PRIME MINISTER

Prime Minister (2)

8 July 1982

MCS 9/7

THE PUBLIC EXPENDITURE DEBATE

At the Cabinet discussion on Public Expenditure on 15 July, there will clearly be anxieties expressed about the modest rate at which output is recovering and the obstinately high level of unemployment.

It may also be argued that yet another "round of cuts" will do little to assist hope of economic revival.

It is tempting to defer a substantive discussion of these points, in view of the unhappy experience of the similar exercise last summer. Now that the Public Expenditure White Paper is published not in December but at the time of the Budget, there is certainly a case for not going into the recess on an acrimonious note. If the Treasury has no operational objections, it would be possible to start the whole exercise in September and still cover the ground thoroughly in good time. Postponement does, however, carry several risks:

(a) The press would get wind of the fact that the Cabinet had postponed meaningful discussion of the central issue. Indeed, the absence of any sparks flying would alert the newspapers to the postponement. This might be taken as meaning that the Treasury had ducked out of meeting the issue and that the Government was weakening in its commitment to the control of public expenditure.

(b) The same interpretation might also spread to the markets. Confidence is always hard to maintain over the financial "silly season". Without the Cabinet having left behind a clear indication of its unwavering determination, the summer holidays might well be an increasingly uncomfortable time. No doubt the position could be recouped somewhat in September, but vital ground might have been lost.

(c) In bilateral discussions with other departments, the Chief Secretary would be at a disadvantage, lacking any overall expenditure limit to back up the arguments for retrenchment. Experience may suggest that this overall limit is not final; even so, it is surely a useful reinforcement for the Chief Secretary.

(d) There is little reason to assume that the discussion would be any easier in the autumn. Indeed, the reverse, since some departments might have taken the delay as a signal to nudge their bids upward.

If well-defined public expenditure targets are to be established before the recess, it is essential to put the argument in a positive and political context. This public expenditure review is a central element in our plans to arrive where we want to be in May-June 1984 or October 1983.

Therefore, we should first remind colleagues of the important benefits to be gained by further restraint.

1. We all agree that falling interest rates are the best stimulant for recovery. Interest rates have now been falling steadily for more than 6 months. As inflation falls, we must retain this momentum, showing that British interest rates are and ought to be primarily determined by domestic monetary conditions and not by US rates and the defence of a particular exchange rate. Even the Daily Telegraph is now urging us to "decouple". But we can translate this attractive notion into action only if we are seen to stick rigidly to our targets for the PSBR.

2. Our aims for the 1983 Budget have to be kept firmly in mind at the start, and not left as a residual. We must index tax allowances fully. If possible, we would like to reduce taxes on low incomes to increase the incentive to work and to retain the loyalty of lower-income taxpayers who have done relatively poorly out of this Government. Beyond that, we wish also to have a modest amount in reserve to help specific industrial and other good causes. All this will require stringent control of public expenditure now if the books are to be seen to balance well enough to allow further falls in interest rates.

3. We are already committed to a huge expenditure on make-work employment subsidies and other methods of reducing the numbers on the employment register. Further such schemes are now in the planning stage. These schemes are of the highest political importance, and room has to be found for them in the Budget.

4. There is also a strong case for further help, apart from the reduction in interest rates, for the construction industry which has borne the brunt of the recession and has contributed so largely to the unemployment totals.

There is an increasing public dissatisfaction with the shabbiness of Britain. We expect our streets to be cleaner and our roads to be better maintained than in other countries. More and more people returning from holiday on the Continent make unfavourable comparisons. Potholed roads and collapsing sewers are a demoralising sight which may well exercise a subtle anti-Government influence. Such public works fall into a different category from many of the giant public investment schemes of which we are rightly so sceptical, such as rail electrification. First, they are essential works, whether financed by Government or, preferably, by private sources. Second, they cost more the longer the delay before tackling them. Third, they employ a great deal of unskilled labour which otherwise finds work hard to come by. Fourth, they can be contracted out to the private sector. A modest programme of rebuilding and cleaning up would have benefits out of proportion to the expenditure involved.

5. Above all, it is politically vital that we should keep inflation on a falling curve. Failing that, all the sacrifices will seem to have been wasted.

6. All these plus factors can be simultaneously achieved only by the most strenuous and unremitting control of public expenditure in all other fields. And this means, above all, maintaining the most stringent control of current expenditure, and in particular of public sector pay. It may help to remind colleagues that every 1% off the public service pay bill saves about £350m.

Each field bristles with difficulties. The Chief Secretary has already had to ask the nationalised industries to reduce their investment demands by £500m.

In social security, we have had the greatest difficulty in rolling back, even fractionally, the advance of indexation.

Defence - even regardless of the Falklands responsibilities - is now "super-indexed" because of the NATO 3% pledge.

We must not allow ourselves - let alone the outside world - to imagine that our series of public expenditure exercises, painful though they were, have succeeded in building in any permanent restraints on the growth of public expenditure.

We have had to back-pedal desperately and even so we have not managed to stay in the same place, and it is of the highest importance that everyone should understand this. Any suggestion that public expenditure is now a matter of secondary importance, which can be "put off until the autumn", would be highly damaging.

7. If we fail, the shape of the future is horrifyingly clear in the Treasury's study of <u>Public Expenditure in the longer-term</u>. The Chancellor estimates that, on a low-growth scenario, public expenditure might rise to no less than 46.8% of GDP by 1990/91 - a higher proportion than at any time since the disbanding of the War economy. Even on a somewhat optimistic assumption of 2½% growth per year, public expenditure would still be taking nearly 40% of GDP by 1990. And this omits the "creep" factor. Judging by all previous experience, the planning total tends to be added to as the year progresses. Cumulatively, outturn expenditure drifts upwards, setting higher base years for succeeding forecasts. The outturn for 1990 thus might be anywhere between 5-10% higher than the forecast If we continue to finance this level of expenditure honestly by taxing and not by borrowing, the implications for tax rates are extremely grim. If nothing else is changed and the money is to be raised out of direct taxation, a standard rate of 35p in the pound is a modest assumption. To avoid that intolerable prospect, we shall need to devise drastically new approaches to public spending.

8. But the long term starts now. And unless we continue to maintain - and intensify - our efforts to control public expenditure, there is every chance that we may be entering one of those periods, such as the early 1960s and early 1970s, when public expenditure simply gallops out of control.

Both Tory periods!

AW

FERDIN

ALAN WALTERS

We have had to back-pedal desperately and even so we have not managed to stay in the same place, and it is of the highest importance that everyone should understand this. Any suggestion that public expenditure is now a matter of secondary importance, which can be "put off until the autumn", would be highly damaging.

7. If we fail, the shape of the future is horrifyingly clear in the Treasury's study of Public Expenditure in the longer-term. The Chancellor estimates that, on a low-growth scenario, public expenditure might rise to no less than 46.8% of GDP by 1990/91 - a higher proportion than at any time since the disbanding of the War economy. Even on a somewhat optimistic assumption of 2½% growth per year, public expenditure would still be taking nearly 40% of GDP by 1990. And this omits the "creep" factor. Judging by all previous experience, the planning total tends to be added to as the year progresses. Cumulatively, outturn expenditure drifts upwards, setting higher base years for succeeding forecasts. The outturn for 1990 thus might be anywhere between 5-10% higher than the forecast If we continue to finance this level of expenditure honestly by taxing and not by borrowing, the implications for tax rates are extremely grim. If nothing else is changed and the money is to be raised out of direct taxation, a standard rate of 35p in the pound is a modest assumption. To avoid that intolerable prospect, we shall need to devise drastically new approaches to public spending.

8. But th[illegible]nless we continue to maintain - and in[illegible]ol public expenditure, there is eve[illegible]ing one of those periods, such as the[illegible]when public expenditure simply gallop[illegible]

FM

AW

FERDINAND MOUNT

ALAN WALTERS