PO CH/GH/0158 Pt. A
PART. A

PO/CH/GH/0158
PART. A.

CONF

PUBLIC EXPENDITURE IN THE LONGER TERM 1982

27-8-82

DD'S 25yrs N.Ajy
13-3-97

THIS FOLDER HAS BEEN
REGISTERED ON THE
REGISTRY SYSTEM

FROM: T F MATHEWS

20 January 1982

CHIEF SECRETARY TO THE TREASURY

PRINCIPAL PRIVATE SECRETARY

PS/Chief Secretary
cc Financial Secretary
PS/Economic Secretary
PS/Minister of State (C)
PS/Minister of State (L)
Sir Douglas Wass
Sir A Rawlinson
Sir K Couzens
Mr Barratt
Mr Ryrie
Mr Burns
Mr Wilding
Mr Byatt
Miss Brown
Mr Kemp
Miss Kelley
Mr Monger
Mr Hansford
Mr Mountfield
Miss Peirson

LONG TERM PUBLIC EXPENDITURE PROSPECTS

The Chief Secretary has seen Mr Barratt's submission of 19 January covering a draft Cabinet Paper. The Chief Secretary thinks the draft paper strikes just the right note, and he is attracted by Mr Barratt's suggestion that it should take the form of a minute from the Chancellor to the Prime Minister.

TM

T F MATHEWS

14/25/1

CONFIDENTIAL

FROM: J.O. KERR
22 January 1982

cc: PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State (C)
PS/Minister of State (L)
Sir Douglas Wass
Sir Anthony Rawlinson
Sir Kenneth Couzens
Mr. Ryrie
Mr. Burns
Mr. Wilding
Mr. Byatt
Miss Brown
Mr. Kemp
Miss Kelley
Mr. Monger
Mr. Hansford
Mr. Mountfield
Miss Peirson

MR. BARRATT

LONG-TERM PUBLIC EXPENDITURE PROSPECTS

The Chancellor was grateful for the draft paper attached to your minute of 19 January. He agrees that it properly discharges the remit from Chevening, but he has decided - after discussion with the Chief Secretary - not to put it to Cabinet colleagues, or indeed to the Prime Minister, at this juncture.

2. The principal reason for this change of course is that the Chancellor has decided, on reflection, that it might be a mistake for him to put a further paper round Cabinet before 28 January. A secondary reason is that some of the ground was, I understand, covered at a meeting of MISC 14 on 20 January (the minutes of that meeting are not yet available).

3. This is not intended to be a postponement sine die. Perhaps when the MISC 14 minutes are available, and next week's Cabinet is out of the way, you could submit further advice on timing.

J.O. KERR

18/150
8/2

SECRET

Mr Rayner

PA

Financial Secretary
Economic Secretary
Minister of State
Minister of State
Sir Douglas Wass
Sir Anthony Rawlinson
Sir Kenneth Couzens
Mr. Ryrie
Mr. Burns
Mr. Wilding
Mr. Byatt
Mr. Barratt
Miss Brown
Mr. Kemp
Miss Kelley
Mr. Monger
Mr. Hansford
Mr. Mountfield
Miss Pearson
Mr. Ridley
Mr. Harris

NOM

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

PRIME MINISTER

LONG-TERM PUBLIC EXPENDITURE PROSPECTS

At Budget time we shall as you know be publishing a White Paper giving details of our public expenditure up to 1984-85.

2. I have been considering the prospects for public expenditure in the period beyond 1985. They are very worrying. We need to take stock of where we are going in the light of our experience in the last two and a half years.

3. Though the problem stretches well beyond the horizons of a normal Public Expenditure Survey, the decisions we take in the next year or so will tend to reduce our room for manoeuvre in the longer term. We are, for example, running into major problems over defence. If we were to continue to aim for the next ten years or so at the NATO target of annual real increases of 3 per cent, we could find at the end of the period that we were spending something like 7 per cent of our GDP on defence, compared with the present 5 per cent.

4. But defence is by no means the only problem. We have also given high priority to some very large civil programmes, such as social security and health. We are committed to maintaining the purchasing power of more than half of social security benefits. We have so far allowed the health programme to grow in real terms. Though as a proportion of GDP education expenditure is falling at present, largely for demographic reasons, the downward trend in the numbers of pupils is likely to reverse in due course. Defence, social security, health, and education together account for over 60 per cent of total public expenditure.

5

8. I am copying this at this stage only to Sir Robert Armstrong. I hope to have an early opportunity of discussing with you the best way of carrying forward the approach that I have suggested.

GH

(G.H.)
5 February 1982

FROM: T F MATHEWS
5 February 1982

PRINCIPAL PRIVATE SECRETARY

cc Financial Secretary
Economic Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Sir Anthony Rawlinson
Sir Kenneth Couzens
Mr Ryrie
Mr Burns
Mr Wilding
Mr Barratt
Mr Byatt
Miss Brown
Mr Kemp
Miss Kelley
Mr Monger o.r.
Mr Hansford
Mr Mountfield
Miss Peirson
Mr Ridley
Mr Harris

LONG-TERM PUBLIC EXPENDITURE PROSPECTS

The Chief Secretary has seen Mr Barratt's minute of 5 February covering a draft minute to the Prime Minister. The Chief Secretary favours the inclusion of paragraph 7(d) of the draft.

TM

T F MATHEWS

RESTRICTED

cc: Mr. Barratt

RA

Mr Rayner

MR. MOUNTFIELD

LONG-TERM PUBLIC EXPENDITURE PROSPECTS

As you know, the Prime Minister decided that she wished to have a word with the Chancellor about his minute of 5 February. It accordingly featured on the agenda for her meetings with him on 10 and 17 February. But it was not in fact discussed on either occasion.

2. Mr. Scholar tells me that the advice which the Prime Minister is getting from within No.10 is generally favourable to the idea of a study. He has agreed to try again to extract a clear decision from the Prime Minister. If he fails, he will set up an early meeting specifically on this subject. *

3. I am so sorry this is taking so long.

* 4. He has failed : meeting on 24/ii.

J.O. KERR
18 February 1982

28/162

12/1162
10/2

10 DOWNING STREET

PA

From the Principal Private Secretary

5 February 1982

Mr Pargner

Dear John,

LOCAL GOVERNMENT : LONG TERM STRATEGY

The Prime Minister has seen the Home Secretary's minute of 4 February 1982 and she is content that matters should now be carried forward in the way agreed at the meeting which Mr Whitelaw held on 3 February.

I am sending copies of this letter to Imogan Wilde (Department of Education and Science), David Edmonds (Department of the Enviroment), Muir Russell (Scottish Office), John Craig (Welsh Office), Anthony Mayer (Department of Transport), David Clark (Department of Health and Social Security), Terry Mathews (Treasury), Lestor Hicks (Department of the Environment), and David Wright (Cabinet Office).

CHIEF SECRETARY
- 8 FEB 1982
Mr Culpin.
PPS FST EST
MST(C) MST(L)
Sir A Rawlinson
Mr Barratt

Mr Kitcatt
Miss Kelley
Mr Monger
~~Mr Mountfield~~
~~Mr Gurin~~
~~Mr Rixon~~
Mr Ridley
Mr Harris.

Yours ever,

Clive Whitmore

Miss Peirson

John Halliday Esq.,
Home Office.

CONFIDENTIAL

FROM: F R BARRATT
DATE: 5 February 1982

CHA ELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (
Minister of State (
Sir Douglas Wass
Sir Anthony Rawlins
Sir Kenneth Couzens
Mr Ryrie
Mr Burns
Mr Wilding
Mr Byatt
Miss Brown
Mr Kemp
Miss Kelley
Mr Monger (or)
Mr Hansford
Mr Mountfield
Miss Peirson
Mr Ridley
Mr Harris

See my amdts. Clearing [illegible] [illegible]

LONG-TERM PUBLIC EXPENDITURE PROSPECTS

I sent you a draft paper about this on 19 January, and Mr Kerr's minute of 22 January asked me to re-submit it when the minutes of the MISC 14 meeting on 20 January were available and the Cabinet discussion on economic strategy of 28 January was out of the way.

2. I have had another look at the original draft which I put to you. It seems to me still pretty well appropriate as it stands, and I am accordingly re-submitting it, with some minimal changes, in the form of a draft minute for you to send to the Prime Minister, with a copy to each of your Cabinet colleagues.

3. I invite your attention particularly to paragraph 7(d) of the draft. The point of your initiative now is to get the exercise on long-term public expenditure launched, in as uncontroversial a way as possible. There would be much advantage in our getting the point in paragraph 7(d) established. But if you think it is likely to excite controversy in a way which will prevent the exercise getting launched, you may prefer to delete it.

4. As regards the timing of this operation, there is no particular nee for you to minute the Prime Minister this week as opposed to next. But if we are to do a proper job, and get a report to Ministers in June, before the PES exercise is brought to Cabinet, we ought to get Ministers' authority to start well before the Budget.

5. You will wish to consider whether to have a word with the Prime Minister about this before sending her the minute.

F R BARRATT

[3742]
Pl. type
5/

~~DRAFT~~ MINUTE TO PRIME MINISTER
from Chanc.

LONG-TERM PUBLIC EXPENDITURE PROSPECTS

At Budget time we shall as you know be publishing a White Paper giving details of our public expenditure up to 1984-85.

2. I have been considering the prospects for public expenditure in the period beyond 1985. They are very worrying. We need to take stock of where we are going in the light of our experience in the last two and a half years.

3. Though the problem stretches well beyond the horizons of a normal ~~PES~~ Public Expenditure Survey, the decisions we take in the next year or so will tend to reduce our room for manoeuvre in the longer term. We are, for example, running into major problems over defence. If we were to continue to aim for the next ten years or so at the NATO target of annual real increases of 3 per cent, we could find at the end of the period that we were spending something like 7 per cent of our ~~$~~GDP on defence, compared with the present 5 per cent.

4. But defence is by no means the only problem. We have also given high priority to some very large civil programmes such as social security and health. We are committed to maintaining the purchasing power of more than half of social

/security

security benefits. We have so far allowed the health programme to grow in real terms. Though as a proportion of GDP education expenditure is falling at present, largely for demographic reasons, the downward trend in the numbers of pupils is likely to reverse in due course. Defence, social security, health, and education together account for over 60 per cent of total public expenditure.

5. Elsewhere, we have found that the scope for reductions is necessarily limited. Indeed some of the smaller programmes (law and order; employment) have required special preference.

6. ~~Yet we need~~ to achieve a reduction in the burden of the public sector on the economy. This is an essential part of our strategy.

7. In bringing public expenditure under control we have concentrated so far on cash and on the relatively short term. But the longer term prospects extending well beyond the lifetime of this Parliament call for thorough study. I am accordingly proposing

(a) ~~that~~ the Treasury, in consultation with major spending Departments and the CPRS, should immediately set in hand an examination of the likely pattern of public expenditure over the next decade, on the basis of a

/range of . .

range of possible assumptions about growth and other factors;

(b) ~~that~~ I should report to Cabinet in the light of this study by next June;

(c) ~~that~~ colleagues in charge of major spending Departments should ensure that the work is given the necessary priority in their Departments; and

(d) ~~that~~ in the meantime we should make no changes in our present expenditure programmes which would pre-empt decisions about the longer term.

8. I am copying this ~~to all~~ Cabinet colleagues and Sir Robert Armstrong.

JH

[372/2]

FEB '82

Mr Mountfield 26.2
CST, FST, EST,
MSTC, MSTL,
Sir D Wass, Sir A Rawlinson,
Sir K Couzens, Mr Ryrie,
Mr Burns, Mr Wilding,
Mr Byatt, Mr Barratt,
Miss Brown, Mr Kemp.
Miss Kelley, Mr Monger
Mr Hansford,
~~Mr Mountfield~~
Miss Pierson.
Mr Ridley.
Mr Harris.

10 DOWNING STREET

From the Private Secretary

25 February 1982

Dear John,

Long-Term Public Expenditure Prospects

The Prime Minister discussed with the Chancellor this morning his minute of 5 February about the longer term prospects for public expenditure in the period beyond 1985.

(X) The Prime Minister said that she thought that it would be a good idea to mount the study which the Chancellor had in mind. She agreed that the Treasury should undertake this work, in consultation with major spending departments and the CPRS. The matter would need to be handled sensitively, to avoid creating difficulties with this year's regular public expenditure exercise.

I am sending a copy of this letter to David Wright (Cabinet Office).

Yours sincerely,

Michael Scholar

John Kerr, Esq.,
HM Treasury

RESTRICTED

FROM: J O KERR
DATE: 26 February 1982

cc. Mr Barratt.

MR MOUNTFIELD

LONG-TERM PUBLIC EXPENDITURE PROSPECTS

You will now have seen Mr Scholar's letter of 25 February to me.

2. He and I have talked about how best to proceed now. Subject to your views, our suggestion is that we should simply revert to the original plan, and re-run the Chancellor's minute of 5 February, adjusting the third sentence of paragraph 7, and paragraph 8, and copying to Cabinet colleagues, Armstrong and Ibbs. On receipt of the Prime Minister's copy, Mr Scholar would immediately write back to me, with a re-run of paragraph 2 of his letter.

3. Please let me know if this, or something else, is what you would like done.

gok.

J O KERR

26/2

cc: CST
FST
EST
MST C
MST L
Sir D Wass
Sir A Rawlins
Sir K Couzens
Mr Ryrie
Mr Burns
Mr Wilding
Mr Byatt
Mr Barratt
Miss Brown
Ms Kemp
Miss Kelley
Mr Monger
Mr Hansford
Mr Mountfield
Miss Peirson
Mr Ridley
Mr Harris

107

1/16
11/3

SECRET

Mr Bagner
c - self

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

PRIME MINISTER

LONG-TERM PUBLIC EXPENDITURE PROSPECTS

The White Paper giving details of our public expenditure up to 1984-85 will be published on Budget Day.

2. The prospects for the period beyond 1985 are very worrying. We need to take stock of where we are going in the lig t of our experience in the last two and a half years.

3. Though the problem stretches well beyond the horizons of a normal Public Expenditure Survey, the decisions we take in the next year or so will tend to reduce our room for manoeuvre in the longer term. We are, for example, running into major problems over defence. If we were to continue to aim for the next ten years or so at the NATO target of annual real increases of 3 per cent, we could find at the end of the period that we were spending something like 7 per cent of our GDP on defence compared with the present 5 per cent.

4. But defence is by no means the only problem. We have also given high priority to some very large civil programmes, such as social security and health. We are committed to maintaining the purchasing power of more than half of social security benefits. We have so far allowed the health programme to grow in real terms. Though as a proportion of GDP education expenditure is falling at present, largely for demographic reasons, the downward trend in the numbers of pupils is likely to reverse in due course. Defence, social security, health, and education together account for over 60 per cent of total public expenditure.

[371/2]

pwp

SECRET

FINANCIAL SECRETARY TO THE TREASURY

FROM: MISS Y WEST
12 March 1982

PS/CHANCELLOR

cc PS/CST
PS/EST
PS/MST (C)
PS/MST (L)
Sir D Wass
Sir A Rawlinson
Sir K Couzens
Mr Ryrie
Mr Burns
Mr Wilding
Mr Byatt
Mr Barratt
Miss Brown
Mr Kemp
Miss Kelley
Mr Monger
Mr Hansford
Mr Mountfield
Miss Peirson
Mr Ridley
Mr Harris

LONG-TERM PUBLIC EXPENDITURE PROSPECTS

The Financial Secretary has seen the Chancellor's minute to the Prime Minister of 8 March and has commented that "perhaps we can all refrain from making any pledges about anything for the next Parliament."

YWest

MISS Y WEST
12 March 1982

SECRET

10 DOWNING STREET

From the Private Secretary

16 March 1982

Mr Mountfield 17.3
CST, FST, EST,
MSTC, MSTL,
Sir D Wass
Sir A Rawlinson,
Sir K Couzens
Mr Ryrie,
Mr Burns, Mr Wil...
Mr Byatt, Mr Barn...
Miss Brown, Mr Kem...
Miss Kelley, Mr Mo...
Mr Hansford, Miss ...
Mr Ridley, Mr Hav...

Dear John,

LONG TERM PUBLIC EXPENDITURE PROSPECTS

The Prime Minister was grateful for the Chancellor's minute of 8 March, in which he proposed a study of the likely pattern of public expenditure over the next decade.

The Prime Minister is content with the proposals set out in paragraph 7 of the Chancellor's minute.

I am sending copies of this letter to the Private Secretaries to the other members of Cabinet, to Murdo Maclean (Chief Whip's Office) and David Wright (Cabinet Office).

Yours sincerely,

Michael Scholar

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

SECRET

AH/1 Miss Leahy (copies to YT)

FROM: P. MOUNTFIELD
DATE: 25 May 1982

cc: ~~COGPEC~~ PA

Copies attached for:

Chancellor
Sir Douglas Wass
Mr. Ryrie
Mr. Ridley
Mr. Kemp

1. SIR ANTHONY RAWLINSON
2. CHIEF SECRETARY

SELECT COMMITTEE ON PROCEDURE - LONGER-TERM PUBLIC EXPENDITURE

The Select Committee have asked for "a short paper from the Treasury setting out the stages by which a major new project involving expenditure over a number of years is approved by Ministers, and thereafter monitored."

2. This request may be seen as part of a wider process. We are watching an attempt by Parliament to extend its control of public expenditure in the widest sense. This Inquiry by the Select Committee needs to be seen alongside their enquiries into Parliamentary supply procedure, and into Parliamentary control of borrowing. It may lead to proposals for Parliamentary control over commitments as well as over annual appropriations. Any paper for this new Inquiry must therefore be carefully drafted. But we think the best tactics are to provide a fairly short strictly factual reply, avoiding any controversy at this stage.

3. The problem is that the Select Committee's very mechanistic approach assumes that there is something like a single model, appropriate to all capital projects. The best format for our paper, therefore, seemed to be a short general passage pulling out some of the common themes, followed by some detailed examples to illustrate the wide range of circumstances and procedure.

4. The Committee's request was unclear about the coverage of their Inquiry. It may be about central government alone; or about Supply Expenditure; (which would bring in the NHS) or about all public expenditure. I have deliberately drafted it in the widest possible sense, in order to fend off possible further requests from the Committee.

5. The annexes have been provided by Divisions (in some cases after discussion with Departments). We shall show the complete version to Departments for information, but I do not think we need clearance from them.

May we have the Chief Secretary's agreement to send the paper to the Select Committee, please?

PM.

P. MOUNTFIELD

ANNEX

PROCEDURE FOR APPROVING A MAJOR CAPITAL PROJECT

The Committee asked for a short paper from the Treasury, setting out the stages by which a major new capital project involving expenditure over a number of years is approved by Ministers, and thereafter monitored.

2. Public expenditure on capital projects covers a wide range of different operations by many different public authorities. Not all of these are seen by the Treasury, or indeed by Ministers. The stages through which each project is handled will vary widely. A number of different examples are therefore given, as appendices to this paper.

3. It may be helpful to distinguish between projects which form part of a continuing series of similar schemes (like the motorway programme) and those which are unique (like the Thames Barrier). For the former there are well-defined procedures, although these will vary from one class to another. For the latter there are no general rules.

4. In considering capital projects, the responsible authority, be it a public corporation, a local authority, or a Government Department, will have the following considerations in mind.

(a) Economic appraisal. The authority would consider the economic return on the project and in particular whether ~~consider whether~~ the project represented the most cost-effective solution, compared with other feasible alternatives. Techniques of investment appraisal are highly developed in many areas. The Treasury "Guide to Investment Appraisal" sets out the general principles to be adopted in the public sector.

(b) The statutory authority for the expenditure concerned. In many cases, no specific statutory authority is necessary since the project will be covered by the inherent powers of the authority concerned.

(c) Its place in the strategy for the programme concerned. For example, a major computerised project in central government might be seen in the context of changes in the system of setting and collecting taxes, or of paying benefits. A new road project would be considered in the context of the development of the

road network as a whole. Appraisal of a new hospital project would involve the demand for hospital facilities in the regions concerned, and of current policy on the types of service to be provided in general hospitals.

(d) Availability of finance. The spending authority should consider whether there was adequate provision for this project, amongst others, in its Public Expenditure Survey programme. In doing so, it would take account of the other potential claims on financial resources over the same period. If the project were of a very long-term nature, stretching beyond the public expenditure survey period, it would also need to consider whether any major changes in the level of expenditure were likely in the period outside the Survey. For expenditure funded by central government out of Parliamentary Votes, the authority would need also to consider whether the necessary funds were available and voted by Parliament in the first year.

5. Once approval has been given, expenditure on any project will be monitored in the course of construction. In doing so, spending authorities will pay particular attention to the availability of finance, in each year's Estimates and in the Public Expenditure Survey as approved by Ministers each year. The spending authority, and in many cases the Government Department, willalso watch the total cost of the project. On completion of the project, most authorities have arrangements for evaluating its success in meeting the original objectives.

6. The procedure for seeking approval varies widely. Expenditure by central government departments, borne on Supply Estimates, needs Treasury approval unless it is within the delegated authority of the Department concerned. In many cases, particularly if controversial, or there is a doubt about the availability of resources in the longer-term, it will be the subject of Ministerial correspondence or be the subject of collective Ministerial discussions. There are however no general rules which require consideration by Treasury Ministers. Within Departments, practice differs: but any significant project would normally be considered by the Departmental Minister concerned, whether or not it was the occasion of subsequent correspondence with the Treasury. If the project forms part of a continuing programme, there will be a standard procedure laid down for all these stages.

7. Where other spending authorities are concerned, practice varies. In the National Health Service, all projects above a certain size are seen by the DHSS (or the Scottish, Welsh or Northern Irish equivalent). Nationalised industries have varying levels of delegated authority from central government, within the ceilings approved by Ministers. Major nationalised industry projects, with a major policy interest,would generally be discussed with the Treasury. But once again, no formal rules apply across the board. Local authority

capital expenditure is subject to aggregate, statutory controls, within which the authorities have considerable freedom to determine the distribution between services. Government Departments do not generally see or approve individual projects unless they are subject to specific grants (eg projects eligible for transport supplementary grant, urban programme grant etc.). However, in the case of education local authorities are required to submit certain details of individual projects to the DES under the provisions of the 1980 Education Act. Water Authority schemes are also subject to aggregate expenditure controls, rather than individual project approval. Major schemes are identified in the plans which the authorities are required to submit to DOE and the Welsh Office for approval each year. These are discussed with the authorities, but the approval relates to the programme as a whole and the expenditure levels, not to the individual schemes. Major works such as reservoirs are, of course, inevitably the subject of planning appeal procedures, and are seen by the Secretaries of State in that context.

8. The attached appendices illustrate some of the many types of capital project which are dealt with in these ways.

APPENDIX 1

DEFENCE EQUIPMENT

1. Procurement of major defence equipment would normally go through a number of main stages. A typical project will start with a Staff Target (ST) reflecting a particular military need. Endorsement of the ST will normally be obtained at official level using the MOD's standard machinery for scrutinising and approving new equipment proposals and will lead to feasibility studies. Following these studies, a Staff Requirement (SR) may be raised and approval sought for project definition (PD). PD normally involves the first large commitment of funds and, for projects estimated to cost £25m or more to develop, will require approval of the MOD's Defence Equipment Policy Committee (attended by representatives of the Treasury and DOI). But Ministerial approval of PD will normally only be sought if the commitment of funds during this stage is estimated to reach a level which is currently set at £25m or more. On completion of PD, approval to enter full development (FD) will be sought, and DEPC and Ministerial authority will be required, for all projects with a total estimated development cost of (currently) £25m or more. Ministerial approval will be sought again before projects enter production in cases where total production costs are estimated to be £50m or more. While the mandatory requirement to obtain Ministerial approval at any point is thus triggered automatically by financial thresholds, Ministers may well be involved in the largest and/or most contentious projects from the earliest stages.

2. The methods for monitoring costs are tailored to the individual needs of the projects. For some projects, a detailed cost plan will be set out to compare the forecast and actual incidence of expenditure against technical milestones. The contractors and the MOD project team will be involved in day-to-day monitoring. Particular problems may be referred to senior management in MOD, to MOD Ministers, to the Treasury, or to Ministers collectively. Any major technical difficulties or major cost escalation would lead to resubmission to MOD Ministers.

3. The expenditure, if it falls outside the authorities delegated by the Treasury to MOD, will need Treasury approval for each main stage; in addition, projects may need fresh Treasury approval if they breach the tolerances granted (especially on cost). Treasury Ministers would be involved as necessary.

4. The largest and most contentious projects will be referred by MOD Ministers to their Ministerial colleagues at various stages as appropriate.

APPENDIX 2

PROPERTY SERVICES AGENCY (PSA) PROJECTS

1. There is no typical PSA project and it might be mis-leading to relate a specific case history to the procedures of approval and monitoring of any one of them. What follows is a general note of how major construction projects are handled. PSA's delegated authority is £7,000,000.

---

2. Major projects (those costing several million pounds) are identified to the Treasury for the first time in the Public Expenditure Survey (PES) which is also the time scale for PSA's forward planning. Exceptionally PSA will be able to identify the largest projects up to 10 years ahead of the planned start. Such a case might be the need for a major new building initially identified by the Department concerned.

3. For projects which exceed delegated authority the PSA first seek Treasury approval in principle. How far ahead of the start date this would be depends on the size and complexity of the project. Three years would not be unusual. The request would be backed up by rough costings and demonstrations of need and feasibility.

4. Following on from this PSA carry out a detailed feasibility study and investment appraisal. This is worked up to a final sketch plan stage, at which time specific Treasury approval would be sought.

5. Major projects within PSA's delegated authority are handled similarly, except no Treasury approval is sought unless there are unusual features. In these cases PSA follow established ground rules which have been approved by the Treasury. In either case (within or outside delegated authority) no money is committed on construction until final approval is obtained.

6. The monitoring of progress against plan, both in terms of the building programme and approved budget, is carried out internally by PSA. The Treasury is brought in as necessary. This might be if the budget of Treasury approved projects is at risk or if unusual difficulties arise, eg delays result in a dispute between the PSA and the primary contractor. At all times the Treasury reserves the right to call for information about any project.

7. If there is no need for specific Treasury involvement the PES and Estimate scrutinies provide convenient opportunities to assess general progress.

8. Major projects which PSA currently have in hand include:-

Project	Cost £ million	Planned year of Completion
International Conference Centre	36	1986-87
Swansea DVLC	5.8	1987-88
Regional Processing Centre for Inland Revenue at Peterborough	2.6	1985-86
Regional Processing Centre for Inland Revenue at West Byfleet	2.6	1985-86

APPENDIX 3

GOVERNMENT COMPUTER PROJECTS

1. Government computer projects are undertaken for the purpose of improving effectiveness and efficiency in the performance of general administrative tasks. They embrace a wide range of such tasks, including, for example, PAYE requirements; NI contribution records and the payment of benefits; financial information systems; payroll and superannuation work; the payment of grants and subsidies. The size of computer projects can therefore vary greatly, according to the nature of the administrative function involved.

2. When developing a computer project, Departments are required to follow specific detailed procedures laid down by the CCTA. These procedures apply whether the project is one which falls within a Department's delegated authority to approve expenditure, or one which requires approval by the CCTA.

3. The progressive stages for approval are:-

(i) The medium term planning figures are included in the annual Public Expenditure Survey, and provision made in Supply Estimates.

(ii) A Preliminary Study is carried out to enable a properly informed decision to be taken on whether to commit resources to a full study.

(iii) If changes in functional staff numbers are likely, manpowr requirements need to be authorised subject to subsequent approval of the project.

(iv) The Preliminary Study Report is submitted to the approving authority which if satisfied that a convincing case has been made will authorise a more comprehensive Full Study to be undertaken.

(v) The Full Study Report will describe the new system, its implementation plan, and costs. It will show the cost-effectiveness of alternatives together with the cost and benefits of the proposed solution. Costs and benefits arenormally appraised over a 10 year life cycle for the project.

(vi) The approving authority in Departments or the CCTA will, if satisfied with the Fully Study Report, authorise the development of the system and procurement of the necessary equipment. If appropriate the case for project approval will be submitted to Ministers.

.. During the development stage of a computer project costs are monitored. Divergences from planned costs are identified and revised approvals obtained if necessary. Any consequences for the project as a whole are taken into account in the investment appraisal included in the Fully Study Report.

5. From the procurement stage onwards through to full implementation of the project, costs and benefits are monitored. The implications of any significant divergence from the project plan originally approved are identified. The consequences for the original investment appraisal in the light of public expenditure plans are identified. Revised plans are submitted if necessary to the approving authority. These may also require the approval of Ministers.

APPENDIX 4

HOSPITAL PROJECTS

(This describes the arrangements in England; though the systems in Scotland and Wales are similar, there are small differences of detail.) The starting point for any hospital development is the identification of a need for new or improved hospital services. This is done in the context of each Regional Health Authority's Strategic Plan which is prepared in consultation with and subject to approval by Health Departments and their Ministers. Health Authorities must have regard also to other relevant Ministerial polities and priorities - eg on hospital size, development of services for priority groups of patients etc. Their programmes are planned in accordance with capital allocations determined annually by the Health Departments and in line with longer term resource assumptions issued from time to time by the Departments.

2. Health Authorities are statutorily bound to follow the NHS Capital Projects Code (Capricode) which lays down the procedures to be followed at each stage in the life of a hospital project, from initial planning and design, through tender and construction, to commissioning and evaluation after completion. At an early stage a Budget Cost is established which serves as a control total for the detailed design and subsequent stages. The Budget Cost is built up from centrally determined standards and cost allowances for individual hospital departments, together with agreed on-costs (specific to each project) for communications, external works, and other exceptional features.

3. The aim of Capricode is to standardise the approach to the planning, programming and control of all health capital projects. For all projects above in specified cost limit, Health Authorities require approval from Health Departments at both the initial outline planning stage (where a decision in principle is made to proceed with the project) and at the budget cost stage. Treasury approval in principle is required for major schemes of more than £10 million. Health Authorities are also required, again above agreed delegated limits, to seek approval from Health departments for certain cost increases which occur after contracts have been signed and construction commences - eg as a result of design and other changes in the original contract specification.

4. The Capricode procedures are currently under review. A major change, already being implemented, is the introduction at the approval in principle stage of mre rigorous and systematic procedures for financial appraisal of capital projects. These new procedures have been approved by the Treasury.

4/2

APPENDIX 5

NATIONALISED INDUSTRIES

1. The Government's approach to the determination and control of investment in the nationalised industries was set out in the White Paper "The Nationalised Industries" (Cmnd 7131) and in Treasury evidence last year to the Treasury and Civil Service Committee (Financing of the Nationalised Industries HC 348 Vols II-III).

2. Although control over investment expenditure by the industries is carried out within a common framework, the diversity of the industries and of their programmes and projects is reflected in significant differences in the detail of the arrangements. As well as satisfying the requirements of public accountability, these arrangements must take account of the industries' statutory position and their needs as trading bodies operating within a commercial environment.

3. This appendix sets out how the controls operate, together with a description of the current delegated financial authorities for nationalised industries' investment expenditure.

Investment plans/programmes

4. The statutes of each industry normally provide for the investment plans of each nationalised industry to be subject to Ministerial approval. As set out in Cmnd 7131, the overall investment plans of each industry are expected to achieve a required rate of return (RRR) - currently 5% in real terms and before tax - reflecting the opportunity cost of capital and estimates of the pre-tax returns earned by the private sector in the recent past and their likely trend in the future. The assumption that new investment is expected to yield at least 5% is built into industries' financial targets which are set in accounting terms and against which the performance of their investment programmes can be measured. This regime replaced the earlier arrangements, which had not worked well, whereby the Government expected all industries to appraise all important investment projects by using discounted cash flow techniques and at a specific test Discount Rate.

5. In practice, each industry develops and puts forward a programme of investment porjects which it considers will meet the RRR and its financial target. These programmes will be the subject of discussion between the industry and its sponsor Department in the context of the industries' corporate plans and the annual Investment and Financing Review (IFR). The latter considers the industry's financing and investment plans over a 3 year forward period, whereas a corporate plan looks forward over whatever longer period is more relevant to the industry concerned.

6. Each year in the IFR Ministers collectively examine the medium term investment plans and financing needs of each industry in the context of budgetary and fiscal decisions. This leads to the medium term investment approvals which sponsor Ministers give to individual industries. Subject to the availability of finance, these approvals are for 100% of their agreed investment programme for the year immediately ahead, 85% for the second year and 70% for the third year. The approvals are designed to give industries a sufficiently firm basis on which to plan their forward investment commitments and to firm up their assessment of individual projects.

Appraisal of projects

7. In addition to these procedures for appraising and approving investment programmes, the industries appraise individual projects within them. As Cmnd 7131 explained, the primary responsibility for operating methods of appraisal, designed to achieve 5% on new investment as a whole, rests with the industries themselves. However they are expected to consult their sponsor Department on those methods including the appropriate discount rate, allowance for risk etc. For management reasons the industries may chose ex ante discount rates higher than 5% in order to achieve an ex post 5% real rate of return.

8. In some cases industries also consult their sponsor Departments on certain major investment proposals before going ahead within agreed financing and investment plans. The current arrangements are set out in the Annex. The diversity in the level and form of these arrangements reflects the wider differences in the make-up of the industries' investment programmes. Where major individual projects are submitted to sponsor Departments, this provides the latter not only with an understanding of the industries' appraisal methodology in practice but a better understanding of the make-up and determinants of the investment programme. This in turn informs decisions on the aggregate totals.

Monitoring of projects in progress

9. Once an investment programme or project has been approved, prime responsibility for monitoring progress rests with the industry concerned, although additional arrangements may be agreed for particular projects, including the carrying out of backchecks, and the setting of trigger points alerts Departments if costs are increasing for major projects. The progress of total expenditure against the agreed ceilings is monitored by sponsor Departments and the Treasury through regular monthly financial monitoring procedures, and each programme is reassessed as part of the annual Investment and Financing Review.

FROM: F R BARRATT
DATE: 26 May 1982

CHANCELLOR

CHIEF SECRETARY — See also comments on draft paper

I have discussed this with Mr. Barratt. I favour a Cabinet discussion, but think a final decision on whether it would be appropriate for 17 June can + should be deferred until the beginning of the week beginning June 7th, when the South Atlantic position may be clearer.
LB
27/

cc Financial Secretary
Economic Secretary
Minister of State (C)
Minister of State (R)
PCC
Mr Spackman
Mr Stannard
Mr Ridley
Mr Harris

PUBLIC EXPENDITURE IN THE LONGER TERM

As you know, an interdepartmental group of officials has been looking at the prospects for public expenditure in the rest of this decade. I now attach a copy of the group's report. In his minute of 8 March to the Prime Minister, the Chancellor proposed that he should report to Cabinet in the light of the report in June. The Prime Minister agreed. I also attach the draft of a paper under cover of which the report might be circulated to the Cabinet.

2. All the major spending Departments, and the CPRS, were represented on the interdepartmental group, and the report has been agreed by the group.

3. It considers what, on the basis of certain assumptions about what might happen to the economy on the one hand and expenditure programmes on the other, public expenditure might amount to by 1990. As expected, the picture is bad. Only on some rather favourable assumptions about the economy and some relatively modest assumptions about expenditure programmes, does public expenditure as a proportion of GDP come out lower in 1990-91 than it was in 1979-80. In cost terms the prospect, whatever the assumptions, is for big increases over this period.

4. At one or two points the report reflects a compromise between the Treasury's desire to ensure that the figures were not understated,

and the fears of some Departments - particularly the Ministry of Defence - of being singled out for attack if the figures for their programmes in the report were too high. It would not wholly surprise me if, assuming that this exercise becomes the subject of Ministerial discussion, the Ministry of Defence did not seek to argue that the figures for the defence programmes are too high (they may argue, for example, that no decision has yet been taken that the UK should fulfil the 3% NATO target right through to 1988-89) while the estimates of economic growth are too low. The latter point does not of course affect the outcome on defence expressed in cost terms; but it would have a big impact on the figure of defence expenditure expressed as a percentage of GDP.

Handling

5. A slot has been provisionally reserved for discussion of this subject in Cabinet on 17 June. Plainly there are strong arguments for pushing forward now to the next stage of Cabinet discussion.

6. In Cabinet you would have several aims. First, as the Chief Secretary has said, you would be seeking conscious decisions in this year's public expenditure survey about the shape of public expenditure in the medium term, so that the last year of the Survey (1985-86) does not simply extrapolate the line of the previous years. You would aim to persuade colleagues not only that the 1990 prospect is bad, but also that decisions to be taken later this year about expenditure in 1985-86 should be a distinct step along the road to a substantial reduction of public expenditure by 1990.

7. Second, as part of this, you would be seeking a commitment from your colleagues to avoid significant expenditure commitments - whether new ones or the extension of existing ones - having longer term expenditure implications.

8. The conclusions of the draft Cabinet paper explicitly reflect these two aims.

9. Third, and more broadly, you would want to stimulate thought and discussion among colleagues about the need for hard choices in

public expenditure. We cannot for as far ahead as we can see have more defence, and more law and order, housing, health and social security, all together, and at the same time less taxation and more growth. It will be particularly important to ensure that this is well understood in the pre-electoral period.

10. But there are problems.

11. The report has been constructed on the basis of two hypothetical economic scenarios - one (A) relatively favourable, the other (B) more pessimistic. Though Scenario B is not perhaps as gloomy as it might be, it does include high figures both for unemployment and for inflation. It could well be embarrassing to the Government if it were to become known that a scenario of this kind for 1990 was being used for the purpose of considering long term expenditure trends. The report attempts as far as possible to defuse potential embarrassment by emphasising that the economic scenarios in it are hypotheses, not forecasts. Nevertheless, a document with a scenario of this kind in it must be regarded as sensitive. You will want to consider whether it should be given further currency. At one stage I considere the possibility of removing Scenario B altogether, or at least downgrading it in the text. But this would give a wholly misleading picture, and probably produce undue complacency about the prospects. To remove or downgrade Scenario B would indeed emasculate the analysis

12. Even with Scenario B included, as in the report, it will be seen that the amount of growth in the economy in the rest of the decade does not have a very significant impact on the outcome as regards public expenditure in 1990 when public expenditure is expressed in cost terms. The 1990 cost terms increase in the programme totals in Scenario A over 1979-80 is £18 billion: in Scenario B it is £16½ billion. This of course partly reflects the relatively moderate assumptions made in Scenario A about the extent to which the Government will accede to public demand for growth in certain expenditure programmes.

13. On the other hand, when public expenditure is expressed as a percentage of GDP, the difference in outcome between Scenario A and

Scenario B becomes very striking indeed. This may dispose some colleagues to argue that the real problem is not that public expenditure is too high, but that GDP is too low. The answer is, as the draft Cabinet paper brings out, that better growth is most unlikely to be attainable without reductions in taxation, and hence in public expenditure. But there must be some risk that the Cabinet discussion will focus on the prospects for economic growth rather than the prospects for public expenditure. This is not what we want.

14. Finally, one of the major issues clearly emerging from the report is whether or not the UK can expect to be able to support anything like the level of defence expenditure envisaged in it. But events in the South Atlantic no doubt make this an unpromising moment for critical discussion of defence expenditure.

CONCLUSION

15. One possible way of proceeding, if you wanted to ensure that colleagues were aware of the very unsatisfactory public expenditure prospects, but also preferred not to stimulate Cabinet discussion of the report now, would be for you to circulate a minute to the Cabinet along the lines of the attached draft paper. It would be for information rather than decision at this stage, but this procedure would ensure that you could at least refer to it in later discussion about 1985-86.

16. If you decide to proceed in this way, the conclusions of your minute would need to be less specific than in the draft Cabinet paper - for example paragraph 9 of the present draft paper would be inappropriate. Other editorial changes would also be required.

17. You will no doubt in any case want to consult the Prime Minister

about the handling of all this. If the subject is to be taken at Cabinet on 17 June, you will need to do this by the end of next week. In this case, we would during next week revise the draft Cabinet paper as necessary in the light of any comments you may have on it, so that you could show it to the Prime Minister before circulation.

F R BARRATT

DRAFT PAPER FOR CABINET

PUBLIC EXPENDITURE IN THE LONGER TERM

Officials have now completed the examination, which I proposed in my minute of 8 March that they should undertake, of the likely pattern of public expenditure over the next decade. I attach a report by an interdepartmental group which sets out how the costs of our present policies could develop against two possible economic backgrounds.

2. The officials' report is in no sense a forecast. It is impracticable to predict in detail how either the economy or public expenditure will develop over the next 8 or 10 years. What officials provide is "a snapshot of 1990", obtained by projecting the expected costs of our present expenditure policies on to two assumed economic backgrounds. One (Scenario A) is favourable. The other (Scenario B) is less so.

3. This technique of presentation has the advantage of clarity. But as the report points out, it sets aside many of the problems regarding the path of the economy and public expenditure on the way to 1990. Nor does it comment on the situation as it might develop thereafter. Some problems lie ahead at even longer range - for example whether we can afford the costs of our present social security structure as they are likely to develop into the next century. But these are matters that need to be looked at separately, and for the present I believe that we need to focus our thoughts on the way in which public expenditure may develop over the lifetime of this and the next Parliament.

4. The report illustrates the proportion of GDP which might, on the assumptions stated, be devoted to public expenditure at the end of this decade if we maintain our present course. It shows that, on less favourable assumptions about developments in the economy (Scenario B), we are on course for an increase in the level of public expenditure as a percentage of GDP of

nearly 6 points above that of our first year of office (1979-80), and 3 points above the level to which we have agreed for 1982-83. An outcome of this kind would surely be altogether unacceptable.

5. On a more favourable view of economic developments (Scenario A), public expenditure as a percentage of GDP falls somewhat below the level of 1979-80 and significantly below that of 1982-83. But I do not think that we should be reassured by this. In real terms public expenditure would be higher in 1990-91 than in either 1979-80 or 1982-83. And the judgments which have been made about the developments of individual public expenditure programmes in Scenario A are in some respects rather moderate: social security benefits for example are assumed to increase by less than earnings; and not enough allowance may have been made for the increases in expenditure which public opinion might expect in a period of higher growth. On balance I believe that on the basis of unchanged policies regarding public expenditure, the totals in Scenario A are more likely to be an under- than an over-estimate.

6. In any event while we are aiming at something like the economic prosperity and lower inflation depicted in Scenario A, we cannot be confident that we are on course for it. It can only come from an expansion of profitable activities in the private sector. For this we need a reduction in interest rates, moderation in pay to reduce unemployment and re-build profit margins, and reductions in the burden of taxation to improve incentives. I therefore see a reduction in public expenditure as a percentage of GDP as a pre-condition of Scenario A. Moreover a continuing high level of public expenditure is incompatible with our objective of widening the range of personal choice.

7. The report shows clearly how the balance of our public expenditure programmes has changed and will, on present policies, continue to do so. It also shows the extent to which the four largest programmes - Defence, Education, Health and Social

Security - dominate public expenditure. In 1979-80 these four programmes between them amounted to about 60% of the total of the expenditure programmes. By 1990-91 on the officials' projections, they would amount to about 63½% in Scenario A. But this overall increase in the four programmes masks a significant decline in one of them (education). Defence on the other hand would increase its share of the total programmes from about 12% to about 15%, while the shares of Health and Social Security would each rise by about 1% - from 11½% to nearly 13% in the case of Health and from about 25% to about 26% in the case of Social Security.

CONCLUSION

8. The longer term public expenditure prospects are very unsatisfactory on any plausible hypothesis about developments in the economy. In my judgment we shall need to take some major and difficult decisions to reduce expenditure if we are to achieve our political and economic objectives in the rest of this decade. I do not at this stage wish to make specific proposals, though I have no doubt that the main weight of the reductions will need to fall on the biggest programmes. The scope for reductions will vary from programme to programme, and the measures adopted will need to reflect our own priorities as a Government. But we need to recognise now that a problem exists, since it is clear that if we intend to arrive at a more satisfactory public expenditure situation in 1990, the necessary decisions must be taken well in advance. Our decisions on the extra year (1985-86) in this year's Public Expenditure Survey ought, I believe, to take into account our longer term concerns about public expenditure. I also attach much importance to the need for us, as a Government, to avoid extending or entering into expenditure commitments which have a significant longer run effect.

9. I accordingly invite the Cabinet

(a) to note the very serious prospects for public expenditure over the rest of this decade;

(b) to agree that these prospects need to be taken in the first instance into account in considering expenditure programmes for 1985-86;

(c) to agree that expenditure commitments having a significant longer run effect should be avoided.

3/3/6

PERSONAL AND CONFIDENTIAL FROM: J O KERR
Date: 2 June 1982

cc Mr Mountfield

cc: PS/Chief Secretary
Sir A Rawlinson
Mr Ridley o.r.
Mr Harris

MR BARRATT

PUBLIC EXPENDITURE IN THE LONGER TERM

The Chancellor has seen your submission of 26 May, the Chief Secretary's reactions to which were set out in Mr Mathews' minute of 1 June.

2. Like the Chief Secretary, the Chancellor is inclined to favour a Cabinet discussion. But he is conscious of the risks, and in particular those highlighted in your paragraph 11 (the high unemployment assumption on the pessimistic scenario), paragraph 13 (the temptation to discuss prospects for growth rather than prospects for expenditure), and paragraph 14 (the awkward timing for a critical discussion of future levels of defence expenditure). He is inclined to think that the best way of dealing with the second and third problems would be to revise the draft Cabinet paper so that it demonstrated rather more convincingly to non-experts the near-inevitability of intolerable growth in public expenditure unless Ministers collectively display greater resolution. One way of doing this might be to look back, as well as forward, and describe how public expenditure has taken off since the 50s. He would be grateful if Mr Harris could look out the speeches on this theme which he delivered at Swinton and to a CPC Festival Hall conference, and the CRD booklet which Messrs Ridley and Cardona wrote, in the 1975/78 period: he recalls that this material included some fairly frightening descriptions of the effect of the public sector continuing to grow over the next 20 years at the rate of the last 20 years.

3. As for the first risk, the Chancellor wonders whether there is any way in which the unemployment assumption on the

PERSONAL AND CONFIDENTIAL

pessimistic scenario could be suppressed. Ideally, he would like the official report to be in a form which would permit its eventual publication, for wider educational purposes. But the existence of the high unemployment assumption would divert attention from the real message, andwreck the exercise. Could a way round this problem be devised?

4. You may think that the best way to deal with these problems would be for us to arrange a short meeting, when the Chief Secretary is again available. Please let me know what you would like. Time is clearly rather short.

J O KERR

1. pl. copy to Mr Mountfield. ✓ FOR FILE PL.
2 Spoke to Mr Ridley
3. (PWP)

CONFIDENTIAL

E.12

FROM: ADAM RIDLEY
11 June 1982

CHANCELLOR

cc CST
Sir D Wass
Sir A Rawlinson
Mr T Burns
Mr Middleton
Mr Harris

LONG TERM PUBLIC SPENDING: THE PROBLEM OF "CREEP"

At Monday's meeting on the report on the longer term, I expressed the view that the projections it included were far more modest than might appear (and indeed significantly biased downwards) because of the process which I termed "creep". I meant by that suitably unpleasant term the inexorable tendency for the planning total for any future year to be added to as it comes closer to the present, because of the steady drip-drip of new and compelling policy commitments well in excess of the contingency reserve, a tendency for outturn to exceed forecast, and, perhaps, other processes too, such as control problems to which no acceptable solutions can be found. This process is of the greatest importance, whether to the proper appreciation of the long term report proper, to the imminent PESC or to judging the adequacy of our methods of expenditure planning and control. What follows is an attempt to make that importance clearer.

2. The extent to which "creep" can take place even over as short a period as a year is well illustrated by recent experience, not least by a comparison between the PEWP planning totals of this year and last:

Planning totals and Creep, £bn cash

		1981/2	1982/3	1983/4	1984/5
	Planning totals				
1.	1981 PEWP	104.8	110.2	113.9	
2.	Outturn/1982 PEWP	106.1	115.2	121.1	128.4
	Excess of 2 over 1 (= creep):				
3.	£bn.	1.3	5.0	7.2	[10]
4.	%	1¼	4½	5¾	[7½]

Source Cmnd 8494 - I p.2. Brackets [ ] are guesses

3. Lines 3 and 4 show that we suffered very badly indeed from cree between the last two surveys, at a rate which adds on an unprovided-for 2% a year cumulatively over the planning period. As the table somewhat naughtily suggests, it could on these trends add some £10 billions to the planning total for 1984/5 by next year's White Paper.

4. It is instructive to consider what this might mean in rough terms to the underlying informal constant price equivalent of the 1982 PEWP planning total, which is as follows (I round the figures a little, and in favour of my argument):

	1981/2	1982/3	1983/4	1984/5	1985/6
1982 PEWP Planning totals (£bn cost terms, 1980/81 prices)	94.5	95.6	93.6	93.2	[93]
Creep, %	94.5	$7\frac{1}{4}$	$4\frac{1}{2}$	$5\frac{3}{4}$	[$7\frac{1}{2}$]
1982 PEWP totals and creep, approx.	-	97	98	99	[100]

5. These simple calculations suggest that the planning total projected for 1984/5 would, by the time of the 1983 PEWP, be over 5% higher than the 1981/2 outturn, rather than about $1\frac{1}{4}$% lower as at present projected; and that by the next PEWP the planning total would be on a steadily rising rather than falling path, going up at about 1% a year in real terms from 1983/4 onwards after a larger jump of $2\frac{1}{2}$% between this financial year and next.

6. However, in strict logic the process is far worse when one allows for the fact that it will be taking place cumulatively year after year. If one assumed creep takes place between every survey, it would build up as follows:

Cumulative Creep

		1981/2	1982/3	1983/4	1984/5	1985/6
1982 PEWP Baseline £bn cost terms, 1980/81 prices		94.5	95.6	93.6	93.2	[93]
Creep between Surveys:	1982/3, %		$1\frac{1}{4}$	$4\frac{1}{2}$	$5\frac{3}{4}$	[$7\frac{1}{2}$]
	1983/4			$1\frac{1}{4}$	$4\frac{1}{2}$	$5\frac{3}{4}$
	1984/5				$1\frac{1}{4}$	$4\frac{1}{2}$
	1985/6					$1\frac{1}{4}$
Total addition			$1\frac{1}{4}$	$5\frac{3}{4}$	$11\frac{1}{2}$	18%
Expected outturn for total PE, £bn.			97	99	104	110

This simple piece of arithmetic shows how the total addition to the planning total for a distant year will be massive, on the assumption that "creep" is a constant process at the percentages shown, since it will build up steadily as a given year appears on the planning horizon and then comes closer and closer to realisation.

7. On this basis the outturn planning total for 1985/6 would be expected to be some 16% above what is now projected.

8. Now it would, of course, be very tempting to argue that the kind of deterioration in the prospect for the planning totals which took place between 1981 and this year is unlikely to repeat itself, or at least that it is unlikely to recur "normally" on anything like the scale we have just experienced. However, such a reassuring line of reasoning needs to be treated with the greatest scepticism. For:

(1) all the evidence appears to suggest that there will be massive bids for higher programme totals when the current PE survey has got well under way, on a scale more than commensurate with the "creep" experienced between last year and this:

(2) there is the obvious bias in the motivation of all spending ministers towards spending more rather

than economising, which will make itself felt all the more strongly in the future as the economy moves out of the period of crisis and can be expected by then to generate more "room" as it recovers:

(3) for the next survey or two, at least, the imminence of an election may weaken the Treasury's hand in resisting a high proportion bids from colleagues.

9. If one is realistic, it is therefore prudent to consider what "creep" might do to the planning totals for 1980/81 suggested by the inter-departmental report. This is done below on three assumptions, viz. pessimistically that it continues at 2% per annum cumulatively, as between the 1981 and 1982 surveys; at 1% per annum cumulative, which may be deemed a more "central" case; or at ½% per annum, which might be deemed optimistic. The effects of these hypotheses is most usefully expressed by looking at the extent to which they would raise the GDP share of total public spending (including debt interest) above the levels suggested in Figure 1 of the Report.

10. First, the total "creep" over the nine financial years between now and 1990/91 would be:

Rate	Total	
½% p.a.	4½%	optimistic
1% p.a.	9%	**central**
2% p.a.	18%	pessimistic

If one applies these factors to the GDP shares for 1990/91 on the two scenarios A & B, the picture is as follows:

GDP share of PE total (including debt interest)	1979/80	1982/3	1990/91 Report Projection	After "creep" at: Optimistic ½% p.a	Central 1% p.a	Pessimistic 2% p.a
Scenario A	41.0	44.0	39.3	41.0	42.8	46.4
Scenario B	41.0	44.0	46.8	48.9	51.0	55.2

The six possible outcomes for the GDP share of PE in 1990/91 suggested by these calculations are, not surprisingly, most unreassuring. The very best - ½% per annum "creep" in scenario A - leaves the PE share in 1990/91 no better than in 1979/80. Perhaps more important, all the outcomes on the far more plausible scenario B suggest 1990/91 PE shares at 49% of GDP or more.

11. In the light of these far-from-frivolous calculations, it must be accepted that "creep" is likely to be an extremely important phenomenon; that the problems of spending planning and control are likely to be even more intractable over the next few years than the figuring in the report; and that the new and more restrained attitudes to PE bids which you are seeking in the light of the report are of even greater importance. I would suggest, tentatively of course, that at least some of the reasoning deployed above could be used with your colleagues before long.

AM

A N RIDLEY

[illegible]
Sir A Rawlinson
Mr Burns
Mr Barratt
Mr Byatt
Mr Mountfield
Mr Ridley
Mr Harris

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

PRIME MINISTER

LONG TERM TRENDS IN PUBLIC EXPENDITURE

In my minute of 8 March, I suggested that officials should undertake an examination of the likely pattern of public expenditure over the next decade.

2. This study has now been completed and I attach a copy of a report by a group of officials on which the main spending Departments, and the CPRS, were represented. The report considers what, on the basis of certain hypotheses about developments in the economy on the one hand and expenditure programmes on the other, public expenditure might amount to by 1990. Some of the hypotheses - for example about unemployment: see Annex 1 - are inevitably sensitive.

3. As expected, the picture is bad. Only on hypotheses that are rather favourable as regards the economy, and relatively modest as regards expenditure programmes, does public expenditure as a percentage of GDP come out lower in 1990-91 than it was in 1979-80. In cost terms the prospect on any of the hypotheses is for big increases over this period.

4. The report shows clearly how the balance of our public expenditure programmes has changed and will, on present policies, continue to do so. It also shows the extent to which the four largest programmes - social security, health, education and defence - dominate public expenditure. In 1979-80 the four programmes between them amounted to about 60 per cent of the total. By 1990-91, on these projections, they would amount to about 63½ per cent, even on the "best case". Within

that, defence would take a higher proportion and education a smaller proportion of the total.

5. The officials' report looks forward, and shows a generally rising trend of future expenditure. Forecasting in an uncertain world is difficult. But if we look backwards over the last twenty years (Table A annexed) a consistent upward pattern emerges, broken only by the two external crises of 1967 and 1976. Even then, the upward trend was soon resumed.

6. This pattern we need to break, decisively.

7. For this purpose, radical changes affecting most, if not all, of the major programmes will be required. They will need to be reinforced by action on the smaller programmes. But that in itself will not be sufficient. Unless we tackle major programmes in a fundamental way, I see no prospect of achieving our taxation objectives even in the next Parliament.

8. Originally I had in mind to circulate the officials' report for Cabinet discussion this month, so as to influence colleagues' approach to this year's Public Expenditure Survey Cabinet discussions. The latter are due to start on 15 July: we face a difficult prospect, as colleagues have put in numerous bids, some very large.

9. On reflection, however, I think it would be better if the report on long term public expenditure were to some extent distanced from operational decisions about the Survey, so that colleagues could be encouraged to see the report as providing the opportunity for a broad-ranging discussion about our long term objectives regarding public expenditure, and the size and shape of the public sector. This would pave the way for some major strategic decisions affecting our programmes as a Government for the next Parliament.

10. At the recent Versailles summit I was struck - just as I know you were - by the extent to which heads of government and finance ministers everywhere are confronted, like ourselves, by major problems of public expenditure, such as untenable commitments to indexation, and the large public sector deficits which represent a threat to economic recovery. This report can help us to convey some of these insights, even though it does not itself deal with international experience.

11. I think that it would be difficult to conduct a discussion of this kind within the framework of our regular Cabinet meetings. It seems to me that we need to put aside at least a good half-day for the kind of wide-ranging consideration of objectives that I have had in mind. If this were arranged in September, it could also form part of the preparation for this year's Party Conference, at which we shall no doubt be under pressure about various aspects of public expenditure. If you were attracted by the idea of proceeding in this way, I should of course circulate a paper of my own for discussion with the officials' report.

12. In it I would be looking for colleagues' endorsement of a number of important practical decisions as an essential preliminary to putting public expenditure onto a better track, and thus sustaining our economic strategy.

13. First, I would seek agreement to set work in hand on the scope for major structural changes in as many as possible of the four major programme areas. Smaller areas ought to be similarly examined if there is prima facie reason to believe that really significant reductions in expenditure could be made in them. A series of strategic reviews of this kind would be very different from the normal examination of options which is carried out during the public expenditure survey. They should not be inhibited by need for legislation, the existence of past commitments or the alleged political impossibility of change. There must be radical thinking. The aim should be

to produce a series of papers for Ministerial consideration, similarly no doubt in some special forum, no later than the spring of 1983. (The exercise would of course need to be handled on a restricted, and confidential, basis.)

14. I would also hope that colleagues would agree not to press for any new significant long term expenditure commitments, or the renewal of existing commitments. This will be important in the context of this year's Party Conference, where, as I said, we may come under pressure. I see this as essentially a holding operation, until we have been able to evaluate the strategic reviews, and assess the extent to which we shall in the light of them be able to make a really important impact on public expenditure.

15. There is also the matter of 1985-86. As I said, I hope that discussion of the longer term prospects can be to some extent distanced from this year's public expenditure operation. But we shall have to take decisions about the new year in the Survey, 1985-86. I hope that these decisions will reflect our determination to reduce public expenditure over the rest of the decade, and that colleagues will endorse a very cautious approach to expenditure in that year.

16. Lastly, there is the question how we can best educate public opinion in these matters. I believe it would help if we were able to find some way of arranging for an assessment of long term public expenditure prospects to be published by a non-governmental body, to provoke public debate and help to demonstrate the need for radical change.

17. If these ideas appeal to you, I hope that we might look to the CPRS for support in the form of a paper pointing up some of the long term options open to us, especially in relation to the kind of structural changes described in paragraph 13 above.

16. I am sending copies of this minute to Sir Robert Armstrong and Mr. Sparrow only.

G.H.

15 June 1982

23/1876

Draft Minute from: Mr Sparrow

to: Prime Minister

cc: Chancellor of the Exchequer
Sir Robert Armstrong

Long-Term Public Expenditure

In his minute to you of 15 June (paragraph 17), the Chancellor suggests that the CPRS might provide a paper on long-term structural options, for the discussion he proposes of the officials' report on public expenditure prospects.

2. I agree that this is a job the CPRS ought to tackle. There is not much time before September, and as you know we have several other major reports to complete in the same time-scale. But for this first wide-ranging discussion, I take it Ministers will not want an elaborate paper with fully worked-out options. The object is not to reach firm decisions, but to have a preliminary debate on the broad options and then decide what further work should be set in hand. I think we can find enough resources to produce a paper for this purpose, and I hope you will agree that we should do so.

3. There is one proviso. We shall need to consult the Treasury and draw on their thinking. But I think we must also be able to consult other Departments concerned. They are not likely to be enthusiastic contributors, but we must at least try out our ideas on them, to correct avoidable mistakes and prevent any accusation that we have circulated an important paper without giving them a chance to comment. I hope we can achieve this, if you agree, by contacting Departments at official (PFO) level, and telling them that as part of the follow-up to the report by the Treasury-chaired group (in which they joined), you have asked the CPRS to produce a paper pointing up some of the long-term options for major structural changes, as a basis for preliminary Ministerial discussion and decisions on commissioning further work.

4. I suppose officials in some Departments may report this to their Ministers, who may need some assurance that they will have a full opportunity to give their views. But I presume it will be possible to reassure them, if you agree to the procedure proposed in Sir Robert Armstrong's minute of 17 June, with a meeting arranged for this purpose. There is also inevitably some risk of leaks in sensitive areas (charging for "welfare" services, pensions indexation, defence), but in my view

X

13
210

this risk (which we will of course do out best to minimise) cannot be allowed to stop any exploration of options for Ministers.

5. I am sending copies of this minute to the Chancellor of the Exchequer and Sir Robert Armstrong.

2&/1876

CONFIDENTIAL

Draft Minute from: Mr Sparrow

to: Prime Minister

cc: Chancellor of the Exchequer
Sir Robert Armstrong

Long-Term Public Expenditure

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X

3
216

CONFIDENTIAL

this risk (which we will of course do out best to minimise) cannot be allowed to stop any exploration of options for Ministers.

5. I am sending copies of this minute to the Chancellor of the Exchequer and Sir Robert Armstrong.

13/29/6

CONFIDENTIAL

FROM: J O KERR
Date: 28 June 1982

cc: PS/Chief Secretary
Sir D Wass
Sir K Couzens
Mr Burns
Sir W Ryrie
Mr Kemp
Mr R I G Allen

SIR A RAWLINSON

It has been decided that the collective Ministerial discussion of the Long-Term Public Expenditure issues will be at an extended Cabinet meeting on 9 September.

2. Copy addressees may wish to know that the only other Cabinet meeting currently planned for September will be on 30 September; and that the next Cabinet thereafter is likely to be on 14 October. (The Party Conference falls in the week beginning 4 October.)

J K Rutter

pp J O KERR

Mr ~~Hart~~

CONFIDENTIAL

Mr Rayner
NFA.

3/7 30/6

FROM: F R BARRATT
DATE: 30 June 1982

FA

SIR ANTHONY RAWLINSON

cc PS/Chancellor
PS/Chief Secretary
Sir Douglas Wass
Mr Wilding
Mr Mountfield —
Mr Hart
Mr Ridley
Mr Harris

LONG TERM PUBLIC EXPENDITURE

In the course of a telephone conversation about today's Times story, Mr Scholar and I exchanged thoughts on how the Cabinet might best be informed of the intention to discuss the report by officials at an extended Cabinet on 9 September, with the help of a paper from the CPRS.

2. We agreed that the best way of doing this would be, in a week or so's time, after the dust of today's Times story had settled, for the Chancellor to minute the Prime Minister enclosing a copy of the report and making the proposals first, that it should be discussed at a special meeting of the Cabinet, and second, that the CPRS should produce a paper for the occasion. In effect the minute would be a shortened version of the Chancellor's minute to the Prime Minister of 15 June. The Prime Minister would immediately reply agreeing with what the Chancellor proposed. Copies would go to the Cabinet.

3. I shall accordingly submit a draft minute for the Chancellor to send early next week.

F R BARRATT

3/50

CONFIDENTIAL

Mr Hart
~~Mr Rayner.~~
RA

FROM: F R BARRATT
DATE: 8 July 1982

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (C)
Minister of State (R)
Sir Douglas Wass
Sir Anthony Rawlinson
Sir Kenneth Couzens
Sir William Ryrie
Mr Burns
Mr Wilding
Mr Byatt
Mr Mountfield
Mr Ridley
Mr Harris

PUBLIC EXPENDITURE IN THE LONGER TERM

The position now is that

(a) the Prime Minister has agreed that this subject should be discussed at an extended meeting of the Cabinet;

(b) this meeting has been fixed for 9 September;

(c) the CPRS are to write a paper for the meeting. They are already in close touch with Treasury divisions about it.

2. But the rest of the Cabinet does not yet know about these arrangements. Other Ministers must now be informed. This will clear the way for the CPRS to talk to Departments about their paper. They need to start this as soon as possible if they are to do an effective job.

3. I have agreed with Mr Scholar at No 10 that the best way of informing the rest of the Cabinet of what is to happen would be for you to minute the Prime Minister afresh, enclosing a copy of the report and proposing that it should be discussed at a special meeting

of the Cabinet, for which the CPRS would produce a paper. The Prime Minister would immediately reply agreeing with what you had proposed. Copies of both minutes would go to the rest of the Cabinet.

4. By agreement with Mr Scholar, I have held up action on this for a few days in case there were any untoward repercussions from last week's unfortunate story in the Times about the long term exercise. But happily the Times story aroused very little press or public interest, and the dust seems now to have settled on it.

5. I accordingly now attach the draft of a minute for you to send to the Prime Minister. It is, as you will see, a shortened version of the minute you sent her on 15 June. In particular, I have omitted most of the exposition you gave the Prime Minister of what you hoped to achieve at the meeting on long term public expenditure.

6. It would be as well if, before your minute goes off, Mr Kerr were to check with Mr Scholar that the arrangements are in place for the Prime Minister to send a quick reply agreeing with your proposals.

F R BARRATT

Encs:

DRAFT MINUTE TO THE PRIME MINISTER

Copies to members of the Cabinet
Sir Robert Armstrong
Mr Sparrow

LONG TERM TRENDS IN PUBLIC EXPENDITURE

In my minute of 8 March, I suggested that officials should undertake an examination of the likely pattern of public expenditure over the next decade.

2. This study has now been completed and I attach a copy of a report by a group of officials on which the main spending Departments, and the CPRS, were represented. The report considers what, on the basis of certain hypotheses about developments in the economy on the one hand and expenditure programmes on the other, public expenditure might amount to by 1990.

3. As expected, the picture is bad. Only on hypotheses that are rather favourable as regards the economy, and relatively modest as regards expenditure programmes, does public expenditure as a percentage of GDP come out lower in 1990-91 than it was in 1979-80. In cost terms the prospect on any of the hypotheses is for big increases over this period.

4. The report shows clearly how the balance of our public expenditure programmes has changed and will, on present policies, continue to do so. It also shows the extent to which the four largest programmes - social security, health, education and defence - dominate public expenditure. In 1979-80 the four programmes between them amounted to about 60 per cent of the total. By 1990-91, on these projections, they would amount to about 63½ per cent, even in the "best case". Within that, defence would take a higher proportion and education a smaller proportion of the total.

5. The officials' report looks forward, and shows a generally rising trend of future expenditure. Forecasting in an uncertain world is difficult. But if we look backwards over the last twenty years (Table A annexed) a consistent upward pattern emerges, broken only by the two external crises of 1967 and 1976. Even then, the upward trend was soon resumed.

6. This pattern we need to break, decisively.

7. For this purpose, radical changes affecting most, if not all, of the major programmes will be required. They will need to be reinforced by action on the smaller programmes. But that in itself will not be sufficient. Unless we tackle major programmes in a fundamental way, I see no prospect of achieving our taxation objectives even in the next Parliament.

8. I accordingly propose that the next step should be for the Cabinet to engage, on the basis of the officials' report, in a very broad-ranging discussion about the Government's long term objectives for public expenditure and the size and shape of the public sector. We should not be inhibited at this stage by such considerations as the need for legislation, the existence of past commitments or the alleged political impossibility of change. A discussion of this kind would pave the way for some major strategic decisions affecting our programmes as a Government for the next Parliament.

9. We are due to start our consideration of this year's public expenditure Survey in Cabinet on 15 July. Obviously there is some connection between decisions on the Survey, at any rate as regards the last year 1985-86, and the longer term. Nevertheless I believe that it will be more conducive to the kind of broad exchanges that I have in mind if our discussion of the longer term is distanced somewhat from our preoccupations with the Survey.

10. It seems to me that it would be difficult to conduct an adequate discussion about the longer term within the framework of

our regular Cabinet meetings, and that some special arrangements for this discussion will be needed - perhaps a specially convened meeting of the Cabinet. If such a meeting took place in September, it could also form part of the preparation for this year's Party Conference, at which we shall no doubt be under pressure about various aspects of public expenditure.

11. I should of course circulate a paper of my own for discussion with the officials' report. I hope too that we might look to the CPRS for support in the form of a paper pointing up some of the longer term options open to us, especially as regards the possibilities for major structural changes affecting the largest expenditure programmes.

12. I am sending copies of this minute and the officials' report to members of the Cabinet, Sir Robert Armstrong and Mr Sparrow.

TABLE A

RATIO OF PUBLIC EXPENDITURE TO GDP(1)

	A	B
1963-64	)	34.3
1964-65	)	34.1
1965-66	)	35.3
1966-67	)	36.6
1967-68	) not	40.2
1968-69	) available	38.5
1969-70	)	37.8
1970-71	)	37.9
1971-72	)	37.8
1972-73	)	38.7
1973-74	)	40.4
1974-75	46.2	45.3
1975-76	46.2	45.7
1976-77	44.5	43.5
1977-78	40.3	39.7
1978-79	41.2	40.9
1979-80	41.0	41.2
1980-81	43.6	43.8
1981-82(2)	44.8	44.6

NOTES

(1) The two columns correspond to two definitions of public expenditure. Column A is total public expenditure as defined in the report on Long Term Public Expenditure. Figures on this definition cannot be taken back beyond 1974-75, since figures for nationalised industries' market and overseas borrowing are not available for the earlier years. The series in Column B excludes nationalised industries' market and overseas borrowing throughout.

(2) Estimated outturn, subject to revision.

FROM: MISS J M SWIFT
DATE: 9 July 1982

CHIEF SECRETARY TO THE TREASURY

Mr Rayner
Mr Hart PA

PRINCIPAL PRIVATE SECRETARY

cc Financial Secretary
Economic Secretary
Minister of State (C)
Minister of State (R)
Sir Douglas Wass
Sir Anthony Rawlinson
Sir Kenneth Couzens
Sir William Ryrie
Mr Burns
Mr Wilding
Mr Byatt
Mr Barratt
~~Mr Mountfield~~
Mr Ridley
Mr Harris

PUBLIC EXPENDITURE IN THE LONGER TERM

The Chief Secretary has seen Mr Barratt's minute of 8 July to the Chancellor.

2. The Chief Secretary is quite content with what is proposed. He notes that it was agreed at the Chancellor's meeting of Ministers and Advisers this morning that the minute to the Prime Minister should not go around before next Thursday.

MISS J M SWIFT

Mr ? [illegible]

FROM: M A HALL
9 July 1982

Mr Bayner

CHANCELLOR

c c Chief Secretary
Financial Secretary
Economic Secretary
Minister of State(C)
Minister of State(R)
Sir Douglas Wass
Sir Anthony Rawlinson
Sir Kenneth Couzens
Sir William Ryrie
Mr Burns
Mr Wilding
Mr Byatt
Mr Mountfield
Mr Ridley
Mr Harris
Mr Barratt

PUBLIC EXPENDITURE IN THE LONGER TERM

Please refer to Mr Barratt's minute of 8 July.

2. I am now convinced that David Blake has got a copy of the document, and he is certainly thinking of reverting to this subject, looking at particular programmes (no doubt in his new capacity as Home Editor). I say this only to dispel the view that the dust seems to have settled. I doubt whether press interest in any way invalidates the exercise.

MAH

M A HALL

FROM: J.O. KERR
12 July 1982

RA

cc: PS/Chief Secretary
Sir Anthony Rawlinson
Mr. Mountfield

Mr Hart

Mr Bayner.

MR. BARRATT

PUBLIC EXPENDITURE IN THE LONGER TERM

The Chancellor last week saw your submission of 8 July, with the draft of his minute to the Prime Minister and Cabinet colleagues.

2. On timing, he was inclined to think, and his Ministerial colleagues agreed - see Miss Swift's minute of 9 July - that it would be best to circulate his minute just <u>after</u> this week's Cabinet.

3. On the draft, he made minor changes only to paragraphs 6 to 8. I attach his revised version.

4. Unless you see objection, this revised version will be circulated on 16 July.

JOK

J.O. KERR

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

PRIME MINISTER

LONG TERM TRENDS IN PUBLIC EXPENDITURE

In my minute of 8 March, I suggested that officials should undertake an examination of the likely pattern of public expenditure over the next decade.

2. This study has now been completed and I attach a copy of a report by a group of officials on which the main spending Departments, and the CPRS, were represented. The report considers what, on the basis of certain hypotheses about developments in the economy on the one hand and expenditure programmes on the other, public expenditure might amount to by 1990.

3. As expected, the picture is bad. Only on hypotheses that are rather favourable as regards the economy, and relatively modest as regards expenditure programmes, does public expenditure as a percentage of GDP come out lower in 1990-91 than it was in 1979-80. In cost terms the prospect on any of the hypotheses is for big increases over this period.

4. The report shows clearly how the balance of our public expenditure programmes has changed and will, on present policies, continue to do so. It also shows the extent to which the four largest programmes - social security, health, education and defence - dominate public expenditure. In 1979-80 the four programmes between them amounted to about 60 per cent of the total. By 1990-91, on these projections, they would amount to about 63½ per cent, even in the "best case". Within that, defence would take a higher proportion and education a smaller proportion of the total.

5. The officials' report looks forward, and shows a generally rising trend of future expenditure. Forecasting in an uncertain world is difficult. But if we look backwards over the last twenty years (Table A annexed) a consistent upward pattern emerges, broken only by the two external crises of 1967 and 1976. Even then, the upward trend was soon resumed.

6. Clearly we cannot go on like this. If we are to break the pattern decisively - as we must - then we shall need to consider radical changes affecting most, if not all, areas of policy. Unless we are willing to tackle some pretty basic questions in a fundamental way, then, so far from being able to offer the chance of some easement of the tax burden (clearly desirable for industrial recovery) we should face instead the prospect of endlessly recurring "public expenditure crises".

7. It would, I am sure, be helpful if Cabinet was now able to engage, on the basis of the officials' report, in a very broad-ranging discussion about the Government's long-term objectives for the size and shape of the public sector. We should not be inhibited at this stage by such considerations as the need for legislation, the existence of past commitments or the alleged political impossibility of change. A discussion of this kind would pave the way for some major strategic decisions affecting our programmes as a Government for the next Parliament.

8. Obviously there is some connection between decisions on this year's public expenditure Survey, at any rate as regards the last year 1985-86, and the longer term. Nevertheless I believe that it will be more conducive to the kind of broad exchanges that I have in mind if our discussion of the longer term is distanced somewhat from our preoccupations with the Survey.

9. It seems to me that it would be difficult to conduct an adequate discussion about the longer term within the framework of our regular

Cabinet meetings, and that some special arrangements for this discussion will be needed - perhaps a specially convened meeting of the Cabinet. If such a meeting took place in September, it could also form part of the preparation for this year's Party Conference, at which we shall no doubt be under pressure about various aspects of public expenditure.

10. I should of course circulate a paper of my own for discussion with the officials' report. I hope too that we might look to the CPRS for support in the form of a paper pointing up some of the longer term options open to us, especially as regards the possibilities for major structural changes affecting the largest expenditure programmes.

11. I am sending copies of this minute and the officials' report to members of the Cabinet, Sir Robert Armstrong and Mr. Sparrow.

G.H.

July 1982

FROM: F R BARRA
DATE: 13 July 1

MR KERR

cc PS/Chief Sec
Sir Anthony
Mr Mountfiel

PUBLIC EXPENDITURE IN THE LONGER TERM

not seen

Thank you for your minute of 12 July. I am well content wit revised draft minute to the Prime Minister. Before you desp it on 16 July, I think it would be desirable for you to chec with the Chancellor and the Chief Secretary that nothing was at Cabinet on 15 July that would call for any further revisi the minute to the Prime Minister.

2. I take it that before the minute goes off, you will be with Mr Scholar about the handling of it, along the lines of paragraph 6 of my minute of 8 July.

F R BARRATT

Mr Rayner.
Mr Hart

RJ

14/13

Confidential.

RA

FROM: J O KERR
21 July 1982

MR BARRATT

cc PS/CST
Sir A Rawlinson
Mr Mountfield

PUBLIC EXPENDITURE IN THE LONGER TERM

I fear that the circulation of the Chancellor's minute, and the report of your inter-departmental group, has been further delayed.

2. You will recall that the Chancellor thought it right not to circulate it before Cabinet on 15 July. I was in touch with Mr Scholar after Cabinet on 15 July, but his feeling was that the Prime Minister would not wish the report circulated before the announcement (20 July) of the latest unemployment figures. I therefore approached him again last night, and he spoke to the Prime Minister this morning: it transpires that she does not wish it to be circulated before next week's debate on the economy/unemployment. We shall therefore now aim for circulation on 29 July.

JOK.

J O KERR

Mr Rayner
Mr Mountfield will want a word about this next week.
AH 23/7.

Mr Hart
(Cd we pl sph abt briefing before you go on leave?)
PR

cc Miss Brown
Mr Sparkman

1/22/7

RA

FROM: J O KERR
21 July 1982

MR ~~BARR~~ATT

cc PS/CST
Sir A Rawlinson
Mr Mountfield

PUBLIC EXPENDITURE IN THE LONGER TERM

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JOK

J O KERR

CONFIDENTIAL

Add to pr for TPEC 4 Aug 87

cc CST
FST
EST
MST(C)
MST(R)
Sir D Wass
Sir A Rawlinson
Sir K Couzens
Mr Burns
Mr Barratt
Mr Wilding
Mr Byatt
Mr Mountfield
Mr Ridley
Mr Harris

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

PRIME MINISTER

LONG TERM TRENDS IN PUBLIC EXPENDITURE

In my minute of 8 March, I suggested that officials should undertake an examination of the likely pattern of public expenditure over the next decade.

... 2. This study has now been completed and I attach a copy of a report by a group of officials on which the main spending Departments, and the CPRS, were represented. The report considers what, on the basis of certain hypotheses about developments in the economy on the one hand and expenditure programmes on the other, public expenditure might amount to by 1990.

3. As expected, the picture is bad. Only on hypotheses that are rather favourable as regards the economy, and relatively modest as regards expenditure programmes, does public expenditure as a percentage of GDP come out lower in 1990-91 than it was in 1979-80. In cost terms the prospect on any of the hypotheses is for big increases over this period.

4. The report shows clearly how the balance of our public expenditure programmes has changed and will, on present policies, continue to do so. It also shows the extent to which the four largest programmes - social security, health, education and defence - dominate public expenditure. In 1979-80 the four programmes between them amounted to about 60 per cent of the total. By 1990-91, on these projections, they would amount to about 63½ per cent, even in the "best case". Within that, defence would take a higher proportion and education a smaller proportion of the total.

6/98

Cabinet meetings, and that some special arrangements for this discussion will be needed - perhaps a specially convened meeting of the Cabinet. If such a meeting took place in September, it could also form part of the preparation for this year's Party Conference, at which we shall no doubt be under pressure about various aspects of public expenditure.

10. I should of course circulate a paper of my own for discussion with the officials' report. I hope too that we might look to the CPRS for support in the form of a paper pointing up some of the longer term options open to us, especially as regards the possibilities for major structural changes affecting the largest expenditure programmes.

11. I am sending copies of this minute and the officials' report to members of the Cabinet, Sir Robert Armstrong and Mr. Sparrow.

G.H.

28 July 1982

For TPEC (R) ~~Tues~~ Wed -

10 DOWNING STREET

From the Private Secretary

29 July, 1982

MST R
Sir D Wass
Sir A Rawlinson
Sir K Couzens
Mr Burns
Mr Bridgeman
Mr Byatt
Mr Mountfield
Mr Ridley
Mr Harris

Dear John,

Long Term Trends in Public Expenditure

The Chancellor minuted the Prime Minister on 28 July about the likely pattern of public expenditure over the next decade.

The Prime Minister agrees that it would be helpful for Cabinet to have a broad ranging discussion, based on the report by officials attached to the Chancellor's minute, about the Government's long term objectives on the size and shape of the public sector. The Prime Minister hopes that this can take place at the meeting of Cabinet arranged for 9 September; I understand that time has been earmarked in Ministers' diaries for an extended discussion on that day. The Prime Minister agrees, too, that it would be useful for the 9 September discussion, if there were to be a CPRS paper pointing up some of the long term options open to the Government, especially as regards the possibilities for major structural changes affecting the larger expenditure programmes.

I am sending copies of this letter to the Private Secretaries to the other members of the Cabinet, to David Wright and to Gerry Spence.

Yours sincerely,

Michael Scholar

John Kerr, Esq.,
H.M. Treasury

44/106

FROM: F R BARRATT
DATE: 6 August 1982

RA

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (C)
Minister of State (R)
Sir Douglas Wass
Sir Anthony Rawlinson (or)
Sir Kenneth Couzens
Mr Burns
Mr Wilding
Mr Byatt
Mr Middleton
Mr Kemp
Mr Moore
Mr Mountfield
Mr G P Smith
Mr Hart (or)
Mr Rayner
Mr Ridley

LONG TERM TRENDS IN PUBLIC EXPENDITURE

As a result of the exchanges at the end of last month between yourself and No 10, we are now on course for a Cabinet discussion of this subject on 9 September. The CPRS are in process of working up their paper for this occasion, in consultation with us and with the main spending Departments. You will also want to circulate a paper of your own.

2. We shall aim to have a draft of your paper ready for you to see on your return about 24 August. It will reflect your objectives for the 9 September Cabinet. As we see it, these are:

(i) to underline the unacceptability of the long-term expenditure prospects described in the officials' report;

(ii) to get agreement on a series of studies, drawing on the suggestions of the CPRS, of radical structural changes in a number of major areas of public expenditure, the outcome to be reported to Cabinet early next year;

50/134

(iii) in the meantime, to obtain some sort of self-denying ordinance from colleagues about significant new expenditure commitments. This will be especially important in the run-up to the Party Conference.

(iv) if possible, to influence the tone of this autumn's discussions on the current Survey, especially as regards 1985/86.

3. As part of (i) - the unacceptability of the long-term public expenditure prospects - you will want to say something to your colleagues about the tax aspects. Some work on the tax implications of the prospects discussed in the officials' paper on expenditure has been going on under the direction of Mr Byatt.

4. I now attach a note on these implications by Mr G P Smith. We envisage that you should make this available to your colleagues. Our proposal is that this note should be attached as an Annex, under the heading "Note by the Treasury", to your paper for the 9 September Cabinet. Your paper would include a couple of pithy paragraphs highlighting the main points of the analysis in the Annex.

5. I should be glad to know whether you are content with this way of proceeding.

F R BARRATT

Enc:

PUBLIC EXPENDITURE IN THE LONGER TERM: FISCAL IMPLICATIONS

The longer-term public expenditure exercise has projected expenditure to the end of the decade on two illustrative macro-economic scenarios, the main features of which are shown at Annex A. This note describes a similar projection of tax revenue on each of the same scenarios, and goes on to look at the balance between revenue and expenditure that is implied. Like the expenditure figures, these projections are dependent on the scenarios assumed: they are not forecasts. The margin of error is inevitably wide when looking so far ahead.

Assumptions

2. Like expenditure, taxes have been projected on the basis of unchanged policy. This has been interpreted to mean that income tax thresholds and specific duties are raised in line with prices, that tax rates are unchanged and that existing allowances and reliefs are continued. Local authority rates and national insurance contributions are calculated from the projections of local authority expenditure and expenditure from the national insurance fund, respectively, on the assumption that an unchanged proportion of such expenditure is met from general taxation. For North Sea taxes the real sterling oil price is assumed to rise by about a third between 1980 and 1990. Even though some new fields are assumed to come on stream, total production is assumed to be a little below its peak level, which is reached in mid-decade.

The projections

3. On scenario A tax receipts are projected to rise about 20% in real terms between 1982-83 and 1990-91 but to fall from 39½% to just over 37% of GDP (see Table A). The main reason for this fall is that local authority rates and national insurance contributions grow a good deal more slowly than GDP. As already explained, these receipts are determined by local authority expenditure

and payments of benefits from the National Insurance Fund assumed in the Public Expenditure projections - these grow a good deal more slowly than GDP. Income tax and consumption taxes fall slightly in relation to GDP, the former because the scenario assumes a falling wage share, the latter because the evidence is that a 10% rise in income leads to less than a 10% rise in consumption of goods that bear specific duties. The yield of capital taxes also declines in relation to GDP, largely because of the indexation of CGT. Corporation tax and North Sea taxes, on the other hand, rise somewhat as a percentage of GDP.

4. On scenario B projected tax receipts rise by only 6% in real terms - a good deal less than on scenario A. But GDP also rises more slowly and taxes remain roughly constant as a percentage of GDP at just below 40% (see Table B). Local rates - derived from the Expenditure projections - fall in relation to GDP as in scenario A, but NIC's remain a roughly constant proportion of GDP because the limited growth in benefit expenditure matches the limited growth in GDP. Capital taxes again fall in relation to GDP. Against this North Sea taxes and income tax rise as a percentage of GDP. (Corporation tax is about constant). The reason why income tax rises in relation to GDP on scenario B, unlike scenario A, is that wages and salaries rise as a share of GDP. 80-90% of the yield of income tax comes from wages and salaries. Consumption taxes, however, fall as a percentage of GDP because of the tendency for expenditure on goods bearing specific duties to rise less fast than income.

Implications

5. The gap between expenditure and revenue on scenario A represents about 2% of GDP - about the same percentage as the PSBR in the last year of the MTFS. But it should be remembered that the projections are based on existing tax rates and real values of thresholds and do not allow for any tax reductions beyond the effect of decisions already taken (such as indexing CGT) and the fall in NIC rates (and local authority rates) implied by the expenditure projections. In particular a borrowing requirement of 2% of GDP

leaves no scope for reductions in income tax in order to give further improvements in incentives and this must cast doubt on the attainability of the growth assumed in scenario A.

6. If the economy develops as in scenario B the problem of financing public expenditure is likely to be a severe one. The projections show expenditure - which is little lower than in scenario A - exceeding revenue by 7% of GDP. If this gap were bridged by borrowing the implication is a reversal of progress so far made in reducing the PSBR and a return to the levels of the mid-70's. But if borrowing were to be restrained to 2% of GDP without cuts in expenditure, taxes would have to be raised by some £15bn at today's prices. The tax burden would rise from 40% to 45% of GDP (having already risen from 35% to 40% since 1978-79).

7. Raising £15bn through income tax would require raising the yield by about half. If it came from the consumption taxes (VAT and specific duties) their combined yield would similarly have to be increased by half. (Raising £15bn in VAT alone would require the VAT yield to be doubled.) How such increases in revenue might actually be achieved is another matter. The response of taxpayers to changes on this scale cannot be predicted with any precision. But in crude "ready reckoner" terms what is implied is, at the least:

- raising the basic rate of income tax to about 45p (more if the tax base were reduced through evasion or disincentive effects). Deductions of tax and NIC together would then be over 50 per cent on a marginal £ of income for nearly all taxpayers

or - abolishing all allowances other than the single allowance (eg the married man's allowance, mortgage tax relief, relief for pension contributions and life assurance) <u>and</u> raising the basic rate to perhaps 33p

or - raising VAT to 25% and doubling the real level of all specific duties

or - levying VAT at 25% on goods which now bear the 15% rate <u>and</u> those now zero-rated (food, fuel, etc)

Conclusions

8. The projections are, as stressed above, subject to a wide margin of error. But they raise doubts about the feasibility of financing the levels of public expenditure implied by the continuation of current policies. If the economy grows very slowly, as in scenario B, the consequences for taxation and/or borrowing appear unacceptable. The economy would need to grow steadily and strongly, as in scenario A, to permit the sort of expenditure levels envisaged. It is questionable whether this growth could arise without any further Government action to improve work incentives or reduce burdens on businesses through tax cuts. But if taxes were cut borrowing could not be restrained to 2% of GDP and the inflation and interest rate assumptions would begin to look implausible.

Annex A

ECONOMIC SCENARIOS - MAIN ASSUMPTIONS

	SCENARIO A	SCENARIO B
GDP (average annual growth rate from 1980-81)	2½%	¾% to 1985-86 then ⅓% to 1990-91
Productivity in the marketed sector (average annual growth rate from 1980-81)	3%	1½%
Unemployment (narrow definition, excluding school leavers)	2 million in 1990-91	3 million in 1990-91
Inflation (GDP deflator)	5% per year in mid and late 1980s	10% per year in mid and late 1980s
Real interest rate	2% in 1990-91	2% in 1990-91
Real trade-weighted exchange rate (1980-81 = 100)	83 in 1990-91	83 in 1990-91
Real marketed sector wages (average annual increase from 1980-81)	1½%	1½%
Real public service wages (average annual increase from 1980-81)	½%	¼%

TABLE A: Tax yields at constant (1980-1) prices and as a percentage of GDP on Scenario A.

	£BN 1980-1 prices		% of GDP	
	1982-3	1990-1	1982-3	1990-1
Income Tax	25.7	32.3	11.1	10.9
NIC's	16.4	18.6	7.0	6.3
Consumption taxes (incl VAT and specifics)	26.6	32.7	11.4	11.1
LA Rates	10.5	9.3	4.5	3.2
Corporation Tax, North Sea taxes and NIS	11.1	16.0	4.8	5.4
Capital taxes	1.8	1.1	0.8	0.4
TOTAL	92.1	109.9	39.4	37.2
Public Expenditure (incld debt interest)	103.0	116.0	44.0	39.3

Note: Columns do not add exactly to totals because of rounding

TABLE B: Tax yields at constant (1980-1) prices and as a percentage of GDP on Scenario B.

	£BN 1980-1 prices		% of GDP	
	1982-3	1990-1	1982-3	1990-1
Income Tax	25.7	29.4	11.1	12.0
NIC's	16.4	17.5	7.0	7.1
Consumption taxes (incl VAT and specifics)	26.6	27.3	11.4	11.1
LA Rates	10.5	9.2	4.5	3.7
Corporation tax, North Sea taxes and NIS	11.1	13.1	4.8	5.3
Capital taxes	1.8	1.1	0.8	0.4
TOTAL	92.1	97.4	39.4	39.7
Public expenditure (incl debt interest)	103.0	115.0	44.0	46.8

Mr Rayner

RA

PS/CHANCELLOR
PS/CHIEF SECRETARY
PS/FINANCIAL SECRETARY
PS/MINISTER OF STATE (C)
PS/MINISTER OF STATE (R)
PS/SIR DOUGLAS WASS
PS/SIR ANTHONY RAWLINSON
PS/SIR KENNETH COUZENS
PS/MR BURNS
PS/MRWILDING
PS/MR BYATT
PS/MR MIDDLETON
MR KEMP
MR MOORE
MR MOUNTFIELD
MR B P SMITH
MR HART
MR RAYNER
MR RIDLEY

LONG TERM TRENDS IN PUBLIC EXPENDITURE

Please substitute the attached front page for the front page of the minute sent round earlier this afternoon on the above subject.

PA/MR F R BARRATT
6 August 1982

17/130

FROM: F R BARRATT
DATE: 6 August 1982

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (C)
Minister of State (R)
Sir Douglas Wass
Sir Anthony Rawlinson (or)
Sir Kenneth Couzens
Mr Burns
Mr Wilding
Mr Byatt
Mr Middleton
Mr Kemp
Mr Moore
Mr Mountfield
Mr G P Smith
Mr Hart (or)
Mr Rayner
Mr Ridley

LONG TERM TRENDS IN PUBLIC EXPENDITURE

As a result of the exchanges at the end of last month between yourself and No 10, we are now on course for a Cabinet discussion of this subject on 9 September. The CPRS are in process of working up their paper for this occasion, in consultation with us and with the main spending Departments. You will also want to circulate a paper of your own.

2. We shall aim to have a draft of your paper ready for you to see on your return about 24 August. It will reflect your objectives for the 9 September Cabinet. As we see it, these are:

(i) to underline the unacceptability of the long-term expenditure prospects described in the officials' report;

(ii) to get agreement on a series of studies, drawing on the suggestions of the CPRS, of radical structural changes in a number of major areas of public expenditure, the outcome to be reported to Cabinet early next year;

Ms Leahy

[redacted]

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (C)
Minister of State (R)
Sir Douglas Wass
Sir Anthony Rawlinson (or)
Sir Kenneth Couzens
Mr Burns
Mr Wilding
Mr Byatt
Mr Middleton
Mr Kemp
Mr Moore
Mr Mountfield
Mr G P Smith
Mr Hart (or)
Mr Rayner
Mr Ridley

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As a result of the exchanges at the end of last month between yourself and No 10, we are now on course for a Cabinet discussion of this subject on 9 September. The CPRS are in process of working up their paper for this occasion, in consultation with us and with the main spending Departments. You will also want to circulate a paper of your own.

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(i) to underline the unacceptability of the long-term expenditure prospects described in the officials' report;

(ii) to get agreement on a series of studies, drawing on the suggestions of the CPRS, of radical structural changes in a number of major areas of public expenditure, the outcome to be reported to Cabinet early next year;

(iii) in the meantime, to obtain some sort of self-denying ordinance from colleagues about significant new expenditure commitments. This will be especially important in the run-up to the Party Conference.

(iv) if possible, to influence the tone of this autumn's discussions on the current Survey, especially as regards 1985/86.

3. As part of (i) - the unacceptability of the long-term public expenditure prospects - you will want to say something to your colleagues about the tax aspects. Some work on the tax implications of the prospects discussed in the officials' paper on expenditure has been going on under the direction of Mr Byatt.

4. I now attach a note on these implications by Mr G P Smith. We envisage that you should make this available to your colleagues. Our proposal is that this note should be attached as an Annex, under the heading "Note by the Treasury", to your paper for the 9 September Cabinet. Your paper would include a couple of pithy paragraphs highlighting the main points of the analysis in the Annex.

5. I should be glad to know whether you are content with this way of proceeding.

F R BARRATT

Enc:

CONFIDENTIAL

PUBLIC EXPENDITURE IN THE LONGER TERM:
FISCAL IMPLICATIONS

The longer-term public expenditure exercise has projected expenditure to the end of the decade on two illustrative macro-economic scenarios, the main features of which are shown at Annex A. This note describes a similar projection of tax revenue on each of the same scenarios, and goes on to look at the balance between revenue and expenditure that is implied. Like the expenditure figures, these projections are dependent on the scenarios assumed: they are not forecasts. The margin of error is inevitably wide when looking so far ahead.

Assumptions

2. Like expenditure, taxes have been projected on the basis of unchanged policy. This has been interpreted to mean that income tax thresholds and specific duties are raised in line with prices, that tax rates are unchanged and that existing allowances and reliefs are continued. Local authority rates and national insurance contributions are calculated from the projections of local authority expenditure and expenditure from the national insurance fund, respectively, on the assumption that an unchanged proportion of such expenditure is met from general taxation. For North Sea taxes the real sterling oil price is assumed to rise by about a third between 1980 and 1990. Even though some new fields are assumed to come on stream, total production is assumed to be a little below its peak level, which is reached in mid-decade.

The projections

3. On scenario A tax receipts are projected to rise about 20% in real terms between 1982-83 and 1990-91 but to fall from 39½% to just over 37% of GDP (see Table A). The main reason for this fall is that local authority rates and national insurance contributions grow a good deal more slowly than GDP. As already explained, these receipts are determined by local authority expenditure

and payments of benefits from the National Insurance Fund assumed in the Public Expenditure projections - these grow a good deal more slowly than GDP. Income tax and consumption taxes fall slightly in relation to GDP, the former because the scenario assumes a falling wage share, the latter because the evidence is that a 10% rise in income leads to less than a 10% rise in consumption of goods that bear specific duties. The yield of capital taxes also declines in relation to GDP, largely because of the indexation of CGT. Corporation tax and North Sea taxes, on the other hand, rise somewhat as a percentage of GDP.

4. On scenario B projected tax receipts rise by only 6% in real terms - a good deal less than on scenario A. But GDP also rises more slowly and taxes remain roughly constant as a percentage of GDP at just below 40% (see Table B). Local rates - derived from the Expenditure projections - fall in relation to GDP as in scenario A, but NIC's remain a roughly constant proportion of GDP because the limited growth in benefit expenditure matches the limited growth in GDP. Capital taxes again fall in relation to GDP. Against this North Sea taxes and income tax rise as a percentage of GDP. (Corporation tax is about constant). The reason why income tax rises in relation to GDP on scenario B, unlike scenario A, is that wages and salaries rise as a share of GDP. 80-90% of the yield of income tax comes from wages and salaries. Consumption taxes, however, fall as a percentage of GDP because of the tendency for expenditure on goods bearing specific duties to rise less fast than income.

Implications

5. The gap between expenditure and revenue on scenario A represents about 2% of GDP - about the same percentage as the PSBR in the last year of the MTFS. But it should be remembered that the projections are based on existing tax rates and real values of thresholds and do not allow for any tax reductions beyond the effect of decisions already taken (such as indexing CGT) and the fall in NIC rates (and local authority rates) implied by the expenditure projections. In particular a borrowing requirement of 2% of GDP

leaves no scope for reductions in income tax in order to give further improvements in incentives and this must cast doubt on the attainability of the growth assumed in scenario A.

6. If the economy develops as in scenario B the problem of financing public expenditure is likely to be a severe one. The projections show expenditure - which is little lower than in scenario A - exceeding revenue by 7% of GDP. If this gap were bridged by borrowing the implication is a reversal of progress so far made in reducing the PSBR and a return to the levels of the mid-70's. But if borrowing were to be restrained to 2% of GDP without cuts in expenditure, taxes would have to be raised by some £15bn at today's prices. The tax burden would rise from 40% to 45% of GDP (having already risen from 35% to 40% since 1978-79).

7. Raising £15bn through income tax would require raising the yield by about half. If it came from the consumption taxes (VAT and specific duties) their combined yield would similarly have to be increased by half. (Raising £15bn in VAT alone would require the VAT yield to be doubled.) How such increases in revenue might actually be achieved is another matter. The response of taxpayers to changes on this scale cannot be predicted with any precision. But in crude "ready reckoner" terms what is implied is, at the least:

- raising the basic rate of income tax to about 45p (more if the tax base were reduced through evasion or disincentive effects). Deductions of tax and NIC together would then be over 50 per cent on a marginal £ of income for nearly all taxpayers

or - abolishing all allowances other than the single allowance (eg the married man's allowance, mortgage tax relief, relief for pension contributions and life assurance) <u>and</u> raising the basic rate to perhaps 33p

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or - levying VAT at 25% on goods which now bear the 15% rate <u>and</u> those now zero-rated (food, fuel, etc)

Conclusions

8. The projections are, as stressed above, subject to a wide margin of error. But they raise doubts about the feasibility of financing the levels of public expenditure implied by the continuation of current policies. If the economy grows very slowly, as in scenario B, the consequences for taxation and/or borrowing appear unacceptable. The economy would need to grow steadily and strongly, as in scenario A, to permit the sort of expenditure levels envisaged. It is questionable whether this growth could arise without any further Government action to improve work incentives or reduce burdens on businesses through tax cuts. But if taxes were cut borrowing could not be restrained to 2% of GDP and the inflation and interest rate assumptions would begin to look implausible.

ANNEX A

ECONOMIC SCENARIOS - MAIN ASSUMPTIONS

	SCENARIO A	SCENARIO B
GDP (average annual growth rate from 1980-81)	$2\frac{1}{3}\%$	$\frac{3}{4}\%$ to 1985-86 then $\frac{1}{3}\%$ to 1990-91
Productivity in the marketed sector (average annual growth rate from 1980-81)	3%	$1\frac{1}{2}\%$
Unemployment (narrow definition, excluding school leavers)	2 million in 1990-91	3 million in 1990-91
Inflation (GDP deflator)	5% per year in mid and late 1980s	10% per year in mid and late 1980s
Real interest rate	2% in 1990-91	2% in 1990-91
Real trade-weighted exchange rate (1980-81 = 100)	83 in 1990-91	83 in 1990-91
Real marketed sector wages (average annual increase from 1980-81)	$1\frac{1}{2}\%$	$1\frac{1}{3}\%$
Real public service wages (average annual increase from 1980-81)	$\frac{1}{2}\%$	$\frac{1}{4}\%$

TABLE A: Tax yields at constant (1980-1) prices and as a percentage of GDP on Scenario A.

	£BN 1980-1 prices		% of GDP	
	1982-3	1990-1	1982-3	1990-1
Income Tax	25.7	32.3	11.1	10.9
NIC's	16.4	18.6	7.0	6.3
Consumption taxes (incl VAT and specifics)	26.6	32.7	11.4	11.1
LA Rates	10.5	9.3	4.5	3.2
Corporation Tax, North Sea taxes and NIS	11.1	16.0	4.8	5.4
Capital taxes	1.8	1.1	0.8	0.4
TOTAL	92.1	109.9	39.4	37.2
Public Expenditure (incld debt interest)	103.0	116.0	44.0	39.3

Note: Columns do not add exactly to totals because of rounding

TABLE B: Tax yields at constant (1980-1) prices and as a percentage of GDP on Scenario B.

	£BN 1980-1 prices		% of GDP	
	1982-3	1990-1	1982-3	1990-1
Income Tax	25.7	29.4	11.1	12.0
NIC's	16.4	17.5	7.0	7.1
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TOTAL	92.1	97.4	39.4	39.7
Public expenditure (incl debt interest)	103.0	115.0	44.0	46.8

FROM: P S JENKINS
9 August 1982

CHIEF SECRETARY

cc FST
EST
MST(C)
MST(R)
Sir D Wass
Sir A Rawlinson
Mr Burns
Mr Barratt
Mr Mountfield
Mr Hart
Mr ~~Kemp~~

THE PUBLIC EXPENDITURE DEBATE

The Chancellor received the attached joint minute by Ferdinand Mount and Alan Walters from the latter. He feels it is on the whole rather useful. Indeed some of the simple, formidable urgency of the note must be reflected in the CPRS paper - to turn it into something more than a shopping list of super-cuts.

PSJ

P S JENKINS

Mr Ragner to see
Mr Hart or

Miss ~~Leahy~~.

PRIME MINISTER [illegible] July 1982

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 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 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.

FERDINAND MOUNT

ALAN WALTERS

16/10 x
H

FROM: P S JENKINS
9 August 1982

MR BARRATT

cc CST
FST
EST
MST(C)
MST(R)
Sir D Wass
Sir A Rawlinson
Sir K Couzens
Mr Burns
Mr Wilding
Mr Byatt
Mr Middleton
Mr Kemp
Mr Moore
Mr Mountfield
Mr G P Smith
Mr Hart
Mr Rayner
Mr Ridley

LONG TERM TRENDS IN PUBLIC EXPENDITURE

The Chancellor was grateful for your minute of 6 August to which was attached a note by Mr Smith on the fiscal implications of the longer term public expenditure projection. On this he had a number of detailed commented which are set out below.

2. On the general objectives in the paper, the Chancellor agrees with those set out in paragraph 2 of your minute. He has commented in relation to objective ii (agreement on a series of studies of radical structural changes in a number of major areas of public expenditure) that it is important that those changes should, so far as possible, be seen as having some possibly linked driving political principle - to make them more acceptable to colleagues and more feasible than mere super cuts. He has discussed this thought with

Mr Ridley, who would be able to explain further as necessary.

3. The Chancellor's detailed comment on the paper on fiscal implications are as follows:-

Paragraph 2. Should not the assumption about the rise in the real sterling oil price of North Sea oil be qualified to make it less "optimistic"?

Paragraph 3. The first sentence might be redrafted to read "on scenario A tax receipts are projected to rise about 20% in real terms between 1982-83 and 1990-91. But if the scenario is fulfilled, GDP grows rather faster, so that as a percentage of GDP they fall from 39½% to just over 37% (see table A)". In the forth sentence of paragraph 3, it is stated that local authority expenditure and payments of benefits from the NIF grow a good deal more slowly than GDP. This seems contrary both to our present experience, and to the main case we wish to make here - but presumably it applies to the scenario A case only (in which case we should say so).

Paragraph 5. This is not really explained clearly enough. It surely needs to say something like: "even on this assumption there is no room for higher tax thresholds let alone for any more fundamental attack on the poverty trap. Incentives remain no better than they are today. And a "balanced Budget" with the assurance of lower interest rates is as faraway as ever".

Paragraph 6. The first sentence is a hostage to fortune, because it may be taken to imply that financing public expenditure would be easy on scenario A. This is no so if we are going to make any major structural changes in the tax system. In the third sentence can we say what we mean by

"a return to the levels of the mid-70s" (and is then not an awkwardness about talking in the next sentence of "some 15 billion at todays prices".)

Paragraph 7. The fourth sentence will not really do as drafted.

The terms used ("they raised doubts about ... appear unacceptable ... it is questionable") are far too understated.

Would not two or three graphs help to make the presentation very much clearer?

PSJ

P S JENKINS

FROM: JOHN GIEVE
DATE: 9 August 1982

CHIEF SECRETARY TO THE TREASURY

PRINCIPAL PRIVATE SECRETARY

cc Financial Secretary
Economic Secretary
Minister of State (C)
Minister of State (R)
Sir Douglas Wass
Sir A Rawlinson o.r.
Sir Kenneth Couzens
Mr Barratt
Mr Burns
Mr Wilding
Mr Byatt
Mr Middleton
Mr Kemp
Mr Moore
Mr Mountfield
Mr G P Smith
~~Mr~~ Hart o.r.
Mr Rayner
Mr Ridley

LONG TERM TRENDS IN PUBLIC EXPENDITURE

The Chief Secretary has seen Mr Barratt's minute to the Chancellor of 6 August. He agrees with the approach recommended there.

JG.

JOHN GIEVE

43/138

FROM: [illegible]
DATE: 12 AUGUST 1982

[illegible]

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (R)
[illegible]
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[illegible]
[illegible]
Mr Battishill
Mr Pratt
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LONG TERM TRENDS IN PUBLIC EXPENDITURE

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The Economic Secretary has commented that he cannot help feeling that the reporting in paragraph 7 is too complacent about the scope for raising tax rates, whether directly or indirectly. In either case the Economic Secretary suspects that evasion and the black economy would subject us to the law of diminishing returns to a "horrendous degree".

MISS [illegible]

27/154

FROM: [illegible]
DATE: 12 AUGUST 1982

DISTRIBUTION

cc Chief Secretary
Financial Secretary
Minister of State (C)
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Mr Byatt
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LONG TERM TRENDS IN PUBLIC EXPENDITURE

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MISS [illegible]

27/154

LONG-TERM PUBLIC EXPENDITURE OPTIONS

Paper by the Central Policy Review Staff

1. The report by officials on longer-term trends in public expenditure (LTPE) sets out the prospects to 1990-91 on present policies. The Chancellor's paper ( ) gives reasons why these prospects are unacceptable.

2. Spending plans which out-strip the resources likely to be available can only result in higher taxes or greater borrowings, or a combination of these. It is an integral part of the Government's overall strategy to reduce both taxation and borrowings, and it is therefore essential to find ways of reducing the prospective expenditure.

3. There is a tendency, when faced with the prospect of expenditure beyond the capacity of the available resources, to look for cuts across the board - what we call in Annex L 'equality of misery'. Whilst this approach has some advantages in making clear the need for economies and to some extent making it easier to achieve them, it also has severe disadvantages (discussed further in Annex L). It leads to an undue emphasis on the options which are least difficult in the short term rather than on those which make most sense in the longer term. Two well-known examples are the tendency to cut capital spending rather than current spending, and the tendency to cut services rather than provide them more efficiently. Moreover, experience suggests that without major policy changes, it is very hard to ensure that the planned cuts are delivered when the time comes.

4. It is therefore necessary to look for radical options. There is and will remain an overall and continuing need for good housekeeping, but over and above that there is a need to examine every activity currently financed by the taxpayer, and to ask -

a. whether it is necessary at all, or to such a great extent;

b. if it is necessary, whether it needs to be carried out by the public sector;

c. if it has to remain in the public sector, whether it could be done more efficiently and more cheaply.

5. Departmental Ministers have been testing activities within their programmes against these criteria. Such questions are examined collectively in each annual review of public expenditure. But the LTPE exercise provides an opportunity for Ministers to stand back from the detail and consider more fundamental changes.

6. The CPRS was therefore asked to point up some of the long-term options open to Ministers for policy changes which would make a significant reduction in expenditure. In particular we were asked to consider the scope for major structural changes in the four major programme areas (defence, health, education, social security). Reductions are of course possible in other programmes, too; we list some of the possibilities below, including cuts in public service manpower. The intention is to invite Ministers to consider whether there should be strategic reviews of these options, aimed at producing papers for Ministerial consideration no later than next spring.

7. The LTPE report shows programme totals £12-13½ bn higher in 1990-91 than this year (1980-81 cost terms). In selecting options we have had two broad criteria in mind -

a. there should be a specific policy change (not just a squeeze on resources) which could usefully be the subject of a full review as a basis for Ministerial decision;

b. if Ministers so decided, the change would achieve a significant reduction in total public spending, (at least of the order of £1 bn a year), by 1990-91.

8. On these criteria, we put forward the following main options (with order-of-magnitude annual savings in brackets); each is discussed in more detail in the attached annexes -

i. Partial charging:
   - A Charge for higher education (say £1 bn)
   - B Increase and extend health charges (say £1 bn)

ii. Comprehensive charging:
   - C Charge for schooling (say £3-4 bn)
   - D Private health insurance (say £4 bn)

iii. De-indexing:
   - E Break link between social security benefits and prices (say £3 bn)

iv. Less resources:
   - F Cut education spending (say £1 bn)
   - G Stop growth of defence spending after 1985-86 (say £1½ bn)

9. We have considered a number of other possible candidates, without finding any options which in our judgement met the two criteria in paragraph 7; some possibilities are discussed briefly in Annex H. The only area where we consider a positive Ministerial decision might lead to significant saving (though not £1 bn a year) is public service manpower - discussed further in Annex J.

10. Apart from the major options mentioned above, a fall in public expenditure would occur if the relative costs (including wage costs) of public expenditure could be held down below the rest of the economy. But the LTPE projections already assume public service wages falling relative to "market sector" wages, by 10 per cent or more in the decade to 1990, and it seems unrealistic to suppose that a large further permanent shift could be achieved. In any case this turns on future wage negotiations, and we see no distinct "policy option" which could usefully be reviewed in advance.

11. In considering the options, we think Ministers will wish to relate them to several main objectives, which are met by some of the options but not others -

i. to improve incentives by reducing the burden of taxation;

ii. to increase freedom of choice;

iii. to require people to pay the costs of the services they demand;

iv. (as a minimum) to reduce the nominal total of public expenditure, even without any of these consequences.

12. There is an important distinction between those options which necessarily involve a reduction in inputs of real resources including labour and the rest. Charges for education or health might have the effect of increasing resource inputs, if people chose to pay more. So long as the services are provided within the public sector, we think Ministers will wish to see their claim on resources reduced. But overall the most important test is whether there is a gain in efficiency - the output delivered by a given level of inputs.

13. If Ministers decide that any of the options should be fully reviewed, we suggest that part of the purpose of the review should be to examine how they measure up to these broad objectives. The main points are briefly mentioned in each of the annexes.

14. The charging options, in particular, raise difficult questions about incentives. If even the poorest had to pay full charges, this would exacerbate poverty to a level which we assume Ministers would judge unacceptable. But if charges are to be rebated or reimbursed to those below some income threshold, with some form of graduation above that level, this must weaken the incentive to take jobs or earn more. Hence the gain to incentives, if the saving went to reduce the burden of direct taxation, would be offset. There would also be massive redistributive effects, in general away from families to people without children. To the extent that it was desired to adjust for these effects, changes would be needed in the tax system, and to adjust fully would

probably require a fully intregated system for combined tax and benefits. Even then there might be little or no gain in incentives, though the effect could be distributed more smoothly up the income scale. If minimum charges for schooling or health insurance were to be compulsory, they would only reduce the aggregate burden of taxation in a nominal sense; but they could allow more people to make their own decisions at the margin (analogous to a shift from direct to indirect taxation).

15. Some of the options would make some people worse off. Without arguing the individual merits of specific proposals, it is worth pointing out at the outset that it is either very difficult or else impossible to make worthwhile spending cuts without making some people worse off. It is therefore necessary to accept that possibility in itself, whilst always recognising that it is the proper function and duty of Government to ensure that no one is made so much worse off that he or she is necessarily subjected to undue hardship. If poverty is thought of as a relative condition, adverse redistributive effects become hard to accept. If, however, it is recognised that there is such a thing as an absolute condition of poverty from which people should be protected and that poor people should share in the increasing wealth of the country, but perhaps not in full proportion, then some redistributive effects can be accepted - as they must be if the amount of wealth available for distribution is to increase.

16. We think it likely that Ministers will not be interested in moves which would merely reduce the nominal total of public expenditure, by accounting changes which would not affect the tax burden or the size of the public sector. But two possible changes are discussed in Annex K. We have also not examined changes in "tax expenditures" (eg mortgage tax relief). We see these as outside the present remit because they would not change the nominal total of public expenditure. But reductions in these specific benefits could make room to reduce tax rates generally.

Conclusion

17. Ministers are invited to decide -

i. whether they wish to commission full strategic reviews on any of the options A-G listed in paragraph 8;

ii. whether they want to include additionally any of the possibilities listed in Annexes H, J (manpower), K (accounting changes), or L (across-the-board).

ANNEX A

CHARGING FOR HIGHER EDUCATION

Proposal

1. A significant saving could be achieved by charging degree students at universities etc for their degree courses. The size of this saving would depend on the amount of State assistance it was decided to make available to higher education students; but £1 bn a year could be saved by charging the full cost of degree courses, while still providing assistance in the form of scholarships and/or State-guaranteed loans to, say, 300,000 students (the exact number of students who could be assisted for the same cost would depend on the way this assistance was distributed as between scholarships and loans).

Background

2. On present projections, there will be about 450,000 students in higher education in 1985-86 of whom 35,000 will be from overseas. The cost of providing courses to these students varies considerably as between the arts and sciences but the average cost (at 1980-81 prices) of a university course is about £4,000 per year and that of a polytechnic is £3,000. At present, all State-assisted institutions of higher education charge all United Kingdom resident students the same fees, (£480); these are met by a grant of £480 from the local authority. The rest of the cost is met by central government grants to universities (£1,263 million in 1982-83) and to other advanced further education institutions (£538 m); although some of this expenditure is for research.

3. Under this proposal, universities and other higher education institutions would receive no funds direct from government (except for research) but would be funded entirely through student fees, plus any outside endowment funds they could raise.

4. This proposal is distinct from the scheme for replacing present maintenance grants, for students' living expenses, with State guaranteed loans, which would only save some £200 m a year. But the two schemes could be combined, by offering loans to cover both tuition costs and maintenance.

Arguments in Favour

5.

i. Charging full cost fees would increase the pressure on institutions of higher education to recruit students and add the dimension of "value for money" to decisions about higher education. This would make them more responsive to the demands of potential consumers, as well as more conscious of the need to control costs and to improve the quality of their "products" (eg it might encourage the development of two-year courses).

ii. More competition between students, for a smaller amount of Government aid, should lead them to appreciate the full value of thier courses and to take them more seriously. It would encourage students to seek financial support from non-governmental sources (eg industry) or to find ways of supporting themselves eg by working part-time, during vacations, before going to university, during years-off between academic years etc.

iii. It would encourage closer links between institutions of higher education and industry and commerce. The universities would have to make greater efforts to seek financial support from industry while firms would want to safeguard their share of the supply of trained manpower. They could do this by providing scholarships to able students who would be required to work for their "supporting" firms for a limited period after having received their degrees.

iv. To the extent that universities etc did not meet demands and raise finance for themselves, they would need to cut back on teaching resources, and student numbers would fall.

Problems

6.

i. This proposal would attract fierce opposition from the academic community, as giving rise to fluctuating demands and making planning impossible.

ii. If the effect of this proposal were to be a significant reduction in total student numbers, this could mean a less qualified work force. But charging for degree courses could lead to more students choosing "industrially-relevant" courses or more mid-career study and this should have beneficial effects on economic performance.

iii. Those who did not qualify for any form of State assistance and did not manage to secure support from industry or other private sources could face a bill of at least £12,000 (or more if maintenance costs were included) for a 3-year degree course. The burden of servicing and paying off a loan of this scale would be a considerable disincentive to higher education.

iv. Because higher education is effectively a life-long investment, those who borrow to finance it would wish to be able to repay their loan over long periods. There could be difficulty in developing a private sector market for such long-term student loans.

v. This proposal might encourage many students to seek higher education in those EEC countries in which fees are subsidised, with some resulting permanent loss of highly skilled manpower.

vi. As science and technology courses are likely to be very much more expensive than arts ones (unless the universities decide to subsidise the former from fees earned from the latter), students might consider the arts courses better "value for money" in terms of potential career advancement, and it might be difficult to attract enough students to the most expensive courses such as medicine.

ANNEX B

INCREASED CHARGES FOR HEALTH SERVICES

Proposal

1. The National Health Service (NHS) would remain broadly as now but a higher proportion of costs would be met from charges to patients. Existing charges for drugs, dental treatment and spectacles would be raised, and extended to cover everyone (including children and old people), except those close to supplementary benefit level. A modest charge would be introduced for consulting the general practitioner, and for hospital outpatient visits. Hospital inpatients would also pay a modest charge (say £5 a day). Total savings would savings would depend on the scheme of charges adopted, but would be unlikely to exceed £1 bn a year, even with a drastic reduction in exemptions.

Background

2. Expenditure on the family practitioner services this year is expected to be £2.4 bn, one-eighth of which (£300 m) will be recovered in charges. There are no charges for NHS hospital treatment, which will cost £8.8 bn this year. Demand for all services is expected to increase steadily, partly because the number of the very elderly will increase up to 1990; and the cost of the NHS rises in real terms because it is labour intensive and because scientific advance leads to better but usually more expensive forms of treatment. The number of people covered by private insurance is growing but still represents less than 10 per cent of the population.

3. Increasing the proportion of costs recovered through NHS charges clearly lessens the distinction between NHS and private treatment; and the logical conclusion of the process would be the abolition of NHS entitlement for certain groups of patient. Under a variant of the proposal above, therefore, drugs, spectacles and dental treatment would no longer be provided under the NHS except to limited exempt groups. The rest of the population would have to make private arrangements with the pharmacist, optician or dentist.

Arguments in favour

4.

i. The proposal leaves the basic structure of the NHS intact.

ii. Patients and others would be more aware of the high costs of medical treatment; unnecessary use of the service would be discouraged; and public opinion might act more powerfully to hold down NHS costs (including wage rates).

iii. Heavier NHS charges would, at least modestly, stimulate the growth of private medical insurance and thus relieve pressure on the NHS. Hence it could be seen as a preparatory move before full privatisation (Option D).

Problems

5.

i. To save substantial sums involves raising existing charges and breaking unpopular ground in three areas - imposing charges (eg for drugs) on patients who are now exempt (eg children); charging for seeing the general practitioner; and for hospital treatment.

ii. It would cost money and staff to collect new categories of charges, and to carry out means tests (a taper would be necessary above supplementary benefit level). Some of the staff involved (eg general practitioners) would object strongly.

iii. People who genuinely needed treatment might be discouraged from seeking it.

iv. As long as the poorest are exempted from charges, increasing the charges would automatically increase the poverty trap - ie makes it less attractive for people to increase their earnings at the margin.

ANNEX C

CHARGING FOR SCHOOLING

Proposal

1. Parents able to afford it would be required to pay the cost of their children's education, whether in the State system (where schools would be required to charge fees which covered their costs) or in competing private schools. It would still be compulsory to have children educated, normally at a school which met statutory minimum educational standards. Those with incomes too low to afford to pay would either have fees rebated or (preferably) would be subsidised via some form of income support.

Background

2. Schools expenditure this year is £7.4 bn, or 6½ per cent of total public expenditure. Nearly all of this is spent by local authorities at their own discretion, and it is about a third of their total current spending. The average cost per pupil is about £950 a year. Numbers of pupils will decline to 1990, and hence spending is projected to fall (but less than proportionately). Education in maintained schools will remain one of the largest social services, with private-sector education for compulsory school-age pupils (at present 5 per cent of all such pupils) remaining small.

3. A scheme for issuing vouchers to parents is sometimes suggested, as a less radical alternative to charging. It could help to promote wider choice, and would make it cheaper to send children to private schools if vouchers had a reimbursable "face value". But it would do nothing to reduce public expenditure, unless as an adjunct to charging with vouchers covering less than the full costs. Indeed there would be increased expenditure to meet any reimbursement for private education. Hence it is not put forward as an option here.

Arguments in Favour

4.

i. The saving could be as large as £3-4 bn, depending on the scale or rebating and whether it counted as public expenditure.

ii. Parents who wanted to secure a higher-quality education for their children, and were prepared to spend more, could do so by shopping around within the State sector or by going to private schools (and they would no longer be contributing to the cost of State schooling via central and local taxation). As real incomes rise, it is right to allow more resources to go into education to the extent that parents wish to purchase more and better schooling for their children.

iii. State schools would need to become more competitive and cost-conscious, and to pay more attention to parents' concerns (examination results, vocationally relevant courses, etc).

<u>Problems</u>

5.

i. There would be formidable political and administrative problems. Some mechanism would be needed for compelling local education authorities to charge "adequate" fees, which would entail new powers of central control and if necessary take-over.

ii. Cost differences do not only reflect differences in quality, and in particular schools in inner city areas tend to have higher costs. Some form of central government equalisation grant would probably still be needed to offset this.

iii. Students taking A-level courses in further education colleges would also be required to pay fees (to match the treatment of sixth-formers in schools). This would increase the discrimination between those in further education colleges undergoing training (on training allowances) and those on "school equivalent" courses (paying fees).

iv. There would be a wholesale redistribution of disposable income from paying parents to tax-paying non-parents. One way to offset this would be to raise child benefit to cover (standard) school fees, but this would

defeat the main object of reducing public expenditure and taxation. An alternative would be to re-introduce child tax allowance, but this would be sharply regressive, helping only parents with taxable incomes.

v. Given that fees would need to be rebated for parents with low family incomes, this would inevitably mean high marginal "tax" rates at the bottom of the scale, with bad effects on poverty trap and in-work/out-of-work incentives. Hence a form of graduated income support, on "negative income tax" lines, would be preferable - but previous tax credit schemes have been extremely costly, and the basic disincentive effect would remain, however distributed up the income scale.

vi. Since children could not be refused schooling, the business of collecting fees would be difficult and administratively expensive.

ANNEX D

PRIVATE HEALTH INSURANCE

Proposal

1. The working population would be obliged by law to obtain insurance to cover the costs of health care for themselves and their dependants. Premiums would relate to the family's risks, not their means, and so the poor would need help with meeting the costs. Either initially or later the scheme could be extended to cover the non-working population, who would obviously need much more subsidy.

Background

2. Expenditure on the NHS this year is some £11.7 bn. The main components are some £2.1 bn (net of charges) for the family practitioner services (the services provided by family doctors, dentists, opticians and chemists); and £8.8 bn for hospital and community health services. Demand for all services is expected to increase steadily, partly because the number of the very elderly is incresing; and the cost of the NHS rises in real terms because it is labour intensive and because scientific advance leads to better but usually more expensive forms of treatment.

3. It would be prohibitively expensive to insure against the costs of long-term medical care and so, as in all countries, the state would have to continue to provide for certain types of patient (eg the mentally handicapped). Even so, it is estimated that the cost of basic medical cover for an average family of four would be about £600 a year. Those below average earnings (and possibly others) would need help with these costs and to the extent that this had to be channelled through payments rather than tax reliefs (since the poorest do not pay income tax), the public expenditure savings would be lessened. It is difficult to envisage a scheme which would reduce public expenditure on the NHS by more than say a third (£4 bn).

4. Within an insurance-based system, providers of health care (eg doctors) could be encouraged to set up companies to offer health care to clients in return for an annual subscription. Limited American experience with such Health Maintenance Organisations suggests that they may help to restrain costs.

Arguments in favour

5.

i. This proposal offers the prospect of a very large cut in the costs of health care to the taxpayer.

ii. The public would have its horizon of choice and of responsibility greatly widened.

iii. Patients could (within the limits imposed by their insurers) shop around for health care, so that doctors and hospitals would have to be more responsive to patients' wishes if they wished to stay in business.

iv. Although initially at least NHS hospitals could remain in state ownership, trading like nationalised industries, they could be progressively privatised. This would give much more scope for experiment and for variety in such matters as rates of pay reflecting local market conditions.

Problems

6.

i. Even though a free state service would be retained for the uninsured and possibly for the non-working population, for the majority the change would represent the abolition of the NHS. This would be immensely controversial.

ii. There would be transitional problems in persuading insurance companies to take on the risks before cash reserves had been built up to meet them.

iii. While this proposal would reduce the amount of public money spent on health, it would not reduce the community's spending on health care: on the contrary it would probably increase sharply. Some of this would be consumers' preference for higher quality, shorter delays etc. But judging by overseas experience, the providers of health care would also take advantage of the ever buoyant demand and of the inability of patients or of insurance companies to control costs, or in most cases to make informal judgments about the medical treatments on offer. Competition between doctors and hospitals would be on quality more than price.

iv. Providing help for those unable to afford the insurance premiums would raise vast difficulties. All claimants (perhaps over half the adult population) would have to be means-tested and even if the help were graduated, on negative income tax lines, there would be a sharp disincentive effect; increasing one's earnings, or moving into work from unemployment, would become less attractive.

v. Patients would face extra complications (form-filling etc). Patients or their insurers would need to be invoiced for treatment, and subsidies of some kind would need to be provided to a large part of the population. It would also be necessary to police the compulsory insurance system.

ANNEX E

CUTTING THE REAL VALUE OF SOCIAL SECURITY BENEFITS

Proposal

1. The present laws which require most benefits to be increased annually by at least as much as prices would be repealed. New legislation would bring these benefits into line with the present arrangements for child benefit: upratings would become a matter of discretion for the Secretary of State who would attempt to preserve their real purchasing power but only as far as economic circumstances permit. If desired the Government could take the opportunity during the first year of operation of the new legislation to uprate some or all benefits by amounts which would effect substantial, once-for-all cuts in the real value of benefits. The bolder these initial cuts were the less need there would be in future years to hold down upratings below the level of inflation.

Background

2. Social Security expenditure in the current year is estimated at £32 bn, (28 per cent of total expenditure). In the three years to 1981-82 social security expenditure rose by 74 per cent, whilst public expenditure in total rose by 61 per cent; but the disproportionate increase was in large part due to the rise in the number of unemployed receiving benefit. At present most benefits must by law be increased annually at least in line with prices. Since 1972 the basic retirement pension has risen by 28 per cent in real terms while real national disposable income has risen by some 10 per cent. (Nearly all this very large improvement in the value of the pension occurred before 1979).

3. For the purpose of illustration, this option would yield some £3 bn a year by 1990-91 if a 10 per cent reduction in the LTPE projections is assumed. The effect on the real value of benefits depends on future economic performance. On the poor performance case - where the LTPE projections assumed that benefits would be maintained in real terms - benefits in 1990-91 would be 10 per cent below their current level in real terms. On the improved

economic performance case - where the LTPE projections assumed a 1 per cent per annum real improvement in social security expenditure ie increased real value of benefits and coverage - benefits in 1990-91 would perhaps be only a little below their existing real value.

Arguments in Favour

4.

i. The real increases in benefit rates during the 1970s have imposed a very large extra burden on the tax payer and those in work. Implementing the proposal could produce very large savings in public expenditure and lighten the burden on employers and the working population. In relation to the 1982 uprating each 1 per cent point reduction would have saved about £0.3 bn in public expenditure, a third of this being reflected in a reduction in the employer's contribution to the National Insurance Fund.

ii. The reduction in the real value of benefits for those of working age would increase incentives to work and increase the attraction of low-paid jobs.

iii. There would be a consequential saving on public service occupational pensions (eg those for civil servants, local government employees, NHS staff, the armed forces). This is because increases in these occupational pensions are statutorily linked to increases in the state retirement pension. A 10 per cent reduction in the value of these public sector pensions would yield about £300 m a year.

Problems

5.

i. Cutting the real value of benefits would be unpopular, particular in relation to the benefits for pensioners where the largest savings can be made. Pensioners would receive a lower share of the nation's wealth than

they do now , at least until the benefits of the new pension scheme become significant (after 1990); this would contrast starkly with what Labour once provided (upratings based on higher prices or earnings).

ii. There would be an increase in real poverty and current problems of social deprivation would be worsened (crime, poor care of children, illness from cold homes and poor nutrition etc).

ANNEX F

CUTTING EDUCATION SPENDING

Proposal

1. Spending on compulsary education for 5-16 year olds would be cut by about £1 bn a year while every effort would be made to maintain essential standards.

Background

2. Economies should be possible across the range of school provision by concentrating on the essentials and cutting out the peripheral. The process woild need to start from an analysis of what schooling is intented to achieve and how the important outputs could be maintained at lower cost. Since 70 per cent of expenditure represents teachers' salaries (£4 bn a year at current prices), it would be impossible to achieve a £1 bn reduction without reducing teacher numbers substantially. But the pupil/teacher ratio in both primary and secondary schools has fallen dramatically since the end of World War II, for example in England between 1950-81 when it fell from 31 to 23 in the primary sector and from 22 to 17 in secondary schools. Although it is often claimed that the pupil/teacher ratio is a measure of the "quality" of education, the relationship between this ratio and academic student performance is far from straight-forward. At present the number of teachers is around 520,000, and the LTPE projections imply a fall to around 440,000 by the end of the decade, roughly in line with the fall in pupil numbers.

Arguments in Favour

3.

i. It would provide an opportunity to weed out the lower qualified and less satisfactory teachers, and achieve a more efficient teaching force, supported by modern information technology to supplement class-room teaching (eg cassette teaching, audio-visual aids, modular courses etc).

ii. The closure of wasteful poorly attended schools with small classes would be speeded up.

iii. Schools would be required to concentrate, particularly at secondary level, on a "core" of academic and vocational subjects, cutting down resources on other non-academic activities (unless on repayment).

Problems

4.

i. Some mechanism would be required for compelling local education authorities to make the planned cuts, eg in teacher numbers. This would entail new powers of central control, with a fall-back power to take over the functions of LEAs.

ii. There would be other formidable problems in implementing this proposal. In particular -

a. Unless the curriculum were severely pruned - see 3 iii above - schools could be left with a core of teachers each of whom would be required to teach a wide range of subjects.

b. There would be major resistance from the teaching profession.

c. There would be considerable redundancy costs.

iii. There might be a significant fall in the overall quality of education provided by the State system, even if this fall were not immediately reflected in public examination results.

iv. Pupils would have to work more on their own and this could have deleterious effects on classroom discipline and on the morale and achievement of the less able. On the other hand, it might help those who go on to higher education.

v. This approach is distinct from, and probably not compatible with the charging approach discussed in Annex C.

ANNEX G

DEFENCE

Proposal

1. LTPE projections assumed that defence spending would increase in volume terms by 3 per cent a year from 1982-83 until 1988-89, with 1 per cent a year thereafter. The United Kingdom commitment to the 3 per cent growth target currently runs only to 1985-86. The proposal is to maintain the 1985-86 level in real terms, which would save about £1½ bn a year by 1990-91 as against LTPE. Internal forward planning in the Ministry of Defence currently assumes no growth in the defence budget after 1985-86. Hence this option could be achieved either by providing for no additions to spending at present planned, or by reductions to make room for some inescapable additions, eg by cancelling Trident. But the present planning assumption is deliberately cautious, to allow for some flexibility, so it does not follow that the option could be achieved without affecting military capabilities.

2. The political and diplomatic difficulties of this option would be reduced if NATO could be persuaded to reduce the 3 per cent target to a level which all or most member countries could realistically be expected to achieve.

Background

3. The present defence base-line is uncertain, in relation both to the level of spending in 1982-83 and to any revisions of plans in the immediate aftermath of the Falkland conflict. But defence spending cannot be ignored in this exercise. It now accounts for about 12 per cent of total public expenditure programmes, and on the basis of the LTPE assumptions (including the assumption that defence prices rise 2 per cent faster than prices generally) it will account for 15 per cent in 1990-91. On these projections, defence is responsible for more than a third of the total expenditure increase (in cost terms) from 1982-83 to 1990-91 - a much larger share than any other programme - though a different base year, or a different assumption about relative prices, would give different results.

Arguments in Favour

4

i. If defence spending is not slowed down, it will continue to rise in relation to GDP, to around 6 per cent on the projection we have taken. Sooner or later, depending on the performance of the economy, this rise is very likely to be found unsustainable, so that drastic cuts will have to be made. It would be more sensible to plan from the outset for a sustainable rate of defence spending, as in the proposal.

ii. In the past a number of other countries have failed to meet the NATO target (even among those with GDP growth rates higher than the United Kingdom), and after 1980 (the last year for which comparative figures are available) their performance is likely to continue to fall short.

iii. The lower expenditure path would be feasible. It would be broadly in line with the forward planning now being undertaken in the MOD (though this deliberately leaves room for flexibility - para 1). Spending with British industry could still be higher than it is today (£6-7 bn per annum).

iv. A lower rate of spend on defence R & D would free scarce resources (high-quality scientists and engineers) for employment in civil R & D.

Problems

5.

i. There would be political problems, international and domestic, in changing course after 1985-86. Last year the United Kingdom supported the NATO Ministerial Guidance extending the commitment to 1988. Present political pressures are for more defence spending, not less.

ii. The absence of real growth in the defence budget, as against the increase in complexity and cost of major equipment, would entail a reduction in United Kingdom military capabilities.

ANNEX H

OTHER PROGRAMMES

1. There is a number of other programmes which have not be included in the list of major options - either because there is no policy issue worth a full-scale review, or because the programme is too small to offer cuts approaching the £1 bn a year threshold, or both.

2. These programmes could nevertheless offer scope for very significant reductions in public expenditure, either by a generalised squeeze or by identifying policy changes. Following is a list of smaller possible areas where there may be scope for review, with figures for present annual spending (in 1980-81 cost terms, from the LTPE report) -

i. Export credits - the LTPE figure of £0.3 bn does not reflect the full extent of commitments, and there may be scope for review.

ii. Employment - £2.2 bn - much of this reflects policy reactions to the state of the labour market and will continue to do so; but there might be some scope for review:

- the Youth Training Scheme might take the place of the last year of compulsory schooling, instead of following it;
- on the training side, a remissible training tax on employers would reduce public expenditure;
- on employment services, privatisation of job centres might be examined.

iii. Regional - counting together expenditure by the Departments of Industry and Environment, this is of the order of £1 bn a year, and is already being reviewed.

Annex H (cont 1)

iv. Housing - £2.9 bn - has been falling, but the future trend depends mainly on the real level of rents (as well as [illegible] building and improvements); a review of rent policy, and of relating subsidy to current rather than historic values, might be worthwhile (though most of the savings would not count as public expenditure).

3. Some other significant areas are -

i. Payments to European Communities - £1.8 bn - depends on future negotiations (in which it maybe necessary to bring in the possibility of alternative defence savings, eg in BAOR).

ii. Other local authority services - £10 bn - there may be more scope for increased contracting out and/or charging, analogous to charging for education (Annex C).

iii. Nationalised industries - £2.3 bn: - privatisation will generate once-for-all gains, but where industries sold are self-financing will have a nil or negative effect on total EFLs thereafter; - continuing deficits might be removed or reduced in the longer term, but this is bound to be a difficult and piecemeal process.

iv. Scotland, Wales, Northern Ireland - £10 bn - extra spending in Scotland in relation to needs has been investigated in the past, and is probably not worth a further full-scale review.

ANNEX J

PUBLIC SERVICE MANPOWER

Proposal

1. Ministers would decide on a target for further reduction of civil service manpower, by say 10 per cent during the next Parliament. This would entail giving a high priority to -

- reducing functions, contracting out etc;
- simplifying policies and procedures (tax, social security etc);
- legislation where necessary to achieve these changes;
- expenditure on information technology.

The overall reduction would be allocated among departments and services according to the scope for such changes.

2. Similar targets would also be set for reductions in NHS and local authority manpower. These could be linked with increasing contracting out and privatisation of services.

Background

3. The pay bill for the civil service (industrial and non-industrial) is about £5 bn this year. Numbers will already have been reduced by about 14 per cent since 1979, so that the scope for further reduction merely by a continuing squeeze on numbers is likely to be small. Hence the need for more radical changes in functions and policies.

4. In principle there should be room for at least equal savings in other public services. The NHS employs approximately 1 million people, and numbers increased by 5 per cent between 1979 and 1981. The Government has set targets for reductions in management costs as a proportion of NHS resources over the next three years (in England, a cut of 10 per cent). Local authorities employ about 2 million people, and have reduced numbers by about 3 per cent since March 1979 - mostly in the education service, which employs nearly half the total (hence there is an overlap with Annex F).

Arguments in Favour

5.

i. Over the rest of this decade, information technology will yield further economies in data processing, storage etc. It is already being applied to Government administrative operations, but the pace could be accelerated.

ii. To achieve anything like a further 10 per cent reduction in civil service numbers would mean a radical review of present functions to achieve contracting out or privatisation of those services where economic costs might be charged (eg PSA, ADAS). This would be in line with Ministers' objective of "rolling back the frontiers of the public sector".

iii. Very worthwhile savings might be achieved by subjecting NHS and local authority manpower to the sort of squeeze which has proved successful in the civil service. Pressure on numbers should lead to the contracting out of functions to the private sector, with gains in efficiency.

Problems

6.

i. A good deal of effort has already gone into the reduction in Civil Service numbers to 630,000 by April 1984. Further substantial cuts will be hard to achieve unless Ministers are prepared to give up significant aspects of their present functions.

ii. A separate manpower target can lead to inefficiencies, where it might be more cost-effective to employ staff (eg on social security fraud cases); and if the reduction of unemployment remains a prime objective, any such inefficiencies conflict with that objection.

iii. In the NHS, given the decentralised system of control and the high proportion of staff closely involved in patient care, it will be alleged that any sizeable cut will mean a reduction in the quality of service.

iv. In the local authorities, if the target is to go beyond exhortation some mechanism will be needed for enforcement, with familiar difficulties (cf Annex F).

ANNEX K

ACCOUNTING CHANGES

a. Local Authority Expenditure. Local authorities at present have a large degree of autonomy, including the right to spend more than the Government's current spending target if they raise the money locally (by rates) to pay for it. Ministers have been considering this is MISC 79. If they decide not to impose direct central control over current spending, there is a case for counting as "public expenditure" only that part of local authorities' spending which is not financed from local revenues - as for nationalised industries and water authorities now, and local authorities in many other countries. This would be easier to justify if there were a limit on Exchequer grant, and non-domestic rates, so that expenditure beyond those limits was entirely a "charge" on local ratepayers/electors for extra services provided; both these changes are under consideration in MISC 79.

b. National Insurance Fund. More than half (£19 bn) of social security payments are met from contributions to the Fund. This will increase with the new State pension scheme, where public expenditure will vary accordig to the number "contracted out". In other countries contributory benefits are often treated "off-budget" rather than as part of public expenditure. The case for such a change would be stronger to the extent that contributions are regarded as different from ordinary direct taxation, and as buying an "entitlement" to benefits.

ANNEX L

ACROSS-THE-BOARD

Proposal

1. Ministers would reach a view on projections for public expenditure programmes reflecting existing policies and priorities, over say the lifetime of the next Parliament, on the lines of the LTPE projections. They would then agree what should be the target share of total public expenditure in GDP at the end of that period. If on a cautious view of GDP growth (on the lines of Scenario B) this target required some reduction in programme projections, then some proportionate reduction would be applied to all programmes, and spending Ministers would be required to make proposals for the necessary policy changes to achieve this reduction. If it later became clear that GDP growth was exceeding the cautious projection, programmes could be scaled up at that stage if Ministers so desired.

Background

2. Options A-G inclusive, if they were all found praticable, might together save some £14 bn a year, which would be sufficient to bring public expenditure un cost terms in 1990-91 down to the current (1982-83) level. To achieve the same order of reduction across-the-board would entail a reduction of 11-12 per cent in the planned 1990-91 total for each programme.

Arguments in Favour

3.

i. If Ministers are prepared to set a target in this form, balancing spending pressures against the need to lighten the burden of taxation, then programme planners would have a clear directive, and enough time to carry it out in the most cost-effective way.

ii. Relative priorities between programmes would be preserved, on a principle of "equal misery" which it would be very important to maintain by allowing no exceptions from the revised planning target (unforeseeable later developments could be taken care of, as usual, by a contingency reserve, which might also provide room to some extent for policy changes).

Miss Leahy.

FROM: F R BARRATT
DATE: 23 August 1982

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (C)
Minister of State (R)
Sir Douglas Wass
Sir Anthony Rawlinson (or)
Sir K Couzens
Mr Burns
Mr Wilding
Mr Byatt (or)
Mr Middleton
Mr Kemp (or)
Mr Mountfield (or)
Mr G P Smith
Mr Hart
Mr Rayner
Mr Ridley

LONG TERM TRENDS IN PUBLIC EXPENDITURE

I now attach, as promised in my minute of 6 August, a draft of your Cabinet paper for 9 September. It is based on discussions with Mr Byatt, Mr Ridley and others.

2. We shall be grateful to have any comments on the draft as it now stands, so that we can reflect them in a final version. The final version may also need some revision to take account of whatever the CPRS paper says. I had a word with Mr Sparrow at the end of last week about the latter. He hopes to be able to discuss it with his people in the next day or two, and to let us see a revised version later this week. It may very well I think look significantly different from the version which I believe you saw earlier.

3. The fiscal Annex attached to the draft paper takes account of your points on the earlier draft as recorded in Mr Jenkins' minute of 9 August - except as regards the assumption about the rise in the real sterling oil price. I do not think that those who made it would claim any special validity for the assumption that the world sterling oil price will rise by about one-third between 1980 and 1990. The

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difficulties of forecasting in this area are of course very great. One is concerned not only with the dollar price at which the oil is sold, but also with the sterling exchange rate. The assumption reflects a combination of a relatively small rise in the real dollar price and some decline in the sterling exchange rate. It is very likely, of course, to be wrong. But it is not obviously so. And there are dangers, when presenting the case to your colleagues, in making assumptions which can be criticised as overly pessimistic.

4. Finally, I invite your attention to the title of your paper: "The longer term". This reflects the feeling at your meeting with the Prime Minister that the title of the papers for 9 September should not include the expression "public expenditure". I have suggested to the Cabinet Office that they adopt similar language for the agenda generally.

F R BARRATT

Encs:

5/1

CONFIDENTIAL

Draft Cabinet paper

THE LONGER TERM

Note by the Chancellor of the Exchequer

The issues we are to discuss on 9 September are among the most important we shall consider at any time in this Parliament. The way we handle them will crucially affect the policies we put forward at the next election,and the performance and shape of the economy for many years to come.

The problem

2. We came to power in 1979 with a firm commitment to reduce the share which the State takes of the nation's income. We argued in the manifesto that when the State spends and borrows too much, "taxes, interest rates, prices and unemployment rise so that in the long run there is less wealth with which to improve our standard of living .....". Nothing has changed to invalidate that judgement. The report by officials (C(82)) shows, however,how far we still are from fulfilling our manifesto commitment: indeed, if we maintain our present policies, with the expenditure to which they commit us, we could well move in the opposite direction.

3. Since 1979, prospects for the world economy have worsened substantially. It is clear that no-one can now confidently predict more than a fairly modest

world growth during the rest of this decade. In addition, the UK economy has faced the particular problems of the pay explosion of 1979-80 and the rise in the exchange rate resulting from the petro-currency status of sterling. The resulting loss of competitiveness will take some time to remedy.

4. It is against this difficult background that the official report describes two "scenarios" for the development of the economy to 1990. Neither is a forecast: they simply illustrate what might happen if we maintain our present expenditure policies against two economic backgrounds, one rather more favourable than the other. On the low-growth Scenario B, the report shows that public expenditure might rise to nearly 47 per cent of GDP in 1990-91 - a higher proportion than at any time since the dismantling of the war economy. This level would be nearly 6 percentage points above that of our first year of office and 3 points above what we have agreed for 1982-83. Such a major departure from one of our central aims for the economy would, surely, be altogether unacceptable.

5. On the somewhat more optimistic assumption of 2½ per cent growth in Scenario A, public expenditure would still be nearly 40 per cent of GDP by 1990. This is somewhat below the level of 1979-80 and about 4 points below that planned for 1982-83. But we cannot be reassured by this. In real terms, public expenditure would still be higher in 1990-91 than in 1979-80 or 1982-83. Moreover, some of the assumptions on which the projections are based are, if anything, over-optimistic. They make little allowance, for example, for the increases in expenditure which public opinion might expect in a period of higher growth. And they ignore "creep" - the apparently inexorable tendency for the planning total for any future year to be added to as it comes closer to the present because new and compelling policy commitments are entered into, or for other reasons.

6. Moreover, the projections in the officials' report, showing as they do significant increases in the social security, health and defence programmes, imply a degree of restraint in the provision of other public services which may in the event prove politically unacceptable. We need to give ourselves some room for manoeuvre in public expenditure.

7. I accordingly believe that:-

(a) We must find ways of permitting some of the demands to be met, both by encouraging people to make extra provision for themselves, at least at the margin, and by finding ways in which those extra services demanded can be supplied without burdening the Exchequer.

(b) We must consider carefully the extent to which we are denying ourselves room for manoeuvre by past pledges and commitments. We must review these, questioning both the objectives and, in some cases, the underlying assumptions. Where priorities have changed, we must be prepared to drop commitments or modify them, perhaps drastically.

(c) We must look much more closely at the efficiency of our spending programmes. This means in practice not only policy reviews,scrutinies and stringent control of manpower, but also opening up more of the routine business of central government, local government and the NHS to private sector competition, as is already being undertaken with local authority direct labour organisations.

(d) Last but not least, it is essential that we get across to the country at large the nature of the longer-run problems of public spending and then seek its support and understanding for sensible ways of solving them.

Taxation and growth

8. I attach at Annex A a note by the Treasury which considers what the expenditure projections in the officials' report (C(82)...) could mean for taxation.

9. On the face of it the gap between revenue and expenditure in Scenario A in (C(82).. does not look too bad. But the better growth of output and productivity reflected in this Scenario is based on an expansion of the private sector encouraged by reductions in interest rates and in taxes, especially taxes and charges on business, such as Corporation Tax, NIS or other National Insurance charges. It will also be important if we are to achieve this better growth performance, to reduce personal taxation so as to improve incentives. We cannot secure the lower interest rates that the private sector needs if we do not hold the PSBR down firmly. The way forward to better economic performance can therefore only be through reducing expenditure.

10. The tax implication of the low growth Scenario B and the related expenditure projections would in my view be wholly unacceptable.

Conclusion

11. The record of the past two decades has shown all too clearly the dangers of planning public spending on the assumption of a continuing economic growth which in the event has not been achieved. It has been a failure of successive Governments that they have assumed growth in the economy without taking the steps necessary to make it possible. Successive expenditure reviews have thus followed a dreary cycle of over-optimism followed, inevitably, by retrenchment.

12. As a Government we need a more robust strategy than this. We must not make the mistake of assuming that faster growth will float us over the rocks. We need to create the conditions for a freer and more prosperous society, in which the public sector is smaller and taxation is lower. This calls in my view

for some thorough study and new insights, leading at a later stage to radical decisions affecting most if not all of the major programmes. We cannot neglect any possible approach.

13. I am not now proposing some kind of long-term total for public expenditure, still less specific cuts or changes of direction in any particular area of expenditure. I do, however, invite my colleagues to agree that the prospects suggested by the officials' reports are unacceptable, and that we need to take a new and fundamental look at levels of public spending. More specifically, I seek their agreement:-

(a) that, as a first step, we should commission further studies of all the options identified by the CPRS in their paper (C(82)) (save where work is already in hand on them) to be completed and reported back to the Cabinet in the spring of 1983;

(b) that meanwhile, to allow ourselves freedom of manoeuvre, we should agree to make no further public commitments which would add significantly to expenditure beyond 1985-86, and that we should avoid repeating former pledges which would otherwise expire;

(c) that in considering this year's public expenditure Survey we should have particular regard to the longer term implications of our decisions, especially, for the "new" year 1985-86; and

(d) that we should consider further how these difficult issues might best be presented to our supporters in Parliament and to the country at large.

PUBLIC EXPENDITURE IN THE LONGER TERM
FISCAL IMPLICATIONS

The longer term public expenditure exercise has projected expenditure to the end of the decade on two illustrative macro-economic scenarios, the main features of which are shown at Annex 1 of the Public Expenditure Paper. This note describes a similar projection of tax revenue on each of the same scenarios, and goes on to look at the balance between revenue and expenditure that is implied. Like the expenditure figures, these projections are dependent on the scenarios assumed: they are not forecasts. The margin of error is inevitably wide when looking so far ahead.

Assumptions

2. Like expenditure, taxes have been projected on the basis of unchanged policy. This has been interpreted to mean that income tax thresholds and specific duties are raised in line with prices, that tax rates are unchanged and that existing allowances and reliefs are continued. Local authority rates and National Insurance Contributions are calculated from the projections of local authority expenditure and expenditure from the National Insurance Fund, respectively, on the assumption that an unchanged proportion of such expenditure is met from general taxation. For North Sea taxes the real sterling oil price is assumed to rise by about a third between 1980 and 1990. (This reflects both a rise in the $ price and a fall in the exchange rate.) Even though some new fields are assumed to come on stream, total production is assumed to be a little below its peak level, which is reached in mid-decade.

The projections

3. If scenario A were to be fulfilled, the projections suggest that tax receipts would rise by about 20 per cent in real terms. This is a rather smaller increase than that assumed for GDP in this scenario so that taxes as a percentage of GDP fall from 39½ per cent to just over 37 per cent. (See table A). However, this mainly reflects a fall in local authority rates and National Insurance Contributions as a percentage of GDP: this would only occur if local authority spending and benefit payments from the National Insurance Fund were in fact held to the levels assumed in the Expenditure projections. Income tax and consumption taxes fall slightly in relation to GDP, the former because the scenario assumes a falling wage share, the latter because the evidence is that a 10% rise in income leads to less than a 10% rise in consumption of goods that bear specific duties. The yield of capital taxes also declines in relation to GDP, largely because of the indexation of CGT. Corporation tax and North Sea taxes, on the other hand, rise somewhat as a percentage of GDP.

4. On scenario B projected tax receipts rise by only 6% in real terms - a good deal less than on scenario A. But GDP also rises more slowly and taxes remain roughly constant as a percentage of GDP at just below 40% (see table B). Local rates - derived from the Expenditure projections - fall in relation to GDP as in scenario A, but NICs remain a roughly constant proportion of GDP because the limited growth in benefit expenditure matches the limited growth in GDP. Capital taxes again fall in relation to GDP. Against this North Sea taxes and income tax rise as a percentage of GDP. (Corporation tax is about constant). The reason why income tax rises in relation to GDP on scenario B, unlike scenario A, is that wages and salaries rise as a share of GDP. 80-90% of the yield of income tax comes from wages and salaries. Consumption taxes, however, fall as a percentage of GDP because of the tendency for expenditure on goods bearing specific duties to rise less fast than income.

Implications

5. On scenario A the projected gap between expenditure and revenue narrows to about 2 per cent of GDP by the end of the decade - no smaller as a percentage of GDP than the target figure set for the PSBR in the last year of the Medium Term Financial Strategy. Moreover, the tax projections make no provision for raising income tax thresholds in real terms or for cutting tax rates to help personal incentives, or to ease the disincentive effects of the poverty trap. Nor do they allow for any reduction in the rate of business taxation*. Corporation tax payments are projected to rise as a percentage of GDP. Without tax reductions to improve incentives and increase net company profitability it is doubtful whether the economic growth postulated could be achieved.

6. If the economy develops less favourably as in scenario B the problem of financing public expenditure is likely to be much more severe. The projections show expenditure - which is lower than in scenario A - exceeding revenue by 7% of GDP. If this gap were bridged by borrowing the implication is a reversal of progress so far made in reducing the PSBR. Indeed, as a percentage of GDP, borrowing approaches the levels which precipitated the 1976 crisis. But if borrowing were to be restrained to 2% of GDP without cuts in expenditure taxes would have to be raised by the equivalent of £15 bn at today's prcies. The tax burden would rise from 40% to 45% of GDP (having already risen from 35% to 40% since 1978-79. See Chart A).

7. If the £15 bn came from income tax alone, the yield would have to be raised by about half. If it came from the consumption taxes (VAT and specific duties) their combined yield would similarly have to be increased by half. (Raising £15 bn in VAT only would require the VAT yield to be doubled). The response of

* Though if the expenditure projections in this scenario are fulfilled, the combined National Insurance Contribution rates of employers and employees taken together could fall by something like 1½ per cent. (There could also be some fall in local authority rate poundages).

taxpayers to changes on this scale cannot be predicted with any precision. But in crude "ready reckoner" terms what is implied is, at the least:

- raising the basic rate of income tax to about 45p (more if the tax base were reduced through evasion or disincentive effects). Deductions of tax and NIC together would then be over 50 per cent on a marginal £ of income for nearly all taxpayers.

or - abolishing all allowances other than the single allowance (e.g. the married man's allowance, mortgage tax relief, relief for pension contributions and life assurance) and raising the basic rate to perhaps 33p.

or - raising VAT to 25% and doubling the real level of all specific duties.

or - levying VAT at 25% on goods which now bear the 15% rate and those now zero-rated (food, fuel, etc.).

Conclusions

8. The projections are, as stressed above, subject to a wide margin of error. But they demonstrate the difficulty of financing the levels of public expenditure implied by the continuation of current policies. If the economy grows very slowly, as in scenario B, the consequences for taxation and/or borrowing are very serious. The economy would need to grow steadily and strongly, as in scenario A, to permit the sort of expenditure levels envisaged. It is doubtful whether this growth could arise without any further Government action to improve work incentives or to improve businesses' profitability through tax cuts. But if taxes were cut borrowing could not be restrained to 2% of GDP and the inflation and interest rate assumptions would begin to look implausible.

TABLE A: Tax yields at constant (1980-1) prices and as a percentage of GDP on Scenario A.

	£BN 1980-1 prices		% of GDP	
	1982-3	1990-1	1982-3	1990-1
Income Tax	25.7	32.3	11.1	10.9
NIC's	16.4	18.6	7.0	6.3
Consumption taxes (incl VAT and specifics)	26.6	32.7	11.4	11.1
LA Rates	10.5	9.3	4.5	3.2
Corporation Tax, North Sea taxes and NIS	11.1	16.0	4.8	5.4
Capital taxes	1.8	1.1	0.8	0.4
TOTAL	92.1	109.9	39.4	37.2
Public Expenditure (incld debt interest)	103.0	116.0	44.0	39.3

Note: Columns do not add exactly to totals because of rounding

TABLE B: Tax yields at constant (1980-1) prices and as a percentage of GDP on Scenario B.

	£BN 1980-1 prices		% of GDP	
	1982-3	1990-1	1982-3	1990-1
Income Tax	25.7	29.4	11.1	12.0
NIC's	16.4	17.5	7.0	7.1
Consumption taxes (incl VAT and specifics)	26.6	27.3	11.4	11.1
LA Rates	10.5	9.2	4.5	3.7
Corporation tax, North Sea taxes and NIS	11.1	13.1	4.8	5.3
Capital taxes	1.8	1.1	0.8	0.4
TOTAL	92.1	97.4	39.4	39.7
Public expenditure (incl debt interest)	103.0	115.0	44.0	46.8

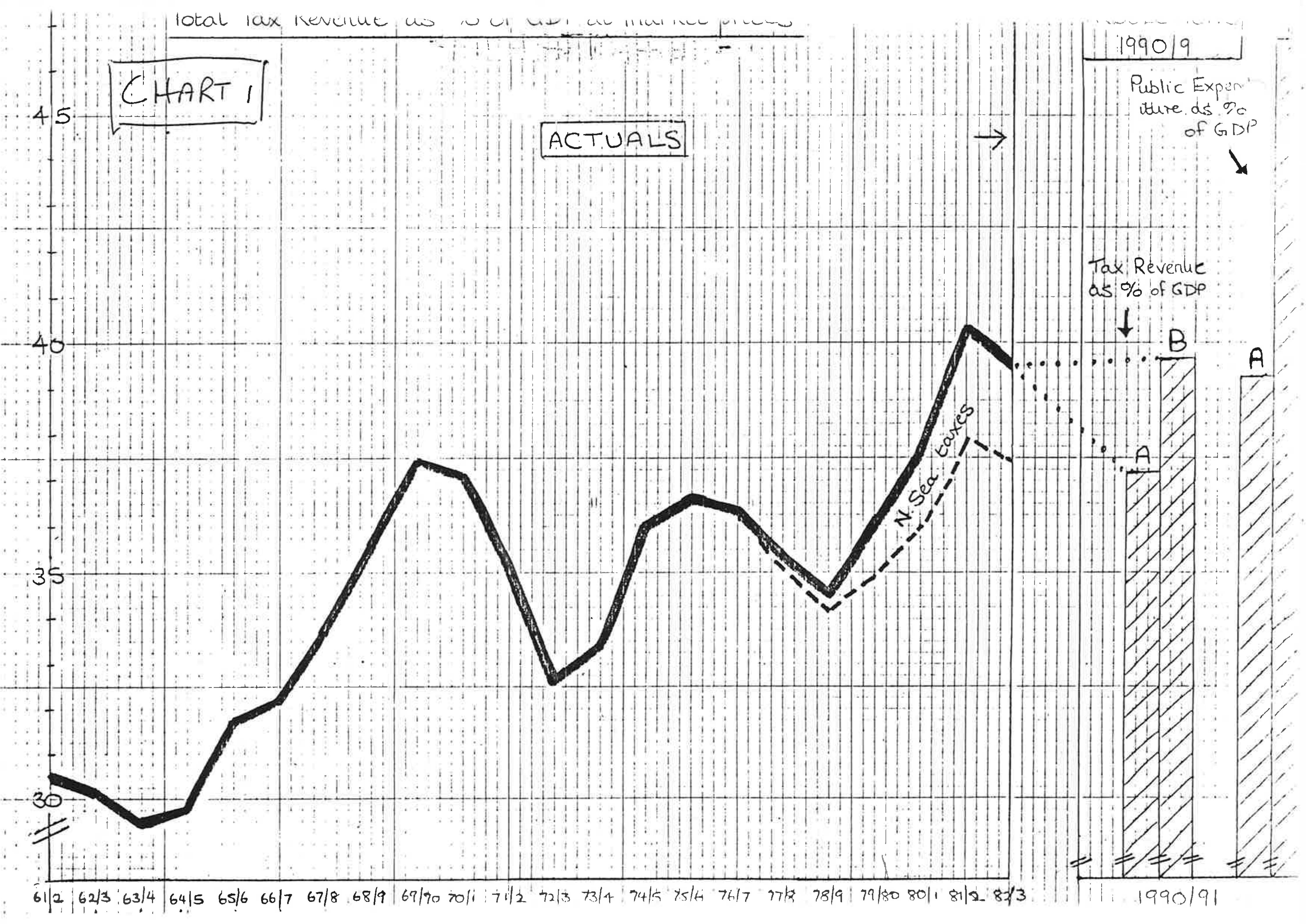
CHART 1
ACTUALS
1990/9
Public Expenditure as % of GDP
Tax Revenue as % of GDP
B
A
A
N. Sea taxes
45
40
35
30
61/2 62/3 63/4 64/5 65/6 66/7 67/8 68/9 69/70 70/1 71/2 72/3 73/4 74/5 75/6 76/7 77/8 78/9 79/80 80/1 81/2 82/3
1990/91

CONFIDENTIAL

RA

From:T A A Hart
Date: 27 August 1982

Chancellor of the Exchequer

cc-

Chief Secretary
Financial Secretary
Economic Secretary
Minister State (C)
Minister of State (R)
Sir Douglas Wass
Sir A Rawlinson
Sir Kenneth Couzens
Mr Burns
Mr Barratt
Mr Byatt or
Mr Middleton
Mr Wilding
Mr Kemp or
Mr Mountfield or
Mr Bottrill
Mr G P Smith
Mr Rayner
Mr Ridley

LONG TERM TRENDS IN PUBLIC EXPENDITURE

I attach a further draft of your Cabinet paper for 9 September entitled "The Longer Term". It has been amended to reflect your earlier comments set out in Mr Kerr's minute of 25 August. (I am grateful to Mr Bottrill for the new paragraph on overseas experience.)

2. The chart and tables have been revised in a way which we hope makes them clearer to follow.We shall also have, early next week, a second chart - rather like the "porcupine" chart - to illustrate the effects of "creep" in public expenditure in recent years. This is now being prepared and I have included a reference to it at the end of paragraph 5 of the draft Cabinet paper.

3. The deadline for circulation of these papers is next Thursday, 2 September and I understand that you may wish to send them to the Prime Minister for this weekend. I am attaching a draft covering minute for this purpose.

AJH

T A A Hart
GEP1

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DRAFT MINUTE FOR THE CHANCELLOR OF THE EXCHEQUER TO SEND TO:

The Prime Minister

THE LONGER TERM

I am enclosing a draft of the paper on the Longer Term which, with your agreement, I should like to circulate for discussion by the Cabinet on 9 September. The CPRS are in parallel producing, at your request, a paper setting out some of the main policy options if we wish to secure - as I am sure we must - a major turnround in public spending in the longer term.

2. I am afraid it may not be an easy discussion. The papers cover a wide range of subjects and the prospect they reveal is not at all encouraging. The proposed remedy may be unwelcome to some of our colleague with spending responsibilities. I am, therefore, very anxious to avoid giving the impression that this is simply another Treasury "cuts" exercise, but with bigger cuts than usual.

3. In my paper, I have sought to distance our discussion from this sort of approach. I hope very much that we shall be able to have a more fundamental and broad-ranging discussion about our long-term policy objectives and the size and shape of the public sector. Inevitably, this means looking at the broader political context and the prospects for the economy both at home and worldwide. In the course of this discussion I hope it will be possible to secure colleagues' general acceptance of the main conclusion in my paper: that the prospects suggested by the officials' reports are unacceptable, and that we need to get public expenditure onto a better track.

4. Having, as I hope, agreed on seriousness of the overall problem and the need for a fresh look at public expenditure, we could then turn to the policy options which the CPRS have identified as worth further study. Colleagues will no doubt want to comment on these individually and some will no doubt ask to be exempted from the exercise. On the whole, I hope we can avoid this. At this stage we are proposing only that there should be further studies, and the exercise will be far more acceptable if all the major departments' are seen to be in it together.

5. In the light of this discussion we could return to the particular recommendations at the end of my paper, the first of which (for further studies) is, of course, the most vital. I do, however, attach importance to the 3 other proposals, in particular the suggestion that, until the further work has been completed and reviewed, we should hold back from new commitments and from repeating pledges which would otherwise expire. I think this should apply equally to new promises on the tax front.

6. I am sending copies of this minute only to Sir Robert Armstrong and Mr Sparrow.

CONFIDENTIAL

Draft Cabinet paper

THE LONGER TERM

Note by the Chancellor of the Exchequer

The issues we are to discuss on 9 September are among the most important we shall consider at any time in this Parliament. The way we handle them will crucially affect the policies we put forward at the next election, and the performance and shape of the economy for many years to come.

The problem

2. We came to power in 1979 with a firm commitment to reduce the share which the State takes of the nation's income. We argued in the manifesto that when the State spends and borrows too much, "taxes, interest rates, prices and unemployment rise so that in the long run there is less wealth with which to improve our standard of living .....". Our experience since 1979, and all experience abroad, has demonstrated how well-founded that judgement was. The report by officials (C(82)) shows, however, how far we still are from fulfilling our manifesto commitment: indeed, if we maintain our present policies, with the expenditure to which they commit us, we could well move in the opposite direction.

3. Since 1979, prospects for the world economy have worsened substantially. It is clear that no-one can now confidently predict more than a fairly modest world growth during the rest of this decade. In addition, the UK economy has faced the particular problems of the pay explosion of 1979-80 and the rise in the exchange rate resulting from the petro-currency status of sterling. The resulting loss of competitiveness will take some time to remedy.

4. It is against this difficult background that the official report describes two "scenarios" for the development of the economy to 1990. Neither is a forecast: they simply illustrate what might happen if we maintain our present expenditure policies against two economic backgrounds, one rather more favourable than the other. On the low-growth Scenario B, the report shows that public expenditure might rise to nearly 47 per cent of GDP in 1990-91 - a higher proportion than at any time since the dismantling of the war economy. This level would be nearly 6 percentage points above that of our first year of office and 3 points above what we have agreed for 1982-83. Such a major departure from one of our central aims for the economy would, surely, be altogether unacceptable.

5. On the somewhat more optimistic assumption of 2½ per cent growth in Scenario A, public expenditure would still be nearly 40 per cent of GDP by 1990. This is somewhat below the level of 1979-80 and about 4 points below that planned for 1982-83. But we cannot be reassured by this. In real terms, public expenditure would still be higher in 1990-91 than in 1979-80 or 1982-83. Moreover, some of the assumptions on which the projections are based are, if anything, over-optimistic. They make little allowance, for example, for the increases in expenditure which public opinion might expect in a period of higher growth. And they ignore "creep" - the apparently inexorable tendency for the planning total for any future year to be added to as it comes closer to the present because new and compelling policy commitments are entered into, or for other reasons.(The effect of this in recent years is clearly illustrated by the chart at Annex A).

6. Moreover, the projections in the officials' report, showing as they do significant increases in the social security, health and defence programmes, imply a degree of restraint in the provision of other public services which may in the event prove politically unacceptable. We need to give ourselves some room for manoeuvre in public expenditure.

7. I accordingly believe that:-

(a) We must find ways of permitting some of the demands to be met, both by encouraging people to make extra provision for themselves, at least at the margin, and by finding ways in which those extra services demanded can be supplied without burdening the Exchequer.

(b) We must consider carefully the extent to which we are denying ourselves room for manoeuvre by past pledges and commitments. We must review these, questioning both the objectives and, in some cases, the underlying assumptions. Where priorities have changed, we must be prepared to drop commitments or modify them, perhaps drastically.

(c) We must look much more closely at the efficiency of our spending programmes. This means in practice not only policy reviews, scrutinies and stringent control of manpower, but also opening up more of the business of central government, local government and the NHS to private sector competition, as is already being undertaken with local authority direct labour organisations.

(d) Last but not least, it is essential that we get across to the country at large the nature of the longer-run problems of public spending and then seek its support and understanding for sensible ways of solving them.

Taxation and growth

8. I attach at Annex B a note by the Treasury which considers what the expenditure projections in the officials' report (C(82)...) could mean for taxation.

9. On the face of it the gap between revenue and expenditure in Scenario A in C(82).. does not look too bad. But the better growth of output and productivity reflected in this Scenario is based on an expansion of the private sector encouraged by reductions in interest rates and in taxes, especially taxes and charges on business, such as Corporation Tax, NIS or other National Insurance charges. It will also be important if we are to achieve this better growth performance, to reduce personal taxation so as to improve incentives. We cannot secure the lower interest rates that the private sector needs if we do not hold the PSBR down firmly. The way forward to better economic performance can therefore only be through reducing expenditure.

10. The rates of tax implied by the low growth Scenario B and related expenditure projections would in my view be wholly unacceptable.They would be seriously damaging to industry and crippling in their effect on personal incentives. Moreover, the increases which would be needed are if anything understated, partly because the expenditure projections make no allowance for "creep", but also because such high rates of tax would create major problems of evasion and enforcement. They would almost certainly run into diminishing returns and lead to a further growth in the black economy.

Overseas experience

11. The UK is not alone in having to take hard decision on public spending. Other countries,too, have had to rein back spending plans. They include both rich and poor. Among our major industrial partners, the US, Germany and Japan have

all sought spending economies. The French Government, too, is now seeking stringent cuts in its previously ambitious plans. Even among the Scandinavian countries, with a long tradition of high public spending, economies are being made. In many cases, previously sancrosanct programmes such as social security, health and education have had to share in the reductions. In developing countries in Africa, Asia and Latin America, reductions in public spending plans form a vital part of many of the adjustment programmes agreed with the IMF. Mexico is the most recent to join the list.

Conclusion

12. The record of the past two decades has shown all too clearly the dangers of formulating or accepting policy commitments on the assumption of a continuing economic growth which in the event has not been achieved. It has been a failure of successive Governments that they have assumed growth in the economy without taking the steps necessary to make it possible. Successive expenditure reviews have thus followed a dreary cycle of over-optimism followed, inevitably, by retrenchment.

13. As a Government we need a more robust strategy than this. We must not make the mistake of assuming that faster growth will float us over the rocks. We need to create the conditions for a freer and more prosperous society, in which the public sector is smaller and taxation is lower. This calls in my view for some thorough study and new insights, leading at a later stage to radical decisions affecting most if not all of the major programmes. We cannot neglect any possible approach.

14. I am not now proposing some kind of long-term total for public expenditure, still less specific cuts or changes of direction in any particular area of expenditure. I do, however, invite my colleagues to agree that the prospects suggested by the officials' reports are unacceptable, and that we need to take a

new and fundamental look at levels of public spending. More specifically, I seek their agreement:-

(a) that (except where work is already in hand) we should as a first step commission further studies of all the options identified by the CPRS in their paper (C(82)) and possily some of those in Annex H. These studies should be completed and reported back to the Cabinet in the spring of 1983;

(b) that meanwhile, to allow ourselves freedom of manoeuvre, we should agree to make no further public commitments which would add significantly to expenditure beyond 1985-86, and that we should avoid repeating former pledges which would otherwise expire;

(c) that in considering this year's public expenditure Survey we should have particular regard to the longer term implications of our decisions, especially, for the "new" year 1985-86; and

(d) that we should consider further how these difficult issues might best be presented to our supporters in Parliament and to the country at large.

PUBLIC EXPENDITURE IN THE LONGER TERM
FISCAL IMPLICATIONS

The longer term public expenditure exercise has projected expenditure to the end of the decade on two illustrative macro-economic scenarios, the main features of which are shown at Annex 1 of the Public Expenditure Paper. This note describes a similar projection of tax revenue on each of the same scenarios, and goes on to look at the balance between revenue and expenditure that is implied. Like the expenditure figures, these projections are dependent on the scenarios assumed: they are not forecasts. The margin of error is inevitably wide when looking so far ahead.

Assumptions

2. Like expenditure, taxes have been projected on the basis of unchanged policy. This has been interpreted to mean that income tax thresholds and specific duties are raised in line with prices, that tax rates are unchanged and that existing allowances and reliefs are continued. Local authority rates and National Insurance Contributions are calculated from the projections of local authority expenditure and expenditure from the National Insurance Fund, respectively, on the assumption that an unchanged proportion of such expenditure is met from general taxation. For North Sea taxes the real sterling oil price is assumed to rise by about a third between 1980 and 1990. (This reflects both a rise in the $ price and a fall in the exchange rate.) Even though some new fields are assumed to come on stream, total production is assumed to be a little below its peak level, which is reached in mid-decade.

The projections

3. If scenario A were to be fulfilled, the projections suggest that tax receipts would rise by about 20 per cent in real terms. This is a rather smaller increase than that assumed for GDP in this scenario so that taxes as a percentage of GDP fall from 39½ per cent to just over 37 per cent. (See table A). However, this mainly reflects a fall in local authority rates and National Insurance Contributions as a percentage of GDP: this would only occur if local authority spending and benefit payments from the National Insurance Fund were in fact held to the levels assumed in the Expenditure projections. Income tax and consumption taxes fall slightly in relation to GDP, the former because the scenario assumes a falling wage share, the latter because the evidence is that a 10% rise in income leads to less than a 10% rise in consumption of goods that bear specific duties. The yield of capital taxes also declines in relation to GDP, largely because of the indexation of CGT. Corporation tax and North Sea taxes, on the other hand, rise somewhat as a percentage of GDP.

4. On scenario B projected tax receipts rise by only 6% in real terms - a good deal less than on scenario A. But GDP also rises more slowly and taxes remain roughly constant as a percentage of GDP at just below 40% (see table B). Local rates - derived from the Expenditure projections - fall in relation to GDP as in scenario A, but NICs remain a roughly constant proportion of GDP because the limited growth in benefit expenditure matches the limited growth in GDP. Capital taxes again fall in relation to GDP. Against this North Sea taxes and income tax rise as a percentage of GDP. (Corporation tax is about constant). The reason why income tax rises in relation to GDP on scenario B, unlike scenario A, is that wages and salaries rise as a share of GDP. 80-90% of the yield of income tax comes from wages and salaries. Consumption taxes, however, fall as a percentage of GDP because of the tendency for expenditure on goods bearing specific duties to rise less fast than income.

Implications

5. On scenario A the projected gap between expenditure and revenue narrows to about 2 per cent of GDP by the end of the decade - no smaller as a percentage of GDP than the target figure set for the PSBR in the last year of the Medium Term Financial Strategy. Moreover, the tax projections make no provision for raising income tax thresholds in real terms or for cutting tax rates to help personal incentives, or to ease the disincentive effects of the poverty trap. Nor do they allow for any reduction in the rate of business taxation*. Corporation tax payments are projected to rise as a percentage of GDP. Without tax reductions to improve incentives and increase net company profitability it is doubtful whether the economic growth postulated could be achieved.

6. If the economy develops less favourably as in scenario B the problem of financing public expenditure is likely to be much more severe. The projections show expenditure - which is litt lower than in scenario A - exceeding revenue by 7% of GDP. If this gap were bridged by borrowing the implication is a reversal of progress so far made in reducing the PSBR. Indeed, as a percentage of GDP, borrowing approaches the levels which precipita the 1976 crisis. But if borrowing were to be restrained to 2% of GDP without cuts in expenditure , taxes would have to be raised by the equivalent of £15 bn at today's prcies. The tax burden would rise from 40% to 45% of GDP (having already risen from 35% to 40% since 1978-79. See Chart J).

7. If the £15 bn came from income tax alone, the yield would have to be raised by about half. If it came from the consumption taxes (VAT and specific duties) their combined yield would similarly have to be increased by half. (Raising £15 bn in VAT only would require the VAT yield to be doubled). The response of

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taxpayers to changes on this scale cannot be predicted with any precision. But in crude "ready reckoner" terms what is implied is, at the least:

- raising the basic rate of income tax to about 45p (more if the tax base were reduced through evasion or disincentive effects). Deductions of tax and NIC together would then be over 50 per cent on a marginal £ of income for nearly all taxpayers.

or - abolishing all allowances other than the single allowance (e.g. the married man's allowance, mortgage tax relief, relief for pension contributions and life assurance) and raising the basic rate to perhaps 33p.

or - raising VAT to 25% and doubling the real level of all specific duties.

or - levying VAT at 25% on goods which now bear the 15% rate and those now zero-rated (food, fuel, etc.).

Conclusions

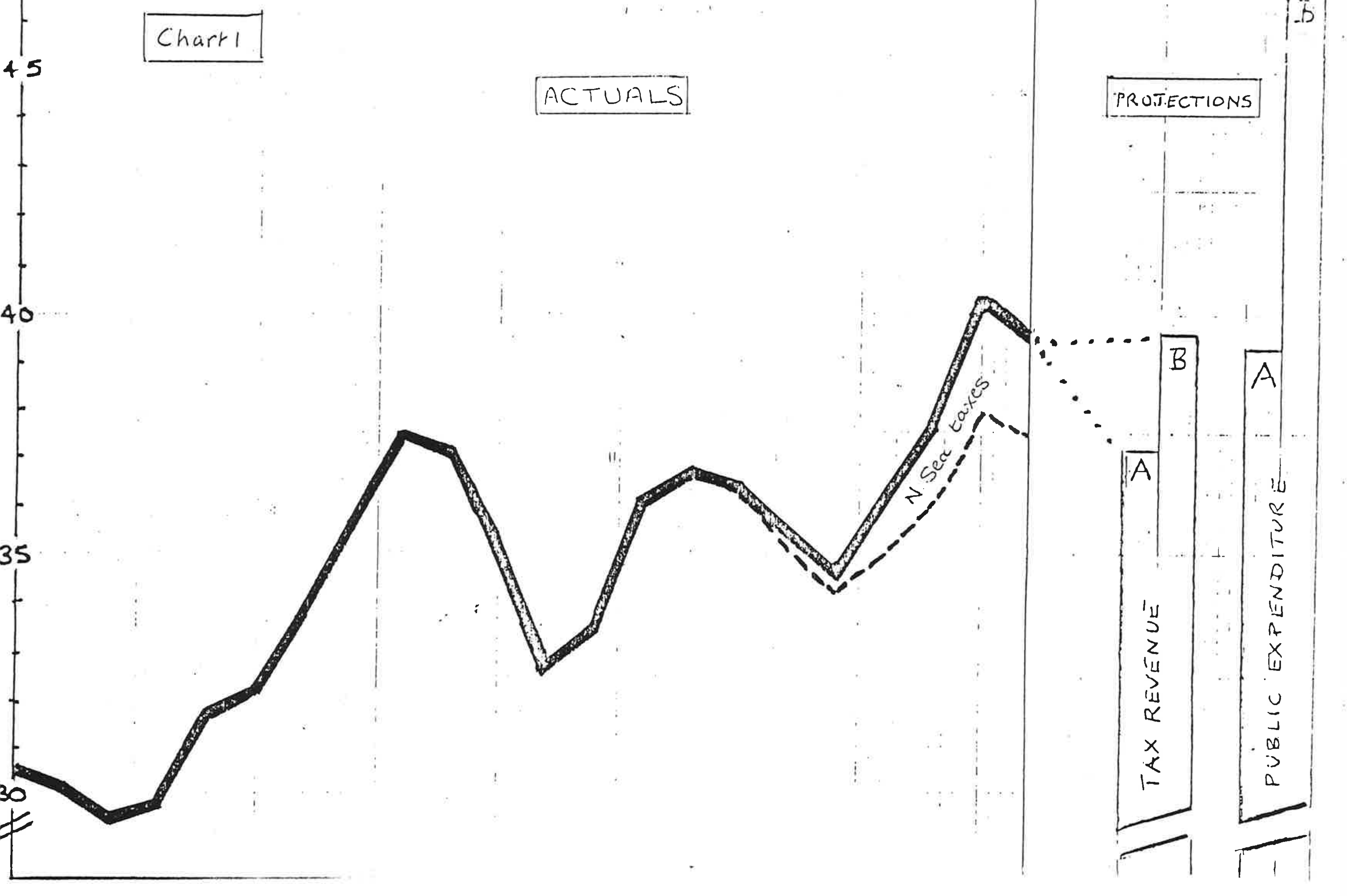
8. The projections are, as stressed above, subject to a wide margin of error. But they demonstrate the difficulty of financing the levels of public expenditure implied by the continuation of current policies. If the economy grows very slowly, as in scenario B, the consequences for taxation and/or borrowing are very serious. The economy would need to grow steadily and strongly, as in scenario A, to permit the sort of expenditure levels envisaged. It is doubtful whether this growth could arise without any further Government action to improve work incentives or to improve businesses' profitability through tax cuts. But if taxes were cut borrowing could not be restrained to 2% of GDP and the inflation and interest rate assumptions would begin to look implausible.

Table A: Tax yields at constant (1980-1) prices and as a percentage of GDP

	£bn 1980-1 prices.			% of GDP		
	1982-3	1990-1 Scenario		1982-3	1990-1 Scenario	
		A	B		A	B
Income Tax	25.7	32.3	29.4	11.1	10.9	12.0
NIC's	16.4	18.6	17.5	7.0	6.3	7.1
Consumption taxes (incl VAT and specifics)	26.6	32.7	27.3	11.4	11.1	11.1
LA Rates	10.5	9.3	9.2	4.5	3.2	3.7
Corporation Tax, North Sea taxes and NIS	11.1	16.0	13.1	4.8	5.4	5.3
Capital Taxes	1.8	1.1	1.1	0.8	0.4	0.4
TOTAL	92.1	109.9	97.4	39.4	37.2	39.7
Public Expenditure (incl debt interest)	103.0	116.0	115.0	44.0	39.3	46.8

Note: Columns do not add exactly to totals because of rounding

Total Tax Revenue as % of GDP at market prices



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

PRIME MINISTER

THE LONGER TERM

We had a word yesterday, and are to talk again on 31 August, about the handling of Cabinet on 9 September. I have talked to John Sparrow today about the paper which the CPRS are producing on the main policy options. You might like to see the attached draft of the paper which I propose to circulate.

2. I am very anxious to avoid giving the impression that this is simply another Treasury "cuts" exercise, but with bigger cuts than usual. In my paper, I have therefore sought to distance our discussion from this sort of approach. I hope very much that we shall be able to have a more fundamental and broad-ranging discussion about our long-term policy objectives and the size and shape of the public sector. Inevitably, this means looking at the broader political context and the prospects for the economy both at home and worldwide. In the course of this discussion I hope it will be possible to secure colleagues' general acceptance of the main conclusion in my paper: that the prospects suggested by the officials' reports are unacceptable, and that we need to get public expenditure onto a better track.

3. Having, as I hope, agreed on the seriousness of the overall problem and the need for a fresh look at public expenditure, we could then turn to the policy options identified by the CPRS as worth further study. Colleagues will no doubt want to comment on these individually and some will no doubt ask to be exempted from the exercise. On the whole, I hope we can avoid this. At this stage we are proposing only that there should be further

studies, and the exercise will be much more acceptable if all the major departments are seen to be in it together.

4. In the light of this discussion we could return to the particular recommendations at the end of my paper, the first of which (for further studies) is, of course, the most vital. I do, however, attach importance to the three other proposals, in particular the suggestion that, until the further work has been completed and reviewed, we should hold back from new commitments and from repeating pledges which would otherwise expire. I think this should apply equally to new promises on the tax front.

5. These suggestions on handling are of course very much subject to your views - and our discussion on Tuesday.

6. I am sending copies of this minute only to Sir Robert Armstrong and Mr. Sparrow.

G.H.

27 August 1982

5/1

CONFIDENTIAL

Draft Cabinet paper

THE LONGER TERM

Note by the Chancellor of the Exchequer

The issues we are to discuss on 9 September are among the most important we shall consider at any time in this Parliament. The way we handle them will crucially affect the policies we put forward at the next election, and the performance and shape of the economy for many years to come.

The problem

2. We came to power in 1979 with a firm commitment to reduce the share which the State takes of the nation's income. We argued in the manifesto that when the State spends and borrows too much, "taxes, interest rates, prices and unemployment rise so that in the long run there is less wealth with which to improve our standard of living .....". Our experience since 1979, and all experience abroad, has demonstrated how well-founded that judgement was. The report by officials (C(82)) shows, however, how far we still are from fulfilling our manifesto commitment: indeed, if we maintain our present policies, with the expenditure to which they commit us, we could well move in the opposite direction.

3. Since 1979, prospects for the world economy have worsened substantially. It is clear that no-one can now confidently predict more than a fairly modest world growth during the rest of this decade. In addition, the UK economy has faced the particular problems of the pay explosion of 1979-80 and the rise in the exchange rate resulting from the petro-currency status of sterling. The resulting loss of competitiveness will take some time to remedy.

4. It is against this difficult background that the official report describes two "scenarios" for the development of the economy to 1990. Neither is a forecast: they simply illustrate what might happen if we maintain our present expenditure policies against two economic backgrounds, one rather more favourable than the other. On the low-growth Scenario B, the report shows that public expenditure might rise to nearly 47 per cent of GDP in 1990-91 - a higher proportion than at any time since the dismantling of the war economy. This level would be nearly 6 percentage points above that of our first year of office and 3 points above what we have agreed for 1982-83. Such a major departure from one of our central aims for the economy would, surely, be altogether unacceptable.

5. On the somewhat more optimistic assumption of 2½ per cent growth in Scenario A, public expenditure would still be nearly 40 per cent of GDP by 1990. This is somewhat below the level of 1979-80 and about 4 points below that planned for 1982-83. But we cannot be reassured by this. In real terms, public expenditure would still be higher in 1990-91 than in 1979-80 or 1982-83. Moreover, some of the assumptions on which the projections are based are, if anything, over-optimistic. They make little allowance, for example, for the increases in expenditure which public opinion might expect in a period of higher growth. And they ignore "creep" - the apparently inexorable tendency for the planning total for any future year to be added to as it comes closer to the present because new and compelling policy commitments are entered into, or for other reasons.(The effect of this in recent years is clearly illustrated by the chart at Annex A).

6. Moreover, the projections in the officials' report, showing as they do significant increases in the social security, health and defence programmes, imply a degree of restraint in the provision of other public services which may in the event prove politically unacceptable. We need to give ourselves some room for manoeuvre in public expenditure.

7. I accordingly believe that:-

(a) We must find new ways of permitting some of the demands to be met, both by encouraging people to make extra provision for themselves, at least at the margin, and by finding ways in which those extra services demanded can be supplied without burdening the Exchequer.

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Taxation and growth

8. I attach at Annex B a note by the Treasury which considers what the expenditure projections in the officials' report (C(82)...) could mean for taxation.

9. On the face of it the gap between revenue and expenditure in Scenario A in C(82).. does not look too bad. But the better growth of output and productivity reflected in this Scenario is based on an expansion of the private sector encouraged by reductions in interest rates and in taxes, especially taxes and charges on business, such as Corporation Tax, NIS or other National Insurance charges. It will also be important if we are to achieve this better growth performance, to reduce personal taxation so as to improve incentives. We cannot secure the lower interest rates that the private sector needs if we do not hold the PSBR down firmly. The way forward to better economic performance can therefore only be through reducing expenditure.

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Overseas experience

11. The UK is not alone in having to take hard decisions on public spending. Other countries,too, have had to rein back spending plans. They include both rich and poor. Among our major industrial partners, the US, Germany and Japan have

all sought spending economies. The French Government, too, is now seeking stringent cuts in its previously ambitious plans. Even among the Scandinavian countries, with a long tradition of high public spending, economies are being made. In many cases, previously sancrosanct programmes such as social security, health and education have had to share in the reductions. In developing countries in Africa, Asia and Latin America, reductions in public spending plans form a vital part of many of the adjustment programmes agreed with the IMF. Mexico is the most recent to join the list.

Conclusion

12. The record of the past two decades has shown all too clearly the dangers of formulating or accepting policy commitments on the assumption of a continuing economic growth which in the event has not been achieved. It has been a failure of successive Governments that they have assumed growth in the economy without taking the steps necessary to make it possible. Successive expenditure reviews have thus followed a dreary cycle of over-optimism followed, inevitably, by retrenchment.

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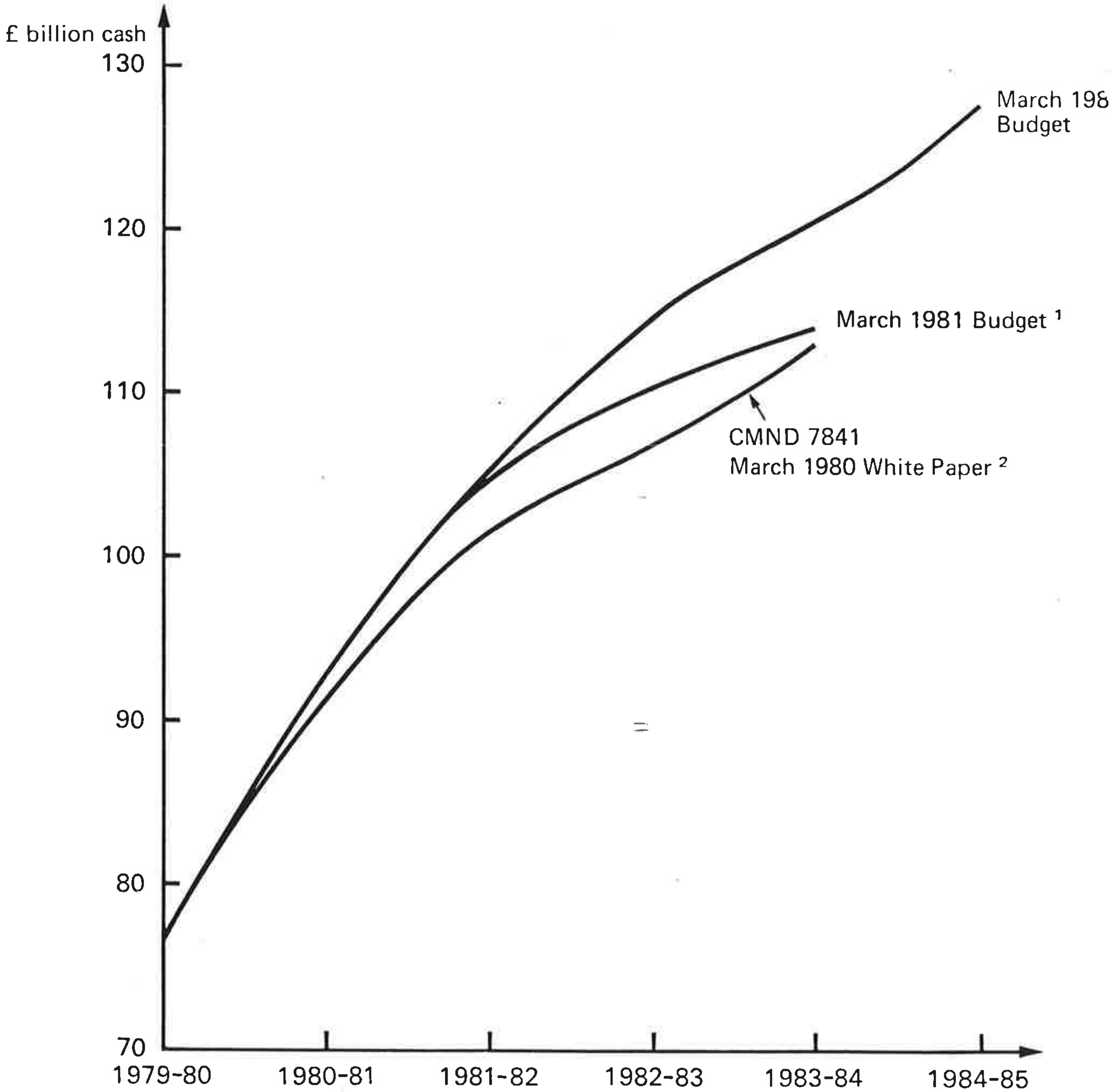
PUBLIC EXPENDITURE PLANNING TOTALS

£ billion cash



Notes: [1]Converted into cash from the plans in 1980 Survey Prices.
[2]Converted into cash using the same inflation assumptions as used for converting the MARCH 1981 BUDGET plans.

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FISCAL IMPLICATIONS

The longer term public expenditure exercise has projected expenditure to the end of the decade on two illustrative macro-economic scenarios, the main features of which are shown at Annex 1 of the Public Expenditure Paper. This note describes a similar projection of tax revenue on each of the same scenarios, and goes on to look at the balance between revenue and expenditure that is implied. Like the expenditure figures, these projections are dependent on the scenarios assumed: they are not forecasts. The margin of error is inevitably wide when looking so far ahead.

Assumptions

2. Like expenditure, taxes have been projected on the basis of unchanged policy. This has been interpreted to mean that income tax thresholds and specific duties are raised in line with prices, that tax rates are unchanged and that existing allowances and reliefs are continued. Local authority rates and National Insurance Contributions are calculated from the projections of local authority expenditure and expenditure from the National Insurance Fund, respectively, on the assumption that an unchanged proportion of such expenditure is met from general taxation. For North Sea taxes the real sterling oil price is assumed to rise by about a third between 1980 and 1990. (This reflects both a rise in the $ price and a fall in the exchange rate.) Even though some new fields are assumed to come on stream, total production is assumed to be a little below its peak level, which is reached in mid-decade.

The projections

3. If scenario A were to be fulfilled, the projections suggest that tax receipts would rise by about 20 per cent in real terms. This is a rather smaller increase than that assumed for GDP in this scenario so that taxes as a percentage of GDP fall from 39½ per cent to just over 37 per cent. (See table A). However, this mainly reflects a fall in local authority rates and National Insurance Contributions as a percentage of GDP: this would only occur if local authority spending and benefit payments from the National Insurance Fund were in fact held to the levels assumed in the Expenditure projections. Income tax and consumption taxes fall slightly in relation to GDP, the former because the scenario assumes a falling wage share, the latter because the evidence is that a 10% rise in income leads to less than a 10% rise in consumption of goods that bear specific duties. The yield of capital taxes also declines in relation to GDP, largely because of the indexation of CGT. Corporation tax and North Sea taxes, on the other hand, rise somewhat as a percentage of GDP.

4. On scenario B projected tax receipts rise by only 6% in real terms - a good deal less than on scenario A. But GDP also rises more slowly and taxes remain roughly constant as a percentage of GDP at just below 40% (see table A). Local rates - derived from the Expenditure projections - fall in relation to GDP as in scenario A, but NICs remain a roughly constant proportion of GDP because the limited growth in benefit expenditure matches the limited growth in GDP. Capital taxes again fall in relation to GDP. Against this North Sea taxes and income tax rise as a percentage of GDP. (Corporation tax is about constant). The reason why income tax rises in relation to GDP on scenario B, unlike scenario A, is that wages and salaries rise as a share of GDP. 80-90% of the yield of income tax comes from wages and salaries. Consumption taxes, however, fall as a percentage of GDP because of the tendency for expenditure on goods bearing specific duties to rise less fast than income.

Implications

5. On scenario A the projected gap between expenditure and revenue narrows to about 2 per cent of GDP by the end of the decade - no smaller as a percentage of GDP than the target figure set for the PSBR in the last year of the Medium Term Financial Strategy. Moreover, the tax projections make no provision for raising income tax thresholds in real terms or for cutting tax rates to help personal incentives, or to ease the disincentive effects of the poverty trap. Nor do they allow for any reduction in the rate of business taxation*. Corporation tax payments are projected to rise as a percentage of GDP. Without tax reductions to improve incentives and increase net company profitability it is doubtful whether the economic growth postulated could be achieved.

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Table A: Tax yields at constant (1980-1) prices and as a percentage of GDP

	£bn 1980-1 prices.			% of GDP		
	1982-3	1990-1 Scenario		1982-3	1990-1 Scenario	
		A	B		A	B
Income Tax	25.7	32.3	29.4	11.1	10.9	12.0
NIC's	16.4	18.6	17.5	7.0	6.3	7.1
Consumption taxes (incl VAT and specifics)	26.6	32.7	27.3	11.4	11.1	11.1
LA Rates	10.5	9.3	9.2	4.5	3.2	3.7
Corporation Tax, North Sea taxes and NIS	11.1	16.0	13.1	4.8	5.4	5.3
Capital Taxes	1.8	1.1	1.1	0.8	0.4	0.4
TOTAL	92.1	109.9	97.4	39.4	37.2	39.7
Public Expenditure (incl debt interest)	103.0	116.0	115.0	44.0	39.3	46.8

Note: Columns do not add exactly to totals because of rounding

Total Tax Revenue as % of GDP at market prices

Chart J