Chancellor last week to consider whether a 3% pay factor would be better than 4%, and he has confirmed his preference for 4%. This makes it all the more important that the figure is not increased in response to general or particular pressure from colleagues responsible for public service groups.

Whatever pay factor is chosen will be threatened by special pleading. It is a feature of the present cash limit approach to public service pay that every group is a potential exception; the civil servants have arbitration; the teachers will want arbitration back; Patrick Jenkin wants special treatment for doctors and nurses; Michael Heseltine wants local authority employees' pay to start from a higher base than last year's cash limit allowed; policemen and firemen have indexation; and the armed forces will expect continued favourable treatment at the hands of the AFPRB. 4% plus special treatment, plus wage drift, would produce an outturn no better than last year's, which would be incompatible with the Government's wider objectives. It is important that Cabinet avoid exceptions, at least at this stage when we want to make maximum impact on the private sector with an announcement of the 4%.

The CPRS Report

Few of your colleagues will have been able to do more than glance at the CPRS report on pay; they may, however, have noted that in general the CPRS see no alternative to the present approach, and that they think it would be wrong to set the pay factor unrealistically low. The report, however, and especially section 2.5, does contain some points which are relevant to the special cases which Cabinet will be discussing.

Review Bodies

Cabinet will be in no position to take decisions on the future of the review bodies; but a very important presentational issue arises. The press briefing prepared by the Treasury presumes that the review bodies will report before the Government

/decides what

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decides what to do with their recommendations, whereas, at least in the cases of the DDRB and the AFPRB, it may be necessary to ask them not to report, or at the very least to restrict their terms of reference. Thus, Patrick Jenkin suggests that the DDRB will have to tailor their recommendations to the cash limit; and the CPRS report (para. 54) argues strongly for an end to comparability for the uniformed services. Indeed, it is hard to see how cash limits on the Pay Bill and independent review bodies can continue to co-exist. So Cabinet ought to:

(a) authorise the Chancellor to take the line that the position of the review bodies will be considered separately, and later; and

(b) ask E(PSP) to look at the position urgently, on the basis of further work by officials.

The Health Service

Patrick Jenkin says he is not seeking a special NHS pay factor, greater than the general pay factor, but that there should be "special treatment for a limited number of staff groups", notably the nurses and doctors. The CPRS report - unhelpfully - does suggest* that the NHS pay provision should be 1% higher than the general pay factor. I think that either of these approaches would be wrong, especially if an indication were given now that the 4% pay factor would not in some way apply to these large groups. The case for special treatment of doctors and nurses is not clear: doctors are by any standards a well paid group, with many opportunities to enhance their pay, both through favourable tax treatment and through private practice; nurses are by no means a limited case: there are almost as many nurses and midwives (over 500,000) as civil servants, and market factors should apply to their pay as to anyone else's. If the inflexibility of the NHS pay factor is thought to pose a problem, which I doubt, then Cabinet should refer the matter to E(PSP) for separate and later consideration on the basis of an analysis by officials.

*para 48(iii)

/Local authority

Local Authority Employees

The position here, as outlined in Michael Heseltine's letter of 11 September to the Chancellor, is complicated by the way in which local authority employees extracted a 7½% pay rise from a 6% cash limit, and at the same time failed to reduce their manpower proportionately. Michael Heseltine argues that since as a consequence their pay is 2½% above the planning level used last year, a 4% pay factor would enable pay increases of only 1½% unless their pay is re-based, or "validated". The question of whether or not to validate in this way is not an integral part of the decision to be taken on pay factors, and should clearly be considered later and separately by officials, and perhaps E(PSP). If Michael Heseltine presses the point, quite a strong case can be made against his proposal, on the grounds that to open the pay round with a 1½% offer would not be inconsistent with the current climate in the private sector (viz, for instance, Hoover's offer of a 10% reduction and a subsequent pay freeze until 1985); and the lesson that those who managed to get more last year will have to give it up this year will be a useful one generally. That, of course, would have to be balanced against the likelihood of industrial action by the local authority manuals.

J.V.

14 September 1981

Ref. A05497

PRIME MINISTER

Cash Factors for Public Expenditure Survey

C(81) 44 and 45 and the Secretary of State for the Environment's letter of 11 September to the Chancellor of the Exchequer

(See also Local Gov: Pt 5: Central/Local Gov relations)

BACKGROUND

In C(81) 45 the Chancellor of the Exchequer recommends that the programme totals shown for 1982-83 in the last Public Expenditure White Paper should now be converted to cash using a factor of 4 per cent for earnings, from due settlement dates from now on, and of 9 per cent for other costs. The resulting totals will provide the base-line against which possible cuts and additional bids will be considered in the Cabinet's public expenditure discussions starting on 20 October and running into November. The overall totals for 1982-83 will be very similar to those arrived at by using the earlier provisional factor of 7 per cent for all costs, but there will be differences in the distribution between manpower intensive programmes and others, and this justifies the use of separate factors for pay and other costs. The Chancellor sees no need at present to change the present general inflation assumptions of 6 and 5 per cent for 1983-84 and 1984-85.

4-9.

2. If the Cabinet approves these proposals on Tuesday morning, the Chancellor of the Exchequer wishes to issue that afternoon the draft press notice annexed to his paper. He wants to move very quickly to avoid misleading leaks and to get home the message that 4 per cent does not represent a pay norm.

3. The Chancellor of the Exchequer will be very keen to reach firm decisions on Tuesday. He will be abroad by the time of the next Cabinet meeting on 24 September, and he would not wish to leave for resolution then any major questions about either of the factors. Any delay beyond 24 September would put the whole timetable in jeopardy: until the base-lines are established the Treasury and spending Departments cannot take a final view on what is the level of additional bids at issue.

All else later

4. As explained in his paragraph 4, the Chancellor of the Exchequer wishes to leave until the October/November discussions any additional bids which particular Departments might put forward on the grounds that either the pay or the other costs factor is inadequate for their particular programme. Whatever the prospective merits of such bids Treasury Ministers will want to look at them altogether, and alongside other additional bids, rather than to take decisions piecemeal.

1) DHSS.

5. In C(81) 44 the Secretary of State for Social Services proposes that while the National Health Service (NHS) should be subject to the general pay factor of 4 per cent, some additional money should be provided for the pay of certain staff groups (he mentions the nurses, doctors and dentists and 'a very small number of smaller staff groups') directly concerned with patient care where particular service problems arise. His case is that, in contrast with the Civil Service and the local authorities, staff numbers cannot fall in these groups, unless pledges on services are to be broken, and so there is no flexibility for savings which would enable him to negotiate higher settlements than 4 per cent if that were necessary. To provide flexibility, he proposes that some additional but unquantified amount of cash should be made available when the overall cash provision for the NHS is settled later in the autumn. In this way he would hope to avoid a confrontation which could be very difficult for the Government to win, particularly in the case of the nurses.

6. The Chancellor of the Exchequer is likely to argue that, while there may well be force in this argument, the bid for extra cash should be resolved in October/November alongside all the other additional bids. There is no apparent need to take a decision now, since the Secretary of State for Social Services does not want to announce it before he announces the size of the overall NHS cash provision; there is no basis for a firm decision now because the Secretary of State has not quantified his bid, argued his case in detail, or specified all the groups to which the concession might apply.

DoEnv. L.A.'s Vol measure reduction [illegible]

7. In his letter of 11 September to the Chancellor, the Secretary of State for the Environment returns to the unresolved question of whether, in calculating the cash totals for local authority expenditure, the Government should also allow for ('validate') the 3 per cent by which increases in the prices and wages paid by local authorities during 1981-82 have outrun the 1981-82 cash limit factors. In addition to allowing them this 3 per cent he now wants to let them off 2 per cent of the 4 per cent volume reduction they are currently facing. He believes - and other local authority Ministers will probably support him - that without such concessions the total cuts demanded of the local authorities will be unrealistic; until this question is resolved the local authorities will not know where they are in making their plans for budgets, rates and pay settlements. The Chancellor of the Exchequer (paragraph 4 of his paper) argues that the money necessary to validate in this way is an additional bid which should be considered with other additional bids in October/November; the further 2 per cent volume concession which the Secretary of State for the Environment is now proposing, and which has not been discussed with the Treasury, would normally be considered at the same time. Cabinet will have had little time to consider the detailed case now made by the Secretary of State and you may wish either to defer discussion of it until October/November or possibly to ask the Chief Secretary to put in a paper in time for discussion by Cabinet on 24 September. In the meantime the Secretary of State would have to tell the local government representatives at the Consultative Council meeting on 17 September that this question was under consideration.

8. The discussion could open up some general points on pay in the coming round. The only major alternative approach which has been canvassed is that suggested by the Secretary of State for the Environment whereby the unions would be offered the prospect of enhanced capital investment, and so employment, in return for nil or negligible pay increases in the coming round. He won no support for this either in Cabinet's discussion on 23 July or on 7 September in your meeting on the pay of the nationalised industries. Other Ministers doubt whether the unions would respond - and the discussions at the TUC Conference this week reinforce their doubts - and they point to the impracticability and unfairness of the Secretary of State's idea that excessive settlements by one group, such as the miners, should be financed by abating the indexation of benefits or tax threshold.

Rev Bodies cmty - Sub Comm

9. Other more limited points on the approach to pay settlements in the coming year may also be raised - for example, the implications of the 4 per cent factor for the work of the various Review Bodies. These could be followed up either in the Chancellor of the Exchequer's Sub-Committee on Public Service Pay (E(PSP)) or, possibly, in the further discussions which will no doubt follow the report which the CPRS will be putting to you very shortly on pay questions.

HANDLING

10. After the Chancellor of the Exchequer has introduced his paper you will wish to hear in particular the views of the Ministers responsible for the major expenditure programmes and the main public service pay groups ; the Lord President of the Council and the Secretaries of State for the Environment, Social Services, Education and Defence. The Secretary of State for Employment will want to give his general views on the implications for pay bargaining of the proposed factors. Before dealing with the proposals for exceptions, you might prefer to establish whether there is agreement on the two figures and on the press statement. The main questions which you will wish to cover seem to be as follows -

11. Are the two figures of 4 and 9 per cent acceptable?

- Although separate factors of 4 and 9 will bring home very sharply the message that, for the public services at least, the prospect is of a fall in living standards in real terms, the case for two factors rather than a 7 per cent average seems overwhelming if there is to be a fair and defensible distribution between the various programmes.

- Anything higher than 4 per cent for pay would be highly unwelcome to the CBI who are looking for a range of 4-8 per cent in the private sector and will not want their own floor raised.

- 9 per cent for other costs compares with the Treasury's present internal forecasts of about 10 per cent for the RPI in this period and represents a rounding down of the 9½ per cent which they judge to be the likely average price increases for Government spending.

12. Is the press statement annexed to C(81) 45 acceptable?

- Paragraphs 4 and 5 make clear that there is flexibility in the system and that the Government's approach is therefore consistent with its assurances to the Civil Service unions of negotiations on the 1982 non-industrial settlement without a predetermined limit on the cost.

- You can ask the Chancellor of the Exchequer to arrange for his officials and those of the other Departments concerned to sort out over lunch-time any drafting points which might be made so that, subject to his approval, the statement could issue later in the afternoon. The Treasury are in touch with the other main departments on supplementary briefing, both generally and for particular pay groups.

13. Should the exception for the NHS, and any other exceptions, be accepted at this stage?

- Given the lack of quantification in his proposal, the best that the Secretary of State for Social Services can expect seems to be agreement that Ministers should look sympathetically at his proposals at a later stage. There might be a case for E(PSP) looking at the details in terms of pay policy before a final decision on the amounts, if any, of any additional cash for the NHS is taken by the Cabinet in the autumn.

- In response to the Secretary of State for the Environment's proposal for the treatment of local authority expenditure you might ask the Chief Secretary, Treasury whether it would be possible for him to put forward proposals on this question for discussion by Cabinet on 24 September (indeed there might be some advantage in getting this question out of the way before 20 October when there will be more than enough other issues for the Cabinet to consider). This should not necessitate postponing the announcement on Tuesday 15 September of the two factors for 1982-83.

CONCLUSIONS

14. You will wish to sum up the discussion with reference to the three recommendations in paragraph 24 of the Chancellor of the Exchequer's paper, C(81) 45 -

i. the two factors

ii. the press statement

iii. the deferment until October of decisions on additional bids to allow for exceptional increases, on pay or prices grounds, for particular programmes.

In summing up on iii. you will wish -

a. with reference to the Secretary of State for Social Services' proposals, either to defer the decision until October/November or to agree in principle now, subject to working out the details later or to agree to look sympathetically at the proposals subject, perhaps, to further work in the meantime on the details by E(PSP).

b. In response to the Secretary of State for the Environment's proposals for local authority expenditure, you will wish either to defer the decision until October/November or to invite the Chief Secretary to make proposals in time for discussion by Cabinet on 24 September.

You will wish to take note of any general points which are made on the approach to pay negotiations in the coming year and, where appropriate, to agree that they might be pursued further either by E(PSP) or, perhaps, in the context of the further discussions following the CPRS report.

D J Wright

ROBERT ARMSTRONG

(approved by Sir R Armstrong and signed on his behalf)

11 September 1981

CONFIDENTIAL

MR. LANKESTER

TL

c.c. Mr. Walters
Mr. Ingham
Mr. Hoskyns O.R.
Mr. Duguid

THE TUC AND PAY

You asked me this morning for some impressions of the TUC, which as you know I attended for only a couple of days, chiefly to see what happened on pay.

The "debate" on pay was fairly reported in the newspapers. Congress, fully aware of what it was doing, simultaneously approved Composite Motion 13 (copy attached) which states that "Congress .... is opposed to any pay restraint policy .... to this end, Congress does not agree to any discussions on pay restraint", and the TUC Labour Party Liaison Committee Report which proposes "a national economic assessment, including analysis of the movement of pay and its impact on prices". Despite objections from Bill Sirs, Tom Jackson and Roy Grantham, Len Murray managed to square this circle by saying that analysing the movement of pay did not imply pay restraint. Composite Motion 25 (also attached) was, thanks to appalling mismanagement of business by Alan Fisher, lost from Wednesday's debate - this is the resolution which asks the General Council to organise "a common strategy to resist the Government's intentions" on cash limits.

The rhetoric of the occasion was even more depressing than last year, chiefly because of the complete absence of any recognition by speakers of the responsibility of those in work towards those out of work. Speaker after speaker openly avowed the doctrine of single-minded pursuit of self-interest. If economic realities have permeated down to trade union members during the last year, that is not yet reflected in the trade union leadership. There was economic illiteracy of a high order - Ken Gill: "unemployment results from lack of orders not from high wages" - as well

/ as some

as some startling honesty - Ken Gill again: "the trade unions exist to increase the standard of living of their members, and no-one joins them in order to lower his standard of living now for some future pie in the sky". David Basnett produced some astonishing rubbish in moving a motion (which was carried) for a statutory maximum 35-hour week - "overtime is stolen time: impoverishing workers and enabling employers not to take more people on".

And there was no shortage of hypocrisy in the shape of criticism of public expenditure cuts from unions from industries whose losses put those cuts into the shade. Emlyn Williams of the NUM, seconding a motion condemning education cuts, promised "whatever initiative Congress takes, they will get the whole-hearted and unstinting support of my union": and Charlie Turner of the NUR, on the Brandt Report, asserted that "we have an overwhelming obligation to assist in the abolition of poverty in the Third World". I would dearly like to use these quotes back at the unions in the context of their next pay claims, but I have no doubt that the sponsor departments would accuse us of being provocative.

The energy debate, not well reported in the media, was better than most. Frank Chapple made an impassioned speech supporting all forms of energy investment, and specifically the gas gathering pipeline ("flaring is a criminal waste of national assets for which theologians in the Treasury are responsible"), gas showrooms, the Vale of Belvoir, and the PWR; but the anti-nuclear lobby was allowed a fair say, and the demand forecasts in the TUC's Review of Energy Policy were described as fraudulent, and Ray Chadburn from the NUM made an aggressive speech against the use of nuclear power for electricity generation.

Finally, it is worth recording that Les Moody from the Civil Service Union, a menacing little figure wearing dark glasses

/even in

even in the gloom of the Blackpool Opera House, whose entry in Who's Who lists "educating management" among his recreations, devoted a large part of his speech on public expenditure to a description of the Prime Minister as "a spiteful, vindictive woman, appealing to extremists .... with a morbid interest in suffering due to sexual deprivation in youth". The outlook for the next round of negotiations on Civil Service pay is clearly not too good.

11 September 1981

FREE COLLECTIVE BARGAINING

(Motions 77, 78 and 79)

Congress congratulates the General Council on the development of the Campaign for Economic and Social Advance.

Congress reaffirms that increased purchasing power is central to the success of the Campaign.

Congress emphatically rejects the view that wage increases are the primary cause of inflation and unemployment.

Congress reaffirms its support for free collective bargaining and is opposed to any pay restraint policies, pay norms or statutory restraints which would interfere with the rights of unions to determine their own policies and resolve their own negotiating procedures and settlements. To this end, Congress does not agree to any discussions on pay restraint.

Moved by

Amalgamated Union of Engineering Workers
(Technical, Administrative & Supervisory Section)

Seconded by

Association of Scientific, Technical & Managerial Staffs

Supported by

Furniture, Timber & Allied Trades Union

TRADES UNION CONGRESS
BLACKPOOL 1981

Composite Motion

25

PUBLIC SERVICE PAY

(Motions 98, 100 and 101)

Congress condemns the Government's attempts to impose a discriminatory incomes policy upon the public services through the application of arbitrary cash limits, the determination of the Government to destroy established bargaining machinery, and the failure of successive governments to uphold the relative levels of pay established by independent committees of inquiry.

Congress declares its willingness to work for improved industrial relations and bargaining procedures in the public sector.

Congress agrees that every effort should be made to organise coordinated action by public service unions during the next pay round if the Government continues with its present policies. Congress therefore calls upon the General Council urgently to create the framework within which the whole of the public service trade union Movement can unite with a common strategy to resist the Government's intentions and, given the necessary support, the General Council should be ready to bring into effect the organisation and resources needed to conduct such a campaign. The General Council, therefore, are urged to make the necessary organisational arrangements so that collective action can be mounted in a more effective manner than proved possible during the 1980–81 pay round.

Moved by
The Civil & Public Services Association

Seconded by
Society of Civil & Public Servants

Supported by
The Educational Institute of Scotland

CONFIDENTIAL

c Mr Duguid
Mr Walters
Mr Vereker
Cabinet Office

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

10 September 1981

T. Lankester, Esq,
Private Secretary,
10, Downing Street

Prime Minister

Dear Tim,

[Cabinet Today].

INFLATION FACTORS FOR PUBLIC EXPENDITURE

Many thanks for your letter of 7 September about the Chancellor's talk with the Prime Minister that afternoon.

When the Chancellor's Cabinet paper is circulated later today, you will see that he still proposes a factor of 4 per cent (rather than 3 per cent) for pay. You should know that, as envisaged, the Ministers in charge of the main spending Departments had been sounded before the Chancellor and the Chief Secretary reached a final decision to go for 4 per cent. The soundings served in fact to reinforce the Chancellor's view that 4 per cent is the right proposal.

TL
10/9

Yours ever,

J. Kerr

J.O. KERR

CONFIDENTIAL

SUBJECT

cc to Master

bc: Mr. Vereker
Mr. Duguid
Cabinet Office

10 DOWNING STREET

From the Private Secretary

7 September 1981

Meeting Record

INFLATION FACTORS FOR PUBLIC EXPENDITURE

The Chancellor minuted the Prime Minister on 4 September enclosing a draft paper which he proposes to circulate to Cabinet for discussion next Tuesday. The Prime Minister discussed the draft with the Chancellor this afternoon. The Prime Minister expressed some misgivings about the proposed 9% price factor as being on the high side; but the Chancellor argued that this was the lowest figure that could be considered realistic, given that the Treasury's latest forecast for the RPI between 1981/82 and 1982/83 was around 10%. The Prime Minister accordingly accepted that the paper should include the figure of 9% for prices.

As regards the pay factor, the Prime Minister also suggested that the proposed figure of 4% was too high. Although she recognised that a lower figure would seem to imply a perhaps unrealistically large reduction in real earnings for public servants, nonetheless she felt that a figure of 3% might be preferable. Insofar as there was going to be some flexibility in the coming year's Civil Service pay negotiations, it was necessary to announce a lower pay factor than the Government was expecting to achieve by way of outcome; furthermore, the lower the announced figure for the public service, the more this would help private and public sector industry to achieve low pay settlements. The Chancellor said that, on balance, he still felt that a 4% pay factor was the correct approach. However, he was prepared to reconsider the choice between 3% and 4%, and he would sound out those Ministers most directly concerned before reaching a final decision on what figure should be included in the paper.

There was also a brief discussion of the draft press statement. The Prime Minister said that this could be a good deal clearer: paragraphs 1 and 4, in particular, could be improved. It was suggested that paragraph 4 might read as follows:

> "The pay factor does not carry the implication that all public service pay increases will or should be [4%]. Some will be less and some may be more. There is no automatic entitlement to any particular pay increase: each must be justified on its merits.

/ The increase

The increase of [4%] is a broad measure of what the Government thinks reasonable to allow for the total increase in the public service wage bill."

T. P. LANKESTER

John Kerr, Esq.,
H.M. Treasury.

SP.

Copies to Mr Wolfson
Mr Vereker
Mr Duguid
Cabinet Office

CONFIDENTIAL

Prime Minister. PM seen.
The Chancellor would like to stay behind after your meeting tomorrow morning on miners' crisis to discuss this. A note by Mr Vereker is at flag 'A'.

CHANCELLOR OF THE EXCHEQUER

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

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PRIME MINISTER

INFLATION FACTORS FOR PUBLIC EXPENDITURE

I would like to discuss with you the paper which I shall be putting to Cabinet on this. We need to take a decision on 15 September on what factors we should use, if we are not to upset the whole timetable for public expenditure decisions, rate support grant and even the Budget.

... 2. I attach the present draft of the paper which has been put to me. The Chief Secretary and I agree with the conclusion that the factors for inflation between 1981-82 and 1982-83 should be 4 per cent for pay and 9 per cent for other prices, and with the general line of argument set out in the paper. I will, however, be reflecting further on the details of the draft.

3. I do not think that there will be much difficulty in persuading our colleagues to accept the 9 per cent factor for prices other than pay. The main argument will relate to the factor for pay.

4. I have been debating whether it might be more realistic to go for a factor of 5 per cent rather than 4 per cent. However, what the CBI told me on Tuesday convinced me that we should go for 4 per cent. They are looking for settlements in industry lying between 4 per cent and 8 per cent. But they think that if their members are to achieve this, it is important that the factor for the public sector should not be higher than 4 per cent. Although this argument is the critical one, I think it prudent to leave it to be put orally, rather than include it in the circulated paper.

/5.

5. Two alternatives may be put forward. Some may argue for using a pay factor of zero as a holding measure. I think that this would be wrong. We would be seen to be shirking an opportunity to give a lead on the desirable level of pay settlements. It will also distort all our public expenditure decisions. I would need to provide for another £1¼ billion claims on the contingency reserve, compared with those for a 4 per cent factor.

6. Michael Heseltine would advocate the use of a zero factor for a different reason; he thinks that we ought to be seeking settlements at that level, or close to it. The idea which he has been exploring with Leon Brittan is that the saving from using such a low factor for the public sector as a whole should be used to finance additional capital expenditure. Then to the extent that settlements actually proved higher, he would suggest reducing welfare payments to achieve the same PSBR. Michael Heseltine may want to put a paper suggesting this to Cabinet for discussion on the 15th.

7. While I see attractions in it, I am very doubtful about its practicability. I do not think that pay increases to public sector workers (including the mine-workers) are going to make it politically any easier to secure reductions in welfare payments. So the cost would in the end fall on the public expenditure totals and the PSBR. Then in the meantime, the public service unions are going to react very strongly against what they would claim to be blackmail.

...... 8. I also enclose a background for you only, a note by the Treasury economists on the inflation prospect.

[Approved by the Chancellor and signed in his absence.]

John Kerr 4/ix

G.H.

4 September 1981

THE PROSPECT FOR INFLATION

Note by EA

Introduction and summary

The forecasters have just completed a re-assessment of the inflation prospect, as background to the Chancellor's paper on cash factors for 1982-83 and beyond for the Cabinet discussion on 15 September. This has been a quick exercise, which has used broadly the same policy assumptions as the June forecast and taken into account latest information directly relevant to the inflation prospect, but has not attempted to update the whole of the forecast.

2. The conclusion which emerges is that the outlook for inflation next year is a little better than we thought likely in June, despite a lower level for the exchange rate, mainly as a result of a further squeeze on profit margins, and thence on to domestic costs. Whereas the June forecast indicated inflation rates for the financial year 1982-83 of $10\frac{1}{2}$-11%, our central estimate is now around 10%.

Latest developments

3. Since the June forecast was completed, there has been a further fall in the effective exchange rate, which in the third quarter of 1981 seems likely to be about 5% lower than forecast. The dollar, above all, has been stronger than expected and as a result sterling oil prices have risen several times in recent months. However, this has been the main factor pushing up prices in the private sector and otherwise recent monthly increases at the retail stage have been very low - with some components, notably clothing and footwear, showing no increase over the last year.

The forecast

4. The forecast takes account of the following changes from the June forecast:-

(i) A lower exchange rate - by an average of nearly 3% in 1982.

(ii) A level of private sector wage costs in the current quarter and thereafter over $\frac{1}{2}$% lower than forecast in June. (This also implies that the gap between settlements and earnings in the 1980-81 pay round was not quite as big as we thought in June.)

(iii) A lower price of oil in 1982, as a result of the forecast continuation of the weak oil market: by the fourth quarter of 1982 dollar oil prices could be over 10% lower than previously forecast.

(iv) Both because of the greater squeeze on profits and because of the lower rate of price increases, we have shaded down the increase in pay: 7% on average for wage settlements; 8½% for earnings over the 1981-82 pay round. These figures are ½% lower than in the June forecast.

(v) In addition to these changes in costs, which on balance reduce the rate of inflation next year, we have allowed for some further intensification of the profit squeeze, in the light of the latest information on price trends in recent months. While the exchange rate has fallen, it remains high and recent evidence suggests that we did not make enough allowance for competitive pressures in the last forecast.

5. The resulting forecast is shown below:-

Price indices:
per cent increase between financial years 1981-82 and 1982-83

	September update	June forecast
RPI	10	11
GDP at market prices	10	11
Private domestic expenditure	9½	10½
General government procurement	9½	10½
General government investment	8	8
Whole economy average earnings	8½	9

The forecasts of the RPI and of GDP are probably more reliable than the forecasts of general government procurement and investment prices, which involve difficulties of measurement and where there are wide variations within the overall averages. These various inflation rates are all fairly similar, though the forecast for investment prices is for a lower rate of increase: this is because building costs (the major part of general government investment) have risen particularly rapidly in recent quarters and we see some slowing down in the course of the next year or so. Procurement expenditure is some four times as large as fixed investment.

Earlier forecast for 1982-83

6. The only previously published official forecast was given with the 1981 Budget, in the FSBR. This was for a rise of 8% in retail prices between the second quarters of 1981 and 1982, a view consistent with a $7\frac{1}{2}$% increase between financial years 1981-82 and 1982-83, though the latter figure was not published. Since the budget, inflation prospects are generally perceived as having worsened, on account of the fall in the exchange rate and the rapid rise in industry's material costs in recent months. But the most recent monthly increases in retail prices have nevertheless been small and views on the inflation prospect are now tending to improve again.

Risks and uncertainties

7. Inflation forecasts made in the Treasury, and elsewhere, over the last eighteen months or so have generally been too pessimistic. In large part this is because the private sector has been forced to limit its price increases well below costs as a result of low demand, partly to sell off surplus stocks, and because of the pressures of foreign competition. The crucial question is how far can this process go: our judgement is that it may not go on much beyond early 1982, as the need to liquidate stocks disappears, and as the lower level of the exchange rate allows firms a little respite. But we could be seriously wrong in either direction. So too on cost pressures: apart from the usual uncertainties about the direction, let alone the extent, of exchange rate changes, our judgement of 7% wage settlements in the next pay round (for private and public sectors allows for a small fall in real earnings and for continuing effects from low profit margins on to wages. Even so, figures like that will do little to improve competitiveness. These uncertainties are reflected in sizeable error margins: the average margin of error of retail price forecasts, at about this time of year looking ahead to the next financial year, is of the order of 3% either way.

Earlier and later years

8. The inflation forecast for the fourth quarter of 1981 is now put at 11%, compared to 12% in the June forecast: this downward revision reflects continuing low profit margins, an inability to pass on the higher costs of imports (except in the case of oil) and a later increase in the mortgage rate.

9. With the exchange rate - very tentatively - not expected to decline further after 1982, and with continuing pressure of demand effects on wage increases and on the level of prices, substantially lower inflation rates are possible in 1983-84 and 1984-85. While our ability to forecast inflation rates two and three years hence is extremely limited, we think it quite possible that, if the pressures to reflate are resisted and interest rates kept high, then inflation rates could be some 7% in 1983-84 and a point or two lower the following year.

Outside forecasts

10. While published forecasts do not generally show figures for financial years, a good approximation for 1982-83 can be found in the increase to the fourth quarter of 1982. On the basis of forecasts of the RPI or consumers' expenditure deflator, outside forecasters span a range of 8% (LBS) to 12% (St James/Item), with many round 10%. Cabinet colleagues will be aware of these forecasts.

Industry Act forecast

11. An Industry Act forecast will be published before the end of November, and will include a forecast of the rise in the RPI between the fourth quarters of 1981 and 1982. Although not quite the same as the change between the financial years 1981-82 and 1982-83, and not for the same price index, the choice (and publication) of a price factor for use in public expenditure planning will constrain to some extent the Industry Act forecast. A difference of much more than 1% would need to be justified by some change in the inflation outlook.

REVISED DRAFT CABINET PAPER - 4 SEPTEMBER 1981

CASH FACTORS FOR PUBLIC EXPENDITURE SURVEY

Note by the Chancellor of the Exchequer

The starting point

1. On 7 May we agreed that, in order to conduct the survey in cash, we should adopt the provisional working assumption that all costs would rise on average by 7% between 1981-82 and 1982-83, and by 6% and 5% in the two following years.

2. It is now necessary to review that provisional decision and to settle the factors to be used for determining the cash programmes in the survey and, in due couse, for the 1982-83 Estimates and cash limits. We need to know what to assume for average costs, both to have a firm baseline against which to consider possible increases and decreases in programmes, and also so that the Ministers concerned can review the prospective costs in their field and reconsider their bids for extra provision and proposals for reduced provision.

3. The cost assumptions will also be the basis for the RSG settlement. The sooner we can settle these assumptions and let them be known, the better our chances of influencing local authority budgets and rates for next year, and of influencing public sector pay settlements, particularly the critical negotiation with the local authority manuals.

4. More generally, our decision is important. The cost assumptions used in preparing the public expenditure plans for 1982-83 and later

years will attract comment, from both the political and economic standpoint. They will be seen, correctly, as an indication of how successful we expect our anti-inflation policy to be, and as a measure of our determination to contain public expenditure.

Role of the factors

5. These factors will determine the "baseline" for our public expenditure decisions: the cash equivalent of the last White Paper. Apart from changes which we will make on policy grounds it will be possible to add or subtract a cash sum in the case of any particular programme if we decide that is necessary to make provision for that programme on a basis that differs significantly from what would be implied by these general factors. But decisions on any such adjustments can be left until October, when we consider the cash provision for particular programmes.

6. In general the cash provision for programmes decided this autumn will determine the corresponding cash limits and Estimates for 1982-83. In exceptional cases, the autumn decision may have to be reopened - any additional cash having to be found from within the Contingency Reserve. This procedure may be necessary to honour the Lord President's pledge to the Civil Service unions.

The proposal

7. I propose that we should now replace the single provisional factor of 7% average cost increase between this year and next, by:-

(i) an average increase of 4% in pay from due settlement dates from now on; and

(ii) an average increase, financial year on financial year, of 9% in other costs. (This would apply from uprating dates for social security benefits.)

I see no need at present to change the assumptions for inflation after 1982-83.

Two factors for 1982-83

8. It is now clear - as it was last year - that we need two factors, rather than one, for the change to 1982-83. Once again there needs to be a large gap - 5 percentage points or so - between what ought realistically to be provided for public sector cost increases other than pay and what is appropriate for increases in the wage bill, as I explain below.

9. With such a wide disparity, the use of a single cost increase factor would give rise to awkward distortions between programmes, in a direction contrary to our priorities, with over-provision for programmes with a large element of public service manpower. And there would be a danger that the continued use of a single figure, which would be significantly higher than what we can afford to pay, would set a damaging point of reference for unions in pay negotiations.

Prices

10. At Budget time, an increase in retail prices of 8% between the

second quarters of 1981 and 1982 was forecast, implying a similar increase between the averages for the two financial years 1981-82 and 1982-83. Inflation prsopects for the year ahead now look somewhate less favourable, because of the fall in the exchange rate, because oil prices in real terms are higher, and because the prospects for reductions in interest rates (which affect the RPI through the mortgage rate) have worsened as a result of the sharp increase in foreign rates. The present outside forecasts for the increase in the RPI from Q4 1981 to Q4 1982 vary between 8% (London Business School) and 12% (St James/Item). The Treasury internal forecasts for the RPI are at present at the middle of that range, about 10%. The latest signs are that there is still very considerable downward pressure on price increases. Some outside forecasters may have overreacted a month or two ago to the changes in the exchange rate.

11. Such indications as there are for likely relative price movements point to the average price increases for government spending on procurement generally and particularly on construction work, being somewhat below the RPI increase. This will partly offset a more rapid increase in the recent past.

12. We have to strike a balance in fixing the price factor in relation to these forecasts.

13. It must be reasonably realistic. It is no good using now a deliberately low figure for the uprating of social security benefits. We may decide to abate some of the upratings in November 1982; but the underlying basis will be the Government's forecast next spring of

of the RPI change, so we only risk deluding ourselves in the meantime about the cash cost.

For those programmes which will be cash limited, it is right to take a figure likely to be, if anything, slightly on the low side in order to ensure tight budgeting in Government departments and other public sector institutions, as a stimulus to efficiency and to holding down, where it is possible, the prices which they pay. But we should not go beyond that, reducing the factor in order to cut those programmes significantly: that should be done, if we so decide, by an overt squeeze.

14. We must also allow for the fact that the Government's forecast, and the assumptions which we ourselves use in framing our plans, inevitably have some effect on pay negotiators and price setters. Our efforts to reduce inflation depend on creating the right climate for expectations.

15. Balancing these considerations, I propose that the price factor should be 9%.

Pay

16. The temptation on pay is to defer a decision. But we need some working assumption so that we can look at expenditure commitments realistically. We cannot afford to give the impression that we are simply waiting to see what pay settlements emerge and will then validate them. And the timetable for the RSG settlement - together with the need for local authorities to know where they stand when negotiating with their manuals later this year - forces us to an early decision.

17. We must seek, and create expectations of, lower wage settlements in the coming round than in the last, and this points to a figure below the 6% we chose for cash limits in 1981-82. Indeed, it should be

"in low single figures".

18. Any figure on this basis will point to a further fall in real living standards of those in the public services, even allowing for some settlements being above the figure. Such a fall for wages generally is essential if we are to make worthwhile headway in restoring competitiveness. But we do not want to inflame the unions by announcing factors which significantly overstate the expected fall.

19. It would be imprudent to take a figure, as the basis of our current financial planning, significantly below what we think can be achieved. To the extent that the eventual outcome is higher than we allow for now, there will either have to be a squeeze on the programmes concerned, or to the extent that additional cash is provided by an allocation from the Contingency Reseve, a squeeze on programmes generally.

20. I propose 4%, which is, just, "a low single figure". In handling publicity, we should emphasise that this is a cash expenditure planning assumption. It does not, and is not designed to, force particular pay settlements to this precise figure. It does, however, indicate the broad measure of what the Government thinks reasonable to allow in its public expenditure plans and, where settlements in the event depart at all significantly from it, there will be necessary consequences - both ways - in public sector services and employment prospects.

Publication

21. The figures we choose now will need to be widely known in Government quickly and would be bound to leak. It will be better to announce

them, with the qualifications we want to get across.

22. I attach a draft statement which I propose should be made by press notice immediately following our decision. It will be necessary for defensive briefing to be ready on the implications for various public sector pay groups, and officials are preparing this.

Conclusion

23. I invite colleagues to agree that:

(i) The provisional inflation factors we chose in May should remain unaltered for inflation after 1982-83, but for inflation between 1981-82 and 1982-83 we should replace the working assumption of 7% for all costs by two factors: 4% for pay on average, applied to settlement dates, and 9% for prices on average, applied year on year.

(ii) We should announce these factors by press notice, as in the attached draft.

(iii) We should defer until October, when we come to consider individual programmes, consideration of any cash increases or reductions in respect of pay and prices.

REVISED DRAFT PRESS STATEMENT : 4 September 1981

PUBLIC EXPENDITURE PLANNING : CASH FACTORS

The Government has decided that, in preparing for the next stage of cash expenditure planning for 1982-83, when detailed decisions will be taken, it will allow for separate rates of increases of costs in respect of public service pay bills and other costs. For pay, the costs of programmes will be recalculated on the basis of an average increase of 4% at due settlement dates in the next 12 months. For other costs the basis will be an average increase of [9%].

2. This is a further stage in the arrangements announced by the Chancellor of the Exchequer in his Budget statement of 10 March 1981, under which the public expenditure survey this year is for the first time being conducted in terms of prospective cash expenditure, rather than in "constant prices".

3. This change requires that, as a starting point, the plans in the last expenditure White Paper (Cmnd 8175) should be put onto this prospective cash basis. At the beginning of the survey, it was decided to do this provisionally allowing for overall increases in costs of 7% between 1981-82 and 1982-83, and 6% and 5% respectively for the following two years. As then envisaged the prospects for the coming year have now been reviewed and the 7% average factor overall replaced by the separate factors of 9% and 4% referred to above. The weighted average of the separate factors now adopted is close to the provisional 7%: the change therefore has little effect on the resultant total for public expenditure, but it does affect the allocation between programmes.

4. The pay factor is not a forecast of pay settlements to be of particular amounts. It will contribute towards calculating the total cash planning figures for all programmes.

5. These assumptions on pay and prices only determine the starting point for this stage of the survey. The actual provision for individual programmes will depend on Ministers' judgements on that survey. Their decisions may include further adjustments to some, if not all, individual programmes. Cash limits for 1982-83 will follow from those decisions on programmes.

6. The Rate Support Grant paid to the local authorities for 1982-83 will be determined by Ministers' decisions on cash provision for local authority services, based on these factors of [4%] for the pay component and [9%] for other costs.

SUGGESTED REDRAFT OF PARAGRAPH 4

The pay factor does not carry the implication that all public service pay

increases

incomes will or should be 4%. There is no automatic entitlement to any particular pay increase: each must be justified on its merits. The pay factor is a broad measure of what the Government thinks reasonable to allow for the total increase in the public service wage bill.

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cc Mr. Hoskyns
Mr. Walters

PRIME MINISTER

Pay and Price Factors for the Public Expenditure Survey

You will be seeing the Chancellor after your meeting on inner cities on Monday morning, to discuss his draft paper for 15 September Cabinet on the pay and price assumptions to be built into this year's public expenditure exercise. Because of the box arrangements for the weekend, I have not seen the final version of the Chancellor's paper at the time of writing this note; but I am working on the assumption, which his Private Office believe to be correct, that the Chancellor will be recommending a pay factor of 4%, and a non-pay factor of 9%. The 9% is subject to confirmation by the Treasury forecasters, and the Chancellor is known to be opposed to a gap between the two factors - implying a fall in living standards for wage earners - of more than 5%.

attached.

There are two issues prior to the setting of the precise figures. First, whether there should be two factors, or one which provides a weighted average of both: because the gap between the two is so large, there can be little doubt that a single figure would be seriously misleading, and would be too high to have the desired effect on pay expectations. Second, whether the assumptions should be announced: the need to show that the Government is prepared to set an example in the new pay round, together with the virtual certainty of a leak if we try to conceal the decisions, argues strongly in favour of an early announcement accompanied by an appropriate explanation.

As for the figures, the non-pay assumption clearly ought to be the Treasury's best estimate of the year on year increase in prices. Otherwise Ministers will be taking public expenditure decisions on an inaccurate basis. But the pay assumption has something of the character of a self-fulfilling prophecy, in that, up to a point, the lower it is the lower the actual outcome on pay will be.

The argument against a very low figure is that the greater the implied fall in living standards, the more likely that the figure will provide a rallying point for union opposition, and that

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it will be breached so frequently as to lose credibility. We did consider the case for announcing that the pay factor would be provisionally set at 0%, with any actual pay rises having to be justified on their merits, but the resulting public expenditure figures would not be consistent with the recent decision to move to cash planning.

There are very strong arguments indeed in favour of a very low pay assumption;

- there are good indications (the FT of 1 September, attached) that at least parts of the private sector are looking to start the pay round at 0% or even lower, and these would be threatened by a possible 5% public service norm;

- whatever figure the Chancellor proposes to Cabinet is rather likely to be increased by 1% or so as a result of Cabinet discussion;

- the Government is committed not to predetermine Civil Service cash limits, and to go to arbitration if necessary, which means that civil servants will expect perhaps 2% more than the pay assumption;

- it will greatly strengthen the hands of Ministers responsible for nationalised industries if they can point to low single figures as being the expectation in the public services.

We think therefore that the Chancellor is being insufficiently ambitious in proposing 4%, with a probable willingness to go up to 5%. We ought rather to be saying that last year we set a pay factor of 6%, and achieved an out-turn in the public services as a whole of just over 8%; this year we should halve the pay assumption to 3%, in the hope of achieving an out-turn of below 5%. That would considerably ease our public expenditure problems and would be consistent with the Government's responsibility to set an example of what is necessary to regain competitiveness.

/As to the

As to the announcement, we think it should be made in the terms that although this is an across the board pay assumption, it does not follow that any public service group is automatically entitled to a pay increase: all pay rises will have to be justified on their merits.

J.

3 September 1981

AL TIMES

RANKFURT

1981 * 30p

LANDS Fl 2.25; NORWAY Kr 6.00; PORTUGAL Esc 50; SPAIN Pta 75; SWEDEN Kr 6.00; SWITZERLAND Fr 2.0; EIRE 42p; MALTA 25c

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ued on Back Page
ground, Page 2;
Comment, Page 16

Silkin

(NUPE), which com- 600,000 votes and rty's fourth largest possible supporter, been thought likely Mr Benn. has already secured of two small unions

Chase cuts prime to 20%

By Paul Betts in New York

CHASE MANHATTAN, the third-largest U.S. bank, reduced its lending rate to prime borrowers by half a full percentage point to 20 per cent yesterday.

The move by the large New York bank—the first decline in the U.S. Prime since U.S. banks increased their key lending rate to 20½ per cent on July 9—did little to lift the prevailing gloom in the U.S. credit markets and the New York Stock Exchange.

An early rally in stocks following Chase Manhattan's prime rate cut quickly wore off and the Dow Jones industrial average ended the day 10.75 points down to close at 881.47, its lowest level in 13 months.

Only two other banks—First National Bank of Chicago and the Los Angeles-based Mitsui Manufacturers Bank—followed the move by Chase Manhattan although Wall Street expects other major U.S. banks to reduce their prime rate eventually.

PRESIDENT REAGAN is under increasing pressure to trim the vast increases in defence spending he had planned for the next three years. Mr Murray Weidenbaum, chairman of the President's Council of Economic Advisers, said no part of the budget should be "sacrosanct." Page 2

Chase warned yesterday that the reduction in its prime was "not necessarily a prediction of the future direction of rates. Rather it is a reflection of current market conditions."

These conditions have seen a drop in the rate of Federal funds, or overnight interbank funds, and a general decline in the banking system's own cost of funds.

Fed funds, which dropped to 14 per cent last Friday, were again trading at the 17 per cent level yesterday. Wall Street was disappointed by the

West Midland workers 'may face pay cuts'

BY ARTHUR SMITH, MIDLANDS CORRESPONDENT

WAGE CUTS may be on the way for some Midland workers, according to Mr Reg Parkes, vice-chairman of the West Midlands region of the Confederation of British Industry.

Wages had been cut during the 1930s, and, because of the depth of the recession, some companies were again considering the possibility following the example set by Pan American World Airways. Pan Am last week started discussions with UK unions about a 10 per cent pay cut is attempting to impose worldwide.

Mr Parkes forecast that the West Midlands, once renowned for its militant workers, would set the pace in bringing down pay settlements to "the very low single figures." Most deals were already being struck at below 5 per cent. Many companies were deferring any increase.

"It is no longer a question of talking about what companies can afford to pay but what their customers can afford. There is no more money in the kitty," he said last night.

Major Peter Forrest, chairman of the West Midlands Engineering Employers' Association, said yesterday there was a mood of realism among workers. "Keeping your job is now so important. Employees know that if they get a silly wage rise jobs will go."

Shop-floor militancy has crumbled in the West Midlands, where unemployment has more than doubled in just 12 months. The level of jobless, already at 14.8 per cent, is rising faster than the national average—and employers are warning of another round of redundancies and possible closures.

Some union leaders privately admit their weakness. "Workers are demoralised and know there is not point in industrial action," according to one regional official.

The BL Cars pay talks on a scheduled November 1 review date will prove a key test. Shop stewards are demanding a £20-a-week rise — worth more than 25 per cent for the lowest paid —but there is little indication that the militant talk is likely to be translated into widespread industrial action.

The apparent lack of shop-floor militancy within BL is mirrored in engineering. Many companies believe that, whatever the outcome of national pay talks on minimum rates now under way, they may negotiate less inflationary deals at the workplace, as they did last year.

Within the region there are hopes that the new mood will survive the recession. Major Forrest said regional officials of one large union had called for a meeting with his association to discuss jointly how to maintain "the more reasonable attitude to bargaining."

Some union officials believe their negotiating power will never return. One said: "The recession has polarised workers—into those with a job and those without. Those in work won't abuse their position for fear of the employment consequences."

In the event of an economic upturn, many workers would be opposed to their management recruiting new labour, he said. "They will grab the overtime rather than run the risk that in the next downturn it will be their job that goes."

Business leaders in the West Midlands, while grateful for an improved industrial relations climate, are increasingly concerned about the failure of the Government to stimulate the economy.

Mr John Warburton, director of the Birmingham Chamber of Commerce, said last night that, without an autumn boost—possibly through public sector capital projects—more redundancies and closures could still be necessary.

Export demand improves

BY PETER RIDDELL, ECONOMIC

Mr Rickett / P.M.

I'm sure [illegible] for Monday morning. [illegible] knows.

1 Mr Whitmore [illegible] 2/9

2 Prime Minister

You could see the Chancellor either after the meeting with Mr Heseltine at 0915 on Monday 7 September, or after the meeting at 1500 on Tuesday 8 September. A meeting on Monday would give the Treasury more time to circulate their paper to Cabinet. Content to have the meeting on Monday?

WR 2/9

MR. RICKETT

Pay and Price Factors for the Public Expenditure Survey

We had a word this morning about preparation for the Cabinet discussion on 15 September on public expenditure.

Treasury officials have now confirmed to me that the Chancellor hopes to let the Prime Minister see in her box this weekend the draft of his paper for the 15 September Cabinet. As I mentioned this morning, I think it is essential that the Prime Minister find time to discuss this with him before he circulates it to his other colleagues, and I understand the Chancellor feels the same way. You indicated to me that this might be possible after the meeting of Ministers on the morning of 7 September; perhaps I could leave it to you to take this forward with the Chancellor's private office.

The main point that the Prime Minister needs to discuss with the Chancellor will be the pay assumption for cash limits. There has been considerable discussion at official level about this, in which I have been involved, and I understand the Chancellor now favours an announcement fairly soon after the 15 September Cabinet on separate pay and price factors; and that this should be in the range 4-5% for pay and 9-10% for prices (he may want to propose to his colleagues 4% for pay, holding back 1% in reserve, and 9% for prices if the latest Treasury forecast justifies that).

Whatever figure is chosen as the pay assumption will have a very considerable effect on the pay round now starting, and not just in the public sector. We have had some ideas of our own about the setting of the pay factor, which have not found favour with the Treasury; I will let you have a note about the Chancellor's proposals when we have seen them, and after I have had a chance to consult John Hoskyns and Alan Walters.

J

2 September 1981

CONFIDENTIAL

Tim / Note: I have suggested to PM she should see the Chancellor at 1115 on Monday 7/9.

CONFIDENTIAL

cc John Hoskyns
Alan Walters

WR 2/9

~~1 Mr Whitmore~~
~~2 Prime Minister~~

MR. RICKETT

~~You could see the Chancellor at 6.00 pm on Wednesday 9 September after your briefing meeting for Mitterrand's visit. Agree?~~ ?

WR 2/9

Pay and Price Factors for the Public Expenditure Survey

We had a word this morning about preparation for the Cabinet discussion on 15 September on public expenditure.

Treasury officials have now confirmed to me that the Chancellor hopes to let the Prime Minister see in her box this weekend the draft of his paper for the 15 September Cabinet. As I mentioned this morning, I think it is essential that the Prime Minister find time to discuss this with him before he circulates it to his other colleagues, and I understand the Chancellor feels the same way. You indicated to me that this might be possible after the meeting of Ministers on the morning of 7 September; perhaps I could leave it to you to take this forward with the Chancellor's private office.

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J.

2 September 1981

CONFIDENTIAL

FROM: THE RT HON MICHAEL JOPLING, MP Econ Pol 2.

Prime Minister

MAP

MS

Government Chief Whip
12 Downing Street, London SW1

13 August 1981

Thank you for your recent letter about the Treasury Select Committee. I fully share your concern that our members on the Committee should turn out in force when a report is being drafted and contentious matters have to be put to the vote. With this in mind I had a meeting about two weeks ago with all our Chairmen and majority leaders and I took the opportunity of making all these points to them. You can rest assured that I will continue to do this.

I am copying this to the Prime Minister and Francis Pym.

The Rt Hon Sir Geoffrey Howe, QC, MP

PERSONAL

2

cc Mr Gow

Prime Minister

Not a satisfactory story

MP 6/8.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

August 1981

The Rt. Hon. Michael Jopling MP
Chief Whip
12 Downing Street
LONDON
SW1

Dear Michael

May I trouble you once again with an irritating problem which arises from time to time with the Treasury Select Committee?

As you know, almost all the reports of this committee attract a high level of public attention and comment. Though they have their good sides, most tend to deal with controversial issues and often to be critical of Government policy. The latest inquiry into the financing of Nationalised Industry investment, which is to be published very shortly, is no exception to this rule.

For obvious reasons we devote a great deal of time and effort to putting our case over properly to the committee, using all the scarce resources that can be spared. But however thorough our efforts, they are of little use if our members on the committee do not turn out in force when the report is being drafted, and contentious matters have to be put to the vote. I gather that this problem arose yet again last Monday, as Tony Newton may have told you. As a result few if any of the forty odd major amendments our people wanted to make to the draft were carried.

I am well aware that it is unrealistic to expect busy MPs to attend every meeting of every Select Committee. But it is surely reasonable that they should make a point of attending at least the key meetings? Do you think there is anything that can be done to help secure better attendance?

More generally, as we enter the second half of this Parliament, is there a chance that "our" committee members can be encouraged to remember that we do all have a common objective. "No more own goals" may be too optimistic a cry: but it's worth shooting for.

/I am

I am sending copies of this letter to the Prime Minister and Francis Pym.

Yours ever

Geoffrey

GEOFFREY HOWE

MR. LANKESTER

3 August 1981

ALAN WALTERS

PRIME MINISTER

Ecm pd

KEYNES, UNEMPLOYMENT AND PUBLIC EXPENDITURE

In 1937, when unemployment was around 12%, Keynes wrote three articles in The Times. The main purpose of these articles was to point out that the public authorities should postpone capital expenditure as much as possible. He was concerned at that time, even though the price level was virtually constant and unemployment was at 12%, that additional expenditure would simply generate inflation. Some quotations will give you the flavour of his advice.

> "We are in more need today of a rightly distributed demand than of greater aggregate demand."

> "Three years ago it was important to use public policy to increase investment, it may soon be equally important to retard certain types of investment so as to keep our most easily available ammunition in hand for when it is more required. Just as it was advisable for the Government to incur debt during the slump, so for the same reasons it is now advisable that they should incline to the opposite policy... Just as it was advisable for local authorities to press on with capital expenditure during the slump, so it is now advisable that they should postpone whatever new enterprise can reasonably be held back."

> "I believe that we are approaching or have reached the point where there is not much advantage in applying a further general stimulus at the centre. So long as surplus resources were widely diffused between industries and localities it was no great matter at which point in the economic structure the impulse of an increased demand was applied. But the evidence grows that - for several reasons into which there is no space to enter here - the economic structure is unfortunately rigid, and that (for

/example)

> example) building activity in the home counties is less effective than one might have hoped in decreasing unemployment in the distressed areas. It follows that the latter stages of recovery require a different technique ....
>
> "We are in more need today of a rightly distributed demand than of a greater aggregate demand; and the Treasury will be entitled to economise elsewhere to compensate for the cost of special assistance to the distressed areas."

In an article headed "Borrowing for Defence" in The Times of 11 March, Keynes maintained: "The Chancellor's loan expenditure need not be inflationary but it may be rather near the limit ..... In two years time or less rearmament loans may be positively helpful in warding off a depression. On the other hand the War Department may not succeed .... in spending up to their timetable." He went on: "The number of insured persons who are still unemployed is indeed as high as 12½%.... but though the new demand will be widely spread .... we cannot safely regard even half of these unemployed insured persons as being available to satisfy home demand for we would have to subtract the unemployables, those seasonally unemployed, etc, and those who cannot readily be employed except in producing for export."

Keynes's concern throughout 1937 was trying to avoid a slump as he made perfectly clear in a letter to The Times of 28 December when he made clear that he supported proposals for preparing schemes of public works against the next downturn when unemployment would be liable to rise again from the 11%-12% level at which it then stood. Yet he conceded that "public loan expenditure is not .... the only way and not necessarily the best way to increase employment". "It is very generally held today that there is a good deal of advantage in retarding expenditure by such bodies when other sources of demand are strong .... This is probably a reason for not pushing such expenditure at present."

/It is clear

It is clear that in 1937 Keynes was mainly concerned with the possible dangers of inflation when unemployment was still round about 12%, and from that level downwards Keynes clearly insisted that unemployment must be dealt with not by general expansion of aggregate demand by Government, but by "a different technique", that is by specific measures in the depressed areas. Keynes was urging the damping down of extra public borrowing and deficits.

This does not imply that Keynes did not think that unemployment could not be brought below 11% or 12%. From other evidence we know that he believed there was much to be done to remove what he called the structural rigidities in Britain. But he clearly regarded it as inappropriate and indeed inflationary to use aggregate demand measures in these circumstances.

AW

3 August 1981

ALAN WALTERS

cc Mr. Wolfson
Mr. Ingham
Mr. Hoskyns
Mr. Duguid
Mr. Lankester

Econ Pol

A05302

MS

PRIME MINISTER

Tax and Public Expenditure
C(81) 37 and 39

BACKGROUND

In C(81) 37 the Chancellor of the Exchequer invites the Cabinet to recognise the need to reduce the burden of taxation and, to that end, to make substantial reductions in public expenditure. The intention is that this discussion should set the scene for the more detailed discussions that will follow after the Recess; the programme for these meetings is annexed to this brief and has been circulated to all Members of Cabinet. My note (C(81) 39) covers a paper by the Central Policy Review Staff (CPRS) on the strategic public expenditure issues, and some questions which need to be considered.

2. On 17 June (CC(81) 23rd Conclusions) the Cabinet endorsed the objective of maintaining the Government's present general approach to the economy and agreed to consider further, in the course of their discussions of the 1981 Public Expenditure Survey, the balance to be struck between the Government's taxation and public expenditure objectives and the balance, within the public expenditure programme, between capital and current expenditure. The Chancellor's present paper is addressed primarily to the balance between taxation and expenditure objectives.

3. The Chancellor of the Exchequer repeats the argument which he put to Cabinet on 17 June that the present burden of tax is too high and must be reduced for both political and economic reasons. In particular, he sees reductions in tax rather than higher public expenditure as the way through to providing permanent jobs. He warns that any weakening of resolve could upset the financial markets and jeopardise the objective of bringing inflation down to single figures and allowing for a fall in interest rates. He argues that the key to tax reductions lies in reducing the present prospective totals of public expenditure. Simply to keep the totals

at the levels in the last Public Expenditure White Paper would allow him to do no more than make good the reduction in real personal tax allowances imposed in his last two Budgets and to provide some limited tax relief to business (paragraph 12). To get the overall tax burden back by 1983-84 to 1979 levels, and to open up the possibility for significant reductions in tax including the national insurance surcharge, would require 'a substantial reduction' in the White Paper totals (paragraph 13).

4. The Chancellor invites the Cabinet to endorse this general approach to Public Expenditure Survey and in particular the overriding aim of getting totals below those derived from the White Paper, so as to make possible, within the overall economic strategy, the tax reductions necessary for fulfilling the Government's economic and employment objectives. He is not at this stage putting forward any specific target figure for public expenditure reductions. His aim for the moment is to secure a general recognition of the problems and of the objectives and to set the tone for the Chief Secretary's bilateral meetings after the Recess leading to Cabinet's further discussions of the 1981 Public Expenditure Survey in the autumn. The approach is also crucially relevant to the discussion by the Economic Strategy Committee next Monday, 27 July, of the nationalised industries' investment and financing review.

5. Even to get the totals down to White Paper levels is a large order. Returns to the Treasury at present indicate an excess in the order of £6½ billion in cash. Of this, around £2½ billion is for the nationalised industries' External Financing Limits, and will be discussed by E next week; £1.4 billion is for the unemployment measures proposed by the Secretary of State for Employment, which are now under separate discussion. The rest is spread around most of the programmes, with a good part of it attributable to the additional provision which Departments claim is necessary to make good inadequate re-valuation by the presently agreed factors for pay and for prices. (The Cabinet will review the inflation factors on 15 September: if they were then to be increased that would reduce the level of additional bids over the base line but it would not, of course, make any difference to the grand total of the cash requirement.) The CPRS pose the question: can the case for these bids be overridden in the interests of achieving the tax objective?

6. Some Ministers will argue that, although tax reductions would obviously be welcome, the Chancellor of the Exchequer is not being realistic in seeking the massive public expenditure reductions which he appears to have in mind. The present crude overrun of £6½ billion may well be reduced, but it would be very difficult to eliminate it because (so they will argue) -

i. Some programmes, such as Education, have also been cut severely and it is politically unrealistic to look for more; and Defence has already been settled in volume terms.

ii. The Government is pledged on the indexation of retirement pensions; there would be considerable political difficulty in limiting annual increases in supplementary benefit, child benefit and unemployment benefit and so on; and there is a commitment to maintain previously planned spending levels for the Health Service.

iii. Some forms of cut would be inflationary if they led to increases in the rates, or price increases by the nationalised industries; and cuts on capital investment would be damaging to employment.

iv. Pay increases in the public sector should be kept as low as possible; but, as the Chancellor of the Exchequer acknowledges, it is important not to base plans on unrealistic assumptions on pay.

The CPRS discuss this problem in Sections II and III of their paper, and put the questions how can further cuts be found and in particular can the public sector be made to yield a dramatic further cut in current spending?

7. The objective of Treasury Ministers will be to use the detailed bilateral discussions with Departments to form a view on what is practicable, and on what proposals they should make on 20 October for overall totals. In the meantime, Ministers may be reluctant to sign up in any meaningful way on the Chancellor's proposition that the Cabinet should now endorse the overriding aim of getting the overall expenditure totals below those derived from the White Paper. If they do not, the Chancellor will be very anxious to avoid any precise counter-proposition, such as that the aim should be to stick to

the White Paper totals. The least unsatisfactory outcome might then be for Cabinet to agree that, against the background of the prospects explained by the Chancellor and the objective of reducing the tax burden, the aim should be to cut public expenditure substantially and as much as is practicable.

8. The Secretary of State for Employment will probably refer to his wish to make a comprehensive statement before the Recess on the special employment measures which he has proposed. Mr Moore's minute to Mr Lankester of today summarises the progress made so far by the Chancellor of the Duchy of Lancaster's Group, MISC 59; you are discussing this issue yourself with the Secretary of State for Employment and other Ministers today.

9. Ministers may refer to the point you made, in your summing up of the discussion in the Committee on Economic Strategy of the employment measures, that each Minister should consider further, before the Cabinet met to discuss the 1981 Public Expenditure Survey, whether there was scope for changing priorities within their proposed programmes to give greater weight to employment generating projects. On present plans the MISC 59 Group will be considering a paper by the Chief Secretary on the relative merits of investment and fiscal measures in terms of generating employment; beyond that - and subject to what the Chief Secretary might say to Cabinet - I think that the practicable way to take account of proposals for employment generating projects is for the Chief Secretary to examine them in his bilateral discussions. In practice, every spending Department can produce a shopping list and the fairest and most sensible method would be to look across the board at all the possibilities. The further work which the Chief Secretary has in hand for MISC 59 is also relevant to the question raised by the CPRS in Section I of their note of whether Ministers will need more information on the employment trade-off when they consider particular tax and expenditure options.

10. In paragraph 17 of his paper the Chancellor of the Exchequer refers to the Secretary of State for Environment's idea that it might be possible to secure some trade-off between pay and capital investment when negotiating public sector pay. This question is discussed in more detail in the Annex

to his paper. The Chancellor is not optimistic that this is a very practicable way forward but he invites the Ministers concerned to put forward by September specific proposals for developing the approach in, for example, the National Health Service and for the Armed Forces.

HANDLING

11. You will wish to ask the Chancellor of the Exchequer to introduce his paper. Since the Chancellor is putting forward very general propositions, the discussion is likely to be wide-ranging and all Members of Cabinet will want an opportunity to comment.

12. A good deal of the discussion is likely to focus on the practicability of achieving massive public expenditure cuts on the lines envisaged by the Chancellor. Your objective, and the Chancellor's, will be to ensure that, before the detailed discussions of programmes get under way, there is full recognition of the need to reduce the burden of taxation and the greatest possible degree of commitment to go hard for the maximum public expenditure savings which can be made.

13. In the light of your discussions today you, and the Secretary of State for Employment, may wish to say something on employment measures. Substantive discussion of nationalised industries' programmes can be left to E next Monday; the spending of the local authorities will be discussed in more detail under the next item on the Agenda.

CONCLUSIONS

14. In the light of the discussion you will wish to record conclusions -

either accepting paragraph 20 of the Chancellor of the Exchequer's paper C(81) 37 - that is, endorsement of the general approach he puts forward and in particular of the overriding aim of getting overall expenditure totals down below those derived from the Public Expenditure White Paper

or, if Cabinet is not prepared to sign up on the Chancellor's objective, endorsing the objective of reducing public expenditure totals substantially (that is, without reference to any particular number or bench-mark).

RTA

22 July 1981 Robert Armstrong

1.

Prime Minister.

I suggest that you discuss this with the Chancellor on the way to Ottawa.

CONFIDENTIAL

Qa 05635

To: MR WHITMORE

From: J R IBBS

Public Expenditure

1. I have seen the Chancellor's draft paper on tax and public expenditure, as he sent it to the Prime Minister on 15 July.

2. It seems to me that there is one central point. It will not be possible to achieve the Chancellor's aim, of getting expenditure totals below those derived from the March White Paper, unless Ministers resolve now to make a much more aggressive attack on current spending than they have achieved so far. An indirect approach, of endorsing this as an 'objective' without accepting the consequences, will not be enough. Previous experience suggests that bilaterals will not achieve the reductions needed. Cabinet in the Autumn will be no further forward. And Ministers in the meantime will be lulled into supposing that they are still on course towards a lower burden of taxation.

3. I suggest that the Prime Minister might find it helpful if the Chancellor's paper were complemented by a short CPRS paper to sharpen up the choice that Ministers face. I attach a draft which takes the Government's economic strategy as its starting point, with the firm objective of a declining PSBR, but then brings out the tax/expenditure choice and what this implies for programmes. Private sector firms have faced similar harsh choices and most have cut back sharply on their current costs. I believe this paper might help Cabinet face the decision with the main issues placed squarely before them.

4. I am sending a copy of this minute to Sir Robert Armstrong.

17 July 1981

Att

CONFIDENTIAL

PUBLIC EXPENDITURE

Note by the Central Policy Review Staff

1. The Chancellor's paper asks Cabinet to endorse the over-riding aim of getting public expenditure totals below those derived from the March White Paper. This is to allow reductions in the tax burden. Treasury Ministers will then discuss with colleagues bilaterally how programmes can contribute to the overall aim, and will make proposals in the Autumn.

2. Cabinet on 17 June endorsed the objective of maintaining the present economic strategy. Within that framework, Ministers may find it useful to have a brief note on the strategic public expenditure issues, even at this stage in advance of the Autumn discussions. Some of the issues cannot be resolved until then.

(I) Public expenditure and taxation. The Chancellor argues the need to reduce the burden of taxation both as a political priority, and to improve supply-side performance via incentives and company profits. The comparison of employment effects is difficult, e.g. because of market reactions (his paragraph 8). But the employment trade-off will depend heavily on the particular tax and expenditure options being considered, and on the time-scale.

Will Ministers need more information on the employment trade-off when considering particular tax and expenditure options?

(II) Public expenditure totals. The attached table gives the figures agreed for the last White Paper, in constant prices of late 1979. They will be updated, and converted into cash, for discussion in the Autumn. But the totals show that in these (volume) terms, the Government has not yet succeeded in reversing the upward trend of public spending. Furthermore, only a small increase of some $1\frac{1}{2}$ per cent would mean that the upward trend would continue in 1982/83.

(III) Programmes. The table shows the main programme totals. These represent the outcome of past Ministerial decisions on priorities. They show once again the large proportion of programmes protected by some form of commitment - social security (28 per cent in 1982/83), defence (13 per cent on these figures, now higher), health (12 per cent), law and order (4 per cent). Beyond these (well over half the total), there are tight constraints on cutting back many other programmes - e.g. EEC, agriculture, industry, employment, education. Much of the rest is current spending by local authorities, where there is the problem of control. In deciding whether a reduction below the White Paper totals should be the overriding aim, Ministers must in effect ask themselves:

Is it realistic to look for further cuts in most of these programmes?

(IV) Additional bids. These are over £6bn. (cash) or 5 per cent of the total. The Treasury's aim implies either rejecting these or offsetting them by extra cuts elsewhere. But the additional bids are by no means all for optional volume additions. They are of various kinds [as the Chancellor says]:

(i) Cash squeeze. Under cash planning, any cash squeeze due to higher prices or pay this year is carried forward into the base for next year. Perhaps £1 bn. (including £$\frac{1}{2}$ bn. for local authorities) more cash is needed now to buy the volume planned for 1982/83 in the White Paper.

(ii) Prices. Nearly £1 bn. of bids is for expected pay and price increases higher than the average (provisionally 7 per cent).

(iii) Nationalised Industries. Bids for increased EFLs amount to £2$\frac{1}{2}$ bn. - mainly to offset the impact of recession. If investment is not to be cut, nor prices increased, reducing the bids requires cuts in current costs (i.e. greater efficiency). In some industries, redundancy payments may make it impossible to do this at least in the first year.

(iv) Local authorities. If the Government cuts back on RSG, differentially or across the board, the main result will be higher rates.

(v) Current vs. capital. Ministers will want to hold back current spending where possible to make room for productive capital investment and other forms of "spend to save". The Chancellor's paper discusses a pay/capital trade-off. Otherwise, central Government manpower is already being squeezed. Are there other forms of current spending (e.g. some social security payments) which could be held back?

(vi) Employment. Ministers have asked for further work on the £1.4 bn. bid and other options. A medium-term package which meets the Government's objectives will not be easy to find without adding substantially to present expenditure totals (even net).

The question for Ministers is:

Can the case for these additional bids be over-ridden in the interests of achieving the tax objective?

Conclusion

3. In summary, the question before Ministers is whether they are prepared to mount now a much more aggressive attack on current spending than they have found possible so far. Otherwise the Government's taxation and public expenditure objective will not be achieved. In the private sector, firms have had to find ways of meeting cash crises by drastic action to cut back, often by doing things they had previously regarded as unthinkable.

Can the public sector be made to yield dramatic further cuts in current spending?

Table 1.7

Total public expenditure by programme

	1981–82	1975–76	1976–77	1977–78	1978–79	1979–80	1980–81 estimated	1981–82	1982–83	1983–84
	£ billion projected cash spend(¹)	£ million at 1980 survey prices								
Defence	12·3	9,436	9,287	9,082	9,026	9,294	9,746	9,750	10,050	10,350
Overseas aid and other overseas services:										
Overseas aid	1·0	707	680	720	805	788	803	741	680	680
EEC contributions	0·5	16	281	632	774	826	380	392	390	390
Other overseas services	0·6	453	445	552	442	455	465	459	460	460
Agriculture, fisheries, food and forestry ...	1·3	2,369	1,433	1,133	971	1,010	1,150	1,005	980	920
Industry, energy, trade and employment ...	5·3	4,850	4,328	2,854	3,530	2,929	3,899	4,023	3,080	2,460
Transport...	3·6	3,953	3,531	2,983	2,915	2,967	2,824	2,736	2,670	2,670
Housing	4·2	6,072	5,880	5,093	4,728	4,928	4,256	3,143	2,720	2,230
Other environmental services	4·0	3,729	3,425	3,308	3,351	3,210	3,064	2,976	2,880	2,860
Law, order and protective services	3·6	2,572	2,629	2,571	2,596	2,698	2,833	2,886	2,960	3,000
Education and science, arts and libraries ...	11·7	9,421	9,393	9,011	9,171	9,236	8,909	8,544	8,360	8,190
Health and personal social services	12·5	8,618	8,700	8,746	8,973	9,003	9,067	9,234	9,400	9,480
Social security	27·4	15,737	16,246	17,093	18,644	19,106	19,775	21,161	21,600	21,400
Other public services	1·3	1,023	954	919	914	931	941	973	930	920
Common services	1·5	1,088	1,108	1,079	1,068	1,103	1,106	1,183	1,180	1,230
Scotland	5·7	4,589	4,518	4,368	4,462	4,530	4,399	4,271	4,170	4,100
Wales	2·2	1,795	1,803	1,744	1,766	1,788	1,737	1,676	1,630	1,600
Northern Ireland	3·2	2,300	2,294	2,278	2,466	2,437	2,472	2,436	2,410	2,410
Government lending to nationalised industries	1·8	1,694	415	−281	812	1,857	2,050	1,400	350	−150
Adjustments										
Nationalised industries' net overseas and market borrowing(²)	−0·8	861	1,853	1,187	537	−322	−500	−585	−400	−550
Special sales of assets	−0·2	—	—	−697	—	−999	−325	−175	−125	−125
Contingency reserve	2·0	—	—	—	—	—	193	1,500	2,000	2,000
General allowance for shortfall	−0·7	—	—	—	—	—	—	−500	−500	−500
Planning total	104·0	81,283	79,202	74,375	77,951	77,776	79,245	79,225	77,900	76,000

(¹) See paragraph 9.
(²) Including Civil Aviation Authority.

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Prime Minister
If you have time to read the attached draft, the Chancellor would like have a word about it. He will need to circulate before the w/end.
JL
15/7

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

TAX AND PUBLIC EXPENDITURE - CABINET ON 23 JULY

In my minute of 25 June I sketched out what might be included in my paper for Cabinet on 23 July, and your Private Secretary's letter of 6 July broadly endorsed this. You may now like to have sight of the papers which the Chief Secretary and I propose to circulate by the end of the week.

2. As you will see, only the Chief Secretary's paper seeks any operational decision - this in relation to local authority current expenditure in 1982-83. All that is looked for in my own paper is an endorsement, or rather re-endorsement, of the need in the forthcoming Public Expenditure Survey to come out with totals below those derived from the March Public Expenditure White Paper. But I have sought to put this squarely against the background of the present excessive tax burden and what we could do if we could reduce this burden especially in relation to our employment policies.

3. I know how very difficult our colleagues are going to find it to restrain public expenditure. But that is why I think it is important that the need for this is put to them firmly in terms of the tax reductions that are within our grasp and are at risk. No doubt there will be those who will argue that it would be quite ambitious enough simply to stick with the present public expenditure plans, which would at least permit some tax tax reductions. But in my view we must try to do better; the margin between the scope for tax reductions and the need for

CONFIDENTIAL

tax increases is narrow, and once the totals start sliding we shall be lost. And we need to bear in mind that although these possibilities of tax reductions are justified by my view of our medium-term economic prospects which I describe in my paper, these themselves are vulnerable; they are subject to forces outside our control and could worsen.

4. In my minute to you I also mentioned that I was considering how, from the point of view of mechanics, we might make improvements in the way we bring the public expenditure discussions in the autumn to a conclusion. I am still giving thought to this, but as you say we need not settle the matter now.

5. I am copying this to Sir Robert Armstrong.

G.H.

July 1981

TAX AND PUBLIC EXPENDITURE

DRAFT PAPER FOR CHANCELLOR OF THE EXCHEQUER TO PUT TO CABINET

Our general approach

At our meeting on 17 June we endorsed the objective of maintaining our present economic strategy.

2. We also agreed to consider further in the context of the 1981 Public Expenditure Survey the balance to be struck between taxation and public expenditure. We noted that during our term of office so far the burdens of tax and public expenditure have both increased, directly contrary to our expectations and our promises.

Taxation

3. The present burden of tax is far too high. It is one of the main factors hindering the growth of new employment opportunities. It is higher as a percentage of output than it was in Labour's last year. Although the basic rate of income tax has been reduced, there has been a substantial increase in indirect taxes, the starting point for income tax is lower in real terms, and National Insurance contributions have been increased. As a result, 48½% of the income of a married man on average earnings is now taken in direct and indirect tax and contributions; when we first took office it was 45%. Many more lower paid people have been pulled into tax. And although we have made some useful changes in the structure of company taxation, the real burden on industry has not been appreciable reduced; the rates of Corporation Tax and National Insurance Surcharge (NIS) are unchanged.

4. To help reduce unemployment, and for other sound social and economic reasons we must do better. A priority must be to raise substantially the starting point for income tax. This is essential in order to widen the gap between incomes in and out of work, to improve incentives for the lower paid and to ease the poverty trap. Raising the income tax threshold would also encourage greater restraint in pay bargaining. We also need to reduce the tax burden on business; a cut in the National Insurance Surcharge would

directly reduce labour costs, encourage firms to take on more people, and improve profitability. Tax reductions of this kind are a better way of stimulating real employment, and likely to do to greater effect and with better long term consequences, than additional public expenditure which further increases the size of the public sector.

5. It follows that a reduction in the burden of taxation is central to the achievement of our objectives and must have a very high priority.

The economy

6. As explained when we discussed economic strategy on 17 June, the background against which we have to look at our tax and public expenditure strategies is one in which the world economy will be slowly recovering from the present recession and our own economy adjusting to a lower rate of inflation and the effects of North Sea oil.

7. The fall in output appears now to have come to an end. But the pace of recovery is uncertain, as the wide array of forecasts indicate. The crucial question is the speed at which inflation adjusts to declining monetary growth. On this much will depend on what happens on pay settlements this autumn and winter. Partly owing to the recent fall in sterling, inflation may not fall as fast as previously expected this year, with something of a pause in coming months.

8. Our policies for public expenditure, taxation and reducing inflation are not exempt from the judgment of the markets. Until recently that judgment, by raising the exchange rate, has been helping us to secure a rapid reduction of inflation; and to shelter our interest rates and hence British industry and employment from the full effect of US interest rates, to which our Community partners have been more exposed. If however the view takes hold in the markets that our determination is weakening, we could find ourselves increasingly exposed to US interest rates and to damage to our efforts to reduce inflation. This is something we must have in mind in taking our expenditure decisions.

9. Provided expectations of lower inflation are maintained, there should be some increase in output in 1982, and a rather bigger increase in 1983 that should halt the rise in unemployment in that year. But given the likely

world environment, and with business profitability still under pressure, it would be unrealistic to expect any strong resurgence of the economy in the next two years.

10. In all the circumstances, and consistently with our decision on 17 June, we must stick with the medium-term financial strategy and the path of the declining PSBR (as a proportion of GDP) set out there. This ashould bring inflation down well into single figures and permit a fall in interest rates over the medium-term. But holding to that strategy will require some tough decisions. The way we may be affected by factors we do not control only means we must make sure we stick to policies where we do.

Public expenditure

11. The key to making tax reductions lies in public expenditure. The Government's record on this is so far a disappointment, to ourselves and to our supporters. We said in the March White Paper that the planned public expenditure totals there indicated are higher than we should wish, and that this requires most serious attention in the current Survey. We must now implement that.

12. Even just to make good the reduction in real personal tax allowances imposed in the last two Budgets, and to provide some tax relief to ease the financial pressures on business requires that our total public expenditure plans are no higher than in the March White Paper.

13. But expenditure at this level would still mean an overall tax burden higher than when we came to office (at the moment if we exclude the North Sea it is 39½% of GDP; it was 35% when we came into office; and the March White Paper plans would imply 37%). A broad ready reckoner is that each £1 billion cash reduction in public expenditure would enable us to reduce taxes by £1½ billion. To get the overall tax burden back by 1982-83 to the level at which it stood when we came to office requires a substantial reduction in the White Paper public expenditure plans. But it would, for example, make possible a real stimulus to employment by enabling us to restore the starting point for income tax to the 1979-80 level and ease

substantially the burden of the NIS. We could also begin to make progress towards fulfilling other long-standing pledges such as an easing of the burden of the capital taxes.

14. Yet is is clear from the Survey so far that there are going to be serious problems even in holding the March White Paper totals. For next year, 1982-83, bids for additions to programmes exceed £6 billion in cash. Of this some £2½ billion is for additions to nationalised industries EFLs. There is a bid of £1.4 billion for employment measures [part of which was recently discussed in E]. There are bids for increases in the majority of other programmes too. Increases will also result from unemployment forecasts worse than were assumed in the White Paper.

15. We have the problem of overspending by local authorities. The overspend in the current year will be substantial despite the counter action taken. We should do all we can to contain this, including timely guidance as suggested by the Chief Secretary in C(81) about plans for current expenditure in 1982-83.

16. There are good arguments in favour of some shift within programmes in favour of capital rather than current expenditure. It is disappointing that most of the bids for additions are for current expenditure, or in the case of the nationalised industries to make good reduced internal finance.

17. Public services pay accounts for some 30% of the public expenditure planning total. The lower we can get pay, the better the services we can provide. But we must not be unrealistic. It would be quite wrong to base our plans for other expenditure on an assumption about pay which we cannot fulfil. This is the difficulty about the otherwise attractive suggestion of linking pay with capital projects, which is discussed in the annex to this paper. There may be some possibility of doing this in certain fields. I should welcome, not later than September, any suggestions from colleagues responsible for particular pay negotiations and capital programmes how the idea might be developed in their areas, e.g. the NHS, the armed forces.

18. But our overwhelming concern must be with the totals. For these it is not necessary at this stage to propose a precise objective, nor do I intend to do so. Amongst other things I would expect that before this is done, the Chief Secretary will examine individual programmes. But the proposals

now emerging would lead to higher totals than the cash equivalent of the March White Paper. Within them the proportion of capital would be lower. This is the opposite of what both we and our supporters think right. Far from enabling us to reduce taxes, it would mean that we would have to increase taxes even further in the remaining Budgets of this Parliament. To go down that road would be economically damaging and politically impossible.

19. It is against this background of political, economic and social considerations all pointing to restraint of public expenditure plans below those derived from the March White Paper that we must approach the present Survey and the current nationalised industries investment and financing review. Whatever the case for increases in certain areas of special priority, our overriding aim must be to get the overall expenditure totals down below those derived from the White Paper.

Conclusion

20. I invite Cabinet to endorse the general approach to the public expenditure Survey indicated in this paper, and in particular the overriding aim in paragraph 19 so as to make possible within our overall economic strategy the tax reductions necessary for fulfilling our economic and employment objectives.

G H

ANNEX

PAY AND CAPITAL PROJECTS

It has been suggested that the provision for pay should be reduced to make room for an increase for capital projects.

2. It is possible to make this trade-off to some extent for public expenditure in total. But we must not make plans for capital (or other) expenditure which depend on provision for pay which is unrealistically low.

3. And it would be difficult to introduce the trade-off between pay and capital investment into the negotiation of public sector pay at this level of aggregation. The link between pay for, say, doctors and investment in, say, roads or in the public sector as a whole is too indirect.

4. The best opportunity to link capital spending to the outcome of pay negotiations, and to make it an element in these negotiations, is where all the following conditions are fulfilled:

(a) there is a clearly defined cash limit within which both pay and capital expenditure have to be found, so that the trade-off is clear eg the EFL for a nationalised industry, the cash limit for the NHS;

(b) the pay negotiations within that cash limit are self-contained, and within the control of the Minister or manager responsible for the cash limit;

(c) <u>either</u> the unions have a direct interest in a higher level of investment, because it means higher employment, or the continued viability of the industry, <u>or</u> moral and political suasion can be applied by the Government saying "we would have liked to have had more investment <u>but</u> the money went as pay instead";

(d) additional investment in that area is desirable on merits;

(e) it is practical to arrange that the capital expenditure is not committed until the savings on pay are secured.

5. This approach has been used for some nationalised industries. For example the Government has linked investment with pay and productivity for the railways. It is for consideration whether it could be introduced for other areas eg the National Health Service, the Armed Forces and Defence.

6. But it would be difficult to apply to:

(a) local authority pay. While the Rate Support Grant is a cash limit, local authority pay is not directly controlled within a cash limit. How would the Central Government be sure enough of savings on pay to increase the cash limit on local authority capital until too late in the year? It would be difficult to make the capital/pay trade-off an effective element in a particular negotiation;

(b) Civil Service pay. The combination of central negotiations on pay and many cash limits including Civil Service pay would make it difficult to establish a trade-off.

7. Nevertheless we should not lose sight of the possibility over time of achieving more on civil service and local authority pay, perhaps by differential treatment of different groups, the introduction of regional pay variations, etc.

LOCAL AUTHORITIES' CURRENT EXPENDITURE 1982-83

Note by Chief Secretary, Treasury

The Chancellor's paper C(81) discusses our general approach to the public expenditure Survey. This note is about an immediate decision concerning local authorities' spending plans.

2. It will be helpful to give local authorities early guidance as to our intentions for their current spending next year 1982-83, which will be reflected in the Rate Support Grant negotiations later. Guidance given before the summer holidays will have more influence on actual spending next year than would a statement delayed until the autumn. For England and Wales the Consultative Councils on 30 and 31 July are suitable opportunities.

3. Despite the conditonal reductions in Rate Support Grant, local authorities are likely to overspend the March White Paper plans for relevant current expenditure for the current year 1981-82 by at least £1 billion. Political opposition to further cuts is increasing. The further powers to influence local authority expenditure which we have discussed in E Committee will not take effect before 1983-84.

4. In consequence of this overspend in the current year, if local authorities are to keep their cash spend next year 1982-83 to the provision in the March White Paper revalued on the present formula, they will have to spend no more

cash next year than this year. This would imply that on present estimates they should reduce their current spending next year in volume terms by some 7 per cent compared with what is now expected for the current year. This 7 per cent comprises elimination of the 3-4 per cent volume excess in 1981-82, the Government's already intended volume reduction of 1 per cent between 1981-82 and 1982-83 as shown in the White Paper, and the carry forward of the cash squeeze of 2-3 per cent now expected to develop in the current year 1981-82.

5. The 2-3 per cent cash squeeze just mentioned occurs in the current year because actual pay and price increases between 1980-81 and 1981-82 are proving to be more than the cash limit factors for this year. The cash planning system is intended to carry forward such a cash squeeze unless it is specifically decided to admit a bid to make it good. The greater part of this year's squeeze for local authorities will result from pay settlements which they have made, accepting the consequent squeeze for this year. It is right to carry this squeeze forward.

6. While in general we ought to be aiming below the March White Paper figures, in the case of local authorities current spending I doubt whether specifying now a further cut in the White Paper figures beyond the carry forward of this year's squeeze would help to get actual spending down. Indeed a 7 per cent volume reduction on this year's expenditure will be tough.

7. I accordingly propose that local authorities should now be told that, except for police pay (see below), they are expected to hold their total cash current expenditure in 1982-83 to the cash equivalent of the provision in the last White Paper, revalued on the present formula, with minimal variations in the service pattern within existing programmes. The revaluation would be on the basis agreed by Cabinet for starting this year's survey : that is, conversion from autumn 1980 prices to 1981-82 prices using the factors (11 per cent and 6 per cent) used for this year's RSG and cash limits, and then revaluation forward to cash provision for 1982-83 using for the present the single 7 per cent factor provisionally adopted. This would be confirmed or revised in the autumn in the light of any general revision of inflation factors for 1982-83 which may then be decided by Cabinet on grounds of realism.

8. Particular services should in general not be exempt from this approach. There is, however, a case for special allowance for the extra cost of the prospective 1981 police pay settlement (say £90 million) and of allowing police forces to recruit up to complement (£25 million). This would recognise our priority for the police service without abandoning the discipline of cash planning.

Conclusion

9. I therefore invite Cabinet :

(i) to agree that the Government's plans for local authoritiesrelevant current expenditure in 1982-83 should be held to the cash equivalent of the March White Paper revalued as in para 7, except for police pay as in para 8;

(ii) to ask the Secretaries of State for the Environment and for Wales to give guidance accordingly at the Consultative Councils on 30 and 31 July, and the Secretary of State for Scotland to give comparable guidance to Scottish local authorities.

Econ Pol

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CF

10 DOWNING STREET

From the Private Secretary

6 July 1981

Dear John,

TAX AND PUBLIC EXPENDITURE: THE NEXT STEPS

The Prime Minister has now had an opportunity to consider the Chancellor's minute of 25 June on the above subject. She has asked me to say that she welcomes his intention to illustrate the tax and expenditure trade-offs as a necessary part of the discussion of public expenditure at the Cabinet meeting on 23 July; that she endorses his view of the objectives of that meeting; and that she agrees that the possibility of establishing a small group of Ministers to assist in the decisions on public expenditure should be borne in mind for decision in September.

B/F

Yours ever,

Tim Lankester

A. J. Wiggins Esq.,
H.M. Treasury.

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Prime Minister 1

This note from the Cabinet Office summarises the Chancellor's proposals at Flag A and recommends how you should respond. Content?

TL 30/6

CONFIDENTIAL

P.0514

MR LANKESTER

Yes - agree [illegible] MT.

cc: Mr Moore
Mr Wright

TAX AND PUBLIC EXPENDITURE - THE NEXT STEPS

below

Flag A You asked for advice on the Chancellor's minute of 25 June to the Prime Minister about this year's public expenditure operation. In it the Chancellor makes three proposals:-

(a) That he should present Cabinet on 23 July with "one or possible more" packages which would illustrate the potential trade-offs between tax and public expenditure next year and in the succeeding years to 1984-85.

(b) That the objective on 23 July would be "to secure colleagues' general agreement" to a broad view of the sort of reductions which might be made from spending in Cmnd 8175 together with an indication of the areas in which these reductions might be found.

(c) That looking further ahead the Prime Minister might envisage establishing (later) a small committee of Ministers which could (i) have a preliminary look in late September/early October at the specific proposals for public expenditure cuts which the Chancellor will be putting to the Cabinet on 20 October; and (ii) after the discussion on 20 October, follow through outstanding points with power to "settle matters". The explicit purpose would be to prevent colleagues, faced with unpalatable cuts to their programmes, appealing again to the full Cabinet.

2. The Chancellor's first proposal (to provide the July 23 Cabinet with a preliminary view of the likely trade-offs between taxation and expenditure) seems both sensible and necessary. There are of course risks (especially of leaks of divergencies of view on strategy or of the Government's specific taxation objectives) but nothing less is likely to put sufficient drive

behind the search for public expenditure savings or to satisfy the critics who say that public expenditure cannot be looked at apart from the broader financial outlook.

3. The second proposal (seeking a broad-brush endorsement of the required scale of public expenditure cuts at the July meeting) is what that meeting is all about. At the same time the Chancellor should not mislead himself (perhaps there is no danger of this) into thinking that he is likely to get conclusions which are "hard" enough to be prayed in aid against spending Ministers later in the year. The latter are bound, in self-defence, to hold open agreement on individual programmes until they can see the Chancellor's specific proposals against the background of more up to date assessment of need in 1982-83 than will be possible this July.

4. The Chancellor is not seeking a decision yet on his proposal for the establishment of a small "Star Chamber" committee. Such committees have of course been used in previous public expenditure cuts operations and can be most useful in removing detailed points from the agenda of the full Cabinet. But again the Chancellor should not mislead himself into thinking that members of the Cabinet, whether as spending Ministers or as politicians, will allow major political issues to be decided other than in full Cabinet. Obviously a lot will depend on the scale of the cuts which turn out to be necessary and the political sensitivity of the particular cuts proposed. But given that the "easy" programmes have been heavily squeezed already, and that defence is largely settled, any major new reductions are bound to call in question both politically sensitive areas of expenditure and the Government's past commitments. Luckily no decisions on this procedural proposal are needed yet.

5. My recommendation therefore would be that the reply to the Chancellor's minute should:-

(a) Welcome his intention to illustrate tax/expenditure trade-off as a necessary part of the discussion of public expenditure in Cabinet on 23 July.

(b) Endorse his view of the objectives of that meeting.

(c) Agree that the possibility of establishing a small group of Ministers to assist in the public expenditure operation (and the remit that any such group should be given) should be borne in mind for decision in September. (The Cabinet meeting already arranged for 15 September to consider the appropriate cash limit factors for next year would provide a suitable occasion for the idea to be launched.)

P Le Cheminant

Cabinet Office
30 June 1981

cc A Duguid
A Walters

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

PRIME MINISTER

TAX AND PUBLIC EXPENDITURE - THE NEXT STEPS

Following our discussion in Cabinet on 17 June I have been considering how we should carry forward decision-making in the tax and public expenditure field, with particular reference to the discussion in Cabinet due to take place on 23 July.

2. We agreed on 17 June that we should in the context of the forthcoming Public Expenditure Survey round consider the balance to be struck between the Government's taxation and public expenditure objectives, and the balance, within the public expenditure programme, between capital and current expenditure.

3. Economic prospects may alter between July and October, so I may not want to be too precise on 23 July. What I have in mind for that discussion, therefore is to put before our colleagues one or possibly more "packages" which would illustrate what the trade-offs might be between specific objectives for the tax burden on the one hand, and public expenditure on the other. These calculations would of course assume that the medium term financial strategy holds, but they might make alternative assumptions about the precise developments in the economy given our overall approach to policy. So far as tax goes, they might explore the implications of alternative assumptions about where any tax relief (over and above normal revalorisation) might be given - eg all to companies, or in part to companies and in part to persons.

4. The other side of this coin is public expenditure. I should at the least want to discuss in my paper for 23 July the preliminary prospects for public expenditure as they are emerging from the Survey, and as they would need to be in the light of the alternative tax strategies presented. This would cover the sort of reductions that might have to be found, and the general sort of areas in which they might be found, if we had to accommodate the additional bids that we expect (notably in respect of nationalised industries), perhaps find some additional money in areas to which colleagues attach particular importance (eg alleviating youth unemployment and may be some more capital expenditure) and still make what necessary overall reductions would be required to meet the tax strategies. The years considered would be 1982-83 through to 1984-85 - the Survey period.

5. My objective on 23 July would be, therefore, to secure colleagues' general agreement, on the basis of a given tax strategy or strategies, to a general view of the sort of reductions from the plans implied in Cmnd 8175, with some ideas as to where these reductions might - or alternatively might not - be found.

6. This would be preparatory to our autumn discussions. As you know we are to consider in Cabinet on 15 September what revision if any might be made to the factors provisionally adopted for translating the Cmnd 8175 public expenditure figures into cash, and we are to consider on 20 October my detailed proposals in respect of public expenditure. The discussion on 23 July is intended to guide me to what I shall propose on 20 October. But I have been considering how, from the point of view of mechanics, we might bring discussion subsequent to 20 October to agreement. Over the last 2½ years we have seen how even when our colleagues have agreed on overall targets or objectives we have had the utmost difficulty in securing the necessary detailed decisions on programmes to get to those totals. We may need a different

approach.

7. I have not come to any final view yet. But depending on the sort of decisions which appear to be necessary and how difficult these are likely to be, I may want to suggest that we should try again, but with some changes, the use of a small group of Ministers charged with implementing Cabinet's decisions. Such a group might comprise Treasury Ministers, some big spending Ministers, and some "non-economic" Ministers. The important thing, however, is that it would be made clear to all our colleagues and to the group, that the group was intended to settle matters. The problem in the past is that spending Ministers have been able, often with success, to appeal to full Cabinet, which undermines the work of such a group. (I should make it clear that such a group would not necessarily completely replace the usual bilateral discussions between spending Ministers and Treasury Ministers; where such bilaterals are likely to be useful - before or after 20 October - I hope they would continue).

8. As I say there is no need to take any decision on this yet. Such a group could not really set to work until after 20 October when I have made my specific proposals - though I would not rule out the possibility of it meeting some time between 15 September and 20 October to consider those proposals. When it does get down to business, however, it will have to conclude its work early in November, in order to enable Cabinet to decide any residual disagreements - in theory there should be none - on 5th or 12th November so as to meet our general timetable.

9. This of course is only a general outline of how I propose to proceed, and there are details yet to be considered. But I hope you will agree to this general way of going forward.

GH

(G.H.)
25th June 1981

CONFIDENTIAL

P.0494

PRIME MINISTER

THE ECONOMIC IMPACT OF NORTH SEA OIL AND GAS REVENUES
MISC 56(81)10

BACKGROUND

In earlier discussions of the Group it was suggested that the Government should do more to rebut criticisms of its energy pricing policy - and help present any new measures - by a more vivid explanation of the ways in which North Sea revenues were already benefiting industrial investment and recovery. The paper by the Chancellor of the Exchequer, MISC 56(81)10, sets out to do that.

HANDLING

2. This paper should not require substantive discussion. You might ask the Chancellor of the Exchequer to say briefly how he thinks the arguments in it could best be used. He might, for example, wish to make it generally available to Members of Cabinet so that they could draw on it in speeches. Other members of the group will wish to say whether they are satisfied with its approach.

CONCLUSIONS

3. Subject to any dissenting comments the Group can simply take note of the paper. You will also wish to record any points on the further use to be made of it.

P Le CHEMINANT

Cabinet Office
9 June 1981

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

PUBLIC EXPENDITURE PROSPECTS

Particularly in the light of our forthcoming discussions of the defence programme, and in due course of public expenditure more generally, I feel you would wish to be kept aware of my continuing concern about the prospects for public expenditure.

2. In Cabinet on 18 June we shall be talking about the general prospects for our economic strategy, and for public expenditure as one element in that. It is too soon to determine a precise target for public expenditure; that is better left until July. But there can be do doubt that our economic and financial objectives call for a reduction in the public expenditure plans represented by our last White Paper (turned into cash).

... 3. The attached note, recently done in the Treasury, surveys the whole public expenditure field. As it indicates, one of the major problems is the pledges surrounding certain major programmes. The political difficulties here are only too evident. But we are also pledged to our economic strategy as a whole, not least as regards the burden of taxation.

4. This is the sombre context of the defence decisions and of the rest of public expenditure discussion later in the year.

/I am circulating

5. I am circulating to OD a paper about the defence problem. I fully recognise the difficulties here. John Nott's radical approach is greatly to be welcomed. Even so the proposed bill is frightening. We must contain it.

6. The formula I suggest in my paper will commit more money to defence than on economic and financial grounds one would wish. Some of our other spending colleagues may have difficulty in accepting the implication for their programmes of allowing so much for defence.

7. It is crucial to be sure that we go no further.

for (G.H.)

4 June 1981

(Approved by the Chancellor & signed in his absence.)

CONFIDENTIAL

PUBLIC EXPENDITURE PROSPECTS

1. As background for further discussion of Defence expenditure in advance of the main Survey, this note summarises the prospect for public expenditure in 1982-83 and 1983-84, as it appears in early June before the assembly of the detailed and updated Survey material, including Departments' considered bids and options for reductions.

2. The table annexed shows the programme figures in the March White Paper (Cmnd 8175) roughly converted into cash, using the inflation assumptions recently approved by Ministers. (More refined calculations will be provided for the main Survey, which will thus use numbers different in detail.) These figures do not allow for the effects in the later years of the decisions on the NCB and fuel prices taken in March.

3. The White Paper said that the level of future spending shown in it was higher than the Government "would wish in the light of their financial and economic objectives". Nothing has happened to modify that. On economic and financial grounds the aim should be lower totals than those implied by the last White Paper. But present policies and prospects point the other way.

The prospect for the main programmes

4. The four programmes largely protected from cuts in public expenditure reviews so far were shown in the White Paper as growing in total by 5 per cent in volume over the next 2 years. They would then account for half the total.

5. These programmes are:

   (a) Defence (13 per cent of the total). The White Paper allowed for 3 per cent annual volume increases. So far from a reduction, Mr Nott is currently proposing a larger increase. The future application of cash planning, especially as to armed forces' pay and other differential price movements, remains to be settled.

(b) Law and Order (4½ per cent of total) : the smallest of the four. Pressure is expected for further increase to meet commitments.

(c) Health (and personal social services) (15 per cent of total). Health is growing in accordance with the pledge not to cut inherited (volume) plans. Also included are personal social services, which are not pledged; but it will be difficult to reduce local authority spending on them to the White Paper level : it is currently nearly 10 per cent higher.

(d) Social Security (pledged elements) (17 per cent of planning total) : this is pensions and related parts of social security expenditure (rather more than 60 per cent) covered by Ministerial statements about maintaining real value.

6. Other social security expenditures are not covered by pledges, notably supplementary benefit, child benefit and unemployment benefit (11 per cent of planning total). The White Paper had the total of these falling by 1983-84, but only because of the expected saving to the public expenditure total (but not the PSBR) from the ESSP scheme. The unemployment assumptions in the White Paper (2.5 million in 1981-82, 2.7 million in each later year, compared with actual 2.5 million in May 1981) may need to be revised upwards, leading to increases here (£0.15 bn for every 100,000 extra unemployed) and in some other programmes.

7. Four programmes intended to yield, over the life of this Government, most of the savings from inherited plans were shown in the White Paper as reducing by 23 per cent in volume over the next 2 years (from 25 per cent to 19 per cent of the total) :

(a) Industry, Energy, Employment (4 per cent of total). In the event these programmes rose in the last 2 years, notably because of employment schemes, redundancy payments, and aid to BL. There are signs of some (but not all) of these programmes exceeding estimates again, and of pressures to extend them. The programme does not include provision for British Leyland in 1983-84, which will be a bid for the Contingency Reserve.

(b) Housing (4 per cent of total). The reductions shown in the White Paper require a continuation of cuts in public sector capital expenditure and increases in rents over the 4 years. For England, for example, capital will need to be cut to half the 1979-80 level and council house rents to rise from 6½ per cent to 11 per cent as a percentage of average earnings. So little scope for further cuts.

(c) Education and Science. Most of this programme is subsumed in local authority current expenditure - discussed below.

(d) Nationalised Industries also discussed below.

8. Finance for the nationalised industries was shown in the White Paper as reducing to a modest net total in 1982-83 and a very small net amount in 1983-84. In the review just beginning the industries' opening bids for 1982-83 totalled some £2 bn in cash more than in the White Paper, without allowing for any increases for BSC, or for the spring decisions on the NCB's finances. Nor do they allow for any energy package. It should be possible to reduce these opening bids, but not to the point where the increase remaining can all be met by an allocation from the Contingency Reserve. Of these bids only £400m is for additional capital investment.

9. The remaining public expenditure programmes account for only some 15 per cent of the total. They have already been cut by nearly 10 per cent and are due to be reduced by a further 4 per cent over the next 2 years. They include some capital programmes, such as roads, and some local authority current expenditure.

10. Local authority current expenditure presents an obvious difficulty. It represents 20 per cent of the total. Measures at present available (including reductions in the Rate Support Grants) can exert a downward pressure, but cannot deliver any specific level of cuts in expenditure. After the intervention

now agreed, expenditure may perhaps turn out about 5 per cent above the cash equivalent of the White Paper figure for 1981-82. It is unlikely that in practice cuts will be achieved across the whole field of local authority current expenditure more ambitious than those in the White Paper for 1982-83 and the later years. Even these will be difficult.

11. The Contingency Reserve provision included in the White Paper was tight. Some of the increases in respect of industry and employment programmes and nationalised industries might fairly be offset against it, but it is not enough to cover all the increases which may be pressed in these programmes.

Assessment

12. Full assessment must wait for the bids and options for cuts being assembled for the survey.

13. The present prospect is disturbing. There are potential bids for increases in at least two of the major programmes. The reductions in housing and some minor programmes should be secured, but the scope for further reductions looks small. The revised economic assessment may lead to a further increase in the figures for unemployment related payments. It will be difficult to secure all the reductions planned in two of the main programmes intended to provide substantial savings, nationalised industries and industry, employment etc, and in local authority current expenditure, including education.

14. The other programmes and the periphery of some of the programmes already mentioned provide a narrow base for further cuts. The options exercise will identify the potential more precisely : but in virtually every case of any significance cuts will involve actions specifically rejected last autumn.

15. There are already signs of a repetition of last year, with general and painful reductions required simply to hold the total against increases for nationalised industries, for industry generally and for unemployment related programmes, let alone reduce the total.

16. The relative size of the hitherto protected programmes is such that it could well prove impossible to reduce the totals unless substantial reductions can be made in one or more of these. It will certainly be difficult to hold the totals if any significant increase is made in any of these programmes.

2 June 1981

MARCH WHITE PAPER FIGURES REVALUED (2) £ billion cash

	1979-80 (outturn)	1981-82 (1)	1982-83	1983-84	% change over 4 years
1. Total	77.1	104.2	109.6	113.4	+ 47
2. Protected programmes					
Defence	9.2	12.3	13.5	14.8	+ 61
Law & Order	3.1	4.3	4.7	5.1	+ 65
Health & Personal Social Services	11.1	15.5	16.9	18.1	+ 63
Social Security (pledged elements)	12.6	17.1	18.7	20.0	+ 57
	36.0	49.2	53.8	58.0	
3. Other Social Security	7.1	11.3	12.4	12.7	+ 80
4. Programmes which have been cut					
Industry, Energy, Employment, Trade	3.3	5.8	4.9	4.3	+ 30
Housing	6.0	5.5	5.2	4.5	- 25
Education & Science	11.2	14.1	14.8	15.4	+ 38
	20.5	25.4	24.9	24.2	
5. Other Programmes	13.0	16.0	16.6	17.5	
6. Nationalised industries borrowing	1.5	1.2	- 0.1	- 0.1	
7. Special sale of assets	- 1.0	- 0.2	- 0.2	- 0.2	
8. Contingency Reserve	Fully Allocated	2.5	2.8	3.0	
9. Shortfall	-	- 0.9	- 0.7	- 0.8	

(1) includes budget measures

(2) The above figures follow the structure of the public expenditure White Paper. This is the structure used for control. It differs slightly from the definition used in the national accounts and hence in the MTFS. The adjustments to move from the above figures to the national accounts basis are

	1979-80	1981-82	1982-83	1983-84
add debt interest	10.4	13.7	14.6	15.2
other adjustments	1.9	2.0	2.1	2.5

10 DOWNING STREET

MR. WOLFSON
MR. HOSKYNS
MR. HAGUE
MR. DUGUID
MR. STRAUSS
MR. LANKESTER

I attach some notes on the public expenditure exercises.

Andrew Duguid

6 May 1981

ALAN WALTERS

Is there to be a meeting?

Mr Lankester
JH wants to mull over this. No meeting in the near future.
11/5.

NOTES ON THE PUBLIC EXPENDITURE EXERCISES

The 1 May memorandum from the Chancellor to Cabinet is the first round of the attempt to make cuts again in public expenditure stretching forward to 1983/84. Since the planning is to be in cash terms, there is some need for the expected inflation rates to be programmed into the cash figures. This cash basis of planning is a major departure from previous exercises. However, the main approach seems to be similar to the ones which have been not conspicuously successful in the past.

During the visit of the President of the Heritage Foundation on 29 April, we asked him to explain the seemingly highly successful tactics adopted by the Foundation in the plans for public expenditure cuts which were published some month or two before inauguration. It is clear that the approach of the Heritage Foundation was quite different from the one used in Britain. First the operation was done by a private foundation outside the Federal bureaucracy. Nevertheless many of the personnel employed in the exercise had very considerable experience in government or the Civil Service. Second, it was on a very considerable scale. The review took almost a year and involved 17 principal investigators, each of which was allocated one of the main budget categories. Their reports were then coordinated and presented as a package. Thirdly, the basic principle of the whole operation was that the cuts had to be ubiquitous. "Everybody's ox was gored." Nevertheless the focus of virtually all the cuts was in terms of cutting programmes. There was to be some "improvements in efficiency and elimination of waste"; but this was reckoned to be, realistically, only a small fraction of the total cuts.

The great success of the Heritage operation is of course not yet secure. But some measure of the likely outcome is that a large faction, approximately 85% in value terms, of the cuts which were suggested in the Heritage programme are still on the programme of the various committees of Congress. Indeed, there has been some competition for additional cuts, especially by Democrats who have identified Republican sacred ungored oxes! However, it is necessary to emphasise that the Reagan Cabinet has taken a very collegiate stand on all these issues. There has been little or no defending of narrow departmental interest. (The general attitude became

/clear

clear at the very early stages when the cuts in the aid programme were leaked with the objective of trying to frustrate them. This was, however, not successful.)

The urgent question is whether we can reproduce our version of the Heritage exercise as a parallel operation to the traditional process of budget cutting. There are a number of problems: personnel seems to me to be the most difficult one, but obviously finance is important too. Nevertheless I think it is worthwhile examining whether we can put together an urgent programme of this kind.

There is, of course, quite a critical problem of timing. What should be our target date? One date we could certainly meet is to prepare for the post General Election Parliament. This, however, is a long way away and we might want to think of 1982/83 as our first target. Ed Feulner has offered to come over to help us and I suspect we should be able to use all the help we can get.

This is likely to be rather a big exercise and we have to think carefully what we can get out of it before committing any of our meagre resources to it. Could we meet on this?

<u>6 May 1981</u> <u>ALAN WALTERS</u>

TL Seen
Econ Pol

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

The Rt Hon Leon Brittan QC MP
Chief Secretary to the Treasury
Parliament Street
LONDON SW1P 3AG

6 May 1981

Dear Leon,

with TL ?

Thank you for your letter of 1 May 1981. You suggest that along with Nicholas Edwards and Humphrey Atkins I should identify costed options for each of the programmes within my block. This, you say, is to ensure that there is adequate information on which to assess options that might mean departure from the formula treatment. You assure me, however, that this does not necessarily imply that any change in the block and formula arrangements will be made or that there will be any change in the discretion I have to deploy resources as I think fit.

I have considered your letter in the context of the wider proposals for the 1981 public expenditure exercise made by Geoffrey Howe and, since I shall be unavoidably absent from Cabinet on 7 May, perhaps I might, before dealing with the specific points in your letter, make one or two general points on those wider proposals.

I fully support the effort to achieve tighter control over public expenditure and I have no doubt that moving to a cash basis will prove to be an important step in this direction. We should not, however, move so far that we overreach ourselves or stake out positions that we cannot be reasonably sure of holding and being seen to hold.

In this connection I would make three points. First, it is surely unrealistic to ask for even 5% costed options for 1982-83 if we shall not reach final decisions on that year until the autumn. It will simply not be feasible to make reductions on this scale at such short notice. It would surely be more sensible to limit the objective for that year to 3%; I agree that we should give local authorities advice before the recession in July.

Secondly, the revaluation factor of 7% - even qualified by the words "temporary and provisional" - is lower than a number of respected outside commentators seem to expect inflation to be. The bodies I have to deal with, particularly local authorities, will be well aware of those predictions and if we are to maintain their confidence we must be quite sure that our figures are realistic. Otherwise we shall be providing a tailor-made excuse for local authorities to increase rate level and lay the blame at our door.

Finally, while in general I support the move from volume to cash-based programmes; I am not wholly persuaded that it makes sense to carry this through to 1983-84 and 1984-85 at this stage. I recognise the arguments for doing so but on balance would prefer a more cautious and gradual approach.

I turn now to your letter. In the special circumstances of this year's Survey I am prepared to go along with what you propose provided that the change in presentation is restricted to the identification of costed options. I must say, however, that I would be reluctant to see the essential features for the territorial programmes changed just at the point when we have all become accustomed to operating them and I am not wholly convinced that this particular move will prove of much value.

I note what you say about the continuation of the block and formula arrangements and your assurance that my discretion in the allocation of resources will not be impaired. I should like to emphasise how much I value the ability, within the total determined by changes to comparable programmes, to allocate expenditure to individual services in Scotland in accordance with my judgement of Scottish needs. This freedom carries with it, of course, the obligation that I must find room within the total resources of my block for any essential additional bids which arise for any reason and that I must take the rough with the smooth in seeing my total decrease or increase as decisions are taken to alter the corresponding English programmes. In my experience, the block system has operated equitably and effectively and I have found that my freedom to allocate within my block total has been an essential tool in the exercise of my complex functions. These arrangements are now widely understood in Scotland and I am sure that any departure from the block concept or restriction on my discretion on allocation within the block would be regarded as a retrograde step by informed public opinion and in particular by the Select Committee on Scottish Affairs, to whom I gave a full account of the block and formula arrangements only last year and before whom I am appearing again on 18 May.

I am sending a copy of this letter to the Prime Minister, the other members of Cabinet and to Sir Robert Armstrong.

Yours ever,

George

CONFIDENTIAL

TL Seen

MINISTRY OF AGRICULTURE, FISHERIES AND FOOD
WHITEHALL PLACE, LONDON SW1A 2HH

From the Minister

The Rt Hon Sir Geoffrey Howe MBE MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON SW1P 3AL

6 May 1981

Dear Geoffrey

1981 SURVEY : CASH PLANNING

I very much agree with the points that Mark Carlisle makes in his letter to you of 5 May.

Whatever the assumption we make now about inflation for 1982-83 - and I agree that the single figure of 7 per cent for all purposes is probably the best solution at this stage - we clearly must make whatever adjustment is needed in the autumn to bring it into line with our forecasts at that time. As I understand it, this is your intention.

I also agree that the best course would be to use 1982-83 prices for 1983-84 and 1984-85. To adopt provisional inflation factors for the later years at this stage seems to me to have considerable disadvantages. The factors you suggest will be criticised as misleading, and the result will be to obscure any volume changes in the figures without replacing them by figures on a firm cash basis. I do hope you can reconsider this.

I am sending copies of this letter to the Prime Minister, other Cabinet Ministers and Sir Robert Armstrong.

Yours ever
Peter

PETER WALKER

CONFIDENTIAL

VM

2 MARSHAM STREET
LONDON SW1P 3EB

Prime Minister

This is essentially a plea for more capital spending and less current spending (principally pay).

My ref:

Your ref:

6 May 1981

TL 6/5

Dear Geoffrey

PUBLIC EXPENDITURE AND ECONOMIC STRATEGY:
C(81)20: PUBLIC EXPENDITURE SURVEY 1981: GUIDELINES

I am deeply concerned by the proposals in your paper which is to be discussed tomorrow to seek still further major economies in public expenditure for 1982-3 by the usual procedures of the public expenditure survey. If I thought this would produce extra economies on revenue expenditure I would support such an approach.

But we know what will happen. After great travail we will again reject as politically impracticable the major changes in welfare programmes that alone offer the hope of strategic economies. So we will, despite our first intentions, again be driven back on the piecemeal economies concentrated on investment and current purchases from the private sector, where already we have cut too much. Jobs in the private sector will suffer again and even further.

Instead I believe we need a much more strategic approach.

We have probably passed the bottom of the recession. So the question now is "What form of recovery do we want?"

I think we would all agree it must be non-inflationary and investment-orientated.

On inflation, we have been helped - unfortunately - by the reduced profits of industry and a vulnerably high exchange rate. Future progress will come only from restraint in domestic costs - above all, unit labour costs. Pay settlements averaging 9 per cent are still much too high - but we shall not get them down much further without our giving that reduction top priority in our strategic thinking.

On investment, the Government's powers to encourage private productive investment by major industry are very wide. The major constraint is one of resources. Lower interest rates (over which we have limited influence) will also be helpful, as will be the new enterprise package. But they are not enough. And a principle reason why they are not enough is that the profits and returns in British industry have been so low for so long that it is unrealistic to believe that industry in today's climate can afford to catch up. Built on the evidence of the past, industry is very cautious and to that caution must be added limited resources. And in the public sphere, we must practice what we preach and begin dramatically to reverse the appalling trend whereby economies have in practice fallen on investment not current expenditure.

These two priorities hang together. Without a commitment in both private and public sectors to using the savings to invest in the future, we have little hope of achieving in practice and on a continuing basis the pay restraint needed if inflation is to be permanently held down.

For the public services, the only realistic source for finance for additional investment is economy on pay. Many were sceptical whether we could make this year's low pay factor stick; but by and large we have succeeded, even in the local government sector where we have no direct power. A tougher factor for the coming round is an essential ingredient of your policy for reducing inflation. The problem for us is to decide how much tougher that factor should be. The achievement of any significant toughening is bound to be hard - the employees involved are bound to see it as a deliberate attack on their standard of living and on their right to be paid the rate for the job, and will resist it very strongly if its only justification seems to be a tight cash limit. But the reaction from the employee side would be very different if a sharp cut in the pay factor was seen to be only one element in a national campaign to forego rights to current income in return for the effective promotion of a major national programme to invest in the future and in the creation of the new job opportunities for today's unemployed. I believe that there would be wide public support for a government offering a constructive and identifiable purpose for the necessary sacrifice.

The ideal method of financing the policy I advocate is forgone wage increases. To the extent that this happens we are able to finance investment and at the same time ensure an important bonus in the enhanced competitiveness the economy would achieve. And the ideal solution is a nil increase in payroll costs. Every 1% off the public sector pay bill is worth £500m. If we could forgo the 6% sometimes referred to as next year's cash limit then £3000m in cash would be the potential trade off in investment. Of course major savings in unemployment pay and increased tax revenue would provide a valuable trade off.

Personally I would go for a nil cash limit but the principle of what I advocate could be achieved to a less extent by any level of forgone wage increase.

My view is that there would be a very considerable response both in the public and private sector to nil or very low cash limits if the trade off in jobs and investment was clear. But I realise that you cannot risk the commitment of investment expenditure and find in addition that you have inflationary pay bills as well. I think therefore that you should make it clear at the outset that if your macro pay targets are not achieved then you will not cut the capital programme but you will take the excess off other inflationary consumption elements of the national account. This would start with a second year without Rooker-Wise. But if this is insufficient other indexing will be affected.

The large financial savings would transform the public accounts. There would be no financial problem about authorising substantial increases in public service investment programmes without raising the PSBR, and these would be one good reason for the employees to acquiesce. And there would be cash to spare to take much more risks in schemes to support private sector investment, along the lines you have already pioneered.

But the success or the failure of such a programme depends on the extent to which such a lead from Government would be followed in the rest of the economy. I think these chances are good and would justify the risks involved. In private industry, where so much progress has already been made in injecting realism into pay bargaining, the feeling that continued toughness in bargaining would not be undermined by weakness in the public sector would re-inforce that progress. Important too would be the demonstration that economies in public expenditure were no longer being mainly found by attacking the public sector's demand for private industry's products. And the switch towards investment as against current consumption in the Government's own priorities would help industry when it too sought to bargain with its workers about the relation between restraint in pay and the growth of profits to finance the investment on which firms' future prosperity depends.

The same switch in priorities is, I think, a constructive feature in our most vulnerable area - policy towards the monopoly public utilities, where the workers have the industrial power to smash realism in pay bargaining if they so choose. External financing limits have always been recognised to be a weak tool for containing that power. But the unions there are definitely concerned that sensible investment in the future of these industries is being forgone - good reason why they as well as the managements would be interested in a trade-off between expanded investment and pay restraint. The risks are obvious; but so too are the risks in thinking that we can get realism here by just appearing tough.

Indeed from the national and particularly our party's point of view I believe that the greater risks now lie in assuming that we can ensure social and political acceptability for the unemployment levels, the regional imbalances and the underlying urban tension that are unavoidable if we continue as at present.

You will realise that I am not challenging the assumption that we cannot afford more public expenditure and I certainly strongly support the benefits you seek from lower borrowing and interest rates. But the mix within those targets could be materially improved without threatening your policy. Indeed you may feel that economically and socially there are benefits in such a switch that would achieve your objectives faster.

I am copying this to the Prime Minister, to all Cabinet colleagues, and to Sir Robert Armstrong.

Yours ever

Michael

MICHAEL HESELTINE

The Rt Hon Geoffrey Howe MP

Ref: A04826

CONFIDENTIAL

PRIME MINISTER

Public Expenditure Survey 1981: Guidelines
(C(81) 20)

BACKGROUND

Flag A

In C(81) 20, the Chancellor of the Exchequer invites the Cabinet to approve the broad guidelines for the preparation by Departments of the 1981 Public Expenditure Survey report, covering 1982-83 to 1984-85. The approval of such guidelines at this stage in the year is a standard feature of the public expenditure planning cycle, but the present proposals have the added importance of incorporating in the guidelines for the first time arrangements for translating the figures from volume to cash terms and, therefore, requiring the endorsement of provisional inflation assumptions much longer in advance than in previous years. This follows Cabinet's agreement in principle on 24th February that the discussion of the plans for 1982-83 should be in cash terms subject to their later approval of the detailed arrangements, including the inflation assumptions (CC(81) 8th Conclusions, Minute 6). At that meeting, the Chancellor said that he did not then wish to propose cash planning for the years beyond 1982-83, since that would raise problems which would need further consideration.

Timetable

2. The Chancellor of the Exchequer envisages that Cabinet would take stock in July of public expenditure plans in general terms (but not of the details of individual programmes) with the possibility of making a provisional proposal for an overall cut, and of giving a steer to the local authorities. Treasury Ministers might then have bilateral discussions in September with spending Ministers on how the overall cut might be implemented. The Chancellor would report on the outcome in early October, leading to decisions by Cabinet at the end of October and in early November.

3. Building on the experience of last year, this timetable recognises that decisions taken in July for 1982-83 on the local authority programmes, or more generally, would probably have to be re-opened in the autumn as the forecasts for the borrowing requirement, and the implications for taxation, clarify. Deferring substantive decisions to the autumn is, therefore, realistic but it will mean that the Cabinet will be faced in September-November with a concentrated programme of complex and difficult decisions. In practice this will be no different from what in the event happened last year, but I shall wish to put further advice to you later on how the timetable might best be handled. In particular, it will be necessary to take account of the Chancellor's absence from about 21st September to 2nd October at the Commonwealth Finance Ministers' meeting in New Zealand followed by the IMF meeting in Washington; your visit to Melbourne from 30th September to 7th October for the Commonwealth Heads of Government Meeting; the Party Conference in the week beginning 12th October; and the Mexico Conference from 21st-24th October.

4. It is likely that Members of the Cabinet will be anxious for the public expenditure discussions to be set in the context of more general discussion of the economic situation. You indicated some weeks ago that opportunity would be found for such a discussion; it will be helpful if you confirm this now, and say that you expect this discussion to be on 4th June. You may want for the present not to give any hint that this might be the first of a regular series of economic discussions three times a year, on the lines suggested by the Chancellor.

Options

5. As is the usual practice, the Chancellor of the Exchequer asks the Cabinet to agree that the Survey report should include costed options for reductions in expenditure, showing the political, social, economic and other implications of each, as well as the separate identification of any bids for additional expenditure for whatever reason. This year he proposes that such options should be presented for all programmes and that they should display the possibilities for cuts of:-

(i) 3 and 5 per cent in 1982-83

(ii) 5 and 7 per cent in 1983-84 and in 1984-85.

The cuts identified would apply to programmes as converted to whatever cash base the Cabinet approves (see below), with the consequence that, if the figures are converted to cash, as proposed by the Chancellor, the option cuts could be additional to any volume squeeze resulting from the inflation assumptions chosen. The options are lower for 1982-83 in recognition of the fact that by the time decisions are finally taken in the autumn a good deal of expenditure will have already been committed. These proposals do not involve any separate exercise on manpower numbers; it would, however, be open to any Department to offer staff cuts, additional to those already in the pipeline, in order to find its option cuts.

6. Although the Cabinet is likely to agree that there should be some identification of the options for cuts, some Ministers will wish to question the levels proposed and whether they should apply to all programmes. It will be argued that it is wholly unrealistic, and an exercise in self-deception, to think of cuts as high as 5 to 7 per cent; and that, apart from any political difficulties (e.g. Social Security and NATO commitments), it is simply impracticable to look for cuts of this order from all programmes when some are demand-led and others (such as the industrial programmes) represent the cash provision for commitments already largely given.

7. In reply to these points, the Chancellor of the Exchequer will be at pains to point out that he is not making substantive proposals for cuts of this order in each and every programme, nor does he expect such across the board cuts to emerge later in the year. What he is looking for is the systematic and orderly identification of all the options - and their attendant difficulties - so that later in the year Ministers have available a basis for taking informed and practicable decisions on cuts in some programmes if this proves to be necessary. The need for cuts, and their extent, will turn on discussion later in the year of the Chancellor's assessment of the economic situation as it is developing, and in particular of the balance which the Government wishes to strike for the next two years or so between its expenditure and taxation objectives. To leave out some programmes from the preliminary stage of identification of options would itself present difficulties of deciding on the exemptions and run the risk that some fundamental possibilities would escape scrutiny.

The timing of the switch to cash figures

8. Had previous practice continued, the programmes in the Public Expenditure White Paper would have been converted now from 1980 prices (i.e. late autumn 1979) to 1981 prices (i.e. late autumn 1980 prices) with the revaluation factors generally tailored to a judgment of the particular circumstances of individual programmes. The Chancellor of the Exchequer proposes - in his paragraphs 8-10 - that the Public Expenditure White Paper figures should be converted to cash now, on the understanding that there will be an amendment in October - if developments show that to be justified - of the general inflation factors assumed.

9. The Minister of Agriculture, Fisheries and Food, and other Ministers are likely to argue that the conversion to cash should not take place until the autumn and that, in the meantime, either the programmes should be converted to 1981 prices (continuing previous practice) or that they should be converted as a first step to estimated 1981-82 outturn prices using the factors already incorporated in the cash limits for that year. They are likely to argue that this would lose nothing since the Cabinet does not propose to take substantive decisions until the autumn, and would avoid the confusion, and the wasted effort by Departments, which could arise from making a provisional conversion to cash now and then a further adjustment in October. They will also point out that, irrespective of the conversion to a cash basis, they and outside commentators including Select Committees have to remain concerned with volume planning too.

10. The Chancellor will argue strongly against this on the grounds that, if there is to be a switch to cash planning, it should be made at this point in the year so that everyone - Ministers and officials alike - start to think in cash terms. He will accept that an adjustment in the autumn will require further work, but he will point out that any such adjustment would be much smaller, and therefore easier to cope with, than the fundamental and much larger adjustments which would have to be made on either of the alternatives likely to be suggested.

Factors for 1982-83

11. The Chancellor proposes that the conversion from 1981-82 to 1982-83 cash figures should be based on an assumption that all costs, including pay, rise by 7 per cent between the two years. He had earlier considered proposing separate factors of $7\frac{1}{2}$ per cent for costs other than pay - in line with the Government's own published forecasts when run on for the full financial year 1982-83 - and 5 per cent for pay. This, however, risked the difficulties, discussed in his paragraphs 13 - 15, of it being leaked, while the present Civil Service dispute is still going on, that the Government had adopted a working assumption of 5 per cent. The provisional use of 7 per cent across the board avoids this problem, although it is probably marginally too low for non-pay programmes and too high for programmes dominated by pay. Further adjustments will therefore be necessary in the autumn, and account will then need to be taken of the increased flexibility in setting the pay cash limits which

Flag B — were proposed by the Chancellor in C(81) 15 and approved by the Cabinet on 14th April (CC(81) 16th Conclusions, Minute 2).

12. Some Ministers might argue that where, in their view, their programmes have an established track record of year to year price increases different from average revaluation factors, this should be recognised from the outset by a special adjustment for their programmes. The Chancellor will strongly resist this and argue - as in his paragraph 5 - that where a Department believes that the standard provision for cost increases is inadequate for its programme it should make a bid for additional expenditure accordingly and put forward detailed arguments in support. It will then be for Ministers collectively to consider such additional bids later in the year when they are looking at the total of the net additions, or reductions, in expenditure which they are prepared to authorise. If exceptions are made at this stage, however, the whole new system of cash limit planning could break apart.

Inflation assumptions for the later years

13. At the discussion on 24th February the Chancellor did not press the question whether the later years of the Survey should be converted to cash figures. He now recommends that they should, using as simple working assumptions factors of 6 per cent for the change from 1982-83 to 1983-84 and 5 per cent for 1983-84 to 1984-85. These factors are consistent with the successful implementation of the Government's economic policy. They would be open to revision in later years if necessary. They avoid the problems of the alternative of a 'broken backed' series with 1982-83 in cash terms and of the later years at 1982-83 prices as estimated in the spring of 1981.

14. Several Ministers are likely to argue strongly against this course on the grounds that the margin of error in forecasting inflation rates increases sharply, the further out one attempts to look, that the inflation factors proposed will almost certainly have to be revised, that their adoption will cause considerable confusion (particularly when Departments must still keep sight of their volume figures), and that there will be enough difficulty in dealing with the problems which they foresee for 1982-83.

15. If the Chancellor is pressed hard on these points, he may concede that, for the 1981 Survey at least, each year should be on a 1982-83 cash basis until the autumn, when the two later years would be converted fully to cash prior to publication of the Public Expenditure White Paper.

HANDLING

16. After the Chancellor of the Exchequer has introduced his paper, you might propose that it would be easier to break the discussion into two broad halves: first, points on the timetable and the costed options; second, the question of the inflation factors for 1982-83 and for the later years. It is likely that all Members of Cabinet will wish to comment, but the Secretaries of State for Defence, Social Services and Education and Science (as the big spenders) and the Secretary of State for the Environment (qua local authorities) might be called early in the discussion.

see Mr Heseltine's letter in this ~~folder~~ form.

[illegible]

17. The main points are those identified in the Chancellor's paper and in this brief. More detailed points, and questions of interest to particular Departments, will be picked up in the detailed guidelines which the Treasury will circulate to Departments in the light of the Cabinet's decisions.

CONCLUSIONS

18. You will wish to sum up with reference to the five proposals listed in paragraph 19 of C(81) 20.

RtA

Robert Armstrong

6th May 1981

CONFIDENTIAL

c Walters
Vereker
Hoskyns.

DEPARTMENT OF EDUCATION AND SCIENCE

ELIZABETH HOUSE, YORK ROAD, LONDON SE1 7PH

TELEPHONE 01-928 9222

FROM THE SECRETARY OF STATE

CF
For Cabinet

The Rt Hon Sir Geoffrey Howe MBE MP
Chancellor of the Exchequer
Parliament Street
London SW1P 3AL

5 May 1981

Dear Geoffrey,

1981 SURVEY: CASH PLANNING

I welcome the proposal in paragraph 14 of C(81)20 that we should for the moment work on a single inflation figure of 7 per cent for 1982-83. But I take it that this figure will be revised - not merely reviewed - in the autumn if the evidence then available shows this to be necessary. Even a one per cent underestimate now would have serious consequences for education and other services if we did not make the necessary adjustment later. Presumably we shall also be able to consider then, as suggested in our last discussion, whether any likely squeeze as a result of the cash limits for 1981-82 should be carried through into next year.

Secondly, is it not dangerous to adopt at this early stage inflation factors for 1983-84 and 1984-85? I understand that in the last decade forecasts of prices in any year made as little as 12 months in advance have been too low on average by 4 percentage points and that 1980 was exceptional. I agree that we need by the autumn provisional cash figures for 1982-83 so that we can compare them with likely revenue, but I cannot see any such operational reason for making inflation assumptions now for the two following years. Might it not be wiser to take one major step towards the new system by using 1982-83 prices throughout rather than to saddle ourselves with so-called cash figures for the two following years which are certain to be misleading when they are published in the next White Paper?

I am sending copies of this letter to the Prime Minister, the other members of the Cabinet and Sir Robert Armstrong.

Yours ever

Mark

MARK CARLISLE

CONFIDENTIAL

cc Walters
Hoskyns

cc Press Ass

Econ Pol

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

29 April 1981

The Rt Hon Lord Soames GCMG GCVO CH CBE
Lord President of the Council
Civil Service Department
Whitehall
LONDON SW1A 2AZ

Dear Christopher

29/4

Thank you for your letter of 18 March suggesting we need to make it clear that we are, or should be, using North Sea oil revenues for investment rather than for financing consumption.

The first response is that I wish we were! Certainly everyone should have constantly in mind that North Sea oil is a wasting resource; and that it is therefore sensible, while we have it, to increase investment in UK productive assets, and in overseas assets which will generate income to help sustain the UK economy when the oil runs out. The problem is that we cannot rely on achieving that objective through what might be no more than an accounting device. Paying for certain investments out of an identified stream of revenues from the North Sea does not itself guarantee that the overall level of investment will be higher. Moreover this Government, of course, has no particular enthusiasm for increasing public, as opposed to private, sector investment.

But certainly it is at present the case that North Sea oil revenue is making it possible for us to support higher levels of public and private consumption than we could have had in its absence. More usefully perhaps it is helping us, by keeping down the PSBR, to reduce the level of interest rates.

But I can still share you anxiety that the oil revenue is, to too great an extent, being "frittered away". And, while I have not myself been persuaded that a separate fund would necessarily help in checking that effect, I do agree that it is well worth while looking for more effective ways of letting people understand the nature of the choices that face the nation. So I shall certainly reflect further about all these points in the context of the future determination and presentation of our spending and other plans.

I am sending copies of this letter to the recipients of yours.

Geoffrey

GEOFFREY HOWE

SECRET

cc Mr. Lankester -OR
Mr. Duguid

MR. INGHAM - on return

MR LANKESTER
Econ Pol

Planning assumptions for the PESC

You should know that the Treasury are now preparing the pay and price planning assumptions for this year's PESC, with a view to discussion in Cabinet on 7 May; and that the proposed "uplift" between 1981-82 and 1982-83 is likely to give rise to some difficult presentational problems.

The Chancellor's proposal, as I understand it, will be a 5% pay assumption and a 7½% non-pay assumption, giving a weighted average of 6⅔%. (For subsequent years the price and non-price assumptions are likely to be combined, at 6% between 1982-83 and 1983-84, and 5% between 1983-84 and 1984-85).

The two problems I see over the 5% pay assumption for the uplift between this year and next are:

(i) Although this is by no means a proposed pay norm, and is indeed not even a cash limit, but merely a planning assumption, it will be widely regarded as the Government's target for the next pay round; and because it will have to be released to both local authorities and the NHS, it will become public knowledge within a matter of weeks. The history of Administrations going for a 5% pay round is not a happy one; and it is particularly unfortunate that the Government has to put its weight behind a specific figure so early, before we can see how private sector pay is likely to be moving. The timing arises, of course, from the Prime Minister's desire to move this year's PESC over to a system of cash planning.

(ii) If the Civil Service dispute is not resolved by the time the figure becomes known, 5% must have a seriously adverse effect on the negotiations, because it will reduce the credibility of the Lord President's assurance to the unions that next year's

SECRET

/ negotiations

negotiations will take place without a pre-determined cash limit.

I conclude that we shall have to gear ourselves up for a massive effort to explain that 5% is in no sense either a cash limit or a pay norm.

John Vereker

24 April 1981

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PUBLIC EXPENDITURE

It is hoped that the following notes will be useful for the debates on public expenditure in the House of Lords on Wednesday 8th April and in the House of Commons, on a Motion to take note of the White Paper on Thursday 9th April 1981.

Contents

Conservative Research Department,
32 Smith Square, London, SW1.

Economic & Home Affairs Sections.

7th April 1981

PUBLIC EXPENDITURE

Progress towards the objectives - and offsetting factors

Expenditure set out in this year's White Paper (Cmnd. 8175) published on Budget day is higher than the Government intended: that it is, nevertheless some 3½ per cent lower than the total planned by the previous Government is, in the circumstances of severe recession a substantial achievement. "The totals of expenditure" - in the words of the second paragraph of the White Paper - "both the outline now estimated in 1980-81 and the planning totals in future years, are higher than in Cmnd. 7841 (the 1980 White Paper) and higher than the Government would wish in the light of their economic and financial objectives. The Government regard this development as one which requires the most serious attention during the 1981 annual survey, when the plans for 1982-83 will be reviewed".

The Government has been criticised both in failing to cut public expenditure enough, and for failing to make adequate allowance for the effects of the recession and the needs of industry and investment. Much of the criticism on both scores can be accounted for by the extent to which action in the one direction has masked, or offset, action in the other: the net saving compared to earlier plans greatly understates the savings that have been made; furthermore, as the Chief Secretary emphasised in his speech on 11th March, the second day of the Budget debate, many of the planned cuts in spending take time to be effective, while many of the increases made in response to the recession are immediate. Other increases in spending, chiefly affecting transfer payments, rise both in step with inflation and with the increase in the number of eligible claimants. £1 billion is being devoted to employment support measures.

As the Chief Secretary to the Treasury commented - "The broad picture is a simple one. We made the often difficult decisions that were required to cut spending plans. Those cuts have been genuine. They have been implemented. Policies have been changed to achieve them. Measures have been taken to encourage efficiency, and the numbers of staff in the Civil Service and so on have been reduced. Moreover, those cuts have been maintained in spite of pressure to relax them. Indeed, we made further cuts last November. But the cuts have been overlaid by increases in spending in other areas, for the most part, but not exclusively, relating to the recession." (col. 924 11th March 1981).

Progress in reducing Public Spending

During the Government's first two years in office, expenditure has been some £3½ billion - 3½ per cent less in real terms than the Labour Government had planned. It was hoped, at the time of publication of last year's White Paper that spending in 1980-81 would be 5 per cent less than the £82.1 billion set in the last Labour White Paper. The recession was to a great extent the cause of the additional spending. The total planned for this year, 1981-82, £79.2 billion is some 5 per cent less than £83.5 billion planned for by the Labour Government. (In cash terms spending in 1980-81 was nearly £94 billion and will be £104 billion in 1981-82).

Planning totals

£ billion, 1980 survey prices

	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84
anuary 1979 White Paper (Cmnd 7439)		80.5	82.1	83.5	85.1	—
arch 1980 White Paper (Cmnd.7841)		78.4	77.8	76.9	75.4	75.2
ow planned	78.0	77.8	79.2	79.2	77.9	76.0

The Chief Secretary referred, in his speech on 11th March, to major expenditure savings made during the past two years - some of them still to take effect and not yet reflected in expenditure totals:-

- re-negotiation of our EEC budget contribution, worth about £600 million in 1980-81 and £825 million in 1981-82.
- Sales of council houses and special sales of assets, which have already yielded £1½ billion.
- education spending cuts amounting to 10 per cent of Labour's planned expenditure.
- 40 per cent reduction in spending on public sector housing
- savings of £½ billion in 1981-82 and, and £1 billion in 1983-84 from indexing pensions and other benefits to prices only, and other changes including the abolition of the earnings related supplement for unemployment and other benefits still to take effect.
- cuts even in priority programmes of defence and law and order.
- cuts in Civil Service manpower of 35,000 since May 1979; planned reductions amounting to 100,000 in total by 1983-84; and reductions of about 40,000 so far in local government full time staff.

Increases in Spending

Much of the increase in spending above the levels anticipated in this Government's two previous White Papers has been due to the recession proving deeper than had been expected. This has affected both the expenditure and the revenue side of the equation. Changes in spending forecasts have included:-

- £¾ million increase in 1980-81 on umployment benefit and special employment measures, in particular the temporary short term working scheme.

- In 1981-82 expenditure on special employment measures and redundancy fund payments will go up by nearly £1 billion partly on account of additional measures announced by Mr Prior on 21st November.

- The largest single programme is social security, which rises to well over a quarter of the total by the end of the period. It rises particularly steeply - by 7 per cent in real terms - between 1980-81 and 1981-82, following a rise of 3½ per cent in 1980-81. The increases reflect the increase in unemployment, and the upward revision of the unemployment assumption, from 1.8 million a year to 2.5 million in 1981-82 and 2.7 million in 1982-3 and 1983-4 (excluding school leavers); together with the increase in the number of retirement pensioners.

- The limits on nationalised industry borrowing will be raised by £1½ billion; £620 million in cash will be provided to British Leyland in 1981-82 (and £370 million in 1982-3); £130 million will be provided to Rolls Royce in 1981-2.

- Overspending on defence by £260 million - above the cash limit already increased by £200 million - partly as a consequence of the rapid completion of defence equipment orders in the slack conditions of the recession.

- Higher local authority spending - but with an outturn total at least 3 per cent lower than it would have been without the Secretary of State for the Environment's action in calling for revised budgets and withholding grant.

- The normal underspending allowed for in the planning totals has not occurred, largely as a result of the recession.

- Three additional items of expenditure as a result of developments since the preparation of the White Paper will be covered by an additior addition of £500 million to the contingency reserve. They are: the withdrawal of the accelerated pit closure programme; real improvements in certain social security benefits; and increases in the EFLs of the gas and electricity industries by £73 million and £45 million respectively to allow for relief on energy prices to industry.

On the revenue side, there was a shortfall of about £1 billion; receipts from both North Sea Oil and indirect taxes fell short of expectations.

Public Sector Pay

For 1979-80 spending on programmes amounted to £77 billion in cash. In 1980-81 it was nearly £94 billion. £2½ billion of the increase resulted from the Clegg comparability pay awards and staged settlements. These were met by the Government in fulfilment of our commitment made before the election to honour awards made by the Commission in cases refered to it by the Labour Government .

The pay bill for the public service in 1980-81 of some £30 billion was about 25 per cent higher than in the previous year. As the Chancellor said in his Budget speech:

> "The immediate lesson is simple - but vital. After the recent large increases it is now both fair and essential that public service pay should grow more slowly. Pay accounted for some 60 per cent of the major programmes such as education and health. This is why it is so important to work out improved ways of settling public service pay. Any new system must take account of all relevant factors: the balance of supply and demand for particular skills as well as comparisons with terms and conditions in outside employment and - inescapably - the limits of finance available. But weight will also need to be given to the expectation and intention of a continuing decline in the rate of inflation." (Hansard, 10th March 1981, Col. 768)

Cash Control

The Chancellor announced a major reform in the method of control and planning of public expenditure, which should make it easier to appreciate the consequences of spending decisions. Hitherto, for a number of years past, expenditure figures in the White Paper have been expressed in volume terms at constant prices - what is known as "funny money". This has too easily led to the assumption that a given item of expenditure can and will be carried out regardless of the increase in costs. The introduction of cash limits by the previous Government paved the way for a further reform. In the first instance, the Contingency Reserve is to be operated as a cash control; decisions to increase cash limits will be treated as a charge upon it. In future the annual reviews of public spending will be carried out in cash terms, in terms of the cash available to pay for it. This change, Sir Geoffrey said, would "make a major contribution to improving financial management, and will do much to support our other efforts to increase cost consciousness and accountability throughout the public sector." (Col. 769).

Fuel in Industry

Speaking in London on 27th February 1981, Mr Norman Lamont, Parliamentary Under-Secretary of State for Energy, promised a swift response to the publication of the NEDC report on industrial fuel prices in the UK compared with other European countries. The report showed that while 95 per cent of the UK individual industrial customers were not paying more than their European competitors, some companies particularly large users, were at a disadvantage on gas and electricity. The Government has for some time been requiring that the gas and electricity industries pay attention to the position of their large customers, and a series of measures to help them was taken throughout 1980. However, the appreciation of sterling against other European currencies in the second half of 1980 had been an important factor in undermining these measures. The Chancellor announced in the Budget that the external financing limits for the gas and electricity industries would be relaxed by £120 million in 1981-2, to allow them to provide further assistance. A further £50 million will be provided to help industry convert to coal, and thereby take advantage of its lower price.

Help with Fuel Bills

Government spending on help with fuel bills will increase from £200 million in 1980-1 to £250 million in 1981-2, and 2¼ million people will benefit. The basic heating addition to supplementary benefit will increase from £1.40 to £1.65 per week, and the higher rate from £3.40 to £4.05 per week. Total expenditure on measures of this kind will increase by more than the expected rise in fuel bills in the year to November 1981.

Employment

The Special Employment Measures which are being expanded following Mr Prior's statement on 21st November 1981 are as follows:

a) Youth Opportunities Programme expanded to provide 440,00 'opportunities' in 1981-82, 180,000 more than planned.

b) The Special Temporary Employment Programme was enlarged into the Community Enterprise Programme, providing 25,000 places by March 1982.

c) The Temporary Short Time Working Compensation Scheme - assistance was expanded from 6 months to 9 months, though the level of assistance was cut from 75% of normal earnings to 50%.

d) Job Release Scheme - gives funds to increase the number of places from 6,000 to 7,000.

At the time the expansion was announced Mr Prior said the total cost in 1981-82 would be some £570 million, an increase over existing provisions of £250 million. It is likely that the measures will cost nearly (an American) billion in 1981-2; (see list on following page)

At the end of February 1981 some 1,214,000 people in Great Britain were covered by the Government's Special Employment and Training measures.

Scheme	Nos. covered end of Feb 81	Est. cost 1980-1981	Est. cost 1981-1982
Temporary Short Time Working Compensation (TSTWC) Scheme	961,900	£415m	£388.5m
Job Release Scheme	59,500	£137.9m	£129m
Youth Opportunities Programme (YOP)	150,000	£196,3m	£299.7m
Community Industry	6,100	£19.9	£22m
Special Temporary Employment Programme (STEP)	12,500	£45m	-
Training for Skills Programme (end of January)	23,800	£46m	£48.5m
Community Enterprise Programme	25,000	-	£93m
		Total:	£980.7m

The Redundancy Fund Bill raises the borrowing limits of the Redundancy Fund from £16 million to £200 million.

PUBLIC EXPENDITURE AND GDP

The ratio of public expenditure to gross domestic product was 41½ per cent in 1978-79 and 1979-80. In 1980-81 it is expected to be 44½ per cent - partly as a result of an increase in the volume of expenditure and its relative cost because of high public sector pay increases, and partly as a consequence of the sharp reduction in real national income. In 1981-82 the Government intend that "the relative cost of the plans (excluding debt interest) should fall by some 1 per cent, which will require a much lower rate of increase in public service earnings than over the past two years." General government expenditure has risen less sharply as a proportion of GDP, because it excludes the sharp rise in loans for payments.

Ratios of public expenditure to GDP at market prices

per cent

	Planning total plus debt interest (1)	General government expenditure on goods and services (1)
1974 - 75	46½	26
1975 - 76	46½	26½
1976 - 77	44½	25½
1977 - 78	40½	23½
1978 - 79	41½	23
1979 - 80	41½	23
1980 - 81 (estimated)	44½	25

(1) The expenditure totals include non-trading government capital consumption to make them comparable with gross domestic product (expenditure estimate) at market prices.

SOurce: Cmnd. 8175 The GovErnments Expenditure Plans 1981-82 to 1983-84

PUBLIC SECTOR BORROWING

The outturn and forecast by the PSBR was summarised in para 24 of the Medium Term Financial Strategy (para 19 of the Financial Statement and Budget Report of the Red Book) :-

"The PSBR for 1980-81 is now estimated at £13½ billion, compared with the forecast of £8½ billion in the Budget. The PSBR of £10½ billion forecast for 1981-82 is about £3 billion higher than that implied in last year's medium-term projections. General government expenditure in that year is now put about £6 billion higher in cash than was then projected, and revenue about £3 billion higher. A substantial part of the increase in the forecast of expenditure in both 1980-81 and 1981-82 is attributable to the recession being worse than expected, with spending on social security benefits, special employment measures, redundancy fund payments and, in 1981-82, external finance for nationalised insutries especially affected. In addition, debt interest payments and some expenditure on goods and services are also higher than forecast a year ago. The main influence on the revenue forecast is the real increase in taxes in the Budget.

PUBLIC SECTOR BORROWING

1979-80 prices(£ billion)

	1979-80	1980-81	1981-82	1982-83	1983-84
Total general government expenditure	88.8	91½	91½	90	87½
Total general government receipts	-78.4	-79½	-82½	-84	-85
Implied fiscal adjustment	-	-	-	1	2
General Government Borrowing Requirement (GGBR)	10.4	12	9	7	4½
PSBR	9.9	11½	8	6½	4
(as percentage of GDP at market prices)	5.0	6	4¼	3¼	2

Source: The F.S.B.R. 1981-82 (the Red Book) table 8, page 18

PUBLIC SECTOR INVESTMENT AND PRIVATISATION

It has been suggested, by the CBI and others, that public sector investment should be stepped up, and that North Sea Oil revenues should be devoted to this purpose. As Ministers have repeatedly pointed out, these revenues are at present contributing both to the reduction of borrowing and as an alternative to higher taxation. They cannot be used several times over. The Chancellor replied to the public investment case in his speech on 16th March:-

> "It must be recognised that to embark on investment just for the sake of it is not enough. Investment must offer the prospect of a real return. Even where that is available, it must still be financed. The question must still be looked at in the context of the overriding need to contain public expenditure - already higher than the Government would have wished.
>
> It is also important to recognise that there is no answer to this in suggesting that investment can be undertaken sensibly through the nationalised industries, because in so far as we stand behind the debts of those industries, their position is exactly the same. It is important to recognise that investment for capital purposes is more virtuous than expenditure for current purposes, but it must still be profitable and well directed.

> There is the same choice even about investment in the nationalised industries, but there they have a choice, and if less is spent on pay, more is available for investment. The Government are not prepared to see more money borrowed or taxed from the private sector simply to shelter the nationalised industries from that fundamental choice. "

Privately financed investment did not pose the same problem. Disposal of public sector assets to the tune of £1 billion in 1979-80 and some £½ billion in 1980-81 and 1981-82 was therefore very helpful in transferring the burden from the taxpayer to the private sector.

THE LABOUR ALTERNATIVE

This was set out by the Shadow Chancellor, Mr. Peter Shore on the second day of the Budget debate. His 'shopping list' of desirable Budget ingredients was a lengthy one. It included:

- removal of the heavy oil duty;
- reduction of the National Insurance Surcharge by a third, or alternatively, this reduction to be applied to manufacturing industry only;
- reinstatement of the regional employment premium (withdrawn by the last Labour Government);
- MLR cut to 12 per cent "and a clear intention of progress into single figures";
- lowering of the exchange rate by lower interest rates and intervention in the foreign exchange market, and by using "whatever other devices are necessary to that end";
- a substantial stimulus to demand by an increase in public expenditure, with some increase in social security benefits and restoration of child benefits to their April 1979 value, full uprating of sickness and unemployment benefits and withdrawal of this year's 1 per cent claw-back on pensions;
- a "major emphasis" on capital investment programmes by nationalised industries, local and central government - railway electrification, enhanced housing programme, hospital and prison building, modernisation of sewerage and water systems, bringing forward of local programmes;
- reinforcement of special employment measures and reinstatement of the small firms employment subsidy;
- a "flow of investment into the renewal and expansion of our manufacturing industries and substantial backing for the growth industries of the future."

There were, Mr. Shore conceded "difficulties in financing the public sector borrowing requirement, but we have done it before ... and we can do it again". The danger of cost inflation on wages would be dealt with directly with both sides of industry, "cementing them in an agreement on a counter-inflation policy". The means towards expansion in a modern economy "will require not a rolling back of the frontiers of the State but a far more positive and purposive role" (Hansard, 11th March 1981, Col.916).

Mr. Leon Brittan, Chief Secretary to the Treasury, commented that Mr. Shore had perpetrated "a fallacy fundamental to the thinking of Opposition Members - namely, that there is a choice between inflation and unemployment, and if one does not mind having a bit of inflation, one can manage to deal with the problem of unemployment ... We do not accept that in today's conditions those alternative choices present themselves ... Mr. Shore has put before the House ... a recipe for fiscal irresponsibility that would be certain to lead to massive inflation which in turn would make the present level of unemployment seem piddling" (Hansard, 11th March 1981, Col.919).

INDUSTRY

The Public Expenditure White Paper demonstrates clearly the extent to which industry in both private and public sectors is benefitting from public expenditure. £516 million is to be provided for Regional and General Industrial support in 1981-82, of which notable components are:

- £351 million on Regional Development Grants to industry in the Assisted Areas
- £42 million in Selective Assistance to industry in these areas (Section 7 of the 1972 Industry Act; up from £27 million in 1980-81)
- £32 million is to be provided in 1981-82 for factory building in the assisted areas; the Industrial Estates Corporation has embarked upon its biggest programme ever, drawing in some private finance

This shows that the Government is determined to provide funds for investment in the regions most affected by closures and demanning.

Similarly, selective help through public spending is being made available in order to ensure that, under conditions of sharply squeezed profitability, industry continues with research and development and other investment :

- General Industrial Research and Development public expenditure is to rise from £108 million in 1980-81 (from £66 million in Labour's last full year of office 1978-79) to £124 million in 1981-82.
- Even selective sectoral and other assistance for investment is to run in 1981-82 at £47 million.

It is worth noting also that private industry is benefitting from:

from:

- Public expenditure which stimulates its markets by providing its public sector customers with funds; the most notable example is, of course, BL, much of whose £990 million funding over 1981-82/82-83 will be spent in sustaining the West Midlands component industry and its dealer network.
- Very heavy relief from taxation as a result of stock relief and 100% capital allowances; table 4.14 (p.220) of Cmnd. 8175 shows that: "The combined impact of capital allowances and stock relief on corporation tax is provisionally estimated at £9,500 million (of which £1,400 million is for public corporations)"

Public spending to support investment in the nationalised industries and publicly owned companies - where that investment is appropriate - is also running at a high level. External Financing Limits of nationalised industries announced on 24th November 1980 (WA Col. 43) totalled £1,538 million, to which BSC's £730 million EFL should now be added. Support for BL (£990 million over two years) and for Rolls Royce (£153 million in 1981-82; Cmnd. 8175) add to this.

Notable examples of public sector investment either provided or planned are:

- £800 million a year for three years from 1980-81 for investment in the coal industry
- £285 million investment in the successful and highly productive Metro plant at Longbridge
- Over £2,000 million investment by BT in telecommunications to meet consumer demand, modernise the network and introduce new services - a higher figure (in constant prices) than any year since 1974-75. (The Government extended BT's EFL for 1980-81, and it is to be allowed to borrow £233 million in 1981-82 - a big increase on recent years when net repayments by BT were required).

EDUCATION

1. The Government's Expenditure Plans 1979-80 to 1983-84

The Public Expenditure White Paper (The government's Expenditure Plans 1980-81 to 1983-84 Cmnd. 8175 10th March 1981) provides for a total fall of about 2½ per cent from £77.8 billion in 1979-80 to £76 billion in 1983-84 in total spending. Within this, spending on Education and Science is planned to fall by just over 11 per cent during this period.

In comparison with expenditure plans set out in the 1980 White Paper (Cmnd. 7841 26 March 1980) the changes are as follows:

Total Expenditure on Education and Science

£m at 1980 survey prices

	1979-80	1980-81	1981-82	1982-83	1983-84
1) Cmnd. 7841 revalued			8325	8168	7977
2) Cmnd. 8175	8833	8528	8186	8000	7840
3) Change			-1.7%	-2%	-1.7%

(Cmnd. 8175 Table 210)

The broad distribution of the £139 million to be achieved in 1981-82 was announced by the Secretary of State Mr Mark Carlisle on 16 December 1980:

- Some £65 - 70 million will be saved from current expenditure on schools. This represents a reduction of only 1½ per cent on planned spending.

Falling School Rolls

The fall in the birth rate during the 1970's has meant that there will be a million and a half fewer children in our schools by 1984. Any upturn for the school population will not occur until after 1986. Current expenditure on schools will fall by some 6½ per cent between 1978-79 and 1983-84 compared with a projected fall of 13 per cent in pupil numbers over the same period.

thousands

	1978-9	1979-80	1980-1	projected 1981-2	1982-3	1983-4
Primary	4138	3980	3808	3642	3453	3332
Secondary	3589	3573	3531	3461	3410	3325
Pupil-Teacher Ratios	18.9	18.7	18.8	18.8	18.8	18.8

(Cmnd. 8175 table 2.10.1)

Falling school rolls mean that if local education authorities plan ahead for the most efficient use of resources, spending per child can be maintained. The Secretary of State has particularly emphasised the need to reduce surplus school places. by March 1982 on present estimates, local education authorities will only have taken out of use some 75,000 of the 970,000 temporary school places. Considerable savings could be made if the national target is achieved, for example for every 100,000 surplus places retained, local authorities will have to spend on average £15 million a year which could be spent on teachers or for other education purposes.

Higher Education

From Higher education we are looking for a reduction of about £44 million in 1981-82, below the levels set out in the last Public Expenditure White Paper, of which £30 million is to be from University expenditure and £12 million from advanced further education in the maintained sector. Another £25 million is to come from further education in the maintained sector. Another £25 million is to come from non-advanced further education to reflect the fact that student numbers were lower than we had expected in 1979-80 and now will be increased from that lower base. Another £20 million will come from science (£2 million) and miscellaneous items. The Government's plans also assume that nearly £20 million of additional income can come from the full implementation of increases in catering and residence charges agreed with the local education authorities. Significant savings can be made if the staff-student ratio in further and higher education is allowed to rise.

2. Conservative Expenditure Policy

a) It is a cause for concern that despite a doubling of education's share of the gross national product over the last thirty years, a 20% reduction of the pupil-teacher ratio over the last ten years and the raising of the school-leaving age in 1973-4 the percentage of school-leavers obtaining five 'O'levels or C.S.E. grade I's in 1977-8 was exactly the same as in 1967-8 - 17.9%.
Over the ten years 1968-9 - 1978-9 the percentage of school-leavers obtaining one or more 'A' levels similarly remained static. In addition the percentage of students from blue collar workers entering university has been dropping steadily for the last ten years from 26% in 1974 to 23% in 1978. The recent report of the Schools Inspectorate on the Inner London Education Authority was critical of the authorities management of its resources demonstrating that the highest spending was also the lowerst achieving.
In the context of our international competitors, in 1975 the United Kingdom spent 6.5% of her gross national product on education, France spent 5.6%, Germany spent 5.2% and the United States spent 6.2%. Yet our competitiveness has failed to match this higher level of expenditure.

b) Many of the problems of our education service are long standing and not simply the consequence of financial stringency. The shortage of teachers in mathematics, physics, chemistry, craft design and technology, provision for minority subjects in the school curriculum, falling school rolls, the relationship between further and higher education courses and national economic needs were certainly evident during the period of the last Labour Government.

SOCIAL SERVICES

The Labour Party often alleges that the Government is "Destroying the welfare state" (Labour Opposition Motion, Hansard, 3rd February 1981), but is an astonishing allegation when the Government is actually spending more in real terms on health, personal social services and social security than in the last year of Labour Government.

Total expenditure on health and the personal social services in the UK will have risen from £11,164m in 1978/9, the last year of Labour Government, to £11,281 in 1980/1 and to £11,300m in 1983-4. (Cmnd. 8175; figures at 1980 survey prices). Similarly, expenditure on social security will have risen from £16,413m in 1978-9, to £20,390m in 1980-81, partly due to increased unemployment but partly due to increases in the number of pensioners and to the improvements in the real value of retirement pensions, and is expected to rise to £22,090m by 1983-4. If the Government is trying to "destroy the welfare state "it is setting about in an odd way!

Health Service As promised in the Manifesto, the resources going into the Health Service has been protected and expenditure is now slightly higher than in any of the years of Labour Government.

One result of Conservative rule is that hospital waiting lists, which went up under Labour by a quarter of a million to three quarters of a million, have been reduced by 111,000 in the eighteen months to September 1980 in England alone.

Administration is also being simplified by removing one tier of administration in England, thereby saving some £30 million in costs.

The Elderly The following points may be helpful:

* pensions will have been increased in the 3 years to November 1981 from £19.50 to £29.60 and the married pension from £31.20 to £47.35 per week.

* Prices This increase of almost 52 per cent compares with an expected price increase of 49 per cent over the three years to November 1981. Retirement pensions are therefore worth more than when Labour was in office.

* Future Levels Conservatives are committed to raising pensions over the lifetime of this Parliament at least in line with prices, and to ensuring that pensioners share in the future rise in national prosperity.

* Savings The rate of inflation is being brought down and this will help safeguard their savings and fixed pensions.

* Supplementary Benefits Pensioners and other groups on low incomes have had their supplementary benefits raised fully in line with prices.

* Heating costs Extra help for heating costs has been concentrated on those dependent on supplementary benefit, with the basic heating addition going up from 95p per week under Labour to £1.65 per week in November 1981.

<u>Families with children</u> Conservatives attach the greatest importance to strengthening the family, which is the basic unit of our society.

* <u>The Supplementary Benefit Rate</u> for children under 5 will have been substanitally increased from £4.40 per week under Labour to £7.90 by November 1981.

* <u>Heating</u> The basic heating addition is now paid automatically to households on supplementary benefit where there is a child under 5.

* <u>Single Parents</u> are now eligible for the long-term rate of supplementary benefit after one year instead of two and more than half their earnings up to £20 per week will be disregarded for supplementary benefit purposes, thus enabling more parents to do part-time work.

* <u>One Parent Benefit</u> (paid for the first child of single parents) will have been increased from £2 per week when the Conservatives returned to office to £3.30 per week in November 1981.

* <u>Child Benefit</u> was not raised in the November 1979 uprating because of the cost of other benefit increases, but it has since been raised in line with prices and will go up to £5.25 per week in November this year.

<u>The Disabled</u>

Since returning to office the Conservatives have taken action to help the disabled:

* <u>The Attendance Allowance</u> was raised in November 1979 by almost 20 per cent, which was ahead of prices, and it has since been maintained in real value.

* <u>Some 15,000 people</u> were phased into the mobility allowance earlier than Labour intended and the mobility allowance will have been raised from £10 per week in May 1979 to £16.50 in November 1981.

* <u>Supplementary Benefit</u> have been fully protected against inflation and the disabled can now claim the higher rate of supplementary benefit after one year instead of two.

* <u>The Tax Allowance</u> for the blind has been doubled from £180 to £360.

* <u>Personal Social Services</u> run by local government, which include home helps and meals-on-wheels, have been encouraged. Expenditure is higher in real terms than in any of the years of Labour Government.

* <u>Voluntary Organisations</u> will benefit from tax concessions to encourage donors introduced inthe 1980 Budget. These incentives are worth £30 million a year and represent the single biggest package to help charities since the war.

TRANSPORT AND HOUSING

Transport

The reductions in expenditure on transport programmes from the levels set out in the 1980 white paper (Cmnd 7841) are of about 1% - 1½%. However, it is envisaged that allocations will be sufficient to preserve effective standards of service and continue a very substantial programme of investment.

The main areas to be affected are :

a) Road Building. Allocations for road building have been reduced by 2%, reflecting the cut on all cash limited programmes announced by the Chancellor in November. However, in real terms the expenditure in 1981 - 82 and later years will be at roughly the level achieved in 1979 - 80, which was the highest for some years. Expenditure in 1980 - 81 is expected to be close to the £550 cash limit, some 20% more than was spent in 1979 - 80, and the department has made good progress with schemes set out in the roads White Paper 1980 (Cmnd 7908).

Top priority for spending is the M25. The planned expenditure to 1983 - 84 will enable 50 miles of motorway to be completed with a further 300 miles of schemes from other programmes. The programmes of motorway renewal will be expanded within the maintenance programme which itself will be running at a higher level than in recent years.

b) Local Transport. Expenditure on local transport is also reduced by about 2% on last years plans, but it is still substantial :- about £1.5 bn in 1981 - 82. This will enable all committed expenditure on capital programmes to be met and starts on over 40 major road schemes. It also allows for considerable investment in public transport. It is hoped that the reductions will come mainly from current expenditure through increased efficiency and some reductions in road maintenance spending.

The other expenditure programmes in transport are unchanged.

Housing

The housing programme has not been reduced since the announcement was made by Mr. Michael Heseltine in December that the housing programme for 1981 - 82 was to be reduced by £69m (£5m from capital, £64m from local authority current expenditure). The apparent reduction in the figure between the 1980 expenditure White Paper and the 1981 White Paper is due mainly to the separation of the Scottish figures from the rest of Britain (about £614m at 1980 survey prices) and the transfer of rent rebates to the social services programme (£342 at 1980 survey prices).

LAW, ORDER AND PROTECTIVE SERVICES

At the time of the last General Election it was made clear that expenditure on Law and Order would be exempted from the requirement to make cuts in public spending, expected of other Departments. Indeed in 1980-81, measured at 1980 survey prices, total expenditure under this head by all Departments involved was £2.833 billion, £237 million up on the corresponding figure for 1978-79.

Projected extra spending in 1981-82 will carry levels of spending to £2.886 billion, more than 10 per cent up on the levels reached in the last years of Labour Government.

Spending by the Home Office alone, has risen from £2.361 billion in 1978-79 to £2.543 billion in 1980-81. In 1981-82 it will rise again to £2.566 billion. (all figures at 1980 survey prices).

The White Paper (Cmnd.8175, p. 93) makes it clear that:

> "in the changed economic circumstances it has no longer proved possible to exempt law and order from the general search for savings".

Nevertheless, as the Paper continues,

> "it has been possible to make provision for continued growth over the survey period."

Police and Prisons

One area where spending will continue to increase will be on provision for the police (up from £1.447 billion in 1978-79 to £1.641 billion in 1981-82). Following the generous pay settlement accorded to the police, recruitment has greatly improved, and the size of the force is expected to continue its growth in the foreseeable future. The White Paper (Cmnd. 8175, p. 96) pledges that:

> "If the forecast for any year is exceeded, further provision will be made both for the cost of additional manpower within individual establishments and for the essential associated expenditure on equipment, training and other support schemes."

On prisons the Government has a significant building programme in train. Present spending levels will be roughly maintained in 1981-2 and will grow slightly up to 1983-4.

Civil Defence

The Home Secretary announced on 7th August 1980 that the Government will provide more funds for the civil defence programme over the next few years. Therefore, spending is projected to rise from £20 million in 1980-81 to £29 million in 1981-2. In 1982-3 it will grow to £40 million (at 1980 survey prices), twice the levels obtaining in the financial year 1980-81.

010

cc Walters
Hoskyns 2

Prime Minister

The Treasury have looked very carefully (under the last Government) at the idea of a separate oil fund - this was a pet idea of Mr. Benn's. I doubt whether the Chancellor will wish to pursue it now.
TL 19/3

LORD PRESIDENT OF THE COUNCIL

Civil Service Department
Whitehall London SW1A 2AZ
01-273 4400

18th March 1981

MT

Dear Geoffrey,

It always has seemed to be important that people should see the Conservative Government's policy as using the revenues from our precious North Sea oil for investment rather than to help finance consumption. I know, of course, that the Treasury does not like apportioning particular revenue to particular expenditure - like the road tax fund. But might it not be a good idea to relate some of the revenues from North Sea oil to Government capital expenditure notably in the public sector.

It seems to me important that people should see the Conservative Government - as opposed to the Socialists - being aware of the "once-for-all" character of North Sea oil, as husbanding and using the benefits therefrom to the best national advantage.

I am sending copies of this letter to the Prime Minister, Sir Robert Armstrong and the Secretary of State for Energy.

Yours ever

Christopher

The Rt.Hon. Sir Geoffrey Howe, QC,MP.

Econ Pol Pt 14

DEPARTMENT OF EDUCATION AND SCIENCE

ELIZABETH HOUSE,
YORK ROAD,
LONDON SE1 7PH
01-928 9222

FROM THE SECRETARY OF STATE

Rt Hon Michael Heseltine MP
Secretary of State
Department of the Environment
2 Marsham Street
LONDON
SW1P 3EB

10 March 1981

18/3

Dear Michael,

I have seen the letter of 25 February from the Chief Secretary's Office to yours about the cash limit on local authority capital expenditure next year.

I am concerned that any failure of local authorities to secure the expected capital receipts on housing might threaten their allocations for other services which, though not earmarked, reflect our assessment of their needs and, in the case of education, have been made public. May I take it that you will consult in good time the rest of us who are concerned if any action should seem to be necessary as the year progresses? To my mind it would be unreasonable to penalise those local authorities which are not housing authorities (ie the counties) for any overspending by the rest.

I am sending copies of this letter to the Prime Minister, the other members of the Cabinet and Sir Robert Armstrong.

Yours ever

Mark

MARK CARLISLE

Econ Pol
Pt 14

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Peter Shaw Esq
Private Secretary to the
Secretary of State
Department of Education
and Science
Elizabeth House
York Road
London SE1 7PH

26 February 1981

Dear Peter,

CASH LIMIT ON LOCAL AUTHORITIES HOUSING CAPITAL EXPENDITURE, 1981-82

The Chief Secretary has seen your Secretary of State's letter of 24 February about the housing cash limit for 1981-82.

Following his letter of 18 February, the Chief Secretary met Mr Heseltine and Mr Stanley the same day to resolve the question of the calculation of the housing cash limit and its presentation in the Public Expenditure White Paper. I enclose a copy of my letter to David Edmonds recording the outcome of that meeting.

I am sending copies of this letter to the Private Secretaries to the Prime Minister, other Members of the Cabinet and Sir Robert Armstrong.

Yours ever

Terry Mathews

T F MATHEWS
Private Secretary

cc

Treasury Chambers, Parliament Street, SW1P 3AG

David Edmonds
Private Secretary to the
Secretary of State
Department of the Environment
2 Marsham Street
London SW1P 3EB

25 February 1981

Dear David,

HOUSING CASH LIMIT: 1981-82

The Chief Secretary met your Secretary of State and Mr Stanley on 18 February to try to resolve the question of how the Housing Cash Limit is to be calculated, and its presentation in the Public Expenditure White Paper.

Mr Stanley said that DOE Ministers believed the Financial Secretary's agreement to the 50:50 arrangement for capital receipts meant that both expenditure allocations to individual local authorities, and the cash limit calculation, would be made on the same basis. They had never expected that the sum of the allocations would be different from the cash limit. He reminded the Chief Secretary that, with Treasury agreement, local authorities had been given borrowing approval and capital allocations totalling £1786 million. This had been announced to Parliament. The Treasury were now proposing to announce a cash limit £369 million less than these allocations. This would rightly be seen as a further cut in the Housing Programme.

The Chief Secretary said that the approved public expenditure planning figure for Housing was net of the total of forecast receipts. The cash limit had to be consistent with the public expenditure plans, and must also be net of all receipts. Otherwise it could not do its job of controlling expenditure. If the expected receipts did not materialise, and expenditure was not correspondingly cut to stay within the cash limit, then the public expenditure target would be exceeded. He appreciated the problem in explaining the difference between the total capital allocations and the cash limit to the local authorities - they should be told that the allocated level of expenditure would be permitted only if the expected level of receipts was achieved. Any shortfall in receipts would be offset by a corresponding reduction in expenditure. Only in this way could the approved public expenditure plans be delivered.

In discussion it was noted that the Financial Secretary's letter of 8 October 1979 to Mr King referred to "the maintenance of a firm annual cash limit on total net capital spending", noted that "the proposed 50:50 arrangement for capital receipts will complicate this task", and agreed to the 50:50 proposal on the understanding that "since the cash limit would cover housing receipts you would monitor the level of receipts and take the necessary corrective action if the arrangement threatened - as it could - a cash limit overspend." The letter had earlier referred to the need for careful monitoring and the need to take action, by reducing the level of allocations, if this proved necessary to ensure that total spending was contained within plans and the national cash limit was not put at risk.

Your Secretary of State did not accept that the approved PESC planning figure for Housing investment was net of receipts. Receipts were highly problematical. He maintained that Cabinet had taken a view on the volume of work to be done in the Housing Programme. He could not agree to any reduction in the gross volume figures which, in his view, had been approved by Cabinet.

The Chief Secretary said that this was a totally different proposition from that which they had met to consider. He pointed out that the announced Housing allocations and borrowing approvals took account of half the expected receipts, showing that DOE Ministers did not regard receipts as irrelevant. Moreover, Treasury agreement to the 50:50 arrangements had been given in response to DOE representations that to allow local authorities to use their total receipts to finance expenditure would allow individual authorities who achieved a high level of receipts to increase expenditure beyond their need.

Since it was clearly impossible to reconcile these differences in the short time available, it was agreed that officials would attempt to draft a form of words for the White Paper. I understand that Mr Stanley has approved the following formulation to appear as the third sentence of paragraph 1 in chapter 2.7 of the White Paper.

> "The government has allocated £1786 million to local authorities to spend on housing capital investment, of which £369 million is supported by a proportion of their housing capital receipts".

The next sentence would now begin:

> "1981-82 will also see....."

The Chief Secretary is content with this wording.

The Chief Secretary has asked me to make it quite clear that he does not accept your Secretary of State's interpretation of what Cabinet has approved. In the course of the 1979 Survey it was agreed that your Secretary of State should be committed to a single net figure for housing in 1981-82 and each subsequent year, the breakdown for 1981-82 to be determined in the course of 1980-81. The starting point of the 1980 Survey, the interdepartmental PESC report of June 1980, showed, as usual, a total for the housing programme net of all receipts and Cabinet and bilateral discussions thereafter, starting with C(80)40, were entirely in terms of the net Cmnd 7841 totals revalued and proposed reductions or increases in those figures.

When Treasury officials corresponded with your officials about the implications of the proposals in C(80)40 in preparation for the bilateral on 14 July, (Norris's letter of 11 July 1980 to Ponsford) they enclosed a table showing ways in which the cuts proposed by the Chief Secretary might be secured, and said,

> "Of course, if there were some unavoidable increases elsewhere in the programme, eg as the result of a shortfall of receipts from sales, further reductions would be needed to achieve this same net result."

Since your Secretary of State's concern is with presentation, I think I should draw your attention to the fact that the cash limit figure that appears in the White Paper is the total for local authority capital, DOE/LA1 £3159.9 million, and it is this figure that has to be delivered. If there is a shortfall of housing receipts, that does not necessarily imply a cut back on housing allocations if the same effect can be achieved by shortfall in expenditure on other local authority capital expenditure.

I am copying this letter to Robin Young.

Yours ever

Terry Mathews

T F MATHEWS
Private Secretary.

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Econ Pol

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

1981 PUBLIC EXPENDITURE SURVEY

Cabinet is to discuss my paper on this subject tomorrow. I have had contact with a few colleagues about it, and there have been helpful discussions between my officials and Permanent Secretaries and Principal Finance Officers of other departments. My impression is that there will be sympathy for my objective, and indeed for the structure of the proposals, combined with a number of worries and doubts. I thought you might find it helpful to have a note of some of these points, and my reaction to them.

2. It may be suggested that my proposals involve a double squeeze, where expenditure is subject to cash limits. The first part arises from carrying forward any existing squeeze from one year to the next, and the second from the temptation for Cabinet generally to agree in advance on optimistic assumptions about future inflation. My response will be:

- the principle of carrying forward from one year to the next must be the right presumption (I accept - and my proposals allow - that colleagues faced with extreme cost pressures can seek extra cash provision,

/but the onus will

but the onus will be on them to make the case for it);

- I agree tha- there is danger in making unrealistic inflation assumptions. Our assumptions will be for Cabinet as a whole to decide, and my proposals allow scope for reviewing them;

- generally, as my paper makes clear, I recognise that levels of service are politically important, and we cannot push the cash constraint to intolerable levels. But our presumptions should give more weight to what can be afforded, and less to the entitlement to levels of service irrespective of cost;

- it may well be argued that the pressures on spending managers will be such that new techniques will be needed to assist them in meeting cash constraints: greater flexibility in handling Government contracts, pay and conditions of service, handling of shortfall and excess over the end of a financial year. I agree, but we shall have to work these out as we go along.

3. Much worry may turn on the uncertainties of future inflation, and the awkwardness of assumptions which are bound to become public. My comments are:

- I am not at this stage pressing for full cash planning for the later years, beyond the target year (1982-83 in the forthcoming Survey). We can discuss later how far we want to go;

- I do want cash from the outset for the target year, but

/have provided that

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have provided that the assumptions we make soon after the Budget can be reviewed, in the light of subsequent events and revised forecasts. Naturally, we shall want to stick to our initial numbers as far as possible. But I fully recognise the need for some flexibility;

- there may be particular worry over pay assumptions. I would like to defer discussion of this until we have numbers in front of us. One possibility is that we may not need to distinguish a separate pay factor in a way which might be publicly embarrassing.

4. I may be pressed to be more open with colleagues in discussing cash revenue prospects, as a natural corollary to discussion of public expenditure in cash terms. I believe this is right. The object is that we should all get a clearer picture of what can be afforded.

5. Finally, I know that some colleagues will be worried about being rushed into a decision of this importance. I have referred already to further discussion after the Budget. I believe it is not unreasonable to ask now for a general decision in principle. We shall have to work out some of the details as we go along, and as I have indicated there will be need of an important discussion after the Budget, when we actually set quantified assumptions as the basis for cash figures for 1982-83. That will be a more appropriate time to go into some of the technical difficulties.

P.S. Jenkins

for (G.H.)

February 1981

(Approved by the Chancellor & signed in his absence).

MA cc Mr Walters Mr Duguid

ELIZABETH HOUSE,
YORK ROAD,
LONDON SE1 7PH
01-928 9222

FROM THE SECRETARY OF STATE

Rt Hon Leon Brittan
Chief Secretary
Treasury Chambers
HM Treasury
Parliament Street
LONDON
SW1

R 24/2

24 February 1981

Dear Leon,

CASH LIMIT ON LOCAL AUTHORITIES HOUSING CAPITAL EXPENDITURE, 1981-82

In his letter to you of 16 February, Michael Heseltine suggests that one possible approach would be to refuse to publish the component parts of the local authority capital cash limit. I can confirm what he goes on to say namely that I would not want to do this especially since we have already announced the total of the allocations for education to individual local education authorities in response to a Parliamentary Question from Mrs Renee Short on 21 January. I agree with Michael that the cash limit should be based on the total of actual allocation.

I am sending copies of this letter to the Prime Minister, other members of the Cabinet and Sir Robert Armstrong.

Yours ever

Mark

MARK CARLISLE

cc

MINISTRY OF AGRICULTURE, FISHERIES AND FOOD
WHITEHALL PLACE, LONDON SW1A 2HH

From the Minister

CONFIDENTIAL

The Rt Hon Margaret Thatcher MP
10 Downing Street
London SW1A

23 February 1981

Dear Prime Minister,

1981 PUBLIC EXPENDITURE SURVEY

My unavoidable attendance at a meeting of the Council of Agricultural Ministers in Brussels will mean that I shall not be present when the Cabinet considers Geoffrey Howe's memorandum on the 1981 Public Expenditure Survey. I would therefore like to let my colleagues have certain comments on the changes proposed.

I fully recognise the force of the considerations behind the aim of enabling the Cabinet to see more clearly the prospective cash costs of expenditure programmes when firm decisions are reached on these. The particular methods for achieving this put forward by Geoffrey Howe would, however, go beyond this. They would in addition carry through into 1982-83 a volume squeeze inherent in the cash limits for 1981-82; and the inflation assumption made for further adjusting to estimated 1982-83 prices could well add a further volume squeeze.

The total impact of these squeezes on departmental programmes could well be substantial. While I fully accept that it is open to the Cabinet to decide on such volume cuts I suggest that this should be a conscious decision, taken in the full knowledge of the implications, and should not flow automatically from inflation assumptions introduced at the outset of the annual Survey.

These difficulties would be avoided if the 1981 Survey were to be carried out initially on the usual price basis, ie actual prices in Autumn 1980, and early in the Autumn of 1981 the resulting volume programmes were then revalued to 1982-83 prices using inflation assumptions agreed at that stage by the Cabinet.

/This approach would

This approach would avoid disrupting from the outset well established Survey procedures. A judgement on inflation assumptions would be made much nearer to the period they concerned. Volume cuts flowing automatically from the Survey procedure would be avoided, without in any way pre-empting a conscious Cabinet decision to make such cuts. More generally the Cabinet would still have before it expenditure proposals expressed in prospective cash terms when reaching firm decisions on programmes for 1982-83.

I suggest that Geoffrey Howe's main aim could be met in this way without the disadvantages carried by his proposals as they stand.

I am copying this letter to other members of the Cabinet and to Sir Robert Armstrong.

Yours sincerely
Kate Timms

for PETER WALKER

(Approved by the Minister
and signed in his absence)

2

Prime Minister to see

Ref: AO 4307

N.P.G. Mitchell
Duty Clerk 20/2/81

PRIME MINISTER

MT

1981 Public Expenditure Survey

(C(81) 10)

BACKGROUND

(FLAG 'A')

The Chancellor of the Exchequer proposes in C(81) 10 that in the 1981 Public Expenditure Survey the discussion should be in terms of cash rather than of survey prices for the focal year, 1982-83. You have seen this paper in draft.

2. The case for change is set out in paragraphs 1-5. The main deficiency of the present system is that, while the Chancellor has projections in estimated cash terms of the revenue side of the account, he - and spending Ministers - do not know until far too late in the day the cash consequences of decisions on expenditure taken on a volume basis. There is then only limited scope to make further changes to expenditure programmes and, if net borrowing is to be contained, the whole burden falls on tax changes. Moreover, the present process of revaluation allows for each programme to be revalued by a multiplicity of particular factors, rather than general inflation factors, so that no account is taken of shifts in relative costs. Decisions are further confused because the prices in which expenditure is discussed are neither those ruling at the time of the discussions nor those likely to rule when the money is spent.

3. The main features of the Chancellor of the Exchequer's proposals are:-

(i) Discussion of the focal year, 1982-83, should be in terms of estimated cash values rather than of 1981 survey prices (ie those ruling in Autumn 1980).

(ii) The inflation assumptions, covering public service pay and prices, to arrive at 1982-83 cash figures should be decided collectively by the Cabinet in March 1981, twelve months before the beginning of the year to which they relate on the basis of his proposals for the guidelines for the 1981 Survey (under the existing system they would not have to be decided before November 1981 (for the Rate Support Grant) or early 1982.

(iii) For 1981-82 all increases on cash limits, whether volume or pay or price increases, should be charged to the Contingency Reserve (Paragraphs 13-15).

(iv) It should be left open, for further discussion in March if necessary, whether the later years of the survey period should also be in cash terms.

(v) He should announce these changes 'in conjunction with the publication of the Public Expenditure White Paper' on 10 March; this language is in response to your wish that he should not refer in the paper to an announcement in his Budget Speech.

4. The proposed system has been discussed this week at interdepartmental official meetings at both Finance Officer and Permanent Secretary level in order to acquaint them with what is proposed. There was general understanding of the problems arising from the present system and of the case, in principle, for greater attention to cash planning. At the same time there was considerable concern over the mechanics of the particular scheme being put forward, and fear that the speed of its implementation might create more problems than it would solve. Much was made of the fact that an interdepartmental report last July on the survey system concluded that there were major objections to moving towards cash planning. (This report was not discussed by Ministers collectively because its conclusions were not accepted by Treasury Ministers.)

5. Your colleagues are likely to be more relaxed about the new system than those who will have to operate it in detail. But some of the concerns expressed could carry through into the Cabinet discussion, and you may find it helpful to have the gist of the criticisms made. Briefly, the system will involve great uncertainty for Departments, who have to be concerned with volume (how many soldiers etc) as well as price. The uncertainty arises principally because under the proposed system (a) the Cabinet will have to choose at the beginning of the PESC operation (March 1981) twelve months ahead of the beginning of the year in question, the assumptions for inflation between 1981-82 and 1982-83, and (b) these assumptions will be generalised and not tailored to the particular programmes. Over the last

five years or so the Government's forecast of inflation, a year before the start of the forecast year, has on average been wrong by 3 or 4 percentage points. If future assumptions are as badly out, it is argued, either there will be a further and substantial volume squeeze on departmental programmes, throwing in doubt major policy aims, or (if the error is the other way) there will be scope for large unintended increases on the volume of expenditure, or there will have to be a series of revisions to inflation assumptions which will undermine the new system.

6. The worry over a severe volume squeeze from the inflation factors is reinforced by the Chancellor's proposal, in his paragraph 10, that in future any squeeze or underspending in the current cash limit year should normally be carried forward into later years. Departments argue that, while this is fully justified when long-term improvements in efficiency have been identified, it will build up trouble when savings in the cash limit year have been achieved only through short term expedients, such as the temporary deferment of essential investment.

7. There is particular worry over the assumption to be made for public sector pay - if this is separately distinguished from the assumption on prices. The assumption chosen will inevitably be known to all those seeing the detailed operational guidelines and involved in survey work and so, even though it will not be published, it will undoubtedly become publicly known. If it is initially pitched too high, it will then be difficult subsequently to wind expectations down. If it is initially pitched too low, there is a risk of a long period of mounting campaigns by unions and a greater disposition towards industrial action.

8. These doubts could lead to either, or both, of the following lines of argument in Cabinet.

9. First, it might be suggested that the introduction of the new system should not be rushed but evolved. This might be done either by starting the survey exercise and the summer discussions on the basis of 1981 survey prices and then deciding the inflation assumptions and converting to a cash base in the autumn; or by making a start now by converting to estimated

1981-82 out-turn prices and making a further cash adjustment in the autumn. Either way would carry the advantage of reducing the period over which inflation assumptions would have to be made, although making the change while the survey discussions were still under way and it was possible to make major changes in programmes. The very plain disadvantage, as the Chancellor of the Exchequer will no doubt point out, is that it would be highly confusing to change the whole basis of the figures half way through what is already a complicated exercise.

10. Secondly, some Ministers may point out that the essence of the proposed system is to shift the burden of uncertainty arising from inflation off the Chancellor's shoulders and on to those of spending Ministers. Spending Ministers, who have a continuing concern with the volume of their programmes, will be particularly vulnerable to the inflation assumptions chosen. In these circumstances they could well argue that they should be given a much stronger collective role in macro-economic forecasting and decision making and, in particular, that they should be entitled to much fuller discussion with the Chancellor of his revenue expectations. They could further argue that, given the strains which the new system will impose, it should be accompanied by other changes in the arrangements - for example, greater flexibility between years, changes in contract procedures, less central constraints on pay and conditions of service.

11. The Chancellor of the Exchequer is likely to argue that, while he accepts that the new system will throw up some very real problems, these do not amount to a case for general deferment of its introduction. Rather they point to the need for care in working out and conducting the new arrangements as they are developed, and also possibly to parallel developments which the proposed move would encourage. There will be greater pressure on those responsible for volume planning, but there is no escaping from the simple fact that decisions on volume are not immune from decisions on the cash which can be afforded. The Chancellor would no doubt wish to consider further with you any proposals that there should be more collective discussion of economic forecasting and of revenue and taxation projections.

12. Some of the concern expressed will be mitigated if the Chancellor can agree to set the inflation assumptions in November rather than in March. If the objections are strenuous, you may wish to see whether the Chancellor would settle for this: I understand that it would be workable.

13. In view of the difficulties likely to be seen in moving to a cash basis for 1982-83 the Chancellor may well not press at this stage for extending the cash base to the later years of the survey, when the problems of making inflation assumptions would of course be all the greater.

HANDLING

14. After the Chancellor of the Exchequer has introduced his paper you will wish to hear the views of each of the Ministers responsible for expenditure programmes and large pay votes, and particularly of the Secretaries of State for Defence, the Environment, Education and Science, and Social Services and the Lord President. If the Cabinet appear ready to accept the general thrust of the Chancellor's approach, but are strongly resistant to commitment to the details, you might point out to them that the specific and detailed ground rules for the 1981 Survey, including the inflation assumptions, will be put to them by the Chancellor of the Exchequer for collective discussion after the Budget; and that these ground rules will have been discussed interdepartmentally at official level first.

15. If Cabinet agree in principle to the introduction of the new scheme, subject to a further look at the details later in March, you will wish to consider whether the Chancellor should refer to the decision in his Budget Speech and, if so, in what terms. He will, in any event, want to avoid commitment to details but how he expresses the general intention will turn very much on the degree of support which Cabinet are willing to give him at this stage. At the very least he should be able to refer to the formulation in the Public Expenditure White Paper which, at present, reads:-

> 'In future the Government intend to give more weight to prospective cash costs and expenditure planning, particularly for the focal year of the Survey, that is the year immediately ahead'.

But he will no doubt want to be more forthcoming than that.

16. You will also wish to decide whether further work should be done with a view to putting the later years of the 1981 Survey on to a cash basis. The probability is that Cabinet will want to see how things work out for 1982-83 before taking this further step, and that this will be acceptable to the Chancellor.

CONCLUSIONS

17. In the light of the discussion, and with reference to paragraph 16 of C(81) 10, you will wish to record conclusions on:-

(i) Whether there is agreement on the broad changes proposed for the 1981 Survey.

(ii) The proposals in paragraphs 13-15 of C(81) 10 on the management of the 1981-82 Contingency Reserve.

(iii) Whether the Chancellor can announce the changes in his Budget Speech and, if so, broadly in what terms.

(iv) Noting that the Chancellor will put detailed proposals to Cabinet in mid-March and directing him on whether these should consider the possibility of putting 1983-84 on a cash basis too.

If necessary it would be possible to have a further discussion of the general principles before the Budget at the meeting on Thursday, 5 March.

ROBERT ARMSTRONG

(approved by Sir R. Armstrong and signed on his behalf)

20 February 1981

cc Vereker
Hoskyns
Wolfson

CONFIDENTIAL

DEPARTMENT OF HEALTH & SOCIAL SECURITY
Alexander Fleming House, Elephant & Castle, London SE1 6BY
Telephone 01-407 5522
From the Secretary of State for Social Services

John Wiggins Esq
Private Secretary to
The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Treasury Chambers
Great George Street
London S W 1

19 February 1981

Dear John

ANCILLARY STAFFS COUNCIL - PAY NEGOTIATIONS

As you know, the ASC are due to meet tomorrow morning for the first time since the Management Side's offer of a 6 per cent increase in pay was rejected (on 29 January) and since the NHS pay factor was made public.

As my Secretary of State mentioned in his letter of 10 February to the Chancellor, the Management Side (whose Chairman I saw this afternoon) see little prospect of a peaceful settlement at this level.

Quite apart from the level of pay to be offered however the Management Side is moving further towards the idea of changing their settlement date from December to April; particularly as a means of bringing ancillary staff on to the same settlement date as the majority of other NHS groups whose cash limit they share (the Ambulancemen's Council whose next meeting has not been arranged have not had an opportunity to discuss this issue yet. The maintenance staff and a small group of dental auxiliaries and pharmacists are the only others with different settlement dates).

Representatives of both Sides are meeting prior to the full Council meeting tomorrow morning in order to discuss the scope for such a move and the Management Side Chairman favours the possibility of offering a lump sum (possibly payable on a monthly basis) in addition to the 6 per cent increase. Spread over 15 months, this would be within the 6 per cent cash limit (on our calculations this would be made up of approximately £16m or about £75 per head, to cover the period from December 1980 until March 1982).

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E.R.

CONFIDENTIAL

The possibility of shifting the settlement date in this way - which my Secretary of State believes desirable and has been strongly pressed by the Management Side - was raised in correspondence between our Finance Division and their colleagues in the Treasury last month. There is a chance that it might allow a settlement to be reached tomorrow without breaching the 6 per cent cash limit for pay even though the Unions would present it as a settlement comparable to the pay settlement for Local Authority manual staff. But unlike that settlement the basic pay scales would only move 6 per cent in the pay year 1981/82. I would be grateful if you could ring my office (extension 7107) by 12.00 noon tomorrow to confirm that the Chancellor would not object to such a settlement.

The Chairman has asked for authority to make a firm offer on this basis if it proved likely to be the means of reaching a settlement. My Secretary of State would like to give this authority and has asked if his colleagues could let him know that they would not oppose it if offered by the Management Side.

Copies to Clive Whitmore (No 10), Jim Buckley (Lord President's Office), Richard Dykes (Employment), David Edmonds (Environment), Terry Mathews (Chief Secretary's Office), Geoffrey Robson (Scottish Office) and John Craig (Welsh Office).

Yours ever
Mary McWenny

pp D BRERETON
Private Secretary

CONFIDENTIAL

Ecn Pol Pt14

Treasury Chambers, Parliament Street, SW1P 3AG

D B Omand Esq
Assistant Private Secretary
to the Secretary of State
Ministry of Defence
Main Building
Whitehall
London SW1A 2HB

19 February 1981

Dear David,

PUBLIC EXPENDITURE WHITE PAPER: DEFENCE

Many thanks for your letter of 17 February.

The Chief Secretary agrees that it would be right to include a brief reference to Defence, picking up the language of part 2, in part 1 of the White Paper. He also agrees that paragraph 21 would be the appropriate place for such a reference, and he is content that it should incorporate the wording which you proposed.

I understand that your Secretary of State has since accepted that it would for editorial reasons be best that the refence should come at the end of the paragraph, and should be expanded to read as follows:-

> "Planned expenditure on Defence has also been revised, though the current plans provide for Defence spending to increase in volume terms over the planning period in accordance with the Government's NATO undertaking to aim for real increases in the region of 3% a year."

With the Chief Secretary's agreement, this amendment to the draft White Paper has now been made.

Copies of this letter go to the other recipients of yours.

Yours ever

Terry Mathews

T F MATHEWS

Private Secretary

Treasury Chambers, Parliament Street, SWIP 3AG

Rt Hon Michael Heseltine MP
Secretary of State
Department of the Environment
2 Marsham Street
London SW1P 3EB

PL 19/2

19 February 1981

Dear Michael,

PUBLIC EXPENDITURE WHITE PAPER

Thank you for your letter of 17 February.

If a specific reference to housing in paragraph 31 will create difficulties for you, I do not wish to insist on it. But I do not think that we can offer no defence of the sharp decline in capital expenditure relative to current in 1981-82, on which we may encounter widespread criticism. And it is hardly sufficient to invoke the general need for reductions in expenditure, since that does not explain why capital expenditure in particular is falling. We must be prepared to explain why capital expenditure is being given lower priority on a number of programmes than was formerly the case.

I think that we do therefore need an explanatory sentence in this paragraph. Taking account of your particular concern, I have had the following more general sentence inserted in the final text:-

> 'Past higher levels of capital spending are no longer sustainable in the changed circumstances which now exist, both in terms of the finance available and the needs of expenditure programmes.'

Your amendment to the previous sentence had already been agreed between our officials.

As regards paragraph 43, I am content with your redraft of the reference to the new capital control scheme. But I have retained the first part of the sentence, which says that block grant will be a strong influence against excessive current spending.

I am copying this letter to the Prime Minister, other members of the Cabinet, and Sir Robert Armstrong.

Ever Leon

LEON BRITTAN

Treasury Chambers, Parliament Street, SWIP 3AG

The Rt Hon The Lord Soames GCMG GCVO CBE
Lord President of the Council
Civil Service Department
Whitehall
London SW1A 2AZ

19 February 1981

Dear Christopher,

PUBLIC EXPENDITURE WHITE PAPER

Thank you for your letter of 17 February.

You will by now have seen my letter of 18 February to Mark Carlisle. I think the redraft about cash in expenditure planning which I proposed there meets your point.

On paragraph 6, I agree that a reference to 'catching-up' would be useful. On your other points, I think the comparisons in the present text can be justified, but need qualification. Since the necessary qualifications would interrupt the flow of the paragraph, and the points are in any event not essential to the argument, I propose to omit them. I attach a copy of the revised text.

I am copying this letter to the Prime Minister and other members of the Cabinet and Sir Robert Armstrong.

Yours,
Leon

LEON BRITTAN

6. Total cash spending, some £ billion in 1979-80, is now expected to total £ billion in 1980-81 and £ billion in 1981-82. An important element in this is the public services wage bill, which has risen by some 50% between 1978-79 and 1980-81. Large increases in pay resulted from 'catching-up' commitments inherited from the previous Government following the failure of their incomes policy. As a result of high pay increases and a slow rundown of employment, between 1979-80 and 1980-81 the pay bill in the public sector will have risen twice as fast as in the private sector.

Econ Pol

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Mark Carlisle QC MP
Secretary of State
Department of Education
 and Science
Elizabeth House
York Road
London SE1 7PH

18 February 1981

Dear Secretary of State,

PUBLIC EXPENDITURE WHITE PAPER

Thank you for your letter of 16 February. Norman Fowler has written in similar terms.

I note what you say about the possibility of further cuts in the education service. However, as I pointed out in my minute to the Prime Minister of 16 February about ESSP, Cabinet have agreed that further savings in 1982-83 should now be sought to replace the ESSP savings. At the very least, therefore, the second sentence of paragraph 2 of the White Paper represents a decision already taken.

I agree that the second sentence of paragraph 7 of the White Paper does go a little too far. We are to discuss the substance of cash planning next week, but meanwhile the White Paper must be settled. I propose the following redraft:

> "In future the Government intend to give more weight to prospective cash costs in expenditure planning, particularly for the focal year of the survey, that is the year immediately ahead."

That does not seem to me so precise as to prejudice our discussion next week, and I assume that you will now agree to the inclusion of this sentence and the one in paragraph 2, unless I here from you by midday tomorrow.

Finally I understand that your point on paragraph 24 has been settled by officials.

I am copying this letter to the Prime Minister, the other members of Cabinet and Sir Robert Armstrong.

Yours sincerely
T. Mattews
for LEON BRITTAN
Approved by the Chief Secretary and signed in his absence.

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Michael Heseltine MP
Secretary of State
Department of the Environment
2 Marsham Street
London SW1P 3EB

18 February 1981

Dear Michael,

CASH LIMIT ON LOCAL AUTHORITIES HOUSING CAPITAL EXPENDITURE 1981-82

In your letter of 16 February you again ask me to agree to only half the housing receipts being included in the cash limit for local authority capital expenditure in 1981-82. You refer to the cash limit figure being published in the Public Expenditure White Paper: this means we must settle this issue by Thursday. I suggest that we meet urgently to decide it.

Your letter does not mention the basis of the agreement that was reached in October 1979. As I have already pointed out, Nigel Lawson accepted Tom King's proposal that an individual allocation would include only half an authority's expected housing receipts - a device aimed at tackling the uneven distribution of receipts among individual authorities - on the clear understanding that the national cash limit would be calculated net of all housing receipts. The complications were recognised at the time, and there has been opportunity since to explain the situation to local authorities if you believed there was cause for misunderstanding.

My main concern must still be to see that the public expenditure totals are not exceeded. I do not think I have to emphasise how important this is to our economic policies. I cannot agree with your conclusion that excluding £369 million of housing receipts from cash control will not prejudice the achievement of the housing programme total. If the receipts fall short of target, there will have to be compensating reductions elsewhere and the only really effective way to ensure this is by including all expenditure and receipts within the cash limit. We have done this for the other services and I do not see why housing should be an exception.

I am sending copies of this letter to the Prime Minister, other members of Cabinet and Sir Robert Armstrong.

Yours ever,

Leon

LEON BRITTAN

P.M.
To see
Duty Clerk

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P.0428

PRIME MINISTER

PUBLIC EXPENDITURE WHITE PAPER

The Chief Secretary circulated the draft of the Public Expenditure White Paper to Cabinet colleagues on 10 February and asked for comments by last Tuesday, 17 February. The hope and intention was to clear the text without discussion in Cabinet. Since then a number of points has been satisfactorily dealt with and we have not heard that any Minister wishes to bring disputed points to Cabinet. But not all issues have been settled and the Treasury regard this weekend as the last time at which changes can be made. It is therefore possible that one or other of your colleagues may seek to raise particular points at tomorrow's meeting. You would obviously wish to discourage any such attempt, if made, especially where technical or Departmental points are concerned. But two general questions are still at issue and could be dealt with by the Cabinet if necessary.

2. The first arises in paragraph 7 of part 1 of the White Paper where there is a sentence - "In future the Government intend the cash aspects of medium-term expenditure planning to predominate". The Secretary of State for Education and Science has argued that this formulation is too sweeping and the Chief Secretary is prepared to accept, in its stead;

> "In future the Government intend to give more weight to prospective cash costs in expenditure planning, particularly for the focal year of the survey, that is the year immediately ahead."

3. The Chief Secretary argues, with reason, that this new formulation is not so precise as to prejudice Cabinet's discussion of cash planning next Tuesday.

4. The second arises in paragraph 2 of part 1 of the White Paper where it is said - "The Government regard this development [ie expenditure higher than expected] as one which requires the most serious attention during the 1981 annual survey when the plans for 1982/83 onwards will be reviewed." Some

colleagues see this as too clear an indication of the Government's intention to undertake a new round of cuts. The Chief Secretary is minded to stand by the words on the grounds that, at the very least, further savings in 1982/83 will have to be sought to replace those lost through the decision on ESSP. The disputed sentence therefore represents a decision already taken.

CONCLUSIONS

5. If these matters surface at all, and given that there will be no further opportunity for collective discussion, you will want to record specific conclusions on any general points made and refer technical and Departmental points for urgent settlement between the Departmental Minister concerned and the Chief Secretary.

P Le CHEMINANT

Cabinet Office
18 February 1981

Econ Pol, Pt 5

Subject
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Master

File

ds

bc: David Wright
CO

10 DOWNING STREET

From the Private Secretary

17 February 1981

1981 Public Expenditure Survey

At their meeting this afternoon, the Prime Minister had a word with the Chancellor about the draft paper for Cabinet enclosed with your letter of 12 February. The Prime Minister said that she was quite content for it to be circulated, although she asked the Chancellor to delete the reference to the Budget in his conclusions. Thus, 13(b) should read something like - "... to agree that I should announce this in conjunction with the publication of the Public Expenditure White Paper"; and 13(c) could read - "to know that in mid March ...".

T. P. LANKESTER

Peter Jenkins, Esq.,
HM Treasury.

cc Cabinet Office

MM

2 PPs

SECRETARY OF STATE FOR THE ENVIRONMENT

2 MARSHAM STREET
LONDON SW1P 3EB

My ref:

Your ref:
17 February 1981

Dear Leon

PUBLIC EXPENDITURE WHITE PAPER

Thank you for sending me a copy of your minute of 10 February to the Prime Minister. I have one or two points to suggest.

Paragraph 31 states that public capital spending on housing has reduced the urgency of further investment in this field. This will gratuitously incense the construction industry and needlessly expose the Government to accusations of complacency. I must ask that the whole final sentence of the paragraph be deleted and the previous sentence be modified to read as follows:-

> "Most of the decline is in fixed capital formation and is reflected in a fall of capital formation and is reflected in a fall of capital expenditure on construction. Further details of expenditure on construction work are contained in table 4.5."

I hope you will agree to redraft the last sentence of paragraph 43 as follows:-

> "The new capital control scheme represents a significant increase in the discretion of local authorities to allocate their capital programmes in line with their local priorities whilst strengthening substantially central government's control over the aggregate of capital expenditure."

I am sending copies of this letter to the Prime Minister, the other members of the Cabinet, and Sir Robert Armstrong.

Yours ever

Michael

MICHAEL HESELTINE

Leon Brittan Esq MP

Civil Service Department
Whitehall London SW1A 2AZ
01-273 4400

2 pps

The Rt Hon Leon Brittan, QC, MP
Chief Secretary to the Treasury
Parliament Street
LONDON SW1P 3AG

17 February 1981

Dear Leon,

PUBLIC EXPENDITURE WHITE PAPER

You asked for comments on the draft of the White Paper attached to your minute to the Prime Minister of 10 February.

Paragraph 4 of the preface about "Main Points" says that the Government intend cash aspects to predominate in medium-term expenditure planning. The point subsequently appears in paragraph 7 of Part 1.

I fully agree that our planning must in future pay much more attention to cash. But I am uneasy about making a commitment to the predominance of cash at this stage. I am not yet at all clear how it would work, either in relation to pay (where we are all too well aware of the difficulties of the present system), or in relation to the control of manpower. I attach great importance to being able to plan a rundown in terms of volume, ie in the numbers of civil servants. Until we can see and agree how the new system is to work I should prefer us to say that greater relative emphasis must be placed on cash but not to promise its predominance.

I am also worried by paragraph 6. I cannot agree that the assertions made in this paragraph are supported by the facts. Jim Prior answered a PQ on 28 January on relative movements of non-manual pay in the public and private sectors. His answer simply does not confirm that public service pay showed a marked improvement relative to private sector pay compared with 1970-72. On the contrary it appears that public service pay is relatively lower than then, after an increase in the mid-70's. If you wish to refer to a 50% increase in the two years 1978-79 to 1980-81 it is only fair to point out that this was a catching-up operation after two bleak years of incomes policy - that's one of the reasons why we don't hold with an incomes policy, isn't it?

Nor can I agree that it is right to contrast the public services with the private sector. The former excludes the nationalised industries where employment is falling, while the latter includes manufacturing industry.

The placing of paragraph 6 seems to suggest that the main object of cash planning is to reduce the rate of rise in the public services pay bill. I do not underestimate the importance of this. But the present sequence surely gives it undue emphasis. The argument about cash planning runs on well from paragraph 5 to paragraph 7. Would not a revised paragraph 6 be better placed with the passage on staffing in paragraph 23 (where the tone is somewhat different)?

My officials have also given yours a small amendment to paragraph 22 resulting from our declared intention to publish a White Paper on efficiency.

I am copying this letter to the Prime Minister, other members of the Cabinet, and Sir Robert Armstrong.

Yours ever

Christopher

SOAMES

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17/2 2pp's

MINISTRY OF DEFENCE
MAIN BUILDING WHITEHALL LONDON SW1
Telephone 01 ~~XXXXXX~~ 218 2111/3

MO 21/2/26

17th February 1981

Dear Terry,

PUBLIC EXPENDITURE WHITE PAPER

I am writing to confirm that the Defence Secretary is content with the defence chapter of the draft Public Expenditure White Paper circulated by the Chief Secretary on 10th February. My Secretary of State is also content with the thrust of Part 1, although as I explained on the telephone he would like a reference to defence to be included, picking up the language of Part 2.1.

I understand that Treasury officials have discussed where such a reference could best go, and are recommending to the Chief Secretary that a sentence on the following lines could be incorporated following that part of paragraph 21 of Part 1 which deals with law and order:

> "Similarly the plans provide for defence spending to increase in volume terms over the planning period in accordance with the Government's NATO undertaking to aim for real increases in the region of 3% a year."

This wording will be acceptable to my Secretary of State.

I am copying this letter to Tim Lankester (No 10), Stephen Boys Smith (Home Office), Francis Richards (FCO), and to David Wright (Cabinet Office).

Yours ever,

David Omand

(D B OMAND)

T F Mathews Esq

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SUBJECT

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Econ Pol, Public Sector Pay

Civil Service Pay.

File LPO/DS

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10 DOWNING STREET

From the Private Secretary

17 February 1981

The Prime Minister held a meeting this morning to discuss further the National Health Service and Civil Service cash limits and pay negotiations. In addition to your Secretary of State, the following were present: the Chancellor of the Exchequer, the Lord President, the Secretaries of State for Employment, Scotland, Wales, the Chief Secretary and Sir Robert Armstrong. They had before them Mr. Jenkin's minute of 13 February.

Mr. Jenkin said that he had been dismayed at the reports in last Friday's newspapers about the Government's proposals for dealing with NHS and Civil Service pay. These reports had cut the ground from under the NHS negotiators. In reaching their decision on the six per cent pay factor, Ministers had assumed that if a settlement was reached at seven per cent, the volume of spending would be protected to some extent by savings on account of the 11 per cent price factor. But in fact, volume was unlikely to be unaffected unless the pay settlement could be held to six and one-third per cent. NHS management were taking the view that once they began to offer money from the non-pay cash limit towards the settlement, it would be very hard to avoid further concessions. They did not wish to see volume cut, and accordingly they seemed prepared to stick at a six per cent pay offer even though this would almost certainly result in industrial action. If they did decide to move to 7%, the consequent volume squeeze would cause considerable political difficulties for the Government. For it would fly in the face of the pre-election commitment to maintain the growth of volume spending. He would be seeing the TUC Health Services Committee later that day at one of his regular meetings with them. He would put to them all the arguments about the need for restraint on pay if volume spending was not to be affected. But he thought it most unlikely that they would listen to these arguments. Because of the link with the local authority manuals, it seemed improbable that the unions would accept an offer of less than 7½%.

Lord Soames said that there was bound to be industrial trouble on a major scale if the Government tried to stick to 6% in either the NHS or the Civil Service negotiations. By offering 7%, there was some prospect of avoiding this.

/In view

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In view of the reports in last Friday's press, it was necessary for the management sides to put the 7% figure on the table rightaway. Given the fact that it had been decided to set the pay factor at 6%, it ought in his view to be possible to finance 7% settlements by a slight manpower squeeze (though in the case of the Civil Service this would be on top of the reductions already agreed) and possibly by some transfer of funds from non-pay expenditure.

In discussion the following points were made:

I Given that manpower in the NHS had risen by some 25,000 since the election, the squeeze consequent on a 7% settlement should not cause too much difficulty. When other programmes were being cut back, many people would be surprised to know that the health service was still expanding. Moreover, the recent report by the Controller and Auditor General seemed to indicate that there was scope for manpower savings.

II On the other hand, it was pointed out that the pre-election commitment had been quite clear, and hitherto Ministers had taken it fully into account in their public expenditure deliberations. The 25,000 manpower increase was an automatic consequence of allowing the volume of spending to increase, and most of the additional posts were medical staff rather than ancillaries or administrators. The increase in spending was itself justified by the UK's ageing population and the resultant increase in the number of patients that the NHS had to cater for. As regards the C&AG's report, DHSS officials were confident that most of its criticisms could be effectively rebutted: for example, the report failed to distinguish the staffing requirements of teaching hospitals from the staffing requirements of ordinary hospitals.

III Whatever the difficulties, the Government could not afford to increase the pay factor above 6%. If the unions insisted on taking out more than 6% in pay, they should be made to take the responsibility for any consequent volume squeeze. The argument should be turned against them to make it clear that they - and not the Government - were cutting volume and causing unemployment.

IV If the pay factor was to be held at 6%, the sooner it and the 11% prices factor were announced the better.

Summing up, the Prime Minister said that there could be no going back on the decision to set the pay factor for cash

/limits

limits at 6% and the prices factor at 11%. Pay settlements for the NHS and Civil Service would have to be negotiated within the cash limits thus set. In both cases, it seemed likely that the management sides would have to offer 7%; and if so, there would have to be some minor volume savings. The cash limit factors should be announced by Written Answer by the Chancellor of the Exchequer tomorrow (Wednesday).

I am sending copies of this letter to John Wiggins (HM Treasury), Jim Buckley (Lord President's Office), Richard Dykes (Department of Employment), Godfrey Robson (Scottish Office), John Craig (Welsh Office), Terry Mathews (Chief Secretary's Office) and David Wright (Cabinet Office).

I would be grateful if you and copy recipients could ensure that this letter has the same limited circulation within departments as the relevant minute of last Thursday's E Committee meeting.

T. P. LANKESTER

Don Brereton, Esq.,
Department of Health and Social Security.

PART 13 ends:-

16 . 2 . 81

PART 14 begins:-

17 . 2 . 81