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CM(76) 13th
Conclusions

COPY NO 85

CABINET

CONCLUSIONS of a Meeting of the Cabinet
held at 10 Downing Street on

TUESDAY 6 JULY 1976

at 10.00 am

PRESENT

The Rt Hon James Callaghan MP
Prime Minister

The Rt Hon Michael Foot MP
Lord President of the Council

The Rt Hon Lord Elwyn-Jones
Lord Chancellor

The Rt Hon Roy Jenkins MP
Secretary of State for the Home Department

The Rt Hon Denis Healey MP
Chancellor of the Exchequer

The Rt Hon Shirley Williams MP
Secretary of State for Prices and Consumer Protection and Paymaster General

The Rt Hon Anthony Wedgwood Benn MP
Secretary of State for Energy

The Rt Hon Eric Varley MP
Secretary of State for Industry

The Rt Hon Peter Shore MP
Secretary of State for the Environment

The Rt Hon Roy Mason MP
Secretary of State for Defence

The Rt Hon Bruce Millan MP
Secretary of State for Scotland

The Rt Hon John Morris QC MP
Secretary of State for Wales

The Rt Hon Merlyn Rees MP
Secretary of State for Northern Ireland

The Rt Hon Fred Peart MP
Minister of Agriculture, Fisheries and Food

The Rt Hon Albert Booth MP
Secretary of State for Employment

The Rt Hon Edmund Dell MP
Secretary of State for Trade

The Rt Hon David Ennals MP
Secretary of State for Social Services

The Rt Hon Harold Lever MP
Chancellor of the Duchy of Lancaster

The Rt Hon Lord Shepherd
Lord Privy Seal

The Rt Hon Fred Mulley MP
Secretary of State for Education and Science

The Rt Hon Reginald Prentice MP
Minister for Overseas Development

The Rt Hon John Silkin MP
Minister for Planning and Local Government

THE FOLLOWING WERE ALSO PRESENT

The Rt Hon Michael Cocks MP
Parliamentary Secretary, Treasury

The Rt Hon Joel Barnett MP
Chief Secretary, Treasury

SECRETARIAT

Sir John Hunt
Mr D le B Jones
Mr J A Marshall

S U B J E C T

PUBLIC EXPENDITURE

PUBLIC EXPENDITURE

Public expenditure was considered by the Cabinet. Their discussion and the conclusions reached are recorded separately.

Cabinet Office

6 July 1976

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CABINET

LIMITED CIRCULATION ANNEX

CM(76) 13th Conclusions

Tuesday 6 July 1976 at 10.00 am

PUBLIC EXPENDITURE

The Cabinet had before them a memorandum by the Chancellor of the Exchequer (CP(76) 42) proposing reductions in public expenditure in 1977-78; a memorandum by the Secretary of State for Energy (CP(76) 43) proposing an alternative course of action; and a note by the Chancellor of the Exchequer (CP(76) 40) covering the 1976 report by the Public Expenditure Survey Committee (PESC).

THE CHANCELLOR OF THE EXCHEQUER said that it was essential to keep both the economy and the social contract afloat. He had resisted pressure for unjustified cuts in public expenditure in 1976-77; but in his view the prospect of economic growth in 1977-78 and 1978-79 could be threatened by excessive domestic consumption, both private and public. The provisional Short Term Economic Forecast, showed that the economy was growing faster than had previously been assumed; Gross Domestic Product (GDP) was likely to grow by 5 per cent between mid-1976 and mid-1977 with a growth of 9 per cent in manufacturing output. These rates were high by past standards, but it would be necessary to maintain them for three years if the Government's employment target was to be achieved. Manufacturing investment in 1976-77 was likely to be 15 per cent higher than in the preceding year; and unemployment was unlikely to rise above its present level. The improved growth prospects were based on exports, which were expected to grow by 11 per cent in volume in 1976 and 12 per cent in 1977, mainly because British products were now very competitive. On the external side, however, the change in the terms of trade, and the J-curve effect of devaluation, meant a deterioration in the balance of payments. Commodity prices were rising higher and faster than had been expected, and invisible earnings were likely to be lower next year than this. The balance of payments deficit in 1976 was now expected to be about £500 million, while in 1977 it would be up to £2,000 million on present policies, and there was no sign of any improvement thereafter.

In resource terms the problem was whether industry would have the capacity to cope with the extra demand for exports and import-substitution without the development of bottlenecks. The danger was that domestic demand might be excessive, particularly if the private savings ratio were to fall. The main problem, however, was one of financing the country's external deficit over the next two years. If overseas lenders were to allow us to borrow £3,500 million, they would need to be satisfied about the viability of the country's economic strategy. They - the International Monetary Fund (IMF) and the individual countries from whom we might borrow - were concerned about the growth of the money supply with a high public sector borrowing requirement (PSBR). It was true that, as economic activity revived, the PSBR should fall from £11,500 million in 1976-77 to £10,500 million in 1977-78 on present policies (and assuming no revalorisation next year of tax allowances); but no other country was planning to continue with as high a Government borrowing requirement. Indeed the United States, France and Germany were all planning to cut or eliminate their deficits.

It would be no solution to raise interest rates since this would choke off economic recovery, or to allow the money supply to grow and feed inflation. It was in his view essential to reduce the prospective PSBR next year by a further £1,000 million. This could be done in theory either through taxation or through public expenditure, but it would not be safe to make the whole of the required reduction by taxation. This would require an increase of 3p in the standard rate of income tax, which would cost the single man £1.38p a week from his pay at a time when real take home pay would be falling and would be likely to wreck the pay policy. If, instead, the sum required were raised through indirect taxes, that would add some 2.7 per cent to the Retail Price Index. It was therefore necessary to do as much as possible by public expenditure reductions. His memorandum suggested cuts of £1,250 million in the programmes listed in Cmnd 6393, which would reduce the PSBR by £1,000 million; but he was prepared to settle for cuts of £1,000 million, which would take £700 million off the PSBR. In announcing cuts of this magnitude, he would have to make clear what the Government's objective for the PSBR was in 1977-78 and also to announce that steps were being taken to limit the money supply. In addition to the resources and financing arguments for this course, he had to emphasise the precarious nature of the external confidence problem. The slide in the exchange rate at the end of May would have led to catastrophe had not the $5,300 million standby been made available - and even so further money had had to be spent subsequently to keep the rate steady. If the PSBR next year were not reduced, there was a serious risk of a run on the pound of a magnitude which using the whole of the standby credit could not stem. After the last drawing from the IMF, some foreign borrowings, and some drawing from the standby, the United Kingdom reserves stood at around $5,000 million. The remaining credits available from the IMF would not in fact be sufficient to repay the whole of the standby - and there was still the problem of financing the deficit for the remainder of 1976 and 1977. Early action was therefore essential if a sterling crisis in August, which could necessitate even more painful decisions in an emergency situation, was to be avoided. He therefore recommended the cut of £1,000 million in public expenditure proposed in his paper.

THE SECRETARY OF STATE FOR ENERGY said that he was opposed to the expenditure cuts which the Chancellor of the Exchequer was recommending; and he very much regretted the publicity given to this recommendation since it meant that if the Cabinet did not agree they might well precipitate the crisis of confidence which the cuts were designed to avert. He noted that the cuts required were of the order of £1,000-£1,250 million, plus the reabsorption of the additional bids of some £1,600 million listed in the PESC report, making a total reduction of nearly £3,000 million. The Cabinet had seen no specific financial forecast of the likely size of the public sector borrowing requirement, and no quantitative forecast of the extent to which it would fall as economic recovery proceeded. Nor were any tax options set out in the Chancellor's paper. He did not deny that there were very real problems to be dealt with. On the political plane, the Opposition had aligned themselves with the market to shake confidence in the Government. The trade unions and the Labour Party had been told that wage claims led to inflation, and in response to this they had now agreed to a restrictive wages policy. They had been told that strikes caused industrial disruption, and industrial disputes were now at a very low level. Having gone so far to meet the Government, were they now to be told that there would have to be further public expenditure cuts? This could only lead to a fatal erosion of the Government's relationship with the trade unions. In economic terms, the PSBR would fall as economic growth built up. The industrial and resource arguments which had been put forward were weak - the country was not in a raging boom, but was at the bottom of a slump, and there was certainly no need to reduce demand to make room for industrial investment and exports. On the international monetary front, the country was very vulnerable as a result of the £7,000 million of short-term sterling holdings in London, which meant that the confidence arguments had to be taken seriously; but the Government should consider possible ways of funding this short term debt and winning the support of the international monetary community for doing so. In his view it was essential to retain the confidence both of the Trades Union Congress (TUC) and the IMF, and therefore to have discussions with both. Public expenditure should be reviewed in accordance with the normal timetable, and no doubt in the process there would be some scope for savings, but drastic public expenditure cuts would not touch the real problems of the country which were to use and expand industrial capacity by concentrating imports on industrial re-equipment and restraining imports for consumption. Taxation on goods with a high imported content could be increased; and steps should be taken to ensure that the higher profits arising from the relaxations in the Price Code were in fact devoted to industrial investment. A long and searching discussion with the IMF was possible because the IMF did not wish to bring about a fall in sterling and knew that the maintenance of the social contract was essential to continued good government in this country. Only through discussion with the IMF could appropriate financial targets be identified.

In discussion, a good deal of doubt was cast on the validity of the resource arguments for cutting public expenditure in 1977-78. Retail sales were not buoyant, and the effect of the pay limit would surely be to keep private consumption fairly flat. Some of the proposed cuts - in housing and subsidies - would in fact have effects in 1976-77, when recovery was certainly not under way. The Treasury forecasts were more optimistic than those of the National Institute for Economic and Social Research. If the cuts proposed were made they could add some 30-40,000 or more to the total of unemployed in 1976-77, rising perhaps to 70,000 by mid-1978 - although by the latter period unemployment as a whole would of course be falling. There might well be growth in output from an export-led boom; but it did not follow that unemployment would fall correspondingly quickly, since it was well known that employment lagged behind output. Industry would, in the early stages of the recovery, increase production by the more efficient use of their existing resources. It would be important for Cabinet to have detailed information on the unemployment implications of both the £1,000 million of cuts now proposed, and of the £1,600 million of additional bids which had to be eliminated or offset. One possibility would be to state firmly that the Government would not exceed the published public expenditure figures but would certainly not take further steps which would add to unemployment. Indeed there was a good case for preparing an unemployment package to put more money into areas of high unemployment. Unless something of this kind were done, the Government's relationship with the trade unions would be eroded. The concept of shifting resources into the balance of payments and industrial investment could be highly relevant to 1978-79, but not to 1977-78; and the argument that insufficient savings would be available in 1977-78 to meet all needs was weak, since industry was already more liquid than last year and would be getting the benefits of the changes in the Price Code. Against this it was argued that the resources argument was even more important than had been suggested. If large sums had to be borrowed abroad, this would inevitably force up interest rates - and United Kingdom rates were already higher than those of our trading competitors - and thus hold back the industrial investment needed. Even if the resources argument related more to 1978-79 than to the previous year, it was hard to believe that economic forecasting could be so precise about particular periods. If action were left for a further year, it might well be too late to exploit the enormous opportunities of the economic upturn. In 1976, even though the United Kingdom was more competitive than it had been for a long time, its share of world trade was likely to drop. If that share were to be maintained, there would certainly be capacity problems in some parts of British industry (eg motor car production), and if private savings were reduced, there could well be an increased demand for consumer durables. The resources problem was therefore a real one.

On the question of confidence, it was argued that any measures to cut public expenditure by £1,000 million would jeopardise the maintenance of the pay policy, not just because of the addition of one-quarter of a per cent to the Retail Price Index, but because of the political and trade union consequences of cutting such services as housing and education. This in turn could damage international confidence as much as the PSBR which the cuts were designed to reduce. Furthermore the damage would not be confined to the relationship with the trade unions, but would spread to the Government's relations with the Parliamentary Party and with Labour local authorities, from whom the cuts would evoke a bitter response. On the other hand, it was argued that the real question was whether a reduction of £1,000 million in the PSBR next year would be enough. There had been pressure for a cut of £2,000 million in the borrowing requirement; and for this reason it might - depending on how far the situation improved as a result of economic recovery - be necessary to make some tax increases next year in addition to expenditure cuts this year. It was noted that, but for the standby credit at the beginning of June, the rate could have dropped to, say, $1.50, which would have added 7 per cent to the Retail Price Index and have produced cataclysmic financing problems. The standby credit was obtained only on condition that the United Kingdom went to the IMF if, at the end of the 6 months, it was unable to repay any drawings; and it was noted that not all the contributors to the standby believed that it would provide sufficient stability to last for 6 months. The truth was that the situation had been extremely serious when the credit was negotiated, and the Cabinet could easily have found themselves having to conduct the present discussions against the background of a plunging rate. The risks were highly asymmetrical: the potential dangers flowing from taking no action were far greater than any which could possibly flow from the kind of action now proposed. The problems were real, and were known to our creditors, who could see our large balance of payments deficit, the likelihood of it increasing, the rate of inflation still higher than that of other countries and the high accumulation of debt. All these considerations made action of the kind proposed by the Chancellor of the Exchequer essential.

On the question of what action should be taken, it was argued that it was unnecessary to take the whole of the burden of reducing the PSBR in the form of cuts in expenditure. Such cuts would begin to bite in the spring of 1977, when settlements under the second round of the social contract were being made, and when discussions would be in train about what might succeed Round 2. The selection of cuts proposed was highly regressive in its social impact; cuts in housing expenditure and subsidies would hit those less well-off and would be very unwelcome to the trade unions. The Cabinet should be given material to enable it to consider tax increases as an alternative to some expenditure cuts, so that a mixed package might be evolved. It was true that taxes on alcohol and tobacco increased the Retail Price Index, but this would be more defensible than increasing the cost of essentials by reducing food subsidies. Not only should some tax increases be included, but the possibility of actually increasing expenditure on some programmes - urban deprivation and employment - so as to present the package as a reordering of priorities, should be considered. It was also argued that it would be important, if any package were to be sold to the trade unions, that the investment programmes of the public sector of industry should go ahead and that the National Enterprise Board should not be starved of resources.

On the question of consultation, there was a wide measure of agreement that it would be essential, preferably before the Government had taken any final decisions, to consult both the Parliamentary Labour Party and the TUC. In the latter case the difficulties of the position of the TUC representatives on the National Economic Development Council and the inadequate extent to which they reflected the views of the public sector unions, had to be borne in mind. The aim would be to explain fully and frankly the difficulties which the Government faced, and to invite views on the action which, in this situation, the Government should take. The exercise would need to be presented to the trade unions as an essential step to the strengthening of our industrial base. It must be genuine consultation, and it was for consideration whether it should not also extend to the Labour local authorities and perhaps also to a joint meeting between the Cabinet and the National Executive Committee of the Labour Party.

In the course of further discussion the following additional points were made -

a. While there was much to be said for making arrangements to fund the existing £7,000 million of short-term debt if this could be done, there was no prospect of doing so without a good deal of help from other countries, help which would not be forthcoming unless they were completely satisfied with the United Kingdom's position and policies.

b. To open up a dialogue with the IMF before taking decisions on public expenditure could be disastrous. The IMF would demand changes in policy more severe than those proposed by the Chancellor of the Exchequer; and such demands would leak and be very damaging for the Government, both politically and in relation to external confidence. Indeed in the normal annual consultation with the Fund staff in May, the IMF had taken the view that the United Kingdom should cut the PSBR by £2,000 millin and should face higher unemployment. Nor could too much be made of the argument that the United Kingdom could rely upon the IMF's unwillingness to see sterling drop heavily. The Fund might prefer not to see it drop, but sterling was no longer the lynch-pin in the world monetary system which it had once been.

c. The United Kingdom presented its public sector borrowing requirement figures in a manner which was disadvantageous to its interests. It was appreciated that it was not possible to change the presentation immediately, but it was a matter which called for later consideration. It was noted that arrangements were already being made to publish a figure for the general Government deficit, which would exclude the borrowing on account of the nationalised industries' investment needs.

d. Finally it was pointed out that the public expenditure reductions proposed in the paper by the Chief Secretary attached to the Chancellor of the Exchequer's memorandum represented his assessment of what was technically and administratively feasible. It would be for Cabinet to judge how far they were politically possible also. Because of the time constraint, it would be necessary for the Chief Secretary to proceed forthwith to conduct bilateral discussions with the spending Ministers, but the nature of such discussions made it difficult to consider the overall effect of the proposed changes on the Government's priorities. It would be desirable for Cabinet to have an opportunity to discuss the general shape of the emerging package after there had been a discussion with the Parliamentary Labour Party. At the same time it would be necessary to take into account the employment implications of the proposals, including the action to eliminate or provide savings in place of the £1,600 million of additional bids shown in the PESC report.

THE PRIME MINISTER, summing up the discussion, said that in the course of discussion a range of views had been expressed, but, whether on resource grounds or for confidence reasons, there seemed to be a majority in the Cabinet which favoured an early statement by the Government of action to reduce next year's public sector borrowing requirement. No final decisions were however being taken at the present meeting. Whether any action taken should consist wholly, or only partly, of reductions in public expenditure was a matter which would need to be discussed further, as would the composition of any particular package of cuts. There was widespread agreement that it would be essential, if the Government were to maintain the confidence of its supporters in Parliament and not damage its relations with the trade unions, for there to be early consultation both with the Parliamentary Labour Party - which should take place the following week - and with the Trades Union Congress. There was a general feeling that this should be genuine consultation, to be held before the Government had reached any final decisions on what they should do; but at the same time it was recognised that the Government could not put the decisions into commission, and that having listened to the reactions of and advice from the Party and the TUC, they would then have to decide themselves the content and timing of any public announcement. The Cabinet would consider the issues further at a meeting in the middle of July, at which the general shape of a possible package, and the possibility of including some taxation adjustments as well as some possible increases in certain expenditures, particularly on unemployment and urban deprivation could be considered. In the meantime, the Chief Secretary, Treasury should proceed to have bilateral discussions with the spending Ministers on a contingent basis with a view to identifying as far as possible those areas on which it might be possible to agree that, if Cabinet eventually decided that expenditure cuts were essential, such cuts might fall. In making this selection, it would be important to have regard to the effects upon employment of particular cuts, and this information should as far as possible be made available to Cabinet, who would also need information on the tax changes which might form part of the package, including their likely effect upon the Retail Price Index. The bilateral discussions should also cover the handling of the additional bids of £1,600 million shown in the PESC report which the Cabinet were agreed must either be eliminated or replaced by other savings. In a difficult situation it was essential to preserve both solidarity in the Cabinet and also complete confidentiality about their discussion. This had been a useful one, but the decisions remained to be taken.

The Cabinet -

1. Took note with approval of the Prime Minister's summing up of their discussion.

2. Invited the Chief Secretary, Treasury, to hold bilateral discussions on a contingent basis with the spending Ministers to identify those areas in which public expenditure reductions might be made if, in due course, the Cabinet decided that such reductions were necessary; to determine how the additional bids of £1,600 million should be handled; and to report back by 15 July.

3. Invited the Chancellor of the Exchequer to circulate information about the estimated employment effects of possible expenditure reductions, and information about possible tax adjustments and their likely effect upon the Retail Price Index.

4. Agreed to resume their discussion at a later date.

Cabinet Office

7 July 1976