PO-CH/NL/0126
PART A

Part. A.

SECRET

(Circulate under cover and notify REGISTRY of movement)

Begins: 15/7/86.
Ends: 16/7/87.

PO -CH /NL/0126

PART A

Chancellor's (Lawson) Papers:

1987 PUBLIC EXPENDITURE SURVEY CABINET

Disposal Directions: 25 Years

21/8/95.

PO -CH /NL/0126
PART A

Pressure on the programmes
Chancellor's paper

SECRET AND PERSONAL

15/7/86.

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

PRIME MINISTER

I am profoundly concerned about the cumulative effect of the increases in public expenditure we have announced in recent weeks, together with those in prospect next week. These are giving a signal which would be disturbing at any time. They cause particular anxiety when the markets are already nervous about weak oil prices. The Chief Secretary shares my concern.

You will have seen recent press comment, notably Adam Raphael in The Observer on Sunday - "Hardly a day goes by without a Ministerial statement announcing a dollop of money for some worthy cause or other". Raphael cited student grants, invalid care allowance, GCSE, TVEI, British Coal Enterprise and the Severn Barrage. He might also have mentioned nurses pay, board and lodging allowances, British Shipbuilders and others. Today we have the announcement about the frigates and tomorrow the legal aid settlement with the barristers and the Law Society.

We face next week announcements of the local authority provision and settlement, adding £3½ billion to provision and over £1 billion to Exchequer grant next year, both of them unprecedented amounts; an overspend in the current year of £700 million on local authority capital expenditure; and a 7½% increase in police pay, which will be the first settlement taking effect in the new pay round. In The Guardian this morning, John Carvel says that local authority leaders regard the news of next year's Exchequer grant increase as "too good to be true". Yet the £1,250 billion we have promised for the teachers over four years, in return for a satisfactory settlement of the teachers' dispute, is not included in the local authority settlement and would be additional to it.

On top of all this, later next week, as Kenneth Baker told MISC 122, an "indicative" figure for teachers' pay is likely to emerge in the ACAS talks. If current reports are anything to go by, that "indicative" figure could be 10-15% on top of the settlements the teachers have already received this year and last. It is essential that we stick firmly to our previous line that we stand by our undertaking to make provision for an additional £1¼ billion in return for a satisfactory settlement and it is for the local authority employers to negotiate with the teachers against that background and within the very generous settlement we have made for them. That is not only the right position for the time being: it is one we must maintain. The local authorities must be forced to choose between their priorities. We know from the work of the Audit Commission that they have plenty of scope for economies without financing any addition for teachers through the rates. That is why we must have a tough grant regime which strongly penalises additional spending. To yield on teachers pay would be profoundly damaging both to public expenditure and to the prospects for next pay round, which are already very worrying. And if we ~~once again~~ give the local authorities the impression that we will finance anything from the taxpayer rather than risk further rises in the rates, there will be no holding them.

The reason why I am expressing my anxiety so frankly to you is that I believe we are not far from creating the impression that in the run-up to the next Election we are throwing all restraint on public expenditure to the winds. Once that impression got around, it would release even more pressure for spending and it would be very hard to reverse. The harm it would do our reputation and to our standing in the financial markets, and the weakening of confidence in our economic management which would result, not to mention the implications for next year's Budget, would do far more damage to us in the approach to the next Election than anything we could hope to gain from the extra expenditure within that time scale.

N.L.

15 July 1986

026

1986

SECRET AND PERSONAL

CST
Sir P. Middleton
Mr F.E.R. Butler

pw

15/7/86.

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

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N.L.

15 July 1986

026

pmg

PETER MIDDLETON'S SPEAKING NOTES

1. Seen Cabinet paper

   - lagged effect of fall in oil price
   - make up next year what lose this
   + immediate (beneficial) effect on inflation
   = source of underlying optimism

2. International policy dilemma

   - world monetary policy too tight
   - but mainly Japan and Germany
   - low interest rates and low inflation
   + monetary dilemma
   + international meetings

3. US went ½ per cent

   - would have taken risk of following but no others went
   - not even France

   GREAT penalties for getting out of line

4. Markets reacted adversely to signals

   - 3 factors

   (a) oil

   (b) Sunday press on Balance of Payments
   - consumption
   - oil

   (c) barrage of comment on PE
   - look as though lost our heads

5. Exchange rate down to just under 74 (as low as 73)

   - itself no cause for worry
   - still highish in oil adjusted terms (but not true comparison)

- give a bit of a help to exporting sectors.

6. But is reminder of great vulnerability

(a) revenues - there for all to see

(b) world - continuing glut leads to increased uncertainty
  - from $15 to $9
  - still glut

(c) domestic scene
  - inflation good and very important
  - unit costs bad
  - output uncertain
  - unemployment difficult
  - public expenditure/election
  - must discuss quietly + within existing policy
  - must not scare markets by making PE look worse than it is

So expect to get though tomorrows Cabinet in usual way

\+ treat next weeks barrage of announcements with good sense

\+ great calm

16/7/86. [illegible]

SPEAKING NOTE FOR PRIME MINISTER

Firm control of public expenditure is an indispensable part of our economic policies. It played an important role in bringing down inflation and Government borrowing and has enabled us, in recent Budgets, to make progress in reducing the burden of taxation. The strength of the public finances has prevented us from being blown off course by the major challenges and economic shocks we have faced. Over the past seven years we have acquired a reputation for soundness which we must not destroy. The question is not whether one can cope under present circumstances but whether one has something in hand if the situation worsens. Caution has served us well as a Government. Recent developments in the economy and in financial markets fully vindicate this cautious approach.

2. I recognise that the control of public expenditure sets any Government its most searching test. Public expenditure surveys are always painful and if we accept the additional provision which is proposed for local authorities we must expect this year's Survey to be very tough indeed. But as a Government we must be prepared to face up to difficult decisions required in setting priorities. What we decide today must demonstrate both our unity and our resolve.

3. I ask colleagues, therefore, to give the Chief Secretary their fullest co-operation in seeking economies. I doubt if any Minister can really say that there is no element of his existing programme which is not of lower priority than items for which he has made additional bids; or that there are no further efficiency savings that can be made. Indeed, as management improves in departments and in the health service, the scope for achieving greater value for money should be increasing.

4. We must not give any sign of weakening in our determination to keep public spending under firm control. To do so would make us more vulnerable to the difficult economic circumstances we face and put at risk our undoubted achievements. The best way to signal our continuing resolve is to work within unchanged planning totals, as

we have done in previous years. Must continue to face up to difficult choices and must continue our search for better value for money.

Points for use, if and when needed

1. No time for complacency

Though the growth of public expenditure has been arrested over the past two years, we cannot afford to be complacent. Public spending this year is likely to be around 12 per cent higher in real terms than it was when we came into office. As a share of GDP it will be more or less exactly the same (around 43 per cent).

Although we have reduced taxation in recent Budgets and have substantially cut income tax, the burden of taxation as a whole is higher than when we came into office (non-North Sea taxes as a proportion of non-North Sea GDP have risen from 34 per cent in 1978-79 to 37 per cent this year). The tax paid by those below average earnings is still too high. Must not rest on our laurels.

2. Priorities/value for money/offsetting savings

The control of public expenditure is one of the most difficult tasks facing any Government. It is essential that we approach public spending by setting ourselves a limit and then living within it. We must be strong enough as a Government to face up to difficult decisions required in setting priorities.

I share disappointment that in the bids presented there is insufficient evidence of a rigorous search for offsetting savings which would allow priorities to be reordered within existing plans. I cannot believe that there are not elements within existing programmes which have lower priority than some of the bids presented.

It is disappointing that despite making more money available for vital services we have not received the credit we are due. The message I draw from this is not that more money is the answer but that it is improvements in services that matter. In achieving this, better value for money and greater efficiency have just as much to contribute.

We must avoid thinking that because we have already achieved substantial efficiency savings there is not much left to be squeezed out. I take the opposite view. With improved management in departments and in the health service the scope for finding greater efficiency should be increasing.

I share the Chief Secretary's disappointment that so few bids have been backed by targets for what they would achieve. The setting of targets is essential first to establish the merits of the bid, and second to provide a benchmark against which the success of the programme can subsequently be evaluated. I welcome the Chief Secretary's intention to press colleagues on this in bilaterals.

3. Pay

It is clear that rapidly rising pay lies behind much of the pressure for higher public expenditure. The pay bill for the public services is £45 billion. Each 1 per cent therefore costs £450 million. Neither in the public nor the private sector have settlements reflected the fall in inflation. A 1 per cent increase in current sufficient to preserve real take-home pay.

I look to colleagues to do all they can to get lower pay settlements in the next round. We need to take a tough line with the Government's own employees in pay negotiations and maintain financial pressures on local authorities and nationalised industries. We must continue to exhort the private sector both publicly and in private contacts.

4. The need to be resolute

We must not give any sign of weakening in our determination to keep public spending under firm control. Far from strengthening our position as a Government, boosting public spending would weaken it, would make us more vulnerable to the difficult economic circumstances we face and would put at risk our undoubted achievements. The best way to signal our continuing resolve is to work within unchanged planning totals, as we have done in previous years. Must continue to face up to difficult choices and must continue our search for better value for money.

002/2765

SECRET AND PERSONAL

PPS/ You have a copy of his minute as despatched in your PM collateral folder.

FROM: PAUL PEGLER
DATE: **16 July 1986**

PRINCIPAL PRIVATE SECRETARY

cc:
Sir Peter Middleton
Mr F E R Butler

PUBLIC EXPENDITURE: MINUTE TO THE PRIME MINISTER

The Chief Secretary has seen Mr Butler's note to the Chancellor of yesterday's date attaching a draft minute to the Prime Minister. I understand the minute was sent to, and seen by, the Prime Minister yesterday evening.

2 The Chief Secretary feels that the tone of the minute was not quite right and that the following points are the ones that should be stressed:

(a) decisions already taken, especially those on RSG/local authority expenditure etc., mean heavy pressure on the Planning Totals etc. And there are others:

(b) other pressures from now on must therefore be strenuously resisted;

(c) teachers' pay is crucial. Must be met from rates because otherwise:

(i) on top of the RSG settlement, will lead to an explosion in local authority expenditure;

(ii) it will give all the wrong signals to local authorities who can agree whatever pay settlement they like and HMG will underwrite;

(iii) makes a mockery of all speeches that employers should stand firm against excessive and 'unaffordable' pay awards.

So in the Chief Secretary's view there must be no further central government contribution to teachers awards over and above what is agreed in the RSG Settlement and that portion of the £1¼ billion addition already offered.

Paul Pegler

PAUL PEGLER

FINAL VERSION

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C(86)

16 July 1986 Copy No

1986 PUBLIC EXPENDITURE SURVEY

Memorandum by the Chief Secretary, Treasury

The report on the baseline for the 1986 Survey, covering both expenditure to be incurred and the outputs and performance to be achieved, was circulated on 30 May. Colleagues have also completed an examination of their programmes and where they are seeking additional provision, have put their proposals to me. I have circulated a summary of departmental bids - my minute to the Prime Minister of 10 July. This paper examines the prospects for public expenditure and makes proposals for the next stage of the Survey.

2. In recent years it has been the practice to consider the prospects for local authority current expenditure separately in E(LA) and for the aggregate objectives for nationalised industry external financing limits to be considered at a separate meeting of E(A). This year I believe it would be helpful, in considering the overall objective for public spending, to take into account the position reached on local authority expenditure; and to set the objectives for the nationalised industries as part of the wider picture. The Lord President will be circulating a progress report on the discussions in E(LA). On nationalised industries, departments have already received copies of the Investment and Financing Review (IFR). The position is further discussed in paragraph 12 below.

Expenditure Baseline

3. For 1987-88 and 1988-89 the baselines for individual programmes have been the figures in the 1986 public expenditure White Paper (Cmnd 9702) plus the changes announced in the Budget for employment measures, together with a few minor technical adjustments. For 1989-90 we agreed to construct the baseline for individual programmes by adding 2½ per cent to the provision for 1988-89, but consideration of the aggregate planning total figure for that year was left until now.

Proposals for expenditure

4. In my minute to the Prime Minister of 6 February I urged departments to "live within their existing baselines with pressures for extra resources met by cutbacks elsewhere and - of particular importance - improvements in efficiency and effectiveness". Although colleagues were asked to scrutinise personally priorities within their programmes, I regret to say that substantial additional bids have been put forward, full details of which were set out in my minute of 10 July. It is very disappointing that so few offsetting savings were identified and that bids were not in general supported by statements of objectives. In my bilaterals I shall be pressing colleagues further on the setting of targets and the measures on which subsequent evaluation would be based. It is clear that the bids made are far in excess of what can be accommodated and that the problem of establishing priorities in the Survey will therefore be severe.

5. Firm control of public spending is central to our economic policy. It is an essential part of our efforts to improve the performance of the economy, and the prospects for both output and jobs, by limiting the role of the state and enabling us to reduce the burden of public borrowing and taxation. It has played an indispensable part in bringing inflation to the lowest level for 19 years. Moreover it is largely because of these achievements, coupled with the reputation we have established for prudent financial management, that we succeeded in weathering both the miners' strike and the collapse in oil prices without any financial crisis. Over the past year both long and short

term interest rates have fallen by 2½ per cent. But further progress is critically dependent on our retaining the confidence of financial markets.

6. If we are not to put all this at risk, it is essential that in the Survey we once again work within the existing and published planning totals for 1987-88 and 1988-89. For 1989-90 we agreed to set the uplift for individual programmes a little below the rate of inflation of 3 per cent assumed for that year in the MTFS. I propose that we now confirm that the planning total should rise by 3 per cent. This will allow a margin for the adjustment of priorities between programmes. This gives broad planning totals for the three years of £144 billion, £149 billion and £153 billion.

<u>Reserves</u>

7. In the White Paper, Reserves of £4½/6¼/8 billion were set for the three years of the plans, figures which were large compared with those set in previous White Papers. In the current year it is already clear that the Reserve of £4½ billion will be under extreme pressure. I must, therefore, treat all applications for access to the Reserve in the current year most strictly and seek colleagues' co-operation in ensuring that cost increases are absorbed and underspendings surrendered.

8. The precise level of the Reserves required for future years depends in part on the decisions taken on programmes during the course of the Survey. If, for example, provision made in programmes is as realistic as possible, lower Reserves can be set than if, as was the case with local authorities in the last Survey, provision is made on a notional basis. I propose, therefore, to consider the precise level of the Reserves later in the Survey, but we must leave, within the public expenditure totals, scope for Reserves which are fully adequate, rising through the period and credible to the financial markets.

Privatisation proceeds

9. During the course of the last Survey the projections for privatisation proceeds were raised from £2¼ billion to £4¼ billion. I indicated in my minute of 6 February that the privatisation programme was now in top gear and that additions to the level of proceeds could not be expected. Although preparations for the BGC sale are proceeding well, and other issues are being worked upon, there is no scope for receipts to be significantly further increased. Moreover, the sums raised by these issues will depend very much on market conditions, which in turn will be strongly influenced by the outcome of the Survey.

Local authority current expenditure

10. The Lord President will be reporting the conclusion of E(LA)'s discussion to Cabinet. I have accepted the consensus at the meeting of the Sub-Committee on 13 June that provision should be increased by £2.9 billion to £25.2 billion. The latter figure represents a real-terms standstill for local authorities' budgets for 1986-87. The Environment Secretary proposes to make a statement on the RSG settlement and on our approach to capital controls before the Houses rises.

11. The size of the proposed increase is very much higher than in recent years. It will need careful presentation if it is not to have an adverse effect on the markets, coming as it does before we are ready to set out the rest of our plans. Setting provision at a real-terms standstill for local authorities' own budgets also carries the danger that we will be seen to be underwriting the existing levels of overspending, which we have constantly criticised, and abandoning our attempts to secure real-terms savings in contrast to previous years. It is vital that we show that we are keeping up our pressure to contain local authority spending. The package put to E(LA) contains some important toughening of the grant pressures on overspenders; and it is essential that these proposals are implemented if an increase on this scale is to be entertained.

12. E(LA) also agreed to an increase in Aggregate Exchequer Grant of £1.1 billion. This will maintain the same grant percentage as in the 1986-87 settlement, after 6 years of steadily declining grant percentages. Together with the realistic provision it will enable those authorities who budget responsibly to have very low rate rises. But such a massive increase - far and away the biggest we have ever been prepared to countenance - also carries dangers of unsettling the markets. We shall again have to stress that this is balanced by action to toughen the pressures on overspenders.

Nationalised Industries

13. I have circulated separately officials' report on the 1986 Investment and Financing Review of the nationalised industries. This shows that the industries' own initial and unamended bids, made in April, are over the baseline by approximately £850 million, £750 million and £575 million in each of the three years respectively. These bids are clearly unrealistic and cannot be accommodated. They now need to be scrutinised rigorously and a number of industries are revising their proposals so that we will have a sounder basis for judging them. In the meantime we cannot take a firm view on the likely overall outcome, but our aim must be to reduce the provision at least to baseline and, where we can, below it. Failure to achieve this would mean greater pressure on departmental programmes.

Running costs and manpower

14. Additional bids for increases in provision for running costs amount to over £550 million in 1987-88 and higher sums for later years. If they were conceded the increase in total running costs expenditure would be more than 6½ per cent on a year earlier, very substantially in excess of the present and expected rate of inflation. Increases of this order would scarcely demonstrate our intention to control expenditure on departmental administration.

15. A significant part of this increase is accounted for by additional bids for pay. But any real increases in pay must be matched by growing productivity if the overall rise in departmental costs is to be kept close to the rise in prices in the economy generally. Departments should be planning the measures necessary to achieve this.

Another large part of the increase claimed for running costs is accounted for by bids for additional manpower. Colleagues will know from the minute I sent to the Prime Minister of 17 February that we must keep a very tight rein on manpower numbers if we are to hold to our published manpower targets. The position now is that if the additional numbers sought by departments were agreed, the target of 590,400 staff at 1.4.88 would be exceeded by 14,000, reversing the downward trend achieved since we took office.

17. I must therefore ask colleagues to re-examine their departmental programmes with a view to reducing the increase in running costs to much more modest levels and to keeping at or below their manpower targets.

<u>Conclusion</u>

18. I invite colleagues to agree:

(a) that I should now conduct bilateral discussions with colleagues on their individual public expenditure programmes, and on their targets for running costs and manpower;

(b) that once again we work within the existing and published public expenditure planning totals of £144 billion and £149 billion for 1987-88 and 1988-89 respectively, and £153 billion for 1989-90;

(c) that provision and grant for local authority current expenditure be set as recommended in the Lord President's minute and that the Secretary of State for the Environment should announce this before the Recess.

(d) that we should aim to hold the provision for nationalised industries at least to baseline and where possible below that;

(e) that we should seek to restrain the growth of running costs and that existing manpower targets should be held.

[JM]

Treasury Chambers
July 1986

CULPIN TO CH
8.7.87
NOTES FOR MTG.

745/79

SECRET

pnp

FROM: ROBERT CULPIN
DATE: 8 JULY 1987

CHANCELLOR

Keys: gradual? When?

cc Chief Secretary
Sir Peter Middleton
Mr F E R Butler
Sir T Burns
Mr Anson
Mr Monck
Mr Turnbull
Mr Luce
Mr Scholar
Mr Gieve
Mr Tyrie

PUBLIC EXPENDITURE CABINET

I attach some notes for your meeting tomorrow. They reflect discussion with Mr Turnbull.

The first page gives a possible line to take. I have then dictated, separately, the sort of follow-up conversations I can imagine having.

RC

ROBERT CULPIN

Encs.

Ch
Not explicitly covered is "is this a defeat"?
AA

SECRET

745/78

Su nv n Ne... (10SP/15BR)

INGHAM COMMUNIQUE

The Cabinet had its usual July discussion of public expenditure today. It reaffirmed the policy that public expenditure should continue to take a declining share of national income. Within that constraint, the Chief Secretary will hold bilateral discussions in the Autumn. In the light of these, the Government will review both the individual spending programmes and the planned total for spending, and will, as usual, announce decisions in the Autumn Statement in November.

Text

"My Government .... will maintain firm control of public expenditure so that it continues to fall as a proportion of national income and permits further reductions in the burden of taxation." - Queen's speech.

Will the planning total be increased?

I can't tell you whether the total will be changed, or if so by how much, or where the money will go. None of that is decided.

There may be some change in the total. But there will be no change whatever in the policy that public expenditure declines as a proportion of GDP.

That is not just an aspiration. It is what we have achieved since 1982-83.

TREASURY NOTES FOR SUPPLEMENTARIES

Is the planning total LIKELY to be increased?

Have to wait and see. Need to conduct the review first.

Why unable to decide, as usual, in July?

Cabinet has decided to stick firmly to the policy.

Details of Survey running a little later this year. Election. Reshuffle. [Local authorities - if no July announcement.]

Leaves things open ended/breaks rule that you must decide what you can afford before examining particular programmes?

No. Commitment to take smaller share of GDP is a binding constraint.

Is the policy that public expenditure should decline as a proportion of GDP by any old amounts or by some predetermined ones?

It should fall to the sort of levels set out in the White Paper.

Silly to put absolutely precise figures on the path from year to year, because it depends on what happens to GDP as well as what happens to spending. But the ratio should certainly decline as much as in the White Paper.

Including or excluding privatisation?

Either.

What is the maximum increase in the planning total this could imply?

Not going to speculate. Early days. But clearly the commitment that public expenditure should grow less fast than the economy as a whole is a major constraint.

When was the last time the Treasury conceded, before the bilaterals, the possibility of an increase in the planning total?

[Being checked]

Why are you considering the possibility this time?

You've seen the local authority settlement [if there is a July announcement]. You know some of the other things in the pipeline - for instance, the continuing extra cost of the nurses' pay award. [And it is plain that the economy is strong.]

We have a tough objective for public expenditure, and we mean to stick to it. But the figures have to be realistic as well.

What's the point of having planning totals when you've raised them substantially three years running?

Better a really demanding target which you may have to raise a bit than an undemanding one.

Proof of the pudding: public expenditure is falling as a proportion of GDP for the fifth year in a row.

Will there be Star Chamber?

No doubt: established part of the constitution.

2136/6

SECRET

FINAL

DRAFT PAPER FOR CABINET (No 5)

THIS DOCUMENT IS THE PROPERTY OF HER MAJESTY'S GOVERNMENT

C(87)
July 1987

Copy No

1987 PUBLIC EXPENDITURE SURVEY

Memorandum by the Chief Secretary, HM Treasury

Introduction

Our policy is to bring public spending down progressively as a proportion of national income. Over the past four years we have succeeded in achieving this. Even excluding privatisation proceeds, general government expenditure (the combined spending of central and local government) has fallen from 47 per cent of GDP in 1982-83 to 44 per cent in 1986-87, and there will be a further fall in 1987-88 - though it will still be higher than it ws in 1978-79. Our progress over the last few years has enabled us to combine a steady but controlled growth of public expenditure in real terms with a reduction in borrowing and, in each of the last five Budgets, a reduction in taxes. This restraint in public spending has made possible the strong performance of the economy which the Chancellor has described in his Memorandum (C(87)).

2. In our Election Manifesto we pledged ourselves to continue the policy of ensuring that public spending takes a steadily smaller share of our national income. This is essential if we are both to maintain the momentum of our economic performance and to deliver of our Manifesto pledge to reduce the burden of taxation.

3. For this year's Survey we have set baseline totals for spending of £154.2 billion in 1988-89, £161.5 billion in 1989-90 and £165.5 billion in 1990-91. For the first two years this was done by retaining the planning totals set out in last year's Public Expenditure White Paper and for the third year we have used an uplift factor of 2½ per cent.

4. Departments were then asked to review their programmes within their baseline figures and to put proposals to me where they felt, after a review of priorities, that additional resources were required. In my minute of 17 July to the Prime Minister, I summarised the bids received from departments.

Objectives for the Survey

5. I have to make it clear to colleagues that bids on this scale are far beyond what can be afforded. If anything like this were accepted, we could not make the further progress in reducing public spending as a proportion of GDP we have set ourselves. This would not only make our objectives for taxation unattainable, it would also trigger a complete reappraisal of the Government's financial standing in the markets, and provide a severe setback to the economic progress we have made.

6. With the time lost as a result of the election, it has not been possible to analyse the bids as thoroughly as normal. There are major uncertainties in a number of areas which I will want to probe further, eg the large estimating changes for social security and the projections of our contributions to the European Community. But it is clear that to hold to our policy on public spending we will have to face up to difficult decisions in a number of areas. Bids will have to be significantly scaled back and, to the greatest extent possible, policy savings found to offset them.

Departmental running costs

7. Colleagues have sought increases in their departments' running costs implying overall cash increases of 8 per cent for 1988-89 over 1987-88 with further increases in later years. The associated manpower projections reverse the downward trend we have achieved, implying a 15,000 increase over published plans for 1988-89. Increases on this scale are clearly unacceptable.

8. In the last few years, the increases in spending on departmental costs agreed for each first Survey year have exceeded our aims. In many cases the figures for the later years have not been set at realistic levels and as a result have had to be increased further in later Surveys. We need to agree a

realistic method for planning provision over the Survey period so that departments have a reasonably reliable basis for making medium-term plans to improve efficiency.

9. My proposals, set out more fully in the annex, are that:

i. the running costs share of total public spending should not rise over the Survey period. This implies that running costs would grow on average in line with our plans for public expenditure generally, ie by about 1 per cent a year in real terms, though individual departments would, of course, have no entitlement to such an increase;

ii. cost and other pressures will need to be met to a large extent by efficiency gains of at least 1½ per cent a year in the use of all resources including manpower. These will need to be planned well in advance and departments should have contingency plans for larger improvements in case they are necessary;

iii. departments should prepare management plans to deliver these gains over the full Survey period. In any case where the plans are not suitably ambitious, or are unrealistic, I would hold over agreement on the later Survey years until the next Survey;

iv. for 1988-89, the aim should be to reduce the overall increase in provision sought by at least half.

Nationalised industries

10. In the 1987 Investment and Financing Review, the nationalised industries' own intial and unamended bids, made in May, exceed the baseline by £0.9 billion in the first year and £1.2 billion in the two subsequent years. These bids are clearly unrealistic and cannot be afforded. They now need to be scrutinised rigorously, and a number of industries are revising their proposals so that we will have a sounder basis for judging them. Apart from the electricity industries in England and Wales and in Scotland, I propose that our aim should be to reduce the provision at least to baseline and, where we can in the case of individual

industries, below it. Failure to achieve this would mean greater pressure on departmental programmes. There are particular problems relating to the electricity industry this year, notably the need to set new financial targets, the implications of privatisation and assessment of a new power station programme. Notwithstanding these uncertainties, the pressure on public expenditure means that it is essential to appraise the industries' bids critically and to set challenging financial targets.

Local authority relevant public expenditure

11. It has been agreed in E(LA) that provision for relevant public expenditure in England should be set at £27,969 million (£27,538 million for relevant current expenditure and £431 million for Rate Fund Contributions to Housing Revenue Accounts). This is an increase of £819 million above the White Paper baseline. Aggregate Exchequer Grant in England is to be set at £13,775 million, an increase of £750 million (5¾ per cent) on the 1987-88 settlement figure including teachers' pay. [Reference to Scotland and Wales to come.] These are substantial additions and we must recognise that they will severely limit what can be made available for other programmes.

Conclusions

12. I ask Cabinet:

i. to reaffirm the Manifesto policy of ensuring that public spending takes a steadily smaller share of our national income and, after excluding privatisation proceeds, does not exceed the path in last year's White Paper;

ii. to note that to secure the policy objective at (i) bids will have to be substantially cut back and difficult decisions will have to be faced in a number of policy areas;

iii. to agree that we should aim to hold the EFLs of the nationalised industries other than electricity at least to baseline and possibly below; and that we should seek to keep the electricity industries' external finance as low as possible;

iv. for running costs, to agree the proposals set out in paragraph 11 and in the Annex;

v. to agree that I should now conduct bilaterals with colleagues on their spending programmes.

TREASURY CHAMBERS
July 1987

[JM]

ANNEX

1987 PUBLIC EXPENDITURE SURVEY: DEPARTMENTAL RUNNING COSTS

Departmental Ministers have sought increased provision for running costs totalling £761 million for 1988-89, £956 million for 1989-90 and £1,203 million for 1990-91.

2. We cannot accept increases of this size. They would mean that overall expenditure on running costs would rise by 8 per cent in cash and 4 per cent in real terms between 1987-88 and 1988-89, with further real increases in the later years. They would also imply an increase in Civil Service manpower of nearly 15,000 over the manpower plan of 583,000 for 1 April 1989 published in this year's public expenditure White Paper and further increases in later years, though some 5,000 of this rise stems from increases agreed after the last Survey.

3. There are undoubted pressures on running costs. In spite of large manpower reductions (135,000 since 1979 and 50,000 since 1983) and, in most years, Civil Service pay settlements at or below general inflation, running costs have continued to rise in real terms as a result of increases in non-manpower costs (eg more buying-in of services rather than providing them internally) and changes in grading mix. Tight pay settlements will continue to be the aim. But if departments are to recruit and retain the staff they need and the Government's objective of making the Civil Service pay structure more conducive to an efficient service and more responsive to labour market conditions is to be met, future pay offers cannot be expected to be immune from pay movements in the economy generally.

4. It is thus realistic to provide for some rise in overall spending on running costs; but the Manifesto pledge to press ahead with management reforms to improve public services and reduce their cost, as well as the aim of ensuring that public expenditure takes a steadily smaller share of national income, mean that the rise must be contained to well below the levels sought.

5. I propose we that we should base our plans on the firm constraint that the share of running costs in total public spending should not rise over the Survey period. This implies that overall running costs must grow no faster than our plans for public expenditure generally, ie by about 1 per cent a year in real terms. If increases in the volume of activity are to be met in some parts of the Civil Service, there must be reductions or lower rates of growth in others where demand is less or of lower priority.

6. To achieve this overall objective, colleagues' running costs bids will need to be substantially scaled down, to less than half the additions to baseline that have been sought for 1988-89; and all departments will need firm plans to offset pay bill and other cost pressures through sustained and incremental efficiency gains. The improved budgetary and management systems stemming from the financial management drive of recent years, the Government's large and continuing investment in new technology, and further improvements in purchasing as as well as the continuing processes of scrutiny and inspection must be used to deliver further improvement in performance, benefiting both input costs and outputs. On the input side, further improvements in the use of manpower and better control of non-manpower costs will be essential.

7. These efficiency gains will be easier to make on the necessary scale if they are planned well in advance; and if the plans are ambitious there will be greater scope for flexibility in future years. I propose that all departments should now prepare or revise management plans committing them, over the Survey period, to the delivery of defined and wherever possible measured improvements in outputs, and progressive overall efficiency gains of at least 1½ per cent a year, with contingency plans for larger improvements in case they are necessary. This is a reasonable minimum target for well managed service organisations. These plans will be especially important for departments with large executive operations.

8. Departments' plans, and their implications for restraining growth in running costs would be discussed in the bilaterals.

Agreement to increases over baseline, particularly for the later years, would be withheld until plans for efficiency gains of at least 1½ per cent a year were demonstrated in a departmental management plan. Departments would be expected to deliver these plans.

Civil Service manpower

9. Earlier this year it was announced that manpower targets would not be set after 1 April 1988, and pressure on Civil Service numbers would be maintained through running costs. The proposed approach to running costs will mean large reductions in the manpower projections of some departments. It is important to show that the running costs regime is an effective control on all Civil Service resources, including manpower. There will otherwise be pressure to reintroduce manpower targets.

Conclusions

10. I invite Cabinet to agree that:

i. the objective should be to restrain running costs over the Survey period to their present share in total public spending by offsetting so far as possible any real rises in pay and other costs through efficiency gains;

ii. departments should prepare or revise three-year management plans for sustained output and cost improvement, for discussion in the bilaterals;

iii. for 1988-89 the aim should be a reduction by at least half of the £761 million additional provision sought in order to keep the overall increase in running costs in line with the medium-term objective in (i) above.

CONFIDENTIAL

FROM T R H LUCE
8 JULY 1987
Room 55/G
Ext 4544

1 MR F E R BUTLER

(With copies for Ministers and Sir P Middleton)

2 CHIEF SECRETARY

Chancellor of the Exchequer
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
PEX
Mr Kemp
HEGS
Mr Gilhooly
Mr Hoare
Mr Cropper
Mr Tyrie
File A
File B

1987 PUBLIC EXPENDITURE SURVEY: DEPARTMENTAL RUNNING COSTS: PRELIMINARY SUMMARY OF BIDS AND PROPOSALS FOR CABINET

Introduction

1 Running cost bids are higher than in previous years. They imply real increases of 4% in 1988-89, and more in later years. We have not yet analysed them in full, but Ministers may find it helpful to have now a preliminary analysis and our recommendations for the PES Cabinet.

Past Years and the Present Position

2 Since 1979 we have relied on strict manpower controls combined with expenditure pressures to keep the domestic spending of central government departments under control. In each year, our objective has been to hold this expenditure level in real terms. We have consistently failed because costs and some volume pressures have driven it up by 1¾% a year on average in real terms in spite of the large reduction in manpower (2% a year on average). Pay settlements were, until 1986, at or below the rate of general inflation. But the Civil Service grade mix became somewhat more expensive and average pay went up by more than settlement rates mainly because the jobs lost were in the lower grades and the numbers joining at the bottom

of incremental scales fell. There were also large and sustained increases in non-pay costs - rent and rates, consultancy services and maintenance for computer schemes, and a shift from manpower to supply expenditure from contracting-out.

3 Manpower targets for the Civil Service overall and for each department were set for three years ahead and rolled forward in each Survey. Expenditure provision, however, has generally been dealt with on a year-by-year basis. In each Survey, departments have negotiated the best they could get for the Estimate year, leaving (with our connivance) the later years to be dealt with properly nearer the time.

4 Efficiency gains of any significance need to be planned well in advance, particularly in large departments. The abolition of manpower targets (on which medium-term management planning has mainly been based) was announced earlier this year from 1 April 1989. The present Survey is thus the first in which expenditure controls will be the main instrument for containing Civil Service costs and providing a framework for the necessary management planning.

5 If expenditure controls are to be successful, we shall need to move as quickly as we can towards (a) greater seriousness in the provision made for the later years and (b) greater realism in the provision made (particularly for the later years) combined with an insistence on ambitious planning for efficiency gains.

Future Cost Pressures

6 We need to put departments under pressure to control non-pay items better. But we anticipate that pressures will continue, particularly on rents in London and other commercial centres and support for new information technology.

7 For pay - the major item, accounting for some 60% of running costs - we think it prudent to expect larger increases than the average for recent years. Forecasts of earnings increases in

the rest of the economy remain well above the MTFS forecasts for general inflation. The Pay Group think it most unlikely that the Civil Service can for long be isolated from pay trends in the rest of the labour market without very serious industrial disputes damaging service to the Government and the public; or that further moves to a more flexible pay structure can be secured without some short-medium term increases in pay costs.

8 The best general assessment we can make is that costs - pay and non-pay - will tend to rise at a minimum of 2% a year in real terms over the Survey period as a whole. There may be particular pressure from pay in 1988-89 when the full year effects of the main 1987 round (which included some deferred elements) will be felt. The 1987 round is not yet over - as well as some tidying up for the main groups London Weighting and "geographical pay" issues remain to be settled. And a number of departments have made or will make in-year bids for 1987-88. Where these bids have to be agreed, they will push up the starting point for further increases in 1988-89. Where they are rejected departments will increase the determination with which they press their 1988-89 bids. The majority of those not bidding for in-year increases claim - probably with justice in most cases - to be feeling the pinch quite badly. Cost pressures alone - before any account is taken of bids to resource new functions - could be argued to justify real increases of 3%, or more if a gloomy view is taken of London Weighting/"geographical pay" prospects.

Baseline and Bids

9 As we have so far analysed them, the bids are:

	1988-89	1989-90	1990-91
£m	750	938	1,114

10 The present baseline implies a fall in real provision reflecting decisions in past Surveys to concentrate on the

Estimate year, in the expectation that departments would bid for more realistic provision for the later years as they came nearer:

	1987-88	1988-89	1989-90	1990-91
Baseline (£m)	13,054	13,342	13,710	14,052
% cash increase on previous year	4.6	2.2	2.8	2.5
% real terms change on previous year (measured by MTFS GDP deflator assumptions)	1½%*	-1.8	-0.7	-0.5

11 If the bids were conceded in full, the figures would become

	1987-88	1988-89	1989-90	1990-91
Provision (£m)	13,054	14,091	14,648	15,197
% cash increase on previous year		7.9	4.0	3.7
% real terms increase on previous year		3.9	.5	.7

12 Most departments have bid seriously for 1988-89, including volume bids where they see a need and also "realistic" provision for pay in 1988-89. We have not yet been able to analyse their pay bids properly, but a good number seem to be assuming real increases in the 1½%-2% range. For the later years, few if any departments have departed from the habit of putting in anything but "marker" bids for volume increases accompanied in some cases by the consequentials of their more considered 1988-89 bids. As a result the later year bids imply much higher eventual levels of provision than are actually sought now.

---

*This was the underlying increase. It was masked in the published figures because the contractorisation of the dockyards transfers a large block of spending from running cost to programme.

13 Substantial bids have been received from nearly all departments. The most important bidders for 1988-89 - in absolute or proportional terms - appear on present information to be

	<u>% cash increase over 1987-88</u>
MOD	6.9
DHSS	7.7
IR	12.3
D.Em Group	6.2
C & E	15.5
Home Office	7.0
LCD	8.4
Land Registry	17

14 <u>Manpower</u> targets are discontinued after 1 April 1988 so departments do not have to make formal Survey bids for increased manpower. They do nevertheless have to show the manpower plans underlying their running cost proposals. We have had no chance to look at these in detail. But at face value they suggest an overall increase of some 15,000 on the planned total of 582,000 published in the 1987 PEWP for 1 April 1989. Of this, very roughly 4,000 are extra staff in DHSS, the Department of Employment group and the Land Registry that were agreed after the last Survey. The largest sources of the genuinely new increases are DHSS (over 3,000), Inland Revenue (nearly 2,000), the Land Registry (another 700 or so) and the Crown Prosecution Service (nearly 700).

<u>Options for Proposals to the PES Cabinet</u>

15 We do not think it feasible to insist that departments collectively or, with perhaps a few exceptions, individually <u>should stick to their baselines</u>, constructed as these were on an artificially low basis (see above). Even as an opening negotiating position we doubt whether this would get through Cabinet. If, unexpectedly, it survived Cabinet and then the bilaterals the result would be a large number of bust running cost and cash limits next year.

16 An alternative would be to propose as an aim that overall

running costs should be held level in real terms. Depending on how far we were in addition willing, or were forced, to agree extra provision to relieve pay and other cost pressures that are building up in 1987-88 and to provide some cover for volume bids, the cost might be from about £200m upwards in 1988-89.

17 This might be accepted by Cabinet as an opening Treasury negotiating aim. But it has not, in previous years, survived the bilaterals. Experience in past Surveys has been that departmental Ministers press running cost bids with tenacity. Last year, for example, we got the bids down from rather over £600m to £460m.

18 The third alternative reflects the need to move towards an expenditure control framework which is not unrealistic but provides departments with a spur to properly planned efficiency savings (see paragraphs 4 and 5 above). It is to trade an acknowledgement that some real growth in running cost spending will be necessary in return for a commitment by departments to the preparation and implementation of management plans to secure year-on-year efficiency gains over the Survey period.

What is this worth?

19 The approach might be as follows:

(i) the overall real growth in running costs spending would be of the order of 1% a year on average. Were this achieved, the present running costs' share in the planning total (on its existing published path) would remain roughly constant over the medium-term

(ii) if our assessment (paragraph 8 above) of real cost pressure of at least 2% a year is right, 1% average real spending growth will leave a gap of at least 1% a year for departments to bridge through efficiency gains. With volume pressures in addition, the efficiency gain would need to be higher

(iii) in principle, the approach would be adopted for all three years, and would involve making somewhat more realistic provision for years 2 and 3 than we have done in the past. In practice, it is unlikely that most departments could come up with acceptable medium-term efficiency gain plans before the end of the 1987 Survey. For those that did not, we would defer agreeing more realistic provision for the later years until the 1988 Survey

(iv) for 1988-89, cost and other pressures will probably in the end force us into conceding extra spending significantly above what is implied in the medium-term path though if the planning total for 1988-89 is itself increased, the inconsistency would be smaller. The absolute minimum we could probably hope to get away with is probably in the £400m-£500m range. But to create the right atmosphere for the bilaterals we should probably want to propose a lower target to Cabinet - say £300m, which would provide roughly 1% real growth in 1988-89 over 1987-88 after allowance for the depressed 1988-89 baseline.

20 The disadvantage of this general approach is that, when fully in operation, it would give departments higher future year baselines from which to negotiate in future Surveys; and would imply - again for future years - some transfer (perhaps of some £150m-£200m) from the reserve to programmes and hence a slightly smaller reserve. There is also a risk that it might be misinterpreted as "taking the pressure off Civil Service pay".

21 In fact its effects on Civil Service pay negotiation should be no worse and might be slightly better than our past practice of publishing relatively large increases in overall running cost provision for the Estimate year each February, just at the beginning of the annual pay round.

Good pt.

22 It has a number of advantages:

(i) even when the strategy was fully operational some adjustments to previously published totals would be necessary in each Survey, but there would be less damage to departments' financial planning and the status of published plans than the past practice of large "hand-to-mouth" increases for each Estimate year

(ii) it might be treated by some departments as evidence of a more "realistic" Treasury approach to running costs - and to that extent might reduce the tension that has tended to characterise the handling of running costs in the bilaterals. But in fact it is an ambitious strategy, implying a lower rate of spending growth and a higher rate of efficiency gain than in the past

(iii) it would underpin the need for better medium-term management planning in departments (an underlying theme of the Ibbs report); would help us to gain a collective commitment to the improvements necessary; and would give us a stronger PES lever over departmental management. The days of quick and easy efficiency gains are largely over; management improvements now need to be planned in a longer time frame than before, and in the absence of manpower controls the expenditure framework must provide the necessary encouragement. We need to adapt our running cost approach accordingly.

23 It is the approach we recommend, and have reflected in the annexed draft Cabinet paper which also emphasises the downward pressure necessary on manpower projections.

24 We should be able to provide a fuller analysis of the bids next week. But in the meantime we should be glad to know if Ministers are content with the approach we recommend. We are at your disposal for an early talk if that would help.

T R H LUCE

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Is this increase separate in the annual analyses?

CABINET

1987 PUBLIC EXPENDITURE SURVEY: DEPARTMENTAL RUNNING COSTS

Memorandum by the Chief Secretary, Treasury

1 Colleagues have sought increased provision for departmental running costs totalling £[750] million for 1988-89, £[938] million for 1989-90 and £[1144] million for 1990-91.

2 If increases occur on this scale, overall expenditure on running costs will rise by [8 per cent] in cash and [4 per cent] in real terms between 1987-88 and 1988-89, with further real increases in the later years. Also implied is an increase in Civil Service manpower of [15,000] over the manpower plan of 583,000 for 1 April 1989 published in this year's expenditure White Paper and further increases in later years, though some [4,000] of this rise stems from increases agreed after the last Survey.

3 In spite of large manpower reductions (135,000 since 1979 and 50,000 since 1983) and, in most years, Civil Service pay settlements at or below general inflation, it has not been possible in recent years to prevent some real increases in running costs. Say where
We shall continue to aim for tight pay settlements. But future pay offers which we may agree collectively will need to take account of pay movements in the economy generally if we are to recruit and retain the staff we need and meet our objective of making the Civil Service pay structure more conducive to an efficient service and more responsive to labour market conditions.

4 It is realistic to provide for some rise in overall spending on running costs; but our manifesto pledge to press ahead with management reforms to improve public services and reduce their cost, as well as our aim of ensuring that public expenditure takes a steadily smaller share of our national income, mean that we must contain the rate of rise to well below the level implied in the increases sought.

5 I suggest that our minimum objective should be that the running costs share in total public spending does not rise over the Survey period. This would imply that running costs would grow approximately on average in line with public expenditure generally, i.e. by about 1 per cent a year in real terms. In practice this would mean that if increases in the volume of activity are to be accommodated, reductions or lower rates of growth would be necessary in areas of the service where demand pressures are less.

6 To achieve this general objective, a substantial scaling-down of the bids will be needed, e.g. from £[750] million to £300 million in 1988-89, and all departments will need firm plans to offset pay bill and other cost pressures through sustained and incremental efficiency gains. The improved budgetary and management systems stemming from the financial management drive of recent years, our large and continuing investment in new technology, and further improvements in purchasing as well as the continuing processes of scrutiny and inspection must be made to deliver further improvement in performance benefitting both input costs and outputs. On the input side we should aim in particular for further improvements in the use of manpower, and for better control of non-manpower costs which have tended to rise quite steeply in recent years.

7 These efficiency gains will be easier to make on the necessary scale if they are planned for well in advance; and if the plans are ambitious will give us greater scope for flexibility in future years. I propose that all departments should now prepare or revise management plans which would commit them over the Survey period to the delivery of defined and wherever possible measured improvements in outputs, and a progressive reduction of input costs by at least 1½% a year - a fair minimum target for well-managed service organisations. These plans will be especially important for departments with large executive operations.

8 I propose in the bilaterals to discuss departments' plans, and their implications for restraining growth in running costs, with their Ministers; and to withhold agreement to increases over baseline, particularly for the last two years of the Survey,

until satisfied that ambitious but realistic plans for efficiency gains over the medium term have been made. In some cases this may mean that the final levels of provision for 1989-90 and 1990-91 will have to be held over until the next Survey.

Civil Service Manpower

9 Earlier this year we announced that we would not be setting manpower targets after 1 April 1988, and would rely on running cost control to keep pressure on Civil Service numbers. The approach to running costs that I am proposing implies large reductions in the manpower projections made by some colleagues.

Conclusions

10 I invite colleagues to agree that;

(i) our aim should be to restrain running costs over the Survey period to their present share in total public spending by offsetting so far as possible any real rises in pay and other costs through efficiency gains

(ii) departments should prepare or revise three-year management plans for sustained output and cost improvement, which I should discuss with their Ministers in the bilaterals

(iii) for 1988-89 the aim should be a reduction in the additional provision sought, from £[750] million to £300 million to keep the overall increase in running costs consistent with the medium-term objective in (i) above.

JM

CONFIDENTIAL

ws 1R/CGS

From : F E R BUTLER
Date : 9 July 1987

CHIEF SECRETARY

cc Chancellor
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
PEX
Mr Kemp
HEGS
Mr Gilhooly
Mr Hoare
Mr Cropper
Mr Tyrie

Ch
It seemed sensible to hold an early meeting on this, given deadlines on getting Cabinet Papers round. discuss
AA

AA

FERB TO CST 9/7

1987 PUBLIC EXPENDITURE SURVEY : DEPARTMENTAL RUNNING COSTS

The attached submission from Mr Luce is an important one, covering both the paper for you to put to the July Cabinet about the approach to running costs in this year's Survey but also a recommended modification to our long-term approach to running costs control.

2. We have been giving much thought to this problem for some time. We are still in the stage of establishing running costs limits as an effective control on administrative expenditure. So far it has been by no means completely successful.

3. The aim is that running costs control should provide as effective pressure for improvements in civil service efficiency as manpower targets did, without the distorting effects of manpower targets (eg hiving activities off, replacing people by machines at whatever cost).

4. One problem has been that we set an over-ambitious target for containing the growth of running costs. We proposed that running costs should rise by the general level of inflation, as measured by the GDP deflator, and no more. The intention was that real increases in pay or other elements of administrative expenditure had to be financed by greater efficiency.

5. There are two pieces of evidence for thinking that this aim was too ambitious. The first is that in two successive Surveys we have not achieved it in negotiating the first year figures

to which departments attach real importance because they turn into control totals. The second is that analaysis shows that running costs have risen by 1¾% year on average over inflation over a much longer period of time, including the period of very large civil service manpower reductions before running cost controls were introduced.

6. The effect has been that (as with public expenditure generally) departments have negotiated very hard on running cost limits for the first year of the Survey. They have given less attention to the figures for the later years which they have regarded as unreal and not worth bothering about, particularly because pay prospects are so important and so uncertain. The real trouble about this is that improvements in efficiency can often not be effectively or sensibly planned only one year ahead: for this reason running cost limits are in danger of producing less effective real pressure for efficiency than manpower targets which forced departments in a very practical way to consider how they would cope with a declining number of staff over a 3-year forward period.

Even this too v tough (A)

7. The essence of the approach in the attached submission is that we would envisage a more realistic target for the growth of running costs - we have suggested that they should go up in line with public expenditure generally, ie by about 1% in real terms. If departments accept this as a realistic aim, there is a prospect that they will begin to think seriously about a medium-term programme of improvements in efficiency on this basis. Indeed we see this as a package deal - to ease the manning cost limits to this extent if we are satisfied that they have a serious programme for efficiency improvements.

[illegible] and (A)

8. The other aspect of this approach to which I attach importance is that, instead of assenting to departments producing acceptable running cost figures by making unrealistically low assumptions about future pay, we should encourage them to make a realistic assumption eg that pay may well go up in line with the national average - and set efficiency targets accordingly. This would be on the basis that it is more effective to assume the worst

and ease up if necessary than to have to impose a last minute squeeze because cost assumptions have turned out too optimistic.

9. In short, I support the approach in Mr Luce's submission, which the pay side of the Treasury have been involved in preparing. The draft Cabinet paper is designed to give you an impression of the way in which we thought that you might put this approach to the Cabinet. The figures are still to be developed, but it would be helpful to have an early word with the Chancellor and yourself to establish whether you are content with the general approach.

F.E.R.B.

F E R BUTLER

2136/7

SECRET

Copy No 1 of 16 Copies

FROM: A TURNBULL
DATE: 10 JULY 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Anson
Mr Monck
Mr Scholar
Mr Luce
Mr Sedgwick
Mr Culpin
Mr Gieve
Mr Cropper
Mr Tyrie

Thanks. OK as shown

DRAFT PAPER FOR PUBLIC EXPENDITURE CABINET

I attach a further draft of the Cabinet paper. This takes account of the points made at your meetings and of your own drafting comments. In discussion with Heads of Groups it was felt that omission of any reference to the territories in paragraph 7 would be noticed and would give the Secretaries of State unnecessary comfort. Equally, we felt that to lead with references to a needs study or the population adjustment could produce an explosive reaction which would not be helpful for the general conduct of the meeting. We have inserted, therefore, a very general reference which you could amplify orally if you wished.

AT

A TURNBULL

Ch

OK? (a few residual comments)

AA

2136/6

SECRET

DRAFT PAPER FOR CABINET (No 2)

THIS DOCUMENT IS THE PROPERTY OF HER MAJESTY'S GOVERNMENT

C(87) Copy No
July 1987

1987 PUBLIC EXPENDITURE SURVEY

Memorandum by the Chief Secretary, HM Treasury

Our policy is ~~has been~~ to bring public spending down progressively as a proportion of national income. Over the past four years we have succeeded in achieving ~~in~~ this. Even excluding privatisation proceeds, general government expenditure (the combined spending of central and local government) has fallen from 47 per cent of GDP in 1982-83 to 44 per cent in 1986-87, and there will be a further fall in 1987-88. This has made it possible to combine a steady growth of public expenditure in real terms with a reduction in borrowing and in each of the last five Budgets a reduction in taxes. ~~At the same time it has been possible, by careful scrutiny of all our spending, to make additional resources available within the totals for our priority programmes.~~ This restraint in ~~on~~ public spending has made possible ~~to~~ the strong performance of the economy which the Chancellor has described in his Memorandum (C(87)).

2. In our Election Manifesto we pledged ourselves to continue the policy of ensuring that public spending takes a steadily smaller share of our national income. This is essential if we are both to maintain the momentum of our economic performance and to deliver another of our Manifesto pledges, a reduction in the burden of taxation.

3. For this year's Survey we have established baseline totals for spending of £154.2 billion in 1988-89, £161.5 billion in 1989-90 and £165.5 billion in 1990-91. For the first two years this was done by retaining the planning totals set out in last year's Public Expenditure White Paper and for the third year we have used an uplift factor of 2½ per cent.

4. Departments were then asked to review their programmes within their baseline figures and to put proposals to me where they felt, after a review of priorities, that additional resources were required. In my minute of July to the Prime Minister, I summarised the bids received from departments.

5. I have to make it clear to colleagues that bids on this scale are far beyond what can be afforded. If anything like this were accepted, we could make no further progress in reducing public spending as a proportion of GDP, as set out ~~envisaged~~ in the White Paper. Indeed, the danger would be that it would rise. ~~damage to econ~~ This would not only trigger a complete reappraisal of the Government's financial standing in the markets, and ~~halt~~ stop our economic progress in its tracks: it would ~~a standing which contributes significantly to the high level of confidence which consumers, companies and overseas investors have in our economy, but~~ also make ~~jeopardise~~ our objectives for taxation unattainable. ~~and borrowing.~~

6. With the time lost as a result of the election, it has not been possible to analyse the bids as thoroughly as normal. There are major uncertainties in a number of areas which I will want to probe further, eg the large estimating changes for social security and the projections of our contributions to the European Community. [Possible reference to lack of agreement on local authority current.]

7. But it is clear that to hold to our policy on public spending we will have to face up to difficult decisions in a number of areas, in particular:

i. for programmes such as defence, health and education which are seeking very large increases, the bids will have to be significantly ~~greatly~~ scaled back and to the greatest extent possible policy savings found to offset them;

ii. for social security we must look at policy changes to help offset the enormous estimating changes;

iii. we need to take a hard look at the employment programmes where, with the better prospects for unemployment, substantial savings can be found;

iv. we need to re-examine the basis of our regional policies. The buoyancy of the economy and in particular of investment, reflecting the increased strength of the corporate sector, X is both increasing the cost of the present system of incentives and reducing the need for them. We should look for savings here partly to release resources for cost effective inner city spending;

v. we must look very carefully at the expenditure of the territories;

vi. we must take a rigorous attitude to running costs as proposed in my companion paper C(87) ;

vii. we should go as far as we can in transferring to the private sector the responsibility for providing services hitherto provided by the public sector.

8. In the 1987 Investment and Financing Review, the nationalised industries' own intial and unamended bids, made in May, exceed the baseline by £0.9 billion in the first year and £1.2 billion in the two subsequent years. These bids are clearly unrealistic and cannot be afforded. They now need to be scrutinised rigorously, and a number of industries are revising their proposals so that we will have a sounder basis for judging them. Apart from the electricity industry in England and Wales, and Scotland, where separate considerations apply, I propose that our aim should be to reduce the provision at least to baseline and, where we can in the case of individual industries, below it. Failure to achieve this would mean greater pressure on departmental programmes. There are particular problems relating to the electricity industry this year, notably the need to set new financial targets, the implications of privatisation and assessment of a new power station programme. Notwithstanding these uncertainties, the pressure on public expenditure means that it is no less important to appraise the industry's bids critically and to set challenging financial targets.

9. [Paragraphs on local authorities. This will depend on whether Cabinet is asked to endorse a settlement reached at E(LA) or whether there is still an issue to be decided.]

10. In the last Survey we provided for Reserves of £3.5 billion in the first year rising to £7.5 billion in the third year. The experience of recent years shows that we need to keep ~~unallocated~~ a larger margin than this, especially in the later years, if we are to cope with the pressures both in-year and in successive Surveys. This too will need to be taken into account in considering the scope for making additions to programmes.

Conclusions

11. I ask Cabinet:

i. to reaffirm the Manifesto policy of ensuring that public spending takes a steadily smaller share of our national income as ~~envisaged~~ set out in last year's White Paper;

ii. to note that bids will have to be substantially cut back to secure the policy objective at (i);

iii. to agree that we explore a wide range of policy changes including those listed in paragraph 7;

iv. to agree that we should aim to hold the EFLs of the nationalised industries other than electricity at least to baseline and possibly below; and that we should seek to minimise the additional bids for the electricity industries;

v. to agree that I should now conduct bilaterals with colleagues on their spending programmes.

TREASURY CHAMBERS

July 1987

[JM]

2136/6

SECRET

DRAFT PAPER FOR CABINET

THIS DOCUMENT IS THE PROPERTY OF HER MAJESTY'S GOVERNMENT

C(87)   Copy No
July 1987

1987 PUBLIC EXPENDITURE SURVEY

Memorandum by the Chief Secretary, HM Treasury

Our policy ~~has been~~ is to bring public spending down progressively as a proportion of national income. Over the past four years we have ~~been notably successful in~~ this. Excluding privatisation proceeds, general government expenditure (the combined spending of central and local government) has fallen from 47 per cent of GDP in 1982-83 to 44 per cent in 1986-87, and a further fall ~~is likely~~ in 1987-88. This has made it possible to reduce taxes in each of the last five Budgets and to bring borrowing down. At the same time it has been possible, by careful scrutiny of all our spending, to make additional resources available within the totals for our priority programmes. This restraint ~~to~~ expenditure has ~~undoubtedly contributed to~~ the strong performance of the economy which the Chancellor has described in his Memorandum (C(87)).

can't we be stronger?

2. In our Election Manifesto we have pledged ourselves to continue to ensure that public spending takes a steadily smaller share of our national income, and within that objective to find more resources for our priorities. This is essential if we are to deliver another of our Manifesto pledges, a further reduction in the burden of taxation.

both to maintain the momentum of our economic performance and

3. For this year's Survey we have established baseline totals for spending of £154.2 billion in 1988-89, £161.5 billion in 1989-90 and £165.5 billion in 1990-91. For the first two years this was done by retaining the planning totals set out in last year's Public Expenditure White Paper and for the third year we have used an uplift factor of 2½ per cent.

4. Departments were then asked to review their programmes within their baseline figures and to put proposals to me where they

felt, after a review of priorities, that additional resources were required. In my minute of   July to the Prime Minister, I summarised the bids received from departments.

5. I have to make it clear to colleagues that bids on this scale are far beyond what can be ? accepted afforded. If anything like this were accepted, we could make no further progress in reducing public spending as a proportion of GDP, as envisaged in the White Paper. Indeed, the danger would be that it would rise. This would not only jeopardise our objectives for taxation and borrowing but would trigger a complete reappraisal of the Government's financial standing in the markets, a standing which contributes significantly to the high level of confidence which consumers, companies and overseas investors have in our economy.

Switch this round to start with destroying economy

1955 [illegible]

6. With the time lost as a result of the election, it has not been possible to analyse ~~either~~ the bids as thoroughly as normal. There are major uncertainties in a number of areas which I will want to probe further, eg the large estimating changes for social security and the projections of our contributions to the European Community. [Possible reference to lack of agreement on local authority current.]

is this (ff) too precise?

7. But it is clear that to hold to our policy on public spending we will have to face up to difficult decisions in a number of areas:

and ?

i. for programmes such as defence, health and education which are seeking very large increases, the bids will have to be drastically scaled back or policy savings found to offset them;

ii. for social security we must look at policy changes to help offset the enormous estimating changes;

iii. we need to take a radical look at the employment programmes where, with the better prospects for unemployment, substantial savings can be found;

iv. we need to re-examine the basis of our regional policies. The buoyancy of the economy and in particular of investment, reflecting the increased strength of the corporate sector is both increasing the cost of the present system of incentives and reducing the need for them. We should look for savings here partly to release resources for cost effective inner city spending;

v. we must take a rigorous attitude to running costs as proposed in my companion paper C(87) ;

vi. we should go as far as we can in transferring to the private sector the responsibility for providing services hitherto provided by the public sector.

8. In the 1987 Investment and Financing Review, the nationalised industries' own intial and unamended bids, made in May, exceed the baseline by £0.9 billion in the first year and £1.2 billion in the two subsequent years. These bids are clearly unrealistic and cannot be afforded. They now need to be scrutinised rigorously, and a number of industries are revising their proposals so that we will have a sounder basis for judging them. Apart from the electricity industry in England and Wales, and Scotland, where separate considerations apply, I propose that our aim should be to reduce the provision at least to baseline and, where we can in the case of individual industries, below it. Failure to achieve this would mean greater pressure on departmental programmes. There are particular problems relating to the electricity industry this year, notably the need to set new financial targets, the implications of privatisation and assessment of a new power station programme. Notwithstanding these uncertainties, the pressure on public expenditure means that it is no less important to appraise the industry's bids critically and to set challenging financial targets.

9. [Paragraphs on local authorities. This will depend on whether Cabinet is asked to endorse a settlement reached at E(LA) or whether there is still an issue to be decided.]

10. [Paragraph on privatisation proceeds?] ?? (last yr?)

11. In the last Survey we provided for Reserves of £3.5 billion in the first year rising to £7.5 billion in the third year. The experience of recent years shows that we need to keep unallocated a larger margin than this, especially in the later years, if we are to cope with the pressures both in-year and in successive Surveys. This too will need to be taken into account in considering the scope for making additions to programmes.

Conclusions

12. I ask Cabinet:

i. to reaffirm the Manifesto policy of ensuring that public spending takes a steadily smaller share of our national income; as set out [illegible] Point

ii. to note that bids will have to be substantially cut back if we are to secure the policy objective at (i);

"to ensure that"

iii. to agree that we explore a wide range of policy changes of which I have given some examples in paragraph 7;

iv. to agree that we should aim to hold the EFLs of the nationalised industries other than electricity at least to baseline and possibly below; and that we should seek to minimise the additional bids for the electricity industries;

v. that I should now conduct bilaterals with colleagues on their spending programmes.

TREASURY CHAMBERS
July 1987

[JM]

SECRET

Ch
Amendments to paras 5 & 12(i) agreed with Turnbull & FERB. OK?
I have deleted a semi-colon!
AA ok

THIS DOCUMENT IS THE PROPERTY OF HER MAJESTY'S GOVERNMENT

C(87)
July 1987

Copy No

1987 PUBLIC EXPENDITURE SURVEY

Memorandum by the Chief Secretary, HM Treasury

Introduction

Our policy is to bring public spending down progressively as a proportion of national income. Over the past four years we have succeeded in achieving this. Even excluding privatisation proceeds, general government expenditure (the combined spending of central and local government) has fallen from 47 per cent of GDP in 1982-83 to 44 per cent in 1986-87, and there will be a further fall in this share in 1987-88 - though it will still be higher than it was in 1978-79. Our progress over the last few years has enabled us to combine a steady but controlled growth of public expenditure in real terms with a reduction in borrowing and, in each of the last five Budgets, a reduction in taxes. This restraint in public spending has made possible the strong performance of the economy which the Chancellor has described in his Memorandum (C(87)).

2. In our Election Manifesto we pledged ourselves to continue the policy of ensuring that public spending takes a steadily smaller share of our national income. This is essential if we are both to maintain the momentum of our economic performance and to deliver of our Manifesto pledge to reduce the burden of taxation.

3. For this year's Survey we have set baseline totals for spending of £154.2 billion in 1988-89, £161.5 billion in 1989-90 and £165.5 billion in 1990-91. For the first two years this was done by retaining the planning totals set out in last year's Public Expenditure White Paper and for the third year we have used an uplift factor of 2½ per cent.

4. Departments were then asked to review their programmes within their baseline figures and to put proposals to me where they felt, after a review of priorities, that additional resources were required. In my minute of 17 July to the Prime Minister, I summarised the bids received from departments.

Objectives for the Survey

5. I have to make it clear to colleagues that bids on this scale are far beyond what can be afforded. If anything like this were accepted, we could not make the further progress in reducing public spending as a proportion of GDP we have set ourselves. This would not only make our objectives for taxation unattainable, it would also trigger a complete reappraisal of the Government's financial standing in the markets, and provide a severe setback to the economic progress we have made. ~~It is essential~~ We must ~~that we~~ keep as close as possible to the existing planning totals and ~~do~~ must not in any circumstances exceed the share of GDP in the White Paper.

6. With the time lost as a result of the election, it has not been possible to analyse the bids as thoroughly as normal. There are major uncertainties in a number of areas which I will want to probe further, eg the large estimating changes for social security and the projections of our contributions to the European Community. But it is clear that to hold to our policy on public spending we will have to face up to difficult decisions in a number of areas. Bids will have to be significantly scaled back and, to the greatest extent possible, policy savings found to offset them.

Departmental running costs

7. Colleagues have sought increases in their departments' running costs implying overall cash increases of 8 per cent for 1988-89 over 1987-88 with further increases in later years. The associated manpower projections reverse the downward trend we have achieved, implying a 15,000 increase over published plans for 1988-89. Increases on this scale are clearly unacceptable.

8. In the last few years, the increases in spending on departmental costs agreed for each first Survey year have exceeded our aims. In many cases the figures for the later years have not been set at realistic levels and as a result have had to be increased further in later Surveys. We need to agree a

realistic method for planning provision over the Survey period so that departments have a reasonably reliable basis for making medium-term plans to improve efficiency.

9. My proposals, set out more fully in the annex, are that:

i. the running costs share of total public spending should not rise over the Survey period. This implies that running costs would grow on average in line with our plans for public expenditure generally, ie by about 1 per cent a year in real terms, though individual departments would, of course, have no entitlement to such an increase;

ii. cost and other pressures will need to be met to a large extent by efficiency gains of at least 1½ per cent a year in the use of all resources including manpower. These will need to be planned well in advance and departments should have contingency plans for larger improvements in case they are necessary;

iii. departments should prepare management plans to deliver these gains over the full Survey period. In any case where the plans are not suitably ambitious, or are unrealistic, I would hold over agreement on the later Survey years until the next Survey;

iv. for 1988-89, the aim should be to reduce the overall increase in provision sought by at least half.

Nationalised industries

10. In the 1987 Investment and Financing Review, the nationalised industries' own intial and unamended bids, made in May, exceed the baseline by £0.9 billion in the first year and £1.2 billion in the two subsequent years. These bids are clearly unrealistic and cannot be afforded. They now need to be scrutinised rigorously, and a number of industries are revising their proposals so that we will have a sounder basis for judging them. Apart from the electricity industries in England and Wales and in Scotland, I propose that our aim should be to reduce the provision at least to baseline and, where we can in the case of individual

industries, below it. Failure to achieve this would mean greater pressure on departmental programmes. There are particular problems relating to the electricity industry this year, notably the need to set new financial targets, the implications of privatisation and assessment of a new power station programme. Notwithstanding these uncertainties, the pressure on public expenditure means that it is essential to appraise the industries' bids critically and to set challenging financial targets.

<u>Local authority relevant public expenditure</u>

11. It has been agreed in E(LA) that provision for relevant public expenditure in England should be set at £27,969 million (£27,538 million for relevant current expenditure and £431 million for Rate Fund Contributions to Housing Revenue Accounts). This is an increase of £819 million above the White Paper baseline. Aggregate Exchequer Grant in England is to be set at £13,775 million, an increase of £750 million (5¾ per cent) on the 1987-88 settlement figure including teachers' pay. [Reference to Scotland and Wales to come.] These are substantial additions and we must recognise that they will severely limit what can be made available for other programmes.

<u>Conclusions</u>

12. I ask Cabinet:

i. to reaffirm the Manifesto policy of ensuring that public spending takes a steadily smaller share of our national income; ~~and,~~ after excluding privatisation proceeds, its share of national income does not exceed the path in last year's White Paper;

ii. to note that to secure the policy objective at (i) bids will have to be substantially cut back and difficult decisions will have to be faced in a number of policy areas;

iii. to agree that we should aim to hold the EFLs of the nationalised industries other than electricity at least to baseline and possibly below; and that we should seek to keep the electricity industries' external finance as low as possible;

and to agree that the level of public expenditure is held as close as possible to the existing planning totals; and, that,

iv. for running costs, to agree the proposals set out in paragraph ~~11~~ 9 and in the Annex;

v. to agree that I should now conduct bilaterals with colleagues on their spending programmes.

TREASURY CHAMBERS
July 1987

[JM]

CHANCELLOR OF THE EXCHEQUER

BF
10/7

Ch

One thing you might discuss with Terry is drafting of Cabinet paper — now no Central Unit this falls to Terry (Odling Smee better than Sedgwick).

Should be circulated by 16 July, so need first draft this w/e.

AA

TB has this in hand.

COVERING CONFIDENTIAL

FROM: SIR T BURNS
DATE: 10 JULY 1987

CHANCELLOR

cc
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr F E R Butler
Sir G Littler
Mr Anson
Mr Monck
Mr Kemp
Mr Odling-Smee
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mr Culpin
Mr Gieve
Mr Hudson
Mr Cropper
Mr Tyrie

Ch
This is pretty good as a first draft.
AA

Thanks. A few amendments passim.

DRAFT OF CHANCELLOR'S PAPER TO CABINET

I attach a draft of your paper to Cabinet which you asked to see this weekend. So far it has not been seen by Treasury officials other than Messrs Odling-Smee and Sedgwick.

[w/i ? over weekend & A

T BURNS

ENC

ECONOMIC PROSPECTS

The of the economy

Growth this year now looks like turning out higher than ~~expected~~ forecast at the time of the Budget. The principal factors behind the buoyant growth rate are strong export performance and successful competition with imports. Unemployment has continued to fall while ~~price~~ inflation has remained close to the ~~published~~ expected path. The current account of the balance of payments has been in surplus so far this year ~~and public sector finances remain strong.~~

2. There are a number of reasons for this successful performance. We are deriving the benefits of prudent monetary and fiscal policies which have stabilised financial conditions, avoided lurches of policy, and increased confidence in the UK as a base for investment. We are also seeing the effects of the measures taken over the past seven years to improve supply performance, ~~These~~ which are producing [more] rapidly growing manufacturing productivity and better trade performance. And finally we are seeing the benefits of the reduction of public expenditure as a share of GDP over the past 4 years. This has left room for the further reduction of the PSBR and the beginning of the necessary process of lowering ~~and reforming~~ taxes.

WORLD ECONOMY

3. The ~~major~~ more obvious threat to continued steady UK growth ~~is a possible~~ comes from a weakening of demand and output in other major developed countries. ~~with implications for UK exports.~~ Since the fall in oil prices at the beginning of 1986, output growth in the G7 economies has been disappointing. Last year the ~~weakness~~ problem originated in weak demand among the developing countries who, as a group, cut back their imports. More recently many of the strains seem to reflect slowness in adjusting to the sharp realignment of exchange rates. Domestic demand in the US is weakening; ~~and~~ whilst in Germany and Japan it is not rising fast enough to offset the adverse effects of currency appreciation on their exports. Their loss of export markets has been made more acute by the increasing shares taken by the newly industrialised

inflating in South-East Asia

countries, who have held

~~economies, especially in South East Asia, allowing~~ little ~~or no appreciation of~~ their currencies steady against the dollar.

4. Inflation rates in the major economies have been reduced, much as expected. And there are ~~tentative~~ now signs of some progress in correcting the large current account imbalances in the US, Japan and Germany. The risk of further turmoil in foreign exchange markets has been reduced, although not eliminated, by successful co-operation between the G7 countries. Following the Louvre Agreement in February the G7 countries have succeeded in stabilising their currencies by a combination of intervention and a greater willingness to ~~pursue~~ adapt ~~consistent~~ their monetary policies ~~that are consistent~~ to conform with the Agreement. And there have been some further steps in Japan and Germany to support domestic demand and open markets. It is vital that these measures are sustained and strengthened. ~~In addition~~ Further steps to reduce the US Budget deficit ~~would make a contribution to reducing the current account imbalances and interest rates.~~ ~~are also needed~~ are also needed.

are also needed, and

Is this true of Germany?

THE BRITISH ECONOMY

5. At home we have seen a continuation of ~~the~~ what has by now become a familiar pattern of ~~steady~~ strong and steady growth coupled with low inflation.

6. A year ago there was ~~some~~ concern in some quarters at the mild pause in growth between mid-1985 and mid-1986. ~~although we argued that a resumption of growth both abroad and at home would be likely later in the year.~~ In the event, despite disappointing growth abroad, performance at home ~~appears to have~~ has exceeded expectations. In the first quarter of ~~1987~~ this year ~~the output measure of~~ GDP was just over 4 per cent higher than a year earlier.

7. The prospect is for continuing strong growth, with the outcome in 1987 as a whole likely to be closer to 4 per cent than the 3 per cent predicted at Budget time. Domestic demand growth is balanced, with fixed investment ~~and~~ ~~growing~~ rising in line with the growth of consumers' expenditure. ~~both growing at similar rates.~~

(to below the three million mark)

This strong growth performance

8. ~~High growth~~ has contributed to a further rise in employment and in turn to ~~one of~~ the fastest recorded ~~the fastest~~ ~~falls~~ fall in unemployment since the war~~, to a figure below 3 million [the next figure to be published on July 16]~~. This ~~very~~ welcome fall in unemployment has occurred at the same time as productivity growth in manufacturing has been exceptionally high by historical standards. Indeed increased industrial efficiency has been an essential factor ~~behind~~ the the greater improvement ~~welcome change in the~~ unemployment prospect. If overall growth continues at a steady and sustainable rate there is every ~~possibility~~ likelihood that the fall in unemployment will also continue.

OK!

We have always known that the UK, as a major oil producer, would

9. ~~Ever since oil prices fell in early 1986 it has been evident that inflation in the UK would~~ not benefit as much from the fall in oil prices as ~~in~~ the other major economies. The necessary fall in sterling during 1986 largely offset the ~~beneficial effect~~ impact on inflation of the lower oil prices. However, we are still on course to achieve the Budget forecast of 4 per cent inflation in the fourth quarter of this year, and the outcome could ~~even~~ well be a little lower. ~~But~~ Nonetheless, this remains uncomfortably above the average ~~inflation~~ rate in other major economies. ~~and~~ It is essential ~~for the maintenance of the steady, healthy recovery~~ that inflation is kept firmly on a downward path over the medium term.

10. So far, lower inflation has not been ~~sufficiently~~ adequately reflected in lower pay settlements. The deceleration of private sector pay settlements in 1986 appears to have ended; ~~and~~ indeed if anything they may have begun to edge up. Some public sector settlements - notably by local authorities - could also set an unfortunate precedent to the private sector and will make it more difficult to control public finances. Pay increases need to be lower if the hard-won ~~recovery~~ fall in unemployment is to continue.

(Pass this on at the time of the next ...)

11. The prospects for the current account of the balance of payments now look better. Over the ~~last~~ past year British companies have competed much more successfully in the home and international markets. In spite of subdued prospects for world trade and buoyant activity at home ~~we now expect~~ it now looks as if the current account this year to be close to balance, in contrast to the Budget forecast of a £2½ billion deficit (a half per cent of GDP).

(Sterling has a pronounced tendency for the ZG strong.)

The Lawson agreement towards the end of)

12. Since February sterling has generally been very ~~strong~~ steady. Indeed, ~~This was most evident~~ during April and May ~~when we reacted [with]~~ by lowering ~~interest rates~~ and intervening in the ~~massive~~ foreign exchange (market on a massive scale ~~intervention~~. ~~This had the effect of stabilising~~ held sterling steady; which ~~has~~ it As a result, the exchange rate moved within a very narrow range over the past 4-5 months. In turn this has strengthened confidence ~~in~~ within industry.

This was contained by reducing interest rates

13. Nevertheless financial markets are watching closely the behaviour of the economy, and in particular the outlook for ~~price and wage~~ inflation. They will also be alert to any signs of a loosening of the firm financial policies that have brought our current success.

Exchange rate has strong

CONCLUSIONS

14. The past economy has been growing steadily at a satisfactory rate for ~~more than~~ six years. With industry competing successfully in the home and international markets the prospect this year is for faster GDP growth than in recent years - more than expected at Budget time. There are, however, definite risks. Abroad the world economy could be more depressed than now envisaged. At home pay settlements badly need to fall. Above all it is essential that the Government demonstrates its firm commitment to the financial policies that have ~~been so successful~~ brought this success and ~~that~~ which alone can ~~guarantee~~ deliver declining inflation and the continuation of steady growth in the years ahead.

I agree with latter pt. Former pt is a good one, too; problem is drafting. One (?) version (2 variants) immediately below, also 2 variants of yr redraft. Problem of "set out" is that we give figs with cum & not ex privatisation proceeds. Possibly consult FERB & come back to me.

Ch

2 comments from FERB – he apologises for lateness but was away yesterday PM.

On (i), his concern is that the BP announcement next week will lead us to stress our objectives excluding privatisation proceeds (for LGE/GDP etc). So he feels this should be mentioned in Cabinet Paper. I have indicated a possible reformulation

On (iii) he feels "a wide range" may be a bit much for colleagues to sign up to

AA

CHANCELLOR OF THE EXCHEQUER

to reaffirm the Govt's commitment to ensuring that PX, excluding privatisation proceeds, takes a steadily smaller share of our national income, as set out in/emphasised by/last year's WP;

10/7/87.

uncertainties, the pressure on public expenditure means that it is essential to appraise the industry's bids critically and to set challenging financial targets.

PUP

Local authority relevant public expenditure

13. We have agreed in E(LA) to set provision for relevant public expenditure in England at £27,969 million (£27,538 million for relevant current expenditure and £431 million for Rate Fund Contributions to Housing Revenue Accounts). This is an incease of £819 million above the White Paper baseline. Aggregate Exchequer Grant in England is set at £13,775 million, an increase of £750 million (5¾ per cent) on the 1987-88 settlement figure including teachers' pay. [Reference to Scotland and Wales to come.] These are substantial additions and we must recognise that they will severely limit what can be made available for other programmes.

~~Excluding privatisation proceeds,~~

and, after excluding privatisation proceeds, does not exceed the path [implicit] ~~set out~~ in last year's White Paper

Conclusions

14. I ask Cabinet:

i. to reaffirm the Manifesto policy of ensuring that public spending takes a steadily smaller share of our national income [as set out in last year's White Paper, after excluding privatisation proceeds;]

ii. to note that bids will have to be substantially cut back to secure the policy objective at (i);

iii. to agree that, in order to ~~retain~~ cut back or offset the bids, we explore ~~a wide range of~~ policy changes including those listed in paragraph 7;

iv. to agree that we should aim to hold the EFLs of the nationalised industries other than electricity at least to baseline and possibly below; and that we should seek to keep the electricity industries' external finance as low as possible;

v. for running costs, to agree the proposals set out in paragraph 11 and in the Annex;

vi. to agree that I should now conduct bilaterals with colleagues on their spending programmes.

TREASURY CHAMBERS

July 1987

[JM]

745/82

FROM: ROBERT CULPIN
DATE: 10 JULY 1987

CHANCELLOR

cc Chief Secretary
Sir Peter Middleton
Mr F E R Butler
Sir Terence Burns
Mr Anson
Mr Monck
Mr Luce
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mr Gieve
Mr Cropper
Mr Tyrie

Many thanks: A few comments passed on.

LINE ON THE PUBLIC EXPENDITURE CABINET

Revised notes attached.

RC

ROBERT CULPIN

Encs

BRIEFING FOR NO.10

Line

The Cabinet had its usual July discussion of public expenditure today. It reaffirmed the policy that public expenditure should continue to take a declining share of national income, as ~~envisaged~~ set out in the White Paper. Within that constraint, the Chief Secretary will hold bilateral discussions in the Autumn. In the light of these, the Government will review both the individual spending programmes and the planned totals for spending, and will, as usual, announce decisions in the Autumn Statement in November.

Text

"My Government .... will maintain firm control of public expenditure so that it continues to fall as a proportion of national income and permits further reductions in the burden of taxation." - Queen's speech.

Will the planning totals be increased?

I can't tell you whether the totals will be changed, or if so by how much, or where the money will go. None of that is decided.

There may be some change in the totals, but if so - and I stress that is not decided - the Government is determined to keep as close to them as possible.

There will be no change whatever in the policy that public expenditure declines as a proportion of GDP, as set out in White Paper.

That is not just an aspiration. It is what we have achieved since 1982-83.

Why might you allow an increase?

I am not saying we will. It is restraint which has brought success. There will be no let-up in the Government's rigorous approach. And we will continue to plan expenditure on a cautious view of what we can afford.

But the strength of the economy is there for all to see.

Why no decision?

Cabinet has decided to stick firmly to the policy.

Final decisions will be taken, as always, when:

- there has been further assessment of the needs of particular programmes
- we have further information on the growth of the economy and so of what we can afford.

TREASURY NOTES FOR SUPPLEMENTARIES

Why not come clean and raise totals?

Acknowledged frankly that planning totals may change. Not clear that they will. Not sensible in those circumstances to set new figures.

Planning totals never revised in July.

Open ended?

Certainly not. Commitment to ~~take~~ steadily smaller share of GDP is a binding constraint.

WHAT smaller share?

No increase on the White Paper percentages ~~[~~in any year~~]~~. Continuing on down in the new final year.

If we can improve on the White Paper percentages, we will.

Including or excluding privatisation?

Excluding.

Applied to what GDP?

Our best estimate. Latest published is in FSBR.

When GDP next revised?

Current and following year: in Industry Act forecast in Autumn Statement.

Full MTFS: in 1988 FSBR.

More GDP means more expenditure?

No entitlement, but may permit it.

New doctrine?

Rubbish. "It would, of course, always be open to the Government to decide, once the virtuous circle of lower taxes and higher growth had been established, to devote some of these resources to improved public services rather than reduced taxation." - 1984 Green Paper.

gov!

Maximum possible increase in planning totals?

Not going to speculate. But two things.

First, commitment that public expenditure should grow less fast than the economy as a whole is a major constraint.

Second, <u>if</u> any change at end of day, firm objective is to minimise it.

<u>When did Treasury last concede possibility of change before bilaterals?</u>

[Being checked - probably 1981]

<u>What pressures?</u>

Seen local authority settlement [if July announcement]. Know some of other things in the pipeline - for instance, continuing extra cost of nurses' pay award.

No blank cheques. All bids rigorously scrutinised.

<u>Why have planning totals only to raise them?</u>

False premis~~s~~e. But better a really demanding target which you may sometimes have to raise a bit than an undemanding one.

Proof of the pudding: public expenditure is falling as a proportion of GDP for the fifth year in a row.

When did this last happen? Long [illegible]

Abandoning cash planning?

Rubbish. All planning done in cash. No funny money. No automatic compensation for inflation.

Star Chamber?

No doubt: established part of the constitution.

3002/11

CONFIDENTIAL

FROM: A TURNBULL
DATE: 13 JULY 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Sir P Middleton
Mr F E R Butler
Mr Anson
Mr Monck
Mr Gieve
Miss Walker

Ch
OK?
AA

OK

JULY CABINET: MEETING OF PRINCIPAL FINANCE OFFICERS

Our intention is to circulate the Chief Secretary's minute on the summary of bids before the end of this week but to delay circulation of the three papers, yours on the economic prospects, and the Chief Secretary's on public expenditure and on running costs until Tuesday of next week.

2. In recent years we have arranged a meeting of PFOs just before the circulation of the papers to give them some advance warning and an opportunity to seek any clarifications they need.

3. We would like to do the same this year. We suggest a meeting on Monday afternoon under Mr Anson's chairmanship. We would issue at the meeting, and collect in afterwards, copies of the Chief Secretary's two papers. We would not make any statement but would answer questions raised. We would not circulate your paper on the economy but would, if asked, offer a summary of it.

4. This course is not without risks. This year the Treasury paper lists a number of areas where policy savings might be found. It is possible that the earlier warning could give more time for departments to organise defences or, at worst, mobilise a counter-attack. In practice we do not think this is too much of a risk. The options are listed for explanation not decision and the most sensitive of all, an adjustment to the territorial blocks, is not mentioned explicitly.

5. We would be grateful to know if you are content for such a meeting to be held on the basis indicated?

AT

A TURNBULL

CONFIDENTIAL

CHIEF SECRETARY TO THE TREASURY

NOTE OF A MEETING HELD IN THE CHANCELLOR'S ROOM
H M TREASURY - ON 13 JULY 1987 AT 6.00PM

Present:

Chancellor
Chief Secretary
Sir Peter Middleton
Mr F E R Butler
Mr Anson
Mr Kemp
Mr Luce
Mr Turnbull
Mr Gilhooly
Mr Haigh
Mr Hoare
Mr Cropper
Mr Tyrie

RUNNING COSTS; AND GEOGRAPHICAL PAY

Papers: Mr Luce of 8 July
Mr F E R Butler of 9 July

The Chancellor said his initial comment was that he thought that the paper should be an Annex to the main public expenditure Cabinet paper. There would be a paragraph in the main paper, and the conclusion on running costs in the annex would be reflected in the conclusions Cabinet were invited to endorse. This was agreed.

2 Introducing the papers, Mr F E R Butler said that the previous approach, based on keeping running costs increases in line with the GDP deflator, had squeezed departments who faced volume increases in their workloads while presenting little

challenge to departments like the Ministry of Defence with falling staff numbers. So he preferred an approach which was more like that adopted for public expenditure generally, where an overall increase was agreed and then the needs of individual departments were looked at within the context of that overall increase. The approach now suggested would give departments something that appeared more generous than the present regime, in return for their taking a medium term view of their running cost demands. It was vital to get away from departments taking a myopic view which prevented serious planning of efficiency improvements. The arithmetic looked workable in the light of the likely upward revision in the GDP deflator by the time of the Autumn State.

3 The Chancellor said that he accepted that the present position was unsatisfactory and could offer no constructive alternative to the approach proposed in Mr Luce's paper. He noted that 1 per cent real increase per annum presented a very tough discipline. He thought departments would realise that. His concern was whether a commitment to management plans was worth anything. Mr Luce said that he believed that, to make it worthwhile, it meant getting commitments from Departments in terms which were usable in subsequent Surveys. Departments were preparing these sort of management plans as part of the Financial Management initiative and the successor to manpower planning and they were supposed to be linking it into their public expenditure requirements. Departments would need to show they were making a serious effort to reduce their unit costs. This would be an issue to be discussed in the bilaterals.

4 The Chancellor asked what would happen if a department lacked a good plan. Presumably the increase earmarked for them would not then be allocated to other departments. Mr F E R Butler confirmed this. In year one the department would be bargaining for real figures which would be turned into running costs limits. So the relevance of the management plans was to years two and three. Departments would be given a firmer base of planning since any increase in the GDP deflator would be allocated pro-rata to each department, thus re-establishing the firm framework that the headcount had given. The corollary

was that departments would not be encouraged to take an unrealistically optimistic view on pay.

5 The Chief Secretary said that he was still unsure what the incentive was for a department to produce a sensible efficiency plan. If it failed to do that he did not see that the position was much changed for the present unsatisfactory position on years two and three. Mr F E R Butler said that the department would remain in the position of being a demandeu until they produced a plan the Treasury could accept.

6 The Chancellor acknowledged that there was a problem on pay since the pay factor had - rightly - been abandoned. The new approach however seemed to be based on encouraging departments to think that pay would move in line with national average. However the Treasury produced that forecast. The move was therefore likely to be a move not to tackle realism but to semi-realism. That was no doubt an improvement over the total unrealism for the present system. Mr Kemp pointed out that the system had withstood a fair degree of unreality on pay to date. Sir Peter Middleton was concerned about the use of average earnings as a signal.

7 The Chancellor noted that a particular embarrassment was the position of the Inland Revenue and Customs and Excise, whose figures were very high, although he accepted they had a very good case for being above the average. Sir Peter Middleton suggested that their case would not exist in perpetuity. MR F E R Butler said that the strength of their case was that more spending on Customs and Excise and Inland Revenue could always improve the Government's overall fiscal position. The Chancellor pointed the switch from employment to self-employment which meant that administration costs were being transferred from the employer to the Inland Revenue. But the Chief Secretary would need very convincing arguments to justify above average increases for the Chancellor's Departments to his colleagues.

8 On the main issue, the Chancellor said he was prepared to go along with the proposition in the paper since there seemed to be no realistic alternative. The Chief Secretary said that he had gone over the same ground this morning with officials and had come to similar conclusion. The approach suggested represented an advance to semi-realism.

9 Mr Tyrie was concerned that the figures might imply that running costs rising as a proportion of public expenditure. Mr Turnbull pointed out that if we achieved our expected outcome the increases in running costs and public expenditure overall would be very similar proportion. Sir Peter Middleton thought the approach set out fitted well with the overall aim for public expenditure. Mr F E R Butler pointed out that the Prime Minister would inevitable think that the increases envisaged were too large. The Treasury however knew that the targets were too tight. The Chief Secretary thought that the proposal would be a material gain if it could be backed-up by practical "teeth". The Chancellor noted that running cost expenditure would have few supporters in any collective discussion.

10 Turning to the text of the Cabinet Paper the Chancellor thought paragraph 3 needed to be expanded to give some explanation for the reasons while the increase in running costs had been unavoidable. He thought that in paragraph 5 the first line should be amended to replace "minimum" with "firm". He wondered whether colleagues would be able to infer our intentions for public expenditure generally from the proposals on running costs. Mr F E R Butler said this was an issue that had been raised with the Chief Secretary, it had been established that the increase based on the running cost figures would come out rather below some of the other calculations possible. Mr Luce thought however it would be preferable to amend paragraph 6 and omit the specific £300 mill target and replace it with the aim of reducing the bids to "less than half". This was agreed.

11 With these amendments, and the paper recast as an annex, it was agreed that this approach should be put to the Cabinet

as proposed. The Chancellor noted that key to its success was to make a change in departmental behaviour.

Geographic pay

12 The Chancellor noted that this was an issue where Government was torn between cash and commonsense. It was commonsense to make moves toward greater geographical pay variation but making the change meant increases in expenditure and a price had to be paid for giving departments discretion. He was in no doubt that geographic variation in pay made sense.

13 Mr Kemp said that there was already tremendous pressure in London and the South East. This point had been raised by Chancellor's ministerial colleagues. The recent London Weighting settlements for the banks added to that pressure if our offer on London Weighting was taken to arbitration the result would be a very large increase. The proposal in the paper Pay Division had come up with to meet these pressures and head off attempts to make expensive additional to London Weighting. It would add ½ per cent to the pay bill in a full year, or £20 million. He agreed that there was a need to take care on giving departments discretion, but eventually departmental discretion would have to be made to work, if we were to move to a move flexible pay regime. Decisions were needed in the next month In his view, the proposals in Mrs Harrop's paper were worth trying. The Chancellor pointed out that dispersal was another part of the solution. The Revenue had produced good plans on dispersal. Mr F E R Butler said that the dispersal plans seemed to produce a high rate of return. Mr Kemp agreed that more dispersal was needed . But there would still be some immovable departments. The problem was less acute in inner London than in some areas with virtually nil unemployment in the South-East.

14 Mr F E R Butler said he was worried about the risks for running cost limits in 1987-88. He was attracted by the approach in the longer-term. But he firmly advocated deferment until 1 April 1988 to avoid putting running cost limits in 1987-88

under pressure. He noted that Mr Kemp thought that this would prove difficult . The Chancellor asked why? Mr Kemp said it was because there was a limit to how far matters could be deferred and there would be considerable pressure from colleagues. He thought the advantage of the approach set out was that departments had the option not to pay the increases if they could not afford them. London weighting increases were compulsory.

15 The Chancellor said he thought it was important to wrap London Weighting up in the overall pay settlement so that the overall cost could be quoted including London Weighting. If London Weighting were detached that would not be possible. Mr Kemp said that in the longer-term the aim would be to let London Weighting wither.

16 The Chancellor asked for a further paper on this issue taking account of comments from Sir Peter Middleton and others. There was no question of this being discussed at a MISC 66 meeting.

JILL RUTTER
Private Secretary

Distribution:

Those present
Mr Scholar

psl/10A

SECRET

Copy No. 15 of 18 Copies

FROM: A C S ALLAN

DATE: 13 July 1987

BF 16/7

MR TURNBULL

cc PS/Chief Secretary
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Anson
Mr Monck
Mr Scholar
Mr Luce
Mr Sedgwick
Mr Culpin
Mr Gieve
Mr Cropper
Mr Tyrie

DRAFT PAPER FOR PUBLIC EXPENDITURE CABINET

The Chancellor was grateful for your minute of 10 July and the further draft of the Cabinet paper.

2. He had the following comments:

(i) in paragraph 5 and again in paragraph 11(i) we should refer to the path for GGE/GDP "set out" in the White Paper, not "envisaged";

(ii) in paragraph 7(i) he felt that the wording should read "... the bids will have to be significantly scaled back to the greatest extent possible and policy savings found ...".

No: see txt

He had a few other drafting comments which I am sending you separately.

ACSA

A C S ALLAN

FROM: **P N SEDGWICK**
DATE: 13 JULY 1987

PRINCIPAL PRIVATE SECRETARY

cc Sir P Middleton
Sir T Burns
Mr Odling-Smee

TABLE FOR THE DRAFT CHANCELLOR'S PAPER FOR CABINET

I attach a table for the draft Chancellor's paper in exactly the same form as for last year's paper. The figures for the current year are, as was the case last year, from the latest internal forecast. (It has been the custom to round the figures for the components of domestic demand more heavily than the rest.)

2. In last year's paper there was a short paragraph at the end of the section on the British economy which read:

> "A summary of the most recent Treasury assessment is shown in the attached annex."

P.N.S

P N SEDGWICK

CONFIDENTIAL

MAJOR ECONOMIC INDICATORS

	UK				G7 excl UK
	1984	1985	1986	1987††	1987
A. Demand & Activity					
GDP	3	3½	3	4	2¼
Domestic demand					
of which					
- consumers' expenditure	2	3½	5	3½	2½
- fixed investment	9	2	1	4	2¾
Exports of Goods & Services	7	6	3	4	2½***
Imports of goods & Services	9	3	6	3	4***
B. Inflation (Q4 on year year earlier)					
RPI	4¾	5½	3½	3¾	3
Average earnings	6½	7	8	7½	3½†
B. Other items (levels)					
Current balance (£bn)	1½	3½	0	-½	-12
Unemployment (per cent, narrow definition)	11	11½	11½	10½	7¼
3 month interest rate	10	½	11	9.2*	6.3*
Sterling index (1980=100)	79	78	73	72.9*	-
Oil price (Brent, $barrel)	29	27	14	19.8**	

* close Friday 10 July
** delivery in July 87, as of 10 July
*** goods only
† manufacturing earnings

CONFIDENTIAL

FROM: F. E. R. BUTLER
13th July, 1987.

SIR T. BURNS

I agree with the Anson/Butler/Turnbull points on tone. Colleagues need sobering up.

Ch

Terry asked me to put these to you to get guidance on what you felt about the tone of the paper.

AA

c.c. Chancellor
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P. Middleton
Sir G. Littler
Mr. Anson
Mr. Monck
Mr. Kemp
Mr. Odling-Smee
Mr. Scholar
Mr. Sedgwick
Mr. Turnbull
Mr. Culpin
Mr. Gieve
Mr. Hudson
Mr. Cropper
Mr. Tyrie

DRAFT OF CHANCELLOR'S PAPER TO CABINET

There was some discussion at PEX this morning of the draft attached to your minute of 10th July, which I had not seen by then.

2. I very much agree with the comments in Mr. Anson's minute of today (copy attached for those who have not received it). The paper gives a general impression which will not promote restraint of the public expenditure bids.

3. In addition to Mr. Anson's points, Mr. Turnbull has suggested to me that, as well as stressing that this year's performance may be cyclical, the paper should make the point that for the purpose of setting plans it is output in the medium-term, and a cautious view of it, which is relevant.

4. I would add that we need to bring out more prominently near the beginning of the paper that some public sector pay has been rising fast and needs to be restrained if the effect is not going to spill over into the private

sector. This point is not put very helpfully in para 10 where it is said that public sector settlements "will make it more difficult to control public finances".

F.E.R.B.

F. E. R. BUTLER

From: J Anson
Date: 13 July 1987

MR F E R BUTLER

cc
Sir T Burns
Mr Monck
Mr Turnbull
Mr Odling-Smee
Mr Sedgewick
Mr Gieve

CHANCELLOR'S PAPER TO CABINET

I feel this too bullish a presentation for the purpose of a public expenditure Cabinet. Paragraphs 1 to 2 contain all the upbeat points and will set the tone in the reader's mind. The reservations are mostly there in the text, and in the final conclusion, but their effect will be muted.

2. I gather from Mr Odling-Smee that paragraphs 1-2 were intended to be a statement of where we are now, rather than a summary of the paper. Even so, they omit some key points, eg our relative inflation rate compared to other G5 or Summit countries. But I would prefer to omit the concluding paragraph and put a balanced summary at the beginning, including eg

or 'overheating' (a) that the growth rate this year may be cyclical

(b) that price inflation is consistently worse than our competitors

(c) that although our real growth has compared well with our competitors over the last few years, we cannot rely on this continuing

(d) that although we are seeing <u>some</u> (rather than <u>the</u>) effects of the measures to improve supply performance over the past 7 years, there is more to be done to get more flexibility and get down rate of earnings increase, stuck above 7%.

(e) that although public expenditure performance has helped to get down PSBR and tax burden, this needs to be continued and markets will be watching it closely. (From this standpoint, ending the paper at paragraph 13 rather than 14 would be helpful).

JA

J ANSON

ECON PROSPECTS
CABINET PAPER

ps2/8A

CONFIDENTIAL.

FROM: A C S ALLAN
DATE: 13 July 1987

SIR T BURNS

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir G Littler
Mr F E R Butler
Mr Anson
Mr Monck
Mr Kemp
Mr Odling Smee
Mr Scholar
Mr Sedgewick
Mr Turnbull
Mr Culpin
Mr Gieve
Mr Hudson
Mr Cropper
Mr Tyrie

Mr Allan,

I have made necessary alterations. Can you ask Chancellor to look through please and implement changes. Then we need to recirculate.

TB

ECONOMIC PROSPECTS: DRAFT CABINET PAPER

The Chancellor was most grateful for your minute of 10 July and the draft paper for Cabinet. He had some, mainly drafting, comments, which we have incorporated into the attached redraft. He would be most grateful for comments from you and others before the paper is finalised.

ACSA

A C S ALLAN

Ch

You may want to discuss general points with Terry. We can then get re-typed for you to work on in detail on Thursday afternoon / Friday morning before it goes to PM for w/e.

AA

206/7/241

ECONOMIC PROSPECTS

ALTERNATIVE BEGINNING

The economy has been growing steadily at a satisfactory rate for the past six years. With industry competing successfully in the home and international markets the prospect this year is for faster GDP growth than in recent years - more than expected at Budget time. The principal factors behind the more buoyant growth rate are strong export performance and successful competition with imports. Unemployment has continued to fall while inflation has remained close to the expected path. So far this year, the current account of the balance of payments has been in surplus.

2. Our prudent monetary and fiscal policies lie behind this successful performance. They have stabilised financial conditions, enabled us to avoid lurches of policy, and have increased confidence in the UK as a base for investment. The reduction of public expenditure as a share of GDP over the past four years has been especially important. It has provided room for lowering the PSBR and adjusting to the loss of North Sea revenues, but we have so far made little progress in reducing the burden of non-North Sea taxation. We are also seeing, especially in rapidly growing manufacturing productivity, some welcome effects from the measures taken over the past seven years to improve supply performance.

3. The growth rate this year is likely to be significantly above the average level of recent years, and we cannot count on it being sustained. There are definite risks. Abroad, the world economy could be more depressed than now envisaged. At home, pay settlements badly need to fall, not least in the public sector. Above all it is essential that the Government demonstrates its firm commitment to the financial policies that have brought this success and which alone can deliver declining inflation and the continuation of steady growth in the years ahead.

even though we have cut the basic rate of income tax, ~~~~ the total tax burden [describe latest position]

and add table of Tax/GDP% ?

ECONOMIC PROSPECTS

See alternative beginning attached at end

~~The growth of the economy this year now looks like turning out higher than I forecast at the time of the Budget. The principal factors behind the buoyant growth rate are strong export performance and successful competition with imports. Unemployment has continued to fall while inflation has remained close to the expected path. So far this year, the current account of the balance of payments has been in surplus.~~

~~2. There are a number of reasons for this successful performance. We are deriving the benefits of prudent monetary and fiscal policies which have stabilised financial conditions, avoided lurches of policy, and increased confidence in the UK as a base for investment. We are also seeing the effects of the measures taken over the past seven years to improve supply performance, which are producing rapidly growing manufacturing productivity and better trade performance. And finally we are seeing the benefits of the reduction of public expenditure as a share of GDP over the past 4 years. This has left room for the further reduction of the PSBR and the beginning of the necessary process of lowering taxes.~~

WORLD ECONOMY

3. The most obvious threat to continued steady UK growth comes from a weakening of demand and output in other major developed countries. Since the fall in oil prices at the beginning of 1986, output growth in the G7 economies has been disappointing. Last year ~~the position originated in~~ weak WORLD demand ~~among~~ originated in the developing countries who, as a group, cut back their imports. More recently many of the strains seem to reflect slowness in ~~the~~ adjusting to the sharp realignment of exchange rates. Domestic demand in the US is understandably weakening; while in Germnay and Japan it is not rising fast enough to offset the adverse effects of currency appreciation on their exports. Their loss of export markets has been made more acute by the increasing shares taken by the newly industrialised countries, notably in South-East Asia, who with the exception of Taiwan have held their currencies steady against the dollar.

4. Inflation rates in the major economies have been reduced, much as expected. And there are now signs of some progress in correcting the large current account imbalances in the ~~UK~~ US, Japan and Germany. The risk of further turmoil in foreign exchange markets has been reduced - although not eliminated - by successful co-operation between the G7 countries. Following the agreement at the Louvre in February, the G7 countries have succeeded in stabilising their currencies by a combination of intervention and a greater willingness to adapt their monetary policies. And there have been some further steps in Germany and even more in Japan ~~and Germany~~ to support domestic demand and open markets. It is vital that these measures are sustained and strengthened. Further reductions in ~~steps to reduce~~ the US Budget deficit are also needed.

THE BRITISH ECONOMY

Sep. para// A summary of the most recent Treasury assessment is shown in the attached annexe.

5. At home we have seen a continuation of what has by now become a familiar pattern of strong and steady growth coupled with low inflation.

6. A year ago there was concern in some quarters at the mild pause in growth between mid-1985 and mid-1986. In the event, despite disappointing growth abroad, performance at home has exceeded expectations. In the first quarter of this year GDP was just over 4 per cent higher than a year earlier.

7. The prospect is for continuing strong growth in 1987, with the outcome in the year ~~1987~~ as a whole likely to be closer to 4 per cent than the 3 per cent predicted at Budget time. Domestic demand growth is balanced, with fixed investment rising in line with the growth of consumers' expenditure. With growth in 1987 above the trend of recent years, it would not be surprising if the growth rate fell back a little next year.

8. This recent ~~strong growth~~ performance of output has contributed to a further rise in employment and in turn to the fastest recorded fall in unemployment since the War. This welcome fall in unemployment to below the three million mark has occurred at the same time as productivity growth in manufacturing has been exceptionally high by historical standards. Indeed increased industrial efficiency has been an essential factor in the greatly improved unemployment prospect. If overall growth continues at a steady and sustainable

rate, even if somewhat lower than this year, there is every likelihood that the fall in unemployment will ~~also~~ continue.

9. We have always known that the UK, as a major oil producer, would not benefit as much from the fall in oil prices as the other major economies. The necessary fall in sterling during 1986 largely offset the beneficial impact on inflation of the lower oil prices. However, we are still on course to achieve the Budget forecast of 4 per cent inflation in the fourth quarter of this year, and the outcome could well be a littler lower. Nonetheless, this remains uncomfortably above the average rate in other major economies. It is essential that inflation is kept firmly on a downward path over the medium term.

10. So far, lower inflation has not been adequately reflected in lower pay settlements. The deceleration of private sector pay settlements in 1986 appears to have ended: indeed if anything they may have begun to edge up. Some public sector settlements - notably by local authorities - could also set an unfortunate precedent for the private sector and will make it more difficult to control public finances. Pay increases need to be lower if the hard-won fall in unemployment is to continue.

11. The prospects for the current account, of the balance of payments now look a little better than they did at the time of the Budget. Over the past year British companies have competed ~~much more~~ successfully in the home and international markets. In spite of subdued prospects for world trade and buoyant activity at home it now looks as if the current account this year will show a smaller deficit ~~to be close to balance, in contrast to~~ than the Budget forecast of ~~a~~ £2½ billion ~~deficit~~ (half a per cent of GDP).

12. Since the Louvre agreement towards the end of February, sterling has generally been very steady. Indeed, during April and May there was a pronounced tendency for the pound to strengthen. This was contained by reducing interest rates and intervening in the foreign exchange markets on a massive scale. As a result, the exchange rate has stayed within a very narrow range over the past 4-5 months. This in turn has strengthened confidence within industry.

13. Nevertheless, financial markets are closely watching the behaviour of the economy, and in particular the outlook for inflation. They will also be alert to any signs of a loosening of the firm financial policies that have brought our current success.

CONCLUSIONS

14. The economy has been growing steadily at a satisfactory rate for the past six years. With industry competing successfully in the home and international markets the prospect this year is for faster GDP growth than in recent years - more than expected at Budget time. There are, however, definite risks. Abroad, the world economy could be more depressed than now envisaged. At home, pay settlements badly need to fall. Above all it is essential that the Government demonstrates its firm commitment to the financial policies that have brought this success and which alone can deliver declining inflation and the continuation of steady growth in the years ahead.

FROM: A C S ALLAN
DATE: 13 July 1987

MR CULPIN

cc PS/Chief Secretary
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Anson
Mr Monck
Mr Luce
Mr Scholar
Mr Sedgewick
Mr Turnbull
Mr Gieve
Mr Cropper
Mr Tyrie

LINE ON THE PUBLIC EXPENDITURE CABINET

The Chancellor was grateful for your note of 10 July and the revised briefing notes for No.10 and Treasury post-Cabinet.

2. He had the following comments:

(i) in the line for No.10, we should say "as set out in the White Paper";

(ii) in the Treasury Notes for Supplementaries, in answer to "open-ended?", we should say "... commitment to steadily smaller share of GDP ...";

(iii) in answer to the question "what smaller share?" we should delete the square brackets around "in any year", so that it reads "no increase in White Paper percentages in any year";

(iv) in the answer to the question "why have planning totals only to raise them?", he wonders when public expenditure last fell as a proportion of GDP for five years in a row. It would be worth finding this out and revealing it;

(v) in the answer to "abandoning cash planning?", the second sentence should read "All planning done in cash".

ACSA

A C S ALLAN

Line

SECRET

FROM: F. E. R. BUTLER
13th July, 1987.

MR. CULPIN

Ch
Seems OK.
AA

Mr [illegible] ([illegible])

c.c. Chancellor
Chief Secretary
Sir Peter Middleton
Sir Terence Burns
Mr. Anson
Mr. Monck
Mr. Luce
Mr. Scholar
Mr. Sedgwick
Mr. Turnbull
Mr. Gieve
Mr. Cropper
Mr. Tyrie

LINE ON THE PUBLIC EXPENDITURE CABINET

I have one major, and a few minor, suggestions on the notes attached to your minute of 10th July.

2. The major comment is one of emphasis, rather than substance. It relates to the first and crucial supplementary question headed "will the planning totals be increased?".

3. Since the cash increase in the planning totals ultimately announced may seem to the outside world substantial in cash terms, I suggest that you should give equal emphasis in this answer to the determination not to exceed the White Paper percentages as to the determination to keep as close as possible to the cash figures. With that in mind, I suggest that this supplementary should read as follows:-

"I can't ...... decided.

There may be some change in the totals, but if so - and I stress that is not decided - the Government will keep as close to them as possible and will in any case not exceed White Paper percentages of GDP.

The policy that public expenditure declines as a proportion of GDP is not just an aspiration. It is what we have achieved since 1982-83."

4. My minor comments are:-

(i) In the main Line "the White Paper" might be expanded to "the last public expenditure White Paper".

(ii) Expand the second para of the second supplementary answer so that it reads:-

"The strength of the economy is there for all to see, though it would be unwise to plan public expenditure on the basis that it will continue to grow ~~indefinitely~~ at this year's growth rate."

(iii) Amend the second indent of the third supplementary "Why no decision?" as follows:-

"- we have further information on the prospects for the economy and so on what we can afford."

(iv) The last word of the last supplementary should be changed from "constitution" to "system".

FERB

F. E. R. BUTLER

Mck2/30

SECRET

1987 Survey Gox

FROM: A TURNBULL
DATE: 14 July 1987

CHANCELLOR

cc Chief Secretary
Sir P Middleton
Mr F E R Butler
Mr Anson
Mr Luce
Mr Gieve

BILATERAL WITH THE PRIME MINISTER [Cabinet was on 23/7]

In addition to the local authority current expenditure on which you have material, there are three issues to be raised on the July Cabinet.

i) Although you are not preparing to seek endorsement of the existing planning totals or agreement to new ones, this does not mean the Survey is open ended. You will be seeking reaffirmation of the existing policy of public expenditure declining as a proportion of GDP. To compensate for the absence of fixed planning totals this must mean achieving the percentages set out in the White Paper, or going lower. Although your report to Cabinet on the economy will in many respects be encouraging, you will argue that this has been built on expenditure restraint which must continue.

PM was anxious that there should not go in paper, but CST should develop orally.

ii) As part of the effort to dampen colleagues aspirations, your paper will list a number of areas where bids must be significantly scaled back or policy reductions sought. There may be an attempt by some Ministers to argue that the is impossible for their programmes. This should be resisted. The paper will not seek <u>decisions</u> but only endorsement that tough options be explored. Given the size of the bids, there is no case for exemptions at this stage.

iii) The paper will propose a new modified approach to running cost limits. The latter have proved an effective way of controlling departmental operating costs for the year immediately ahead; they avoid many of the distortions of manpower control and they fit better with the delegating budgetting being developed in departments. But there is evidence that for years 2 and 3 they provide departments with a less clear signal than the old manpower targets and that the figures agreed for in the future years have become pretty unrealistic.

21/7

The paper proposes that departments should commit themselves to medium term plans to improve productivity by say 1½ per cent a year. At the same time the Government would adopt a more realistic objective for running costs ie that they should rise in line with public expenditure as a whole or about 1 per cent a year in real terms. Previously the objective has to keep running costs constant in real terms, while the outcome has been growth of 1¾ per cent. The approach this represents a convergence of setting a more realistic target with an effort to secure improvement on what has been achieved in the past.

AT

A TURNBULL

RA7 33

CONFIDENTIAL

pup

FROM: A C S ALLAN

DATE: 14 July 1987

MR TURNBULL

cc Chief Secretary
Sir P Middleton
Mr F E R Butler
Mr Anson
Mr Monck
Mr Gieve
Miss Walker

JULY CABINET: MEETING OF PRINCIPAL FINANCE OFFICERS

The Chancellor was grateful for your minute of 13 July. He is content for you to hold a meeting of PFOs on the basis you indicated.

ACSA

A C S ALLAN

3645/58

PxL

This is a little late in the day. The Luce paper was dated 8/7, & SEL and (I think) on 9/7:
2. A 1% real rise is not soft: it is a v. tough discipline. Look @ what happened even in the golden age of manpower targets. ~~[illegible]~~ But I am strongly in favour of strengthening the quid pro quo - ...

PERSONAL AND CONFIDENTIAL

FROM: A TYRIE
DATE: 14 JULY 1987

CHANCELLOR

cc Chief Secretary
Mr P Cropper

RUNNING COSTS

I have now had time to read Mr Luce's paper carefully and am not sure we are on the right track with the '1% real' proposal. I think it may be unwise to index administrative expenses:

(i) What is the justification for linking civil service administration costs to, for example, success in negotiating refunds from the European Community. That is exactly what the proposed formula would do. For many departments, the link between overall spending and the cost of administering that spending is completely spurious.

(ii) I am pretty sure departments would see the 1% real increase as their new floor above which they could pitch even higher bids. We would end up spending more money. The 1% real increase would also confirm the departments in their view that the worst of the ghastly staff cutting cost cutting exercise was over. They have always seen the search for productivity gains and reductions in manpower as a one-off exercise, to be weathered. I think the 1% real increase could send them exactly the wrong signal.

(iii) From what little I have seen of the spending departments, it is absurd to expect most of them to come up with anything other than bogus "management plans to secure year on year efficiency gains over the survey period", (paragraph 18 of Mr Luce's paper). I expect many colleagues' reaction to paragraph 10 of the draft Cabinet paper would be mild relief that the Treasury are letting up a little. Officials would not find any difficulty in coming up with suitably pliable management plans.

(iv) Mr Luce's note says that departments' bids suggest an increase of 15,000 civil servants in one year. Even Oonagh McDonald recommended increasing civil service manpower by only 50,000 over 5 years, and she admitted that much of this was sheer job creation! I think we need to fight any increases in manpower <u>at all</u> tooth and nail. The 1% real increase would make that fight much more difficult.

(v) Presentationally, the 1% increase is a substantial retreat from the line we have hitherto taken: that we have found substantial efficiency savings in the civil service, that we have been able to reduce manpower, and that there are further substantial savings to be had. Our Manifesto says that we will reduce the cost of the public services not index real term increases!

<u>Some suggestions:</u>

2. (i) Perhaps we should stay with the existing system, at least for the time being. The unrealism of the cash numbers undoubtedly gives us something of a lever. This would imply asking departments to stick to their base lines in the July Cabinet. I am not convinced by Mr Luce's contention that "even as an opening negotiating position we doubt whether this would get through Cabinet" (paragraph 15).

(ii) We could consider reintroducing partial manpower targets for each department, or at least a freeze on existing manpower. Manpower targets were evaded but there was at least some residual benefit. By being forced into contracting-out departments were made to look at staff management in a more business-like manner. By contracting-out they also often found cheaper ways of doing things. I recall Terry Heiser waxing lyrical about savings he'd found, both manpower and cash, from contracting-out in the DOE.

(iii) If we do stick to a 1% real ceiling, it must be accompanied by something much more robust than exhortation to departments to draw up management plans. For example, it might give spending departments an appropriate shock if they were told that the quid pro quo for the 1% was that running costs were not even going to be put into PESC, (with the exception of the new third year). Once they were signed up to 1% there was nothing to be negotiated. In other words, they would not be able to reopen their running cost settlement for years two and three, force majeur excepted.

AGT.

A TYRIE

RA7.31

CONFIDENTIAL

FROM: A C S ALLAN
DATE: 14 July 1987

SIR T BURNS

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Anson
Mr Monck
Mr Kemp
Mr Odling-Smee
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mr Culpin
Mr Gieve
Mr Hudson
Mr Cropper
Mr Tyrie

DRAFT OF CHANCELLOR'S PAPER TO CABINET

The Chancellor has seen Mr Butler's minutes to you of 13 July, and Mr Anson's minute to Mr Butler.

2. He agrees with the Anson/Butler/Turnbull points on tone: colleagues need sobering up. He would therefore be grateful if you could provide drafting suggestions for changing the paper on the lines they suggest.

ACSA

A C S ALLAN

RA7.32

SECRET

Bf 16/7

FROM: A C S ALLAN
DATE: 14 July 1987

MR CULPIN

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Anson
Mr Monck
Mr Luce
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mr Gieve
Mr Cropper
Mr Tyrie

LINE ON THE PUBLIC EXPENDITURE CABINET

The Chancellor has seen Mr Butler's minute to you of 13 July. He agrees with Mr Butler's suggestions, subject to one point on Mr Butler's paragraph 4(ii). He feels that the expanded version suggested by Mr Butler should be toughened by deleting "indefinitely" in the last line, so that it reads "... it would be unwise to plan public expenditure on the basis that it will continue to grow at this year's growth rate".

ACSA

A C S ALLAN

001/2761

CONFIDENTIAL

FROM: JILL RUTTER

DATE: 15 July 1987

MR LUCE

cc:
Chancellor
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middidleton
Mr F E R Butler
PEX
Mr Kemp
HEGS
Mr Gilhooly
Mr Hoare
Mr Cropper
Mr Tyrie

on Monday 13 Jan, before you meeting.

1987 PUBLIC EXPENDITURE SURVEY: DEPARTMENTAL RUNNING COSTS

The Chief Secretary discussed with you and others your minute of 8 July.

2 The Chief Secretary said that the present position appeared to be that while we had realistic figures for running costs in year 1, the figures for years 2 and 3 were total fudges. The cork now appeared to be coming out of the bottle both on pay and non-pay costs. You pointed out that some of the non-pay cost increases were a result of contracting out, some reflected investment in computer projects which would enhance the efficiency of the operations. It would be wrong to think that non-pay costs were the sole source of problems. Now that the policy of control over manpower totals had been weakened it was important to get expenditure properly into the Survey throughout the Survey years. Manpower totals had outlived their usefulness. Departments had been tempted to substitute expenditure outside the manpower count to keep within the arbitrary totals set - e.g. by using more overtime or employing casuals. Morevoer the big reductions in

civil service manpower were unlikely to continue. Manpower targets had broadly achieved their objective.

3 In the light of this the Chief Secretary asked if running costs had risen by 1¾ per cent per annum in real terms when big reductions in manpower were taking place, how realistic was the objective of 1 per cent per annum increase in real terms over the Survey period, when we acknowledged that the scope for such reductions was drastically reduced? You explained that this was a target. You would be surprised if it were achieved. But the aim of setting tight targets was to ensure that running costs grew no faster than public expenditure as a whole, despite the very severe pressures on pay.

4 The Chief Secretary asked what sanctions we had in practice against a department which failed to achieve its target. Was there positive action we could take or did we just have to hope that departments would live by their plans? You explained that in the first year the running cost limit was a cash limit. Where possible we would refuse any increase in those limits. The record of the past two years was not bad in this respect. But the aim was to increase pressure through management planning. The Chief Secretary asked if you had any specific ideas of how efficiency gains could be increased. He noted that the Chancellor's Departments were among the "worst offenders" on running costs. He agreed that the proposal was good in theory but he wanted to be sure that it actually meant something in practice. You explained that the aim would be to get a forward projection of unit costs. In effect what was being proposed was a two year Survey strategy. Where agreement in year one was not possible then a solution would be imposed on the Department and the running cost provision set accordingly. The efficiency gains in the NHS which gave some indication of what might be achieved in Government departments.

5 The Chief Secretary asked whether anything could be deduced about the Treasury's intentions for the planning total from the £300 million increase proposed in running costs, since running

costs were 9 per cent of public expenditure. It was pointed out that the increase implied, was, if anything, somewhat lower than the likely increase in the planning total.

6 Mr F E R Butler said there was a need to strike a balance. Figures had to be acceptable to the Prime Minister. Even a 1 per cent real terms increase, which in the light of past experience looked ambitious, would be difficult to sell to the Prime Minister who would wish to see continuing downward pressure on administrative costs. As far as departments were concerned the forecast of GDP deflator given by the Treasury always turned out to be on the low side, and so did the pay forecast. The combination of the two made their running costs figures completely unrealistic. The new real terms formulation would provide a better medium term framework for departmental planning. The assurance of 1 per cent real growth would give them a better idea of the gap they would have to bridge. Mr Kemp added that this was not an easy target. Civil service pay been had pushed down relative to other earnings. Eventually public service earnings would have to level out at something like the rate of increase of the private sector - which was running at about 7½ per cent per annum. This posed problems not only for departments but for services like the NHS. He noted that pay settlements to date had been 2 per cent plus per annum over the GDP deflator.

7 Summing up, the Chief Secretary said he was content with the approach set out in the Cabinet paper, subject to any views the Chancellor might express at his meeting later that day. His concern was that the strategy of requiring efficiency plans from departments should be shown to have teeth. It should not prove a useless sanction. On the Cabinet Paper itself he had doubts about the bluntness of paragraph 9 which seemed to attempt to resurrect the manpower targets which we had just discontinued through the backdoor.

Jill Rutter

JILL RUTTER
Private Secretary

FROM: A C S ALLAN
DATE: 15 July 1987

MR TYRIE

cc Chief Secretary
Mr Cropper

RUNNING COSTS

The Chancellor was grateful for your minute of 14 July. He feels it is rather too late to be reopening the issue now: the Luce paper was sent round in the middle of last week and discussed at the meeting on Monday.

2. He does not believe that a 1 per cent real increase is soft: it is a very tough discipline, as is demonstrated by what happened even in the golden age of manpower targets. But he is strongly in favour of strengthening the quid pro quo.

ACSA

A C S ALLAN

2/020

CONFIDENTIAL

FROM T R H LUCE
15 July 1987
Room 55/G
Ext 4544

CHIEF SECRETARY

Chancellor of the Exchequer
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
PEX
Mr Kemp
Mr Gilhooly
Mr Hoare
Mr Cropper
Mr Tyrie
File A
File B

PES 1987: DEPARTMENTAL RUNNING COSTS: REVISED MATERIAL FOR CABINET

1 I attach revised running cost material for next week's Cabinet. It takes account of your own and the Chancellor's views at Monday's meetings. In particular we have recast it as an annex to your main PES paper, not a separate paper in its own right. A draft summary contribution to the main paper is at 'A'; the annex is at 'B'.

2 You may wish to consider in particular the revised paragraph on manpower (paragraph 9 of the annex). You raised doubts at our meeting about the "bluntness of paragraph 9 which seemed to attempt to resurrect the manpower targets which we [have] just discontinued". The revised paragraph - though a little fuller - continues to emphasise the link between control of manpower numbers by departments and the effectiveness of the running cost control arrangements which are replacing the old manpower target system. We do not think you should do less because:

(i) the manpower increases some departments are projecting, when combined with mounting pressures on pay, would make it impossible to keep overall running costs to any acceptable path. Departments, understandably, hate centrally imposed manpower targets. The possibility of bringing them back in some form or another is an ultimate weapon in your hand, reluctant though you might be ever to use it.

(ii) in announcing the change to Parliament earlier this year, your predecessor said "the new arrangements ... will maintain the momentum of the drive for increased efficiency and leaner staffing by Government departments."

3 You may also like to know that the manpower projections departments have sent with their bids imply, by 1991, a Civil Service of just over the 600,000 mentioned in the Conservative manifesto.

4 If you are content with the material it will be incorporated in the revised Cabinet paper GE are planning to submit tomorrow.

TRL.

T R H LUCE

'A'

RUNNING COSTS CONTRIBUTION TO PES CABINET PAPER

Departmental Running Costs

Colleagues have sought increases in their departments' running costs implying overall cash increases of 8 per cent for 1988-89 over 1987-88 with further increases in later years. The associated manpower projections reverse the downward trend we have achieved, implying a 15,000 increase over published plans for 1988-89.

In the last few years, the increases in spending on departmental costs agreed for each first Survey year have exceeded our aims. The figures for the later years have not been treated realistically and as a result have had to be increased substantially in later Surveys. We need to agree a realistic method for planning provision over the Survey period so that departments have a reasonably reliable basis for making medium-term plans to improve efficiency.

My proposals, set out more fully in the annex, are that:

(i) The running costs share of total public spending should not rise over the Survey period. This implies that running costs would grow on average in line with public expenditure generally, i.e. by about 1 per cent a year in real terms.

(ii) cost and other pressures will need to be met to a large extent by efficiency gains of at least 1½ per cent a year in the use of all resources including manpower. These will need to be planned well in advance and departments should have contingency plans for larger improvements in case they are necessary.

(iii) departments should prepare management plans to deliver these gains over the full Survey period. In any case where the plans are not suitably ambitious, or are unrealistic, I should hold over agreement on the later Survey years until the next Survey.

(iv) for 1988-89, the aim should be to reduce the overall increase in provision sought by at least half.

CONFIDENTIAL

'B'

1987 PUBLIC EXPENDITURE SURVEY: DEPARTMENTAL RUNNING COSTS

Annex by the Chief Secretary, HM Treasury

1 Departmental Ministers have sought increased provision for running costs totalling £761 million for 1988-89, £956 million for 1989-90 and £1203 million for 1990-91.

We cannot accept increases of this size. They would mean that

2 [~~If increases on this scale were agreed,~~] overall expenditure on running costs would rise by 8 per cent in cash and 4 per cent in real terms between 1987-88 and 1988-89, with further real increases in the later years. They would also imply an increase in Civil Service manpower of nearly 15,000 over the manpower plan of 583,000 for 1 April 1989 published in this year's expenditure White Paper and further increases in later years, though some 5,000 of this rise stems from increases agreed after the last Survey.

There are undoubted pressures on running costs.

3 In spite of large manpower reductions (135,000 since 1979 and 50,000 since 1983) and, in most years, Civil Service pay settlements at or below general inflation, running costs have continued to rise in real terms as a result of increases in non-manpower costs (e.g. more buying-in of services rather than providing them internally) and changes in grading mix. Tight pay settlements will continue to be the aim. But if departments are to recruit and retain the staff they need and the Government's objective of making the Civil Service pay structure more conducive to an efficient service and more responsive to labour market conditions is to be met, future pay offers cannot be expected to be immune from pay movements in the economy generally.

4 It is thus realistic to provide for some rise in overall spending on running costs; but the manifesto pledge to press ahead with management reforms to improve public services and reduce their cost, and the aim of ensuring that public expenditure takes a steadily smaller share of national income, mean that

the rise must be contained to well below the levels sought.

5 I ~~It is~~ propose~~d~~ ~~as a firm objective~~ we resolve that the share of running costs ~~share~~ in total public spending should not rise over the Survey period. This implies that running costs would grow ~~approximately~~ on average in line with public expenditure generally, i.e. by about 1 per cent a year in real terms. It means that if increases in the volume of activity are to be met in some parts of the service, reductions or lower rates of growth will be necessary in others where demand is less or of lower priority.

6 To achieve this ~~general~~ overall objective, ~~the~~ colleagues' running costs bids will need to be substantially scaled down, ~~e.g.~~ to less than half the additions to baseline that have been sought for 1988-89; and all departments will need firm plans to offset pay bill and other cost pressures through sustained and incremental efficiency gains. The improved budgetary and management systems stemming from the financial management drive of recent years, the Government's large and continuing investment in new technology, and further improvements in purchasing as well as the continuing processes of scrutiny and inspection must be used to deliver further improvement in performance, benefiting both input costs and outputs. On the input side, further improvements in the use of manpower and better control of non-manpower costs will be essential.

7 These efficiency gains will be easier to make on the necessary scale if they are planned ~~for~~ well in advance; and if the plans are ambitious there will be greater scope for flexibility in future years. ~~It is~~ I propose~~d~~ that all departments should now prepare or revise management plans committing them, over the Survey period, to the delivery of defined and wherever possible measured improvements in outputs, and progressive overall efficiency gains of at least 1½% a year, with contingency plans for larger improvements in case they are necessary. This is a ~~fair~~ reasonable minimum target for well-managed service organisations. These plans will be especially important for departments with large executive operations.

8 Departments' plans, and their implications for restraining growth in running costs, would be discussed in the bilaterals. Agreement to increases over baseline, particularly for the ~~last two~~ later years ~~of the Survey~~, would be withheld until ~~it was clear that ambitious but realistic~~ plans for efficiency gains ~~over the medium term had been made. In some cases this might mean that the final levels of provision for 1989-90 and 1990-91 would have to be held over until the next Survey.~~ of at least 1½ per cent a year were demonstrated in a departmental management plan. Departments would be expected to deliver these plans.

Civil Service Manpower

9 Earlier this year it was announced that manpower targets would not be set after 1 April 1988, and pressure on Civil Service numbers would be maintained through running costs. The proposed approach to running costs will mean large reductions in the manpower projections of some departments. It is important to show that the running costs regime is an effective control on all Civil Service resources, including manpower. There will otherwise be pressure to reintroduce manpower targets.

Conclusions

10 ~~The~~ I invite Cabinet ~~is invited~~ to agree that:

(i) the ~~aim~~ objective should be to restrain running costs over the Survey period to their present share in total public spending by offsetting so far as possible any real rises in pay and other costs through efficiency gains;

(ii) departments should prepare or revise three-year management plans for sustained output and cost improvement, for discussion in the bilaterals;

(iii) for 1988-89 the aim should be a reduction by at least half of the £761 million additional provision sought in order to keep the overall increase in running costs in line with the medium-term objective in (i) above.

RUNNING COSTS

PERSONAL AND CONFIDENTIAL

I agree with the statement in para 4; but with the rest [illegible] in practice – [illegible] 'give away' proposal. So although I share Mr T's scepticism [illegible] quid pro quo [illegible] proposal [illegible]

FROM: A G TYRIE

DATE: 16 JULY 1987

CHANCELLOR

cc Chief Secretary

RUNNING COSTS: CABINET

I have just seen Mr Luce's revised material for Cabinet on running costs. As it stands, I think it gives away the 1% real increase without an adequate quid pro quo. Either we elicit a bigger price from departments in return for the 1% or we should tone down the sections which describe what we are giving away as much as possible.

below

Option 1: a substantive quid pro quo

2. Paragraph 8 would need strengthening. After the first sentence I think this should read: "Agreement to increases over the baseline would be withheld until plans for efficiency gains of at least 1½% a year were demonstrated in a departmental management plan. It would not be anticipated that years 2 and 3 of the survey would be renegotiated in the following year's survey. Departments would be expected to deliver their management plan."

Option 2: watering down the 1% offer

3. The second sentence of paragraph 5 should read: "This implies that running costs should not grow faster than public expenditure plans generally." The reference to 1% a year in real terms should be removed altogether.

PERSONAL AND CONFIDENTIAL

4. Whichever course we take I suggest we add a sentence on to the end of paragraph 2: "This is clearly unacceptable." As it stands paragraph 2 implies that we are resigned to accepting a 15,000 manpower increase. Again, either way, the covering letter to the Annex would also have to be amended along with some other minor changes.

5. On balance I favour option 2 rather than trying to cobble together a quid pro quo at this stage.

AGT.

A G TYRIE

013/4

CONFIDENTIAL

pw

FROM T R H LUCE
16 July 1987
Room 55/G
Ext 4544

MR A C S ALLAN

Mr F E R Butler
Mr Anson
Mr Turnbull
File A
File B

cc PS/CST
Mr Tyrie.
ACSA.

RUNNING COSTS: CABINET

Mr Tyrie's comments on our material of yesterday.

2 I do not see the point of removing the 1% a year reference in paragraph 5. Everyone knows that the public spending total is planned to rise somewhat in real terms. It may turn out to rise a little faster than now planned. The 1% reference could turn out to be useful to us if it does. And it gives departments some concrete idea of what the strategy means. This should help with their planning. It will be worse for us if they have to do their own arithmetic about planning total movements. So I do not favour Mr Tyrie's Option 2.

3 As regards his option 1 I do not think we can credibly refuse to allow any increase on the artificially low 1988-89 baseline even if departments fail to produce an efficiency plan; or that we can refuse to renegotiate the later years in all circumstances. There are changes between Surveys in programme provision for a whole variety of reasons - altered priorities (sometimes in our favour, not departments'), changes in underlying economic assumptions and so forth. If we totally excluded running costs from any alteration, departments would not believe us. And if they did, they would press for such large increases when the provision was being fixed that the running cost element in the Survey would be unmanageable.

4 If - short of that - paragraph 8 is to be strengthened I suggest:-

"Departments' plans, and their implications for restraining the growth in running costs, would be discussed in the bilaterals. Agreement to increases over baseline, particularly for the later years, would be withheld until plans for efficiency gains of at least 1½% a year were demonstrated in a departmental management plan. Departments would be expected to deliver these plans."

5 I do not think paragraph 2 implies acceptance of the manpower increases, particularly when taken with paragraphs 4 and 9 and the sharper reference in the covering paper. But, if we are to make Mr Tyrie's point, we should apply it to the running costs increase, not just to the manpower increase: we need to be careful not to provoke Ministers into protesting that we are trying to re-introduce manpower targets by the backdoor. So I suggest we begin paragraph 2:

"These increases are much too high. If they were agreed ... [as before].

6 I have discussed this advice with Mr F E R Butler

T R H LUCE

3002/20

SECRET

pvp

FROM: A TURNBULL
DATE: 16 JULY 1987

PS/CHANCELLOR

cc PS/CST
Mr F E R Butler
Mr Anson
Mr Luce
Mr Gieve

BRIEFING FOR NO 10 PRIVATE OFFICE

We agreed that it would be helpful to give David Norgrove a sight of the current draft of the Cabinet paper and the post Cabinet line today so that when the versions for the Prime Minister are sent over tomorrow he is able to bring out for her the thinking underlying the tactics and the outcome we are seeking from the meeting.

2. I have prepared a note which sets out the arguments. I suggest you send this, together with the latest draft, over at lunchtime today. I can then speak to David Norgrove at the end of the day to clear up any points he may have. You should point out that he should not, at this stage, discuss the post Cabinet line with Mr Ingham.

AT

A TURNBULL

DRAFT CABINET PAPER ON PUBLIC EXPENDITURE

(i) As last year, do not believe an increase in planning total can be avoided.

(ii) Do not believe that can repeat last year's tactic of "working within existing planning totals" and then announcing an increase at the end. After last year, colleagues will be seeking some indication of Treasury's thinking.

(iii) But do not want to name new planning totals in July:

- no economic context in which to place them;

- would require Parliamentary statement;

- uncertainties make it difficult to name figure which we can be sure of holding to;

- to announce figures we think can be held would whet departmental appetites.

(iv) Therefore propose that no decision be taken on planning toals but that policy of reducing public expenditure as a proportion of GDP, <u>as set out in the PEWP</u>, be reaffirmed.

(v) Thus, while likelihood of some increase is implicitly acknowledged, aim is to keep as small as possible and in any case subject to constraint of GGE/GDP ratio. Reference to "as set out in the White Paper" means must keep to White Paper percentages or better. Any decline, however small, is not acceptable. Survey is not open-ended.

(vi) Necessary to deflate expectations. Two devices for this:

a. paper deliberately maintains a number of areas where difficult policy savings should be explored;

b. paper stresses extent of prior claims eg agreed decisions, local authority current expenditure, social security estimating changes, need to hold back more for larger Reserves.

(vii) Some colleagues may argue that their programmes cannot contribute savings/scale back bids. Paper does not seek decisions, but seeks to keep open areas for further investigation. Attempts to gain exemption should be resisted. Meeting should not attempt to discuss substance of individual issues.

(viii) On nationalised industries, recommendation is straightforward. Important to leave open option of "challenging financial targets" for electricity.

(ix) On running costs, a modified approach is suggested. Running costs limits have proved an effective way of controlling departmental operating costs for the year immediately ahead; they avoid many of the distortions of manpower control and they fit better with the delegating budging being developed in departments. But there is evidence that for years 2 and 3 they provide departments with a less clear signal than the old manpower targets and that the figures agreed for in the future years have become pretty unrealistic.

(x) The paper proposes that departments should commit themselves to medium-term plans to improve productivity by, say, 1½ per cent a year. But where departments fail to come up with medium-term efficiency plans, it might be necessary to hold over agreement on the final levels of provision in 1989-90 over 1990-91, until the next Survey. At the same time the Government would adopt a more realistic objective for running costs, ie that they should rise in line with public expenditure as a whole or about 1 per cent a year in real terms. Previously the objective has been to keep running costs constant in real terms, while the outcome has been growth of 1¾ per cent. This represents a convergence of setting a more realistic target with an effort to secure improvement on what has been achieved in the past.

(xi) As on previous occasions, Cabinet would be asked to agree a line to be issued to the Lobby (and to be used by the Prime Minister if necessary at Questions). A draft is attached, together with suggested responses to immediate questions.

BRIEFING FOR NO 10

Line

The Cabinet had its usual July discussion of public expenditure today. It reaffirmed the policy that public expenditure should continue to take a declining share of national income, as set out in the last Public Expenditure White Paper. Within that constraint, the Chief Secretary will hold bilateral discussions in the Autumn. In the light of these, the Government will review both the individual spending programmes and the planned totals for spending and will, as usual, announce decisions in the Autumn Statement in November.

Text

"My Government ... will maintain firm control of public expenditure so that it continues to fall as a proportion of national income and permits further reductions in the burden of taxation." - Queen's Speech.

Will the planning totals be increased?

I cannot tell you whether the totals will be changed, or if so by how much, or where the money will go. None of that is decided.

There may be some change in the totals, but if so - and I stress that it is not decided - the Government will keep as close to them as possible and will in any case not exceed the White Paper percentages of GDP.

The policy that public expenditure declines as a proportion of GDP is not just an aspiration. It is what we have achieved since 1982-83.

Why might you allow an increase?

I am not saying we will. It is restraint which has brought success. There will be no let-up in the Government's rigorous approach. And we will continue to plan expenditure on a cautious view of what we can afford.

But the strength of the economy is there for all to see, though it would be unwise to plan public expenditure on the basis that it will continue to grow at this year's growth rate.

Why no decision?

Cabinet has decided to stick firmly to the policy.

Final decisions will be taken, as always, when:

- there has been further assessment of the needs of particular programmes;

- we have further information on the prospects for the economy and so on what we can afford.

PMP

CHANCELLOR OF THE EXCHEQUER

Broadly OK - one or two changes..

Ch

OK? The brief for summing up on Star Chamber will be in Cabinet Office brief.

AA

(This is Turnbull draft, approved by Butler et al).

3002/14

CONFIDENTIAL

16/7/87.

SPEAKING NOTE FOR THE PRIME MINISTER

The Chancellor's paper provides an encouraging picture of the economy, but it is important to draw correct messages from this and to avoid complacency.

~~43¼ in 78-79~~
~~44 in PEWP~~

i. Although public spending has been coming down as a proportion of national income, its share this year (around 43 per cent) is likely to be about the same level as we inherited in 1978-79.

~~38.0 versus 34.1~~

ii. Although taxes have been cut in each of the last five Budgets, the burden of non-oil taxes is still significantly higher than it was in 1978-79.

iii. The strength of the economy has been built on sound finance and the restraint of public spending. We have achieved a consistency of policy which has given confidence, which in turn has transformed the investment climate in this country.

iv. Although inflation is low by historical standards, at 4 per cent it is still above the average for our major competitors.

2. Looking to the future, we must set spending plans which sustain this confidence. The Chancellor and Chief Secretary seek a continuation of the Manifesto policy of reducing public spending as a proportion of national income. And by this they rightly mean not just any decline, however small, but one at least as fast as we set ourselves in the last White Paper. This is essential if we are to achieve another of our Manifesto pledges - a further reduction of taxation.

3. [~~But paradoxical as it may seem,~~] Restraint of public spending is also the best way to build up our public services. For it is the resulting strength of the economy ~~that results~~ which will provide the resources we need to carry out our Manifesto programme.

4. Although growth this year looks like being faster than the recent trend, we must not fall into the trap of previous governments of basing our spending plans on over-optimistic projections. We must plan on a cautious assessment of what can be afforded. ~~By doing this in the past we have given ourselves something in hand to cope with unforeseen events~~.

Colleagues will assume budget [illegible] problem

5. It is clear that the bids submitted are ~~quite~~ inconsistent with the policy we are following. The bids will have to be substantially cut back ~~of~~ or policy savings found to offset them. As the Chief Secretary's paper points out, this may involve difficult choices. But now, at the start of a Parliament, is the time to face up to them. Across the whole range of spending, I hope there will be a thorough review of the options, not just within bids but within baselines as well.

6. Meanwhile, the pursuit of better value for money must continue. I welcome the Chief Secretary's proposal to establish medium-term efficiency plans for departmental running costs. We must also seek greater effectiveness for departmental programmes.

CONFIDENTIAL

cc B/UP
cc HMT

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

16 July 1986 7.

David Norgrove Esq
10 Downing Street
LONDON
SW1

Dear David,

BRIEFING FOR PUBLIC EXPENDITURE CABINET

... As agreed, I attach a speaking note for the Prime Minister's use at tomorrow's Cabinet, together with some supplementary notes for use as and when needed during the course of the discussion.

Yours ever
Rachel

RACHEL LOMAX
Principal Private Secretary

SPEAKING NOTE FOR PRIME MINISTER

Firm control of public expenditure is an indispensable part of our economic policies. It played an important role in bringing down inflation and Government borrowing and has enabled us, in recent Budgets, to make progress in reducing the burden of taxation. The strength of the public finances has prevented us from being blown off course by the major challenges and economic shocks we have faced. Over the past seven years we have acquired a reputation for soundness which we must not destroy. The question is not whether one can cope under present circumstances but whether one has something in hand if the situation worsens. Caution has served us well as a Government. Recent developments in the economy and in financial markets fully vindicate this cautious approach.

2. I recognise that the control of public expenditure sets any Government its most searching test. Public expenditure surveys are always painful and if we accept the additional provision which is proposed for local authorities we must expect this year's Survey to be very tough indeed. But as a Government we must be prepared to face up to difficult decisions required in setting priorities. What we decide today must demonstrate both our unity and our resolve.

3. I ask colleagues, therefore, to give the Chief Secretary their fullest co-operation in seeking economies. I doubt if any Minister can really say that there is no element of his existing programme which is not of lower priority than items for which he has made additional bids; or that there are no further efficiency savings that can be made. Indeed, as management improves in departments and in the health service, the scope for achieving greater value for money should be increasing.

4. We must not give any sign of weakening in our determination to keep public spending under firm control. To do so would make us more vulnerable to the difficult economic circumstances we face and put at risk our undoubted achievements. The best way to signal our continuing resolve is to work within unchanged planning totals, as

we have done in previous years. Must continue to face up to difficult choices and must continue our search for better value for money.

CHANCELLOR OF THE EXCHEQUER

Ch

There is a orange folder in your box with a few additional comments from CST etc. Do you want to take them on board?

Yes: take all of them on board.

AA

Thanks Jon –

Ch

I thought it would be helpful to get these* to you now, to look at on plane at time, since tomorrow will be rather rushed.

AA

* 3 bundles:
  - Main PES paper
  - Running Costs Annex
  - Economic Prospects.

002/2761

SECRET

CHIEF SECRETARY TO THE TREASURY

FROM: JILL RUTTER
DATE: 16 July 1987

PRINCIPAL PRIVATE SECRETARY

cc:
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr Anson
Mr Turnbull
Mr Monck
Mr Scholar
Mr Luce
Mr Sedgwick
Mr Culpin
Mr Gieve
Mr Tyrie
Mr Cropper

Ch
Marked on version above.
AA

DRAFT PAPER FOR THE PUBLIC EXPENDITURE CABINET

The Chief Secretary has seen the draft attached to Mr Turnbull's minute of 16 July. The Chief Secretary has the following comments.

Paragraph 3

For reasons of avoiding ambiguity the Chief Secretary would prefer to start the first sentence:

> "For this year's Survey we have set baseline totals for spending......"

Paragraph 5

Since we are going to have to concede a substantial proportion of the bids in the Survey the Chief Secretary was anxious that the paper should not overstate the economic consequences. He therefore wondered whether it might not be better to slightly tone down the middle clause of the last sentence and replace it with:

> "...provide a severe setback to the economic progress we have made ...."

SECRET

Paragraph 8

The Chief Secretary notes that even if we had got our way on grant in the RSG settlement in full we would still be faced with the problem of having to make an allowance within the Reserve for local authority overspending. He therefore would prefer to redraft the penultimate sentence as follows:

> "In particular we need to take account of the fact that local authority current spending is again likely to exceed the figure we will publish for provision".

Paragraph 10

The Chief Secretary would redraft the second sentence:

> "The figures for later years have not been set at realistic levels and as a result ......"

Paragraph 12

I have discussed with Mr Turnbull and he suggests that to clarify the middle sentence of this paragraph it should be redrafted:

> "Apart from the electricity industries in England and Wales and in Scotland I propose that our aim should be to reduce provision ...."

Jill Rutter

JILL RUTTER
Private Secretary

ECONOMIC PROSPECTS

psl/18A

CONFIDENTIAL

FROM: A C S ALLAN
DATE: 16 July 1987

SIR T BURNS

I have made a number of changes

Ch
You have version with Terry's scribbles: this is typed-up version.
AA

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir G Littler
Mr F E R Butler
Mr Anson
Mr Monck
Mr Kemp
Mr Odling-Smee
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mr Culpin
Mr Gieve
Mr Hudson
Mr Cropper
Mr Tyrie

ECONOMIC PROSPECTS: DRAFT CABINET PAPER

You supplied the Chancellor with some suggested amendments for the draft Cabinet paper, including a new introduction, which I have incorporated in the attached retyped version. I should be grateful for any further, urgent comments; the Chancellor will need to consider these overnight, before the draft is sent to No.10 for approval over the weekend.

ACSA

A C S ALLAN

! forecast

ECONOMIC PROSPECTS

The economy has been growing steadily at a satisfactory rate for the past six years. With industry competing successfully ~~in the~~ both at home and ~~international markets~~ abroad the prospect this year is for faster GDP growth than in recent years, and more than ~~expected~~ the forecast at the time of the Budget. ~~time. The principal factors behind the more buoyant growth rate are strong export performance and successful competition with imports.~~ Unemployment has continued to fall while inflation has remained close to the expected path. So far this year, the current account of the balance of payments has been in modest surplus, though the outcome for the year as a whole remains uncertain.

2. Our prudent monetary and fiscal policies ~~lie behind~~ have made possible this successful economic performance. They have stabilised financial conditions, enabled us to avoid lurches of policy, and increased confidence in the UK as a base for investment. The reduction of public expenditure as a share of GDP over the past four years has been especially important. It has ~~provided room for lowering~~ enabled us to reduce the PSBR despite having to adjust ~~and adjusting~~ to the sharp loss of North Sea revenues. ~~but we have made little progress in reducing the burden of non-North Sea taxation.~~ We are also seeing, especially in the rapid~~ly~~ growth of manufacturing productivity, some effects from the measures taken over the past seven years to improve supply performance. But we have failed to make much progress in reducing the burden of non-North Sea taxation as a share of GDP.

3. The growth rate this year is likely to be significantly above the average ~~level~~ of recent years, and we clearly cannot count on it being sustained at this level. There are also ~~definite risks~~ evident dangers. Abroad, the world economy could be more depressed than now envisaged. At home, pay settlements badly need to fall, not least in the public sector. Above all it is essential that the Government demonstrates its firm commitment to the financial policies that have brought ~~this~~ our present success and which alone can deliver declining inflation and the continuation of steady growth in the years ahead.

WORLD ECONOMY

4. The most obvious threat to continued steady UK growth comes from a weakening of demand and output in other major developed countries. Since the fall in oil prices at the beginning of 1986, output growth in the G7 economies has been disappointing. Last year weak world demand originated in the developing countries who, as a group, cut back their imports. More recently many of the strains seem to reflect slowness in adjusting to the sharp realignment of exchange rates. Domestic demand in the US is understandably weakening; while in Germany and Japan it is not rising fast enough to offset the adverse effects of currency appreciation on their exports. Their loss of export markets has been made more acute by the increasing shares taken by the newly industrialised countries, notably in South-East Asia, who with the recent exception of Taiwan have held their currencies steady against the dollar.

5. Inflation rates in the major economies have been reduced, much as expected. And there are now signs of some progress in correcting the large current account imbalances in the US, Japan and Germany. The risk of further turmoil in foreign exchange markets has been reduced - although not eliminated - by successful co-operation between the G7 countries. Following the agreement at the Louvre in February, the G7 countries have succeeded in stabilising their currencies by a combination of intervention and a greater willingness to adapt their monetary policies. And there have been some further steps in Germany and even more in Japan to support domestic demand and open markets. It is vital that these measures are sustained and strengthened. Further reductions in the US Budget deficit are also needed.

THE BRITISH ECONOMY

6. A summary of the most recent Treasury assessment is shown in ... the attached annex.

7. At home we have seen a continuation of what has by now become a familiar pattern of strong and steady growth coupled with low inflation.

8. A year ago there was concern in some quarters at the mild pause in growth between mid-1985 and mid-1986. In the event, despite disappointing growth abroad, performance at home has exceeded expectations. In the first quarter of this year GDP was just over 4 per cent higher than a year earlier.

9. The prospect is for continuing strong growth in 1987, with the outcome in the year as a whole likely to be closer to 4 per cent than the 3 per cent predicted at Budget time. Domestic demand growth is balanced, with fixed investment rising in line with the growth of consumers' expenditure. With growth in 1987 above the trend of recent years, it would not be surprising if the growth rate fell back a little next year.

10. ~~This~~ The recent strong performance of output has contributed to a further rise in employment and in turn to the fastest recorded fall in unemployment since the War. This welcome fall in unemployment to below the three million mark has occurred at the same time as productivity growth in manufacturing has been exceptionally high by historical standards. Indeed increased industrial efficiency has been an essential factor in the greatly improved unemployment prospect. If overall growth continues at a steady and sustainable rate, even if somewhat lower than this year, there is every likelihood that the fall in unemployment will also continue.

11. We have always known that the UK, as a major oil producer, would not benefit as much from the fall in oil prices as the other major economies. The necessary fall in sterling during 1986 largely offset the beneficial impact on inflation of the lower oil prices. However, we are still on course to achieve the Budget forecast of 4 per cent inflation in the fourth quarter of this year, and the outcome could well be a little lower. Nonetheless, this remains uncomfortably above the average rate in other major economies. It is essential that inflation is kept firmly on a downward path over the medium term.

12. So far, lower inflation has not been adequately reflected in lower pay settlements. The deceleration of private sector pay settlements in 1986 appears to have ended: indeed if anything they

may have begun to edge up. Some public sector settlements - notably by local authorities - could also set an unfortunate precedent for the private sector and will make it more difficult to control public finances. Pay increases need to be lower if the hard-won fall in unemployment is to continue.

X 13. The prospects for the current account of the balance of payments now look a little better than they did at the time of the Budget, (and the estimate of last year's deficit has been revised down almost to £3bn.) Over the past year British companies have competed successfully in the home and international markets. In spite of subdued prospects for world trade and buoyant activity at home it now looks as if the current account this year will show a smaller deficit than the Budget forecast of £2½ billion, or ~~(~~half ~~a~~ of one per cent of GDP~~)~~.

14. Since the Louvre agreement towards the end of February, sterling has generally been very steady. Indeed, during April and May there was a pronounced tendency for the pound to strengthen. This was contained by reducing interest rates and intervening in the foreign exchange markets on a massive scale. As a result, the exchange rate has stayed within a very narrow range over the past 4-5 months. This in turn has strengthened confidence within industry.

15. Nevertheless, financial markets are closely watching the behaviour of the economy, and in particular the outlook for inflation. They will also be ~~alert to~~ on the look-out for any signs of a loosening of the firm financial policies that have brought our current success. It is vital that we maintain the firm control of public expenditure in the Chief Secretary's programme.

psl/18A

CONFIDENTIAL

FROM: A C S ALLAN
DATE: 16 July 1987

SIR T BURNS

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir G Littler
Mr F E R Butler
Mr Anson
Mr Monck
Mr Kemp
Mr Odling-Smee
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mr Culpin
Mr Gieve
Mr Hudson
Mr Cropper
Mr Tyrie

cc. as before

Mr.. Allan

The re-ordering of the first page attached would bring out more clearly the contrast between the ~~first~~ current year and the future years relevant to the Survey exercise. I have asked Sir T. Burns to let you know if he is content. FERB 16.7.

ECONOMIC PROSPECTS: DRAFT CABINET PAPER

You supplied the Chancellor with some suggested amendments for the draft Cabinet paper, including a new introduction, which I have ... incorporated in the attached retyped version. I should be grateful for any further, urgent comments; the Chancellor will need to consider these overnight, before the draft is sent to No.10 for approval over the weekend.

Mr Allan c. FERB

I am content with these changes

TB

ACSA

A C S ALLAN

Ch

OK to attached? — marked also on revised version below

AA

OK. 2. Pl. let me have state of figs ~~[illegible]~~ wk. like others X.

919

MR 1/20

CONFIDENTIAL

This is pre-revised version — see below

ECONOMIC PROSPECTS

The economy has been growing steadily at a satisfactory rate for the past six years. With industry competing successfully in the home and international markets the prospect this year is for faster GDP growth than in recent years - more than expected at Budget time. The principal factors behind the more buoyant growth rate are strong export performance and successful competition with imports. Unemployment has continued to fall while inflation has remained close to the expected path. So far this year, the current account of the balance of payments has been in surplus.

3. Our prudent monetary and fiscal policies ~~lie behind this successful performance. They~~ have stabilised financial conditions, enabled us to avoid lurches of policy, and increased confidence in the UK as a base for investment. The reduction of public expenditure as a share of GDP over the past four years has been especially important. It has provided room for lowering the PSBR and adjusting to the loss of North Sea revenues, but we have made little progress in reducing the burden of non-North Sea taxation. We are also seeing, especially in rapidly growing manufacturing productivity, some effects from the measures taken over the past seven years to improve supply performance.

2. The growth rate this year is likely to be significantly above the average level of recent years, and we cannot count on it being sustained over the Public Expenditure Survey period. There are definite risks. Abroad, the world economy could be more depressed than now envisaged. At home, pay settlements badly need to fall, not least in the public sector. Above all it is essential that the Government demonstrates its firm commitment to the financial policies that have brought this success and which alone can deliver declining inflation and the continuation of steady growth in the years ahead.

BR 1/20

CONFIDENTIAL

Revised version AM 17/7.

ECONOMIC PROSPECTS

The economy has been steadily growing at a satisfactory rate for the past six years. With industry competing successfully both at home and abroad the prospect this year is for faster GDP growth than in recent years, and more than I forecast at the time of the Budget. Unemployment has continued to fall while inflation has remained close to the expected path. So far this year, the current account of the balance of payments has been in modest surplus.

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3. The growth rate this year is likely to be significantly above the average of recent years, and we clearly cannot count on it being sustained at this level over the Public Expenditure Survey period. There are also evident dangers. Abroad, the world economy could be more depressed than now envisaged. At home, pay settlements badly need to fall, not least in the public sector. Above all it is essential that the Government demonstrates its firm commitment to the financial policies that have brought our present success and which alone can deliver declining inflation and the continuation of steady growth in the years ahead.

WORLD ECONOMY

4. The most obvious threat to continued steady UK growth comes from a weakening of demand and output in other major developed countries. Since the fall in oil prices at the beginning of 1986, output growth in the G7 economies has been disappointing. Last year weak world demand originated in the developing countries who, as a group, cut back their imports. More recently many of the strains seem to reflect slowness in adjusting to the sharp realignment of exchange rates. Domestic demand in the US is understandably weakening; while in Germany and Japan it is not rising fast enough to offset the adverse effects of currency appreciation on their exports. Their loss of export markets has been made more acute by the increasing shares taken by the newly industrialised countries, notably in South-East Asia, who with the recent exception of Taiwan have held their currencies steady against the dollar.

5. Inflation rates in the major economies have been reduced, much as expected. And there are now signs of some progress in correcting the large current account imbalances in the US, Japan and Germany. The risk of further turmoil in foreign exchange markets has been reduced - although not eliminated - by successful co-operation between the G7 countries. Following the agreement at the Louvre in February, the G7 countries have succeeded in stabilising their currencies by a combination of intervention and a greater willingness to adapt their monetary policies. And there have been some further steps in Germany and even more in Japan to support domestic demand and open markets. It is vital that these measures are sustained and strengthened. Further reductions in the US Budget deficit are also needed.

THE BRITISH ECONOMY

6. A summary of the most recent Treasury assessment is shown in
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8. A year ago there was concern in some quarters at the mild pause in growth between mid-1985 and mid-1986. In the event, despite disappointing growth abroad, performance at home has exceeded expectations. In the first quarter of this year GDP was just over 4 per cent higher than a year earlier.

9. The prospect is for continuing strong growth in 1987, with the outcome in the year as a whole likely to be closer to 4 per cent than the 3 per cent predicted at Budget time. Domestic demand growth is balanced, with fixed investment rising in line with the growth of consumers' expenditure. With growth in 1987 above the trend of recent years, it would not be surprising if the growth rate fell back a little next year.

10. The recent strong performance of output has contributed to a further rise in employment and in turn to the fastest recorded fall in unemployment since the War. This welcome fall in unemployment to below the three million mark has occurred at the same time as productivity growth in manufacturing has been exceptionally high by historical standards. Indeed increased industrial efficiency has been an essential factor in the greatly improved unemployment prospect. If overall growth continues at a steady and sustainable rate, even if somewhat lower than this year, there is every likelihood that the fall in unemployment will also continue.

11. We have always known that the UK, as a major oil producer, would not benefit as much from the fall in oil prices as the other major economies. The necessary fall in sterling during 1986 largely offset the beneficial impact on inflation of the lower oil prices. However, we are still on course to achieve the Budget forecast of 4 per cent inflation in the fourth quarter of this year, and the outcome could well be a little lower. Nonetheless, this remains uncomfortably above the average rate in other major economies. It is essential that inflation is kept firmly on a downward path over the medium term.

12. So far, lower inflation has not been adequately reflected in lower pay settlements. The deceleration of private sector pay settlements in 1986 appears to have ended: indeed if anything they

may have begun to edge up. Some public sector settlements - notably by local authorities - could also set an unfortunate precedent for the private sector and will make it more difficult to control public finances. Pay increases need to be lower if the hard-won fall in unemployment is to continue.

13. The prospects for the current account of the balance of payments now look a little better than they did at the time of the Budget, and the estimate of last year's deficit has been revised down almost to zero. Over the past year British companies have competed successfully in the home and international markets. In spite of subdued prospects for world trade and buoyant activity at home it now looks as if the current account this year will show a smaller deficit than the Budget forecast of £2½ billion, or half of one per cent of GDP.

14. Since the Louvre agreement towards the end of February, sterling has generally been very steady. Indeed, during April and May there was a pronounced tendency for the pound to strengthen. This was contained by reducing interest rates and intervening in the foreign exchange markets on a massive scale. As a result, the exchange rate has stayed within a very narrow range over the past 4-5 months. This in turn has strengthened confidence within industry.

15. Nevertheless, financial markets are closely watching the behaviour of the economy, and in particular the outlook for inflation. They will also be on the look-out for any signs of a loosening of the firm financial policies that have brought our current success. It is vital that we maintain the firm control of public expenditure the Chief Secretary proposes.

PUBLIC EXPENDITURE

3002/19

SECRET

FROM: A TURNBULL
DATE: 16 JULY 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Anson
Mr Monck
Mr Scholar
Mr Luce
Mr Sedgwick
Mr Culpin
Mr Gieve
Mr Tyrie
Mr Cropper

DRAFT PAPER FOR PUBLIC EXPENDITURE CABINET

I attach a further draft of the Chief Secretary's paper. The aim is to send it, amended in the light of any comments you and the Chief Secretary may have, to the Prime Minister on Friday evening.

2. The main changes since the last version are:

i. the material on running costs which Mr Luce submitted to the Chief Secretary yesterday is attached as an annex with a summary incorporated in the main body of the paper. The Chief Secretary has not yet had time to consider this and any changes he wishes to make will need to be incorporated tomorrow;

ii. inclusion of a passage on local authority current expenditure. Although it takes account of the settlement of England agreed at E(LA) this morning, the position of the territories has yet to be finalised. It may therefore need to be amended. The passage on the Reserves takes the opportunity of pointing out to Cabinet that, given what has been agreed on grant, allowance has to be made for a likely overspend.

3. After taking account of any comments from the Prime Minister, we propose to circulate the paper to Cabinet on Tuesday morning.

4. In order for the Prime Minister to have a complete picture of the Treasury's tactics I suggest that you also send the proposed form of words and the responses to immediate questions.

5. I am submitting separately proposals for briefing the No 10 Private Office.

AT

A TURNBULL

SECRET

DRAFT PAPER FOR CABINET (No 3)

THIS DOCUMENT IS THE PROPERTY OF HER MAJESTY'S GOVERNMENT

C(87) Copy No
July 1987

1987 PUBLIC EXPENDITURE SURVEY

Memorandum by the Chief Secretary, HM Treasury

— though it will still be higher than it was in 1978-79. Our success in

Introduction

Our policy is to bring public spending down progressively as a proportion of national income. Over the past four years we have succeeded in achieving this. Even excluding privatisation proceeds, general government expenditure (the combined spending of central and local government) has fallen from 47 per cent of GDP in 1982-83 to 44 per cent in 1986-87, and there will be a further fall in 1987-88. This has ~~made it possible~~ enabled us to combine a ~~steady~~ steady but controlled growth of public expenditure in real terms with a reduction in borrowing and, in each of the last five Budgets, a reduction in taxes. This restraint in public spending has made possible the strong performance of the economy which the Chancellor has described in his Memorandum (C(87)). stet

2. In our Election Manifesto we pledged ourselves to continue the policy of ensuring that public spending takes a steadily smaller share of our national income. This is essential if we are both to maintain the momentum of our economic performance and to deliver ~~another of~~ our Manifesto pledges~~, a reduction in~~ to reduce the burden of taxation.

3. For this year's Survey we have ~~established~~ set baseline totals for spending of £154.2 billion in 1988-89, £161.5 billion in 1989-90 and £165.5 billion in 1990-91. For the first two years this was done by retaining the planning totals set out in last year's Public Expenditure White Paper and for the third year we have used an uplift factor of 2½ per cent.

4. Departments were then asked to review their programmes within their baseline figures and to put proposals to me where they

felt, after a review of priorities, that additional resources were required. In my minute of July to the Prime Minister, I summarised the bids received from departments.

Objectives for the Survey

5. I have to make it clear to colleagues that bids on this scale are far beyond what can be afforded. If anything like this were accepted, we could make no further progress in reducing public spending as a proportion of GDP, as set out in the White Paper. This would not only trigger a complete reappraisal of the Government's financial standing in the markets, and ~~stop~~ ~~our~~ provide a severe setback to the economic progress we have made. ~~in its tracks;~~ ~~it would~~ make our objectives for taxation unattainable, it would also

6. With the time lost as a result of the election, it has not been possible to analyse the bids as thoroughly as normal. There are major uncertainties in a number of areas which I will want to probe further, eg the large estimating changes for social security and the projections of our contributions to the European Community.

7. But it is clear that to hold to our policy on public spending we will have to face up to difficult decisions in a number of areas, in particular:

i. for programmes such as defence, health and education which are seeking very large increases, the bids will have to be significantly scaled back and, to the greatest extent possible, policy savings found to offset them;

ii. for social security we must look at policy changes to help offset the enormous estimating changes;

iii. we need to take a hard look at the employment programmes where, with the ~~better prospects for~~ greatly improved trend in unemployment, substantial savings can be found;

iv. we need to re-examine the basis of our regional policies. The buoyancy of the economy and in particular of investment, reflecting the increased strength of the corporate sector, regional

is both increasing the cost of the present system of incentives and reducing the need for them. We should look for savings here partly to release resources for cost effective inner city spending;

v. we must look very carefully at the expenditure of the territories;

vi. we should ~~go as far as we can in transferring~~ seek every & opportunity to transfer to the private sector the responsibility for providing services hitherto provided by the public sector.

Reserves

~~8. In the last Survey we provided for Reserves of £3.5 billion in the first year rising to £7.5 billion in the third year. The experience of recent years shows that we need to keep a larger margin than this, especially in the later years, if we are to cope with the pressures both in-year and in successive Surveys. In particular we need to take account of the fact that the grant agreed in E(LA) may not succeed in holding local authority current spending to the figures agreed for provision. Keeping larger reserves will reduce the scope for making additions to programmes.~~

Departmental running costs

9. Colleagues have sought increases in their departments' running costs implying overall cash increases of 8 per cent for 1988-89 over 1987-88 with further increases in later years. The associated manpower projections reverse the downward trend we have achieved, implying a 15,000 increase over published plans for 1988-89.

Essential to make clear strongly that this is unacceptable

10. In the last few years, the increases in spending on departmental costs agreed for each first Survey year have exceeded our aims. The figures for the later years have not been ~~treated realistically~~ set at realistic levels and as a result have had to be increased substantially in later Surveys. We need to agree a realistic method for planning provision over the Survey period so that departments have a reasonably reliable basis for making medium-term plans to improve efficiency.

Do we want to say this now? It will add to expectations about what the increase in the planning total will eventually need to be.

I agree

11. My proposals, set out more fully in the annex, are that:

i. the running costs share of total public spending should not rise over the Survey period. This implies that running costs would grow on average in line with our plans for public expenditure generally, ie by about 1 per cent a year in real terms;

ii. cost and other pressures will need to be met to a large extent by efficiency gains of at least 1½ per cent a year in the use of all resources including manpower. These will need to be planned well in advance and departments should have contingency plans for larger improvements in case they are necessary;

iii. departments should prepare management plans to deliver these gains over the full Survey period. In any case where the plans are not suitably ambitious, or are unrealistic, I ~~should~~ would hold over agreement on the later Survey years until the next Survey;

iv. for 1988-89, the aim should be to reduce the overall increase in provision sought by at least half.

Nationalised industries

12. In the 1987 Investment and Financing Review, the nationalised industries' own intial and unamended bids, made in May, exceed the baseline by £0.9 billion in the first year and £1.2 billion in the two subsequent years. These bids are clearly unrealistic and cannot be afforded. They now need to be scrutinised rigorously, and a number of industries are revising their proposals so that we will have a sounder basis for judging them. Apart from the electricity industr~~y~~ies in England and Wales and in Scotland, ~~where separate considerations apply,~~ I propose that our aim should be to reduce the provision at least to baseline and, where we can in the case of individual industries, below it. Failure to achieve this would mean greater pressure on departmental programmes. There are particular problems relating to the electricity industry this year, notably the need to set new financial targets, the implications of privatisation and assessment of a new power station programme. Notwithstanding these

uncertainties, the pressure on public expenditure means that it is essential to appraise the industry's bids critically and to set challenging financial targets.

It has been

<u>Local authority relevant public expenditure</u>

13. ~~[We have]~~ agreed in E(LA) ~~[to set]~~ that provision for relevant public expenditure in England should be set at £27,969 million (£27,538 million for relevant current expenditure and £431 million for Rate Fund Contributions to Housing Revenue Accounts). This is an incease of £819 million above the White Paper baseline. Aggregate Exchequer Grant in England is to be set at £13,775 million, an increase of £750 million (5¾ per cent) on the 1987-88 settlement figure including teachers' pay. [Reference to Scotland and Wales to come.] These are substantial additions and we must recognise that they will severely limit what can be made available for other programmes.

<u>Conclusions</u>

14. I ask Cabinet:

i. to reaffirm the Manifesto policy of ensuring that public spending takes a steadily smaller share of our national income as set out in last year's White Paper;

ii. to note that bids will have to be substantially cut back to secure the policy objective at (i);

iii. to agree that we explore a wide range of policy changes including those listed in paragraph 7;

iv. to agree that we should aim to hold the EFLs of the nationalised industries other than electricity at least to baseline and possibly below; and that we should seek to keep the electricity industries' external finance as low as possible;

v. for running costs, to agree the proposals set out in paragraph 11 and in the Annex;

vi. to agree that I should now conduct bilaterals with colleagues on their spending programmes.

TREASURY CHAMBERS

July 1987 **[JM]**

CONFIDENTIAL

I have marked some comments on a version in separate management bundle.

I agree with yr comments & have made some further changes in drafting.

ANNEX

1987 PUBLIC EXPENDITURE SURVEY: DEPARTMENTAL RUNNING COSTS

Departmental Ministers have sought increased provision for running costs totalling £761 million for 1988-89, £956 million for 1989-90 and £1,203 million for 1990-91.

2. If increases on this scale we agreed, overall expenditure on running costs would rise by 8 per cent in cash and 4 per cent in real terms between 1987-88 and 1988-89, with further real increases in the later years. They also imply an increase in Civil Service manpower of nearly 15,000 over the manpower plan of 583,000 for 1 April 1989 published in this year's public expenditure White Paper and further increases in later years, though some 5,000 of this rise stems from increases agreed after the last Survey.

3. In spite of large manpower reductions (135,000 since 1979 and 50,000 since 1983) and, in most years, Civil Service pay settlements at or below general inflation, running costs have continued to rise in real terms as a result of increases in non-manpower costs (eg more buying-in of services rather than providing them internally) and changes in grading mix. Tight pay settlements will continue to be the aim. But if departments are to recruit and retain the staff they need and the Government's objective of making the Civil Service pay structure more conducive to an efficient service and more responsive to labour market conditions is to be met, future pay offers cannot be expected to be immune from pay movements in the economy generally.

4. It is thus realistic to provide for some rise in overall spending on running costs; but the Manifesto pledge to press ahead with management reforms to improve public services and reduce their cost, as well as the aim of ensuring that public expenditure takes a steadily smaller share of national income, mean that the rise must be contained to well below the levels sought.

5. It is proposed as a firm objective that the running costs, share in total public spending should not rise over the Survey period. This implies that running costs would grow approximately on average in line with public expenditure generally, ie by about 1 per cent a year in real terms. It means that if increases in the volume of activity are to be met in some parts of the Civil Service, reductions or lower rates of growth will be necessary in others where demand is less or of lower priority.

6. To achieve this general objective, the bids will need to be substantially scaled down eg to less than half the additions to baseline that have been sought for 1988-89; and all departments will need firm plans to offset pay bill and other cost pressures through sustained and incremental efficiency gains. The improved budgetary and management systems stemming from the financial management drive of recent years, the Government's large and continuing investment in new technology, and further improvements in purchasing as as well as the continuing processes of scrutiny and inspection must be used to deliver further improvement in performance, benefiting both input costs and outputs. On the input side, further improvements in the use of manpower and better control of non-manpower costs will be essential.

7. These efficiency gains will be easier to make on the necessary scale if they are planned for well in advance; and if the plans are ambitious there will be greater scope for flexibility in future years. It is proposed that all departments should now prepare or revise management plans committing them, over the Survey period, to the delivery of defined and wherever possible measured improvements in outputs, and progressive overall efficiency gains of at least 1½ per cent a year, with contingency plans for larger improvements in case they are necessary. This is a fair minimum target for well managed service organisations. These plans will be especially important for departments with large executive operations.

8. Departments' plans, and their implications for restraining growth in running costs would be discussed in the bilaterals. Agreement to increases over baseline, particularly for the last two years of the Survey, would be withheld until it was clear

that ambitious but realistic plans for efficiency gains over the medium-term had been made. In some cases this might mean that the final levels of provision for 1989-90 and 1990-91 would have to be held over until the next Survey.

Civil Service manpower

9. Earlier this year it was announced that manpower targets would not be set after 1 April 1988, and pressure on Civil Service numbers would be maintained through running costs. The proposed approach to running costs will mean large reductions in the manpower projections of some departments. It is important to show that the running costs regime is an effective control on all Civil Service resources, including manpower. There will otherwise be pressure to reintroduce manpower targets.

Conclusions

10. The Cabinet is invited to agree that:

i. the aim should be to restrain running costs over the Survey period to their present share in total public spending by offsetting so far as possible any real rises in pay and other costs through efficiency gains;

ii. departments should prepare or revise three-year management plans for sustained output and cost improvement, for discussion in the bilaterals;

iii. for 1988-89 the aim should be a reduction by at least half of the £761 million additional provision sought in order to keep the overall increase in running costs in line with the medium-term objective in (i) above.