

Ref A09400

PRIME MINISTERThe Longer Term: C(82) 30, 31, 32 and 33

BACKGROUND

Early this year, after the Chancellor of the Exchequer had expressed concern about the prospects for public expenditure in the longer term, you agreed that officials should set in hand an examination of the likely pattern of public expenditure over the next decade on the basis of a range of possible assumptions about growth and other factors. The resulting study by officials was circulated to the Cabinet (and has been re-circulated with C(82) 32) with the Chancellor's minute of 28 July, which suggested that the prospects revealed in the study were disturbing and that the Cabinet should have a broad-ranging discussion about the Government's long-term objectives for the size and shape of the public sector. He suggested, and you agreed, that the CPRS should be asked to prepare a paper outlining possible ways of making significant changes in the scale and pattern of public expenditure.

2. This line of thought is developed further in the Chancellor's memorandum (C(82) 30), and the accompanying note by Treasury officials containing projections of tax revenue and borrowing.

3. The memorandum by the CPRS (circulated with C(82) 31) discusses a number of radical options for achieving substantial reductions in the longer-term. The memorandum by the Secretary of State for Defence (C(82) 33) argues against one of these options, a levelling-off of defence expenditure after 1985-86 rather than a continuance of 3 per cent annual growth in volume.

4. The Treasury notes on expenditure and taxation explore two economic scenarios -

Scenario A: GDP grows at an average rate of $2\frac{1}{2}$ per cent a year; unemployment falls to 2 million by 1990-91; and inflation runs at 5 per cent a year in the middle and late 1980s.

Scenario B: GDP grows at an average of $\frac{3}{4}$ per cent a year to late 1985-86, then at $\frac{1}{2}$ per cent a year to 1990-91; unemployment is 3 million in 1990-91; and inflation runs at 10 per cent a year in the middle and late 1980s.

Under both scenarios real wages in the market sector are assumed to increase at $1\frac{1}{2}$ per cent a year; but under Scenario A, productivity in the market sector is assumed to increase at 3 per cent a year, implying a significant increase in profits.

5. The expenditure, taxation and borrowing projections under the two scenarios are set out in the table annexed to this brief, which also sets out comparative figures for 1982-83. The Chancellor argues that the outlook under Scenario B is unacceptable: in order to contain the borrowing requirement at a tolerable level taxes would have to be raised to levels which would wreck the Government's whole economic and political approach (and would probably lead to serious evasion, involving still higher nominal rates of tax).

6. The Chancellor also argues that even the outlook under Scenario A is not really acceptable, on the grounds that the expenditure figures are probably understated; that in order to improve incentives and profitability reduction in taxation will be needed; and that it will not be possible to do this, consistently with a tolerable borrowing requirement, unless expenditure is lower than projected. In any event, it would be imprudent to plan on the assumption that the economy will develop as favourably as Scenario A implies.

7. He therefore concludes that it is essential to study ways of creating room for manoeuvre in public expenditure. He does not seek specific cuts at this stage, but suggests that the options identified in the CPRS memorandum should be studied and the results reported to Cabinet in the Spring of 1983. He also proposes -

- i. that Ministers should make no further public commitments which would add significantly to expenditure beyond 1985-86, and should avoid repeating former pledges which would otherwise expire;
- ii. that in this year's Public Expenditure Survey particular regard should be paid to the longer-term indications of decisions; and
- iii. that Ministers should consider further how the issues should be presented publicly.

MAIN ISSUES

8. The importance of this meeting lies in the opportunity it provides for the Cabinet to lift their eyes from current and short-term preoccupations and to focus on what they would like the shape of things in this country to be at the end of the decade. The discussion should be not just on the size of public expenditure in relation to the gross domestic product but about the role of the Government and the public sector, particularly in the fields of education, health and the social services. If broad political judgments and conclusions on chosen matters can be established, they will give a basis for and a sense of direction to the discussion of specific options. It would be better to use the time in that way than in detailed discussion and criticism of the Chancellor's projections and scenarios.

THE PROJECTIONS

9. The projections are stylized and in no sense forecasts; but, on their own terms, it is hard to see much wrong with them. The projections for individual expenditure programmes have been discussed between departments at official level. The Ministry of Defence have complained that it is unfair to draw attention in paras 15 and 16 to the increase in the share of GDP devoted to defence and the fact that in cost terms the projected percentage increase in the defence programme is greater than that for other programmes, without reminding the reader that the social security programme is about twice the size of the defence programme. This is what Mr Nott is referring to in the first sentence of paragraph 4 of C(82) 33. However although some Ministers may complain about presentation there is so far as we know, no disagreement about the figures.

THE PROSPECTS

10. There may be criticism of the Chancellor's argument that the projections reveal an unacceptable prospect. Possible lines of arguments are as follows -

a. 'Scenario B is not realistic.' It may be said that if, for a decade, growth remained at little more than $\frac{1}{2}$ per cent a year and inflation at 10 per cent, and unemployment was permanently over 3 million (the 3 million given in the note by officials is the narrow definition - the 'headline figure' would be significantly larger), there would be profound social and political upheavals. To plan for Scenario B is therefore to plan for disaster. Moreover, Scenario A may be optimistic by comparison with our own performance for much of the 1970s; it is less so by comparison with the 1950s and 1960s in the United Kingdom, or even later in other countries.

b. 'The prospects under Scenario A are less serious than the Chancellor suggests.' His argument that the expenditure figures are understated may be challenged (the health figures, for example, allow for significant real growth; it may be possible, with faster economic growth, to cut back substantially on expenditure on industrial support and employment and training measures); and there may be room, as real incomes grow, to improve incentives by a further switch from direct to indirect taxation. It may

also be suggested that his arguments about the need to reduce the size of the public sector are overstated since the Government's privatisation programme will achieve a much larger transfer of economic activity to the private sector than appears in the public expenditure figures. (The public expenditure figures include only the external financing requirements of the nationalised industries; a much better measure of the importance of their economic activity is their turnover.) The Government certainly regards defence and law and order as essential public sector activities and has made clear its intention to increase expenditure on them.

c. 'The prospects, if realistic, cast doubt on current economic policies.' Some of your colleagues may wish to broaden the discussion out to include short-term economic prospects and policies. However, the purpose of the meeting is to discuss the longer-term. Moreover it is a misunderstanding of the Chancellor's argument to suggest that the modest economic performance implied by the two scenarios calls the Government's basic economic policy into question. The scenarios are not forecasts; and the Chancellor is arguing that a reduction in the relative size of the public sector is a necessary condition of being able to improve on them (and perhaps even to achieve an outcome as favourable as Scenario A).

WHAT IS TO BE DONE?

11. Your colleagues will naturally see a link between the question whether the prospects sketched in the papers are unacceptable and the question of what should be done to change them. At the extreme, some may argue that to adopt any of the radical proposals discussed by the CPRS would be even

more unacceptable than the prospects on unchanged policies. But the meeting will have failed in its purpose if Ministers collectively are not willing at least to contemplate the possibility of radical action. If they are willing to contemplate that, then it would probably be best to say that all options should be remitted for further study, unless there are any that you and your colleagues think so unrealistic that it would be a waste of time to study them. If many areas are exempted from study, it will be more difficult to persuade those whose responsibilities are not exempted to give full co-operation.

OPTIONS DISCUSSED BY THE CPRS

12. For the most part, the considerations relating to the proposals discussed in Annexes A to K of the CPRS paper (C(82) 31) are very clearly set out, and the paper serves as its own brief. But in a few cases there are additional points that you may wish to bear in mind, or which seem worth emphasising further.

i. SMALLER PROGRAMMES (ANNEX A)

There may be more to be looked at in the field of housing than the note suggests. Increasing rents - and relating rents more closely to standards of accommodation - should reduce the demand for housing and so save money indirectly as well as directly. If such possibilities are to be looked at, it will be for question whether it is necessary also to look again at mortgage interest relief.

ii. PUBLIC SERVICE MANPOWER (ANNEX B)

The Cabinet is not being asked to take immediate decisions on Civil Service manpower. Treasury Ministers intend to bring forward a paper on this subject to Cabinet before the end of this year.

It will be important to ensure that any study of reduction in expenditure outside central government includes a study of methods of enforcement. There is, for instance, little point in constructing public expenditure programmes on the assumption that local authorities will reduce manpower simply in response to Government exhortation.

iii. ACCOUNTING CHANGES (ANNEX C)

As the CPRS point out, these changes would be purely cosmetic, and would have no effect on the balance of the economy.

iv. PRIVATE HEALTH INSURANCE (ANNEX E)

As the Annex implies, it will be important to be clear whether the aim is to reduce taxation and the size of the public sector or 'national overheads' - the burden on productive industry and commerce. If it is the latter, private health insurance could even be counter-productive, for the reasons given in paragraph 6 iii. of the Annex.

v. CUTTING SOCIAL SECURITY BENEFITS (ANNEX J)

If Ministers are willing to 'think the unthinkable', they may wish to consider more radical changes in the structure as well as the value of social security benefits. Is it, for example, necessary to provide indefinitely a comprehensive system of widows' pensions if women are expected to become economically more self-sufficient?

13. There are also some more general questions (including those discussed in paragraph 15 of the CPRS memorandum) which Ministers may wish to have considered, either as points to be taken into account in whatever specific studies may be commissioned or as subjects in their own right, for example -

i. As is pointed out several times in the paper, public expenditure has a strong tendency to increase, almost irrespective of circumstances. (It is, for example, striking that the levels of expenditure projected under Scenarios A and B are virtually the same.) What are the reasons

for this? Is it largely as the Chancellor implies, a matter of changing public expectations which can be achieved by the necessary degree of political will and a major effort of public education? Or are there other causes which need to be identified and remedies found for them?

ii. There is little pressure in much of the public sector to find ways of doing the same thing at lower cost. It appears, for example, to be taken for granted in Annex 2.11 to the officials' note on the expenditure projections that improvements in medical care will mean more expenses. But industry would probably think it as important to find ways of doing the same thing at less cost as to find ways of doing new things. Can more of this approach be imported into public service?

iii. As paragraph 15b. of the CPRS memorandum points out, some of the options, involving new charges with reliefs for the less well-off, would have important effects on incentives. Should there be a study of the structure of taxation, benefits and public sector charges in the longer term?

iv. A related question is the extent to which the problem discussed in the papers is a problem of the prospective total tax burden or a problem of high nominal rates of direct taxation. If it is solely the former, reductions in prospective expenditure are the only solution. But if it is partly the latter, it strengthens the case for examining the structure of the tax system, including tax relief.

ORGANISATION OF STUDIES

14. If there is to be a programme of far-reaching studies by officials, it will need to be carefully organised. At the meeting, I suggest that you should say that you yourself will consider how it should be set up. I will then offer you further advice when it is clearer what the exact scope of the studies is to be.

PUBLIC PRESENTATION

15. It is implicit in much of the discussion that public opinion has come to expect an ever-increasing provision of public services. If this expectation is to be reversed, a major campaign of public education will be needed. You may wish to ask the Chancellor of the Exchequer to bring forward specific proposals in the light of the discussion.

HANDLING

16. I suggest that it will be convenient to break the discussion into two parts. (This will fit in well with the suggestions in the Chancellor's minute of 27 August to you - not copied to other Ministers), ie -

i. A general discussion, relating mainly to the two Treasury papers, (C(82) 30 and 32), on the prospects for public expenditure, taxation and borrowing over the period to 1990-91, and what the Government's broad aims and strategy ought to be.

ii. A discussion, relating mainly to the CPRS paper (C(82) 31), of the options which might be studied for bringing public expenditure in the longer-term more in line with the Government's preferred strategy.

17. Depending on how the discussion goes, the first part might be taken before lunch and the second in the afternoon.

18. You will wish to invite the Chancellor of the Exchequer to introduce the first part of the discussion. All your colleagues will wish to contribute; but I suggest that it will be desirable to try to avoid discussion of purely departmental points (unless they have a significant bearing on the prospects for expenditure or taxation) and concentrate on the broad political aspects.

19. For the second part of the discussion, you will wish to ask Mr Sparrow to introduce the CPRS memorandum. You might then go through each of the Annexes to that paper in turn, inviting comments from the responsible Minister or Ministers (there are, in particular, important Scottish and Welsh dimensions to education, health and local authority matters).

The Secretary of State for Defence will presumably wish to speak on his paper (C(82) 33). The Chief Secretary, Treasury may also wish to offer comments on individual programmes. You might then ask for additional suggestions, whether general or particular; or advance any which seem to you to merit further study.

CONCLUSIONS

20. You will wish the Cabinet to reach conclusions on the following -

a. whether, as the Chancellor of the Exchequer recommends in C(82) 30, there is a need for a new and fundamental look at levels of public spending; which calls for a programme of studies by officials reporting back in (say) six months;

b. whether, as part of the new and fundamental look at public spending, there should be studies relating to -

i. Health (increased and extended health charges - Annex D and private health insurance - Annex E);

ii. Education (cutting spending - Annex F, charging - Annex G, and charging for higher education - Annex H);

iii. Social Security (breaking the link between benefits and prices - Annex J);

iv. Defence (Annex K);

v. Smaller programmes (Annex A);

vi. Public service manpower (Annex B);

vii. Accounting changes (Annex C);

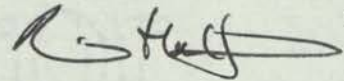
viii. Any other subjects proposed in discussion.

c. whether it is agreed, as recommended in C(82) 30 -

i. that no further public commitment should be made adding significantly to expenditure in the longer-term, and that pledges which would otherwise expire should not be extended;

ii. that in the 1982 Public Expenditure Survey particular regard should be paid to longer-term implications;

iii. that further consideration should be given to the public presentation of the issues.



Approved by
ROBERT ARMSTRONG
and signed in his absence.

8 September 1982

	<u>1990-91</u>				<u>1982-83</u>	
	<u>Scenario A</u>		<u>Scenario B</u>		<u>£m*</u>	<u>% gdp</u>
	<u>£m*</u>	<u>% gdp</u>	<u>£m*</u>	<u>% gdp</u>		
Programme totals	109.0	36.9	107.5	<u>43.8</u>	95.5	40.7
Debt interest	7.0	2.4	7.5	3.0	7.5	3.3
	—	—	—	—	—	—
Total public expenditure	116.0	39.3	115.0	46.8	103.0	44.0
<u>less</u> taxation	109.9	37.2	97.4	39.7	92.1	39.4
	—	—	—	—	—	—
Borrowing requirement	6.1	2.1	17.6	7.1	10.9	4.6
	—	—	—	—	—	—

* At 1980-81 cost terms or prices.