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PART B

CHANCELLOR'S PAPERS ON
PUBLIC EXPENDITURE
PROGRAMMES AND THE
PUBLIC SECTOR BORROWING
REQUIREMENT (PSBR)

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PART B

Begin: 15/5/87
Ends: 18/1/88 (CONTINUED)

DD: 25 years

20/9/95

CONFIDENTIAL AND PERSONAL

FROM: COLIN MOWL
DATE: 15 May 1987

→ CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Sedgwick
Mr Ritchie
Dr Clark

MONTHLY NOTE ON THE PSBR

I attach the draft monthly note.

2. Comments on the draft note on Monday would be appreciated. The note is due to be given wider circulation on Monday evening.

Colin Mowl

COLIN MOWL

PUBLIC SECTOR BORROWING

Summary

- The PSBR for April is provisionally estimated at £1.8 billion. This is about £0.6 billion lower than last month's Budget forecast (Chart 1). Borrowing on central government own account was close to forecast. Local authorities and public corporations each borrowed £0.3 billion less than forecast.
- The April PSBR is £1.1 billion higher than in April 1986 (Chart 2), largely because of lower privatisation proceeds.
- The PSBR is forecast to be about £¼ billion over the next three months, close to the Budget profile.
- The PSBR for 1986-87 remains at £3.3 billion, ¾ to 1 per cent of money GDP.

Figures in this report are not seasonally adjusted and also may not sum precisely because of rounding.

Chart 1 : 1987-88: Comparisons with 1987 Budget profiles

£ billion cumulative

- = Estimated outturn in 1987-88
- - - = Latest forecasts
- = Budget profile

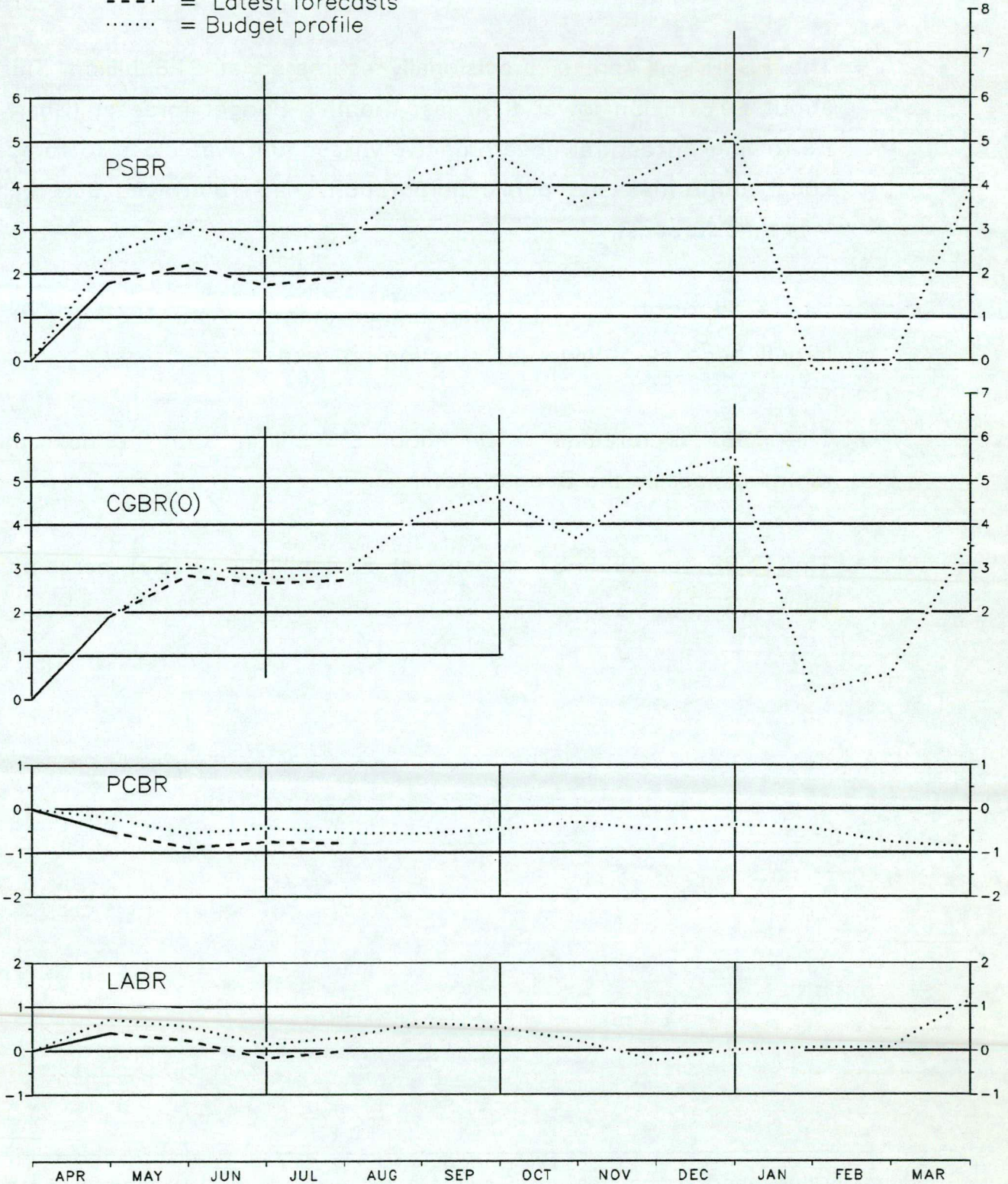


Chart 2: 1987-88: Comparisons with outturns for 1986-87

£ billion cumulative

- = Estimated outturn in 1987-88
- - - = Latest forecasts
- = 1986-87 outturn

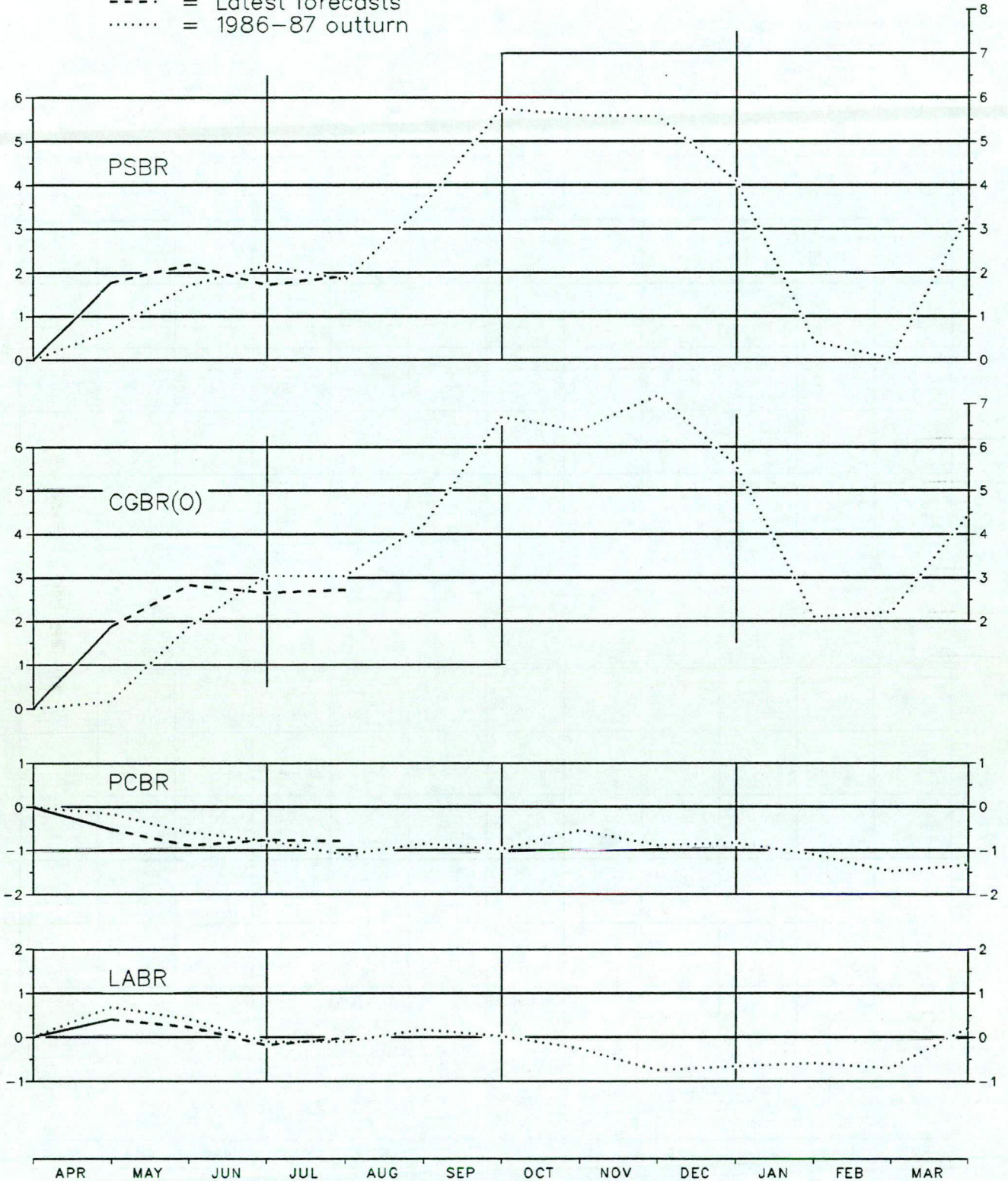
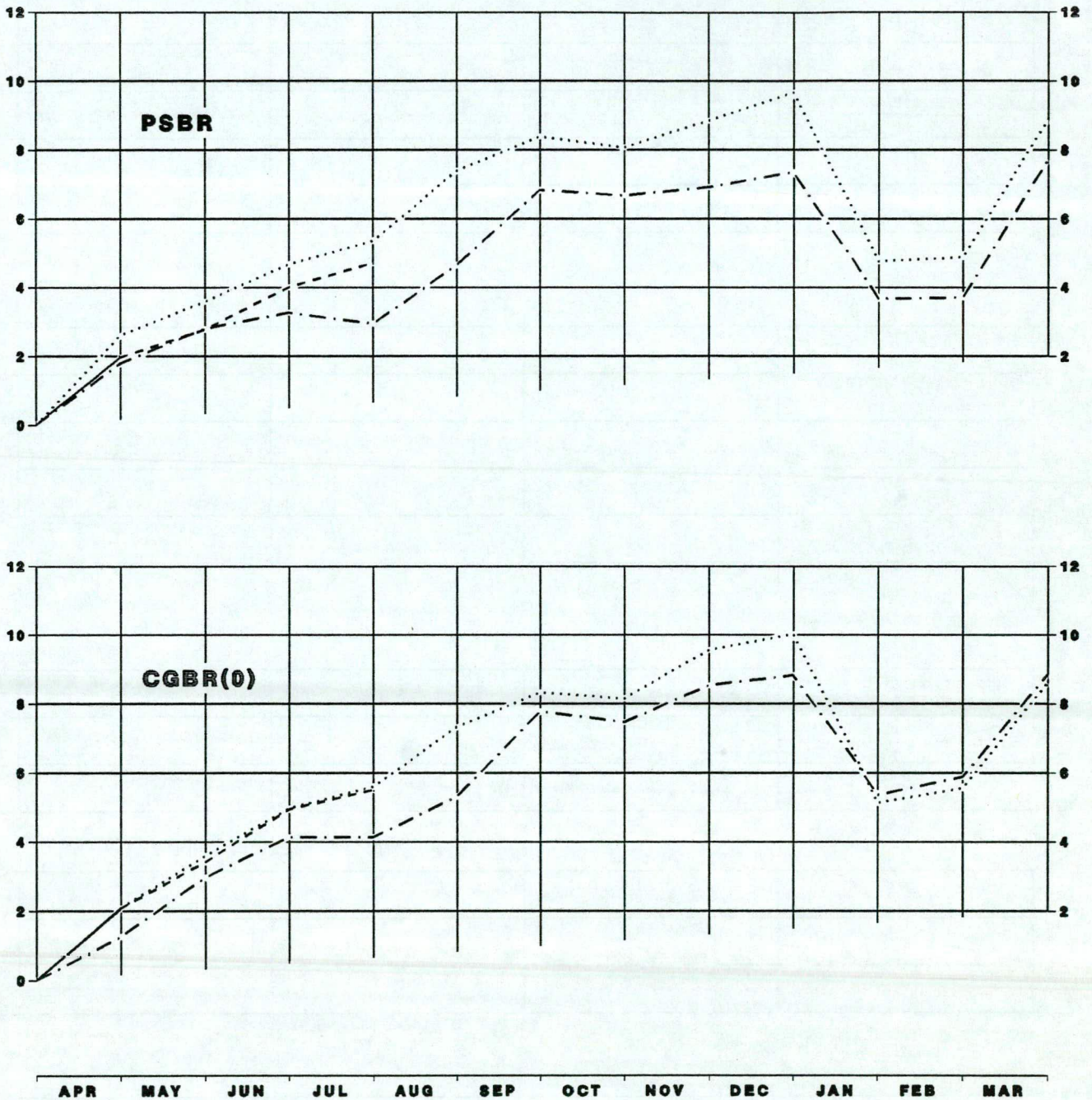


Chart 3: Comparisons excluding privatisation proceeds

£ billion cumulative

- = Estimated outturn in 1987-88
- - - = Latest forecasts
- · - = 1986-87 outturn
- = 1987-88 Budget profiles



Borrowing in April

(Outturn compared with last month's Budget forecast)

1. The provisional estimate of the PSBR in April is £1.8 billion, compared with last month's forecast of £2.4 billion. The differences between forecast and outturn on the individual sub-sectors are shown in the table below.

Table 1: April 1987 borrowing requirements

£ billion

	PSBR	Comprising		
		CGBR(O)	LABR	PCBR
Forecast*	2.4	1.9	0.7	-0.2
Outturn	1.8	1.9	0.4	-0.5
Difference	-0.6	-	-0.3	-0.3

*made on 15 April

2. Borrowing on central government's own account was as forecast last month. The main differences on components were higher Inland Revenue receipts (by £0.2 billion, mainly Corporation Tax), lower National Insurance contributions (by £0.2 billion) and higher Supply expenditure (by £0.1 billion). The monthly profile for National Insurance contributions over April-June has been erratic in recent years, so it is not possible at this stage to assess the effect of the April shortfall.

3. Local authorities provisionally showed net borrowing of £0.4 billion in April, a month with low rate receipts and seasonally high borrowing. The April outturn was £0.3 billion lower than last month's forecast and £0.3 billion below April 1986.

4. Public corporations made a net repayment of debt of £0.5 billion in April, compared with a forecast repayment of £0.2 billion. Currently available information from individual industries, which is not always consistent with the aggregate PCBR figure, indicates that

Electricity, British Steel and British Rail each borrowed around £0.1 billion less than forecast. Borrowing in the last three months has been much lower than in the corresponding months of 1986.

April to July

5. The PSBR for the period May–July is forecast to be about £¼ billion, close to the Budget forecast. This brings the total for the first four months of 1987–88 to £2 billion, about £¾ billion below the Budget profile (Chart 1 and Table 2).

6. Table 4 shows the latest detailed profile of borrowing on central government own account for April to July; a comparison with the Budget forecast for those months and with the outturn in April–July 1986 is shown in Table 5.

7. The CGBR(O) is forecast to be about £¼ billion below the Budget profile over the next three months, due mainly to higher Corporation Tax receipts (by £0.1 billion), higher privatisation proceeds (by £0.1 billion, from the sale of Rolls Royce), and higher receipts of Vehicle Excise Duty (by £0.1 billion, as a result of later information from the Post Office).

8. The monthly path of the CGBR(O) is as follows:

- In May, the CGBR(O) is forecast to be £1 billion. High debt interest payments and relatively low Inland Revenue receipts are partly offset by proceeds from the Rolls Royce sale.
- In June, the CGBR(O) is forecast to be in surplus by about £¼ billion, benefitting from the £1¾ billion proceeds from the second call on British Gas.
- In July, the CGBR(O) is forecast to be close to zero. Receipts of Advanced Corporation Tax will exceed £1 billion, but net debt interest payments are very high. The forecast assumes (as in the Budget profile) that the sale of British Airports Authority will raise £½ billion in the month.

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9. Local authorities are assumed to show net borrowing close to the Budget profile over the next three months, and hence the cumulative total is assumed to remain about £¼ billion below it.

10. The PCBR in the next three months is forecast to be about £0.1 billion more than in the Budget profile, on account of higher forecast borrowing in July by British Coal. Public corporations are assumed to make a further net repayment in May - Electricity is assumed to continue repayments, and seasonal repayments by the Post Office and Water Authorities are expected. Small positive borrowing in total is forecast for June and broad balance for July.

1986-87

11. The estimate for the PSBR outturn for 1986-87 remains at £3.3 billion, ¾-1 per cent of GDP. The estimate of the CGBR(O) has been revised downwards by nearly £0.2 billion following an increase in the estimate of on-lending, while the LABR and PCBR have risen correspondingly.





1987-88

12. As foreshadowed in last month's note, the PCBR (and hence the PSBR) monthly profile for 1987-88 has been revised slightly following receipt of information from individual industries. The final Budget profiles are shown in Table 6.

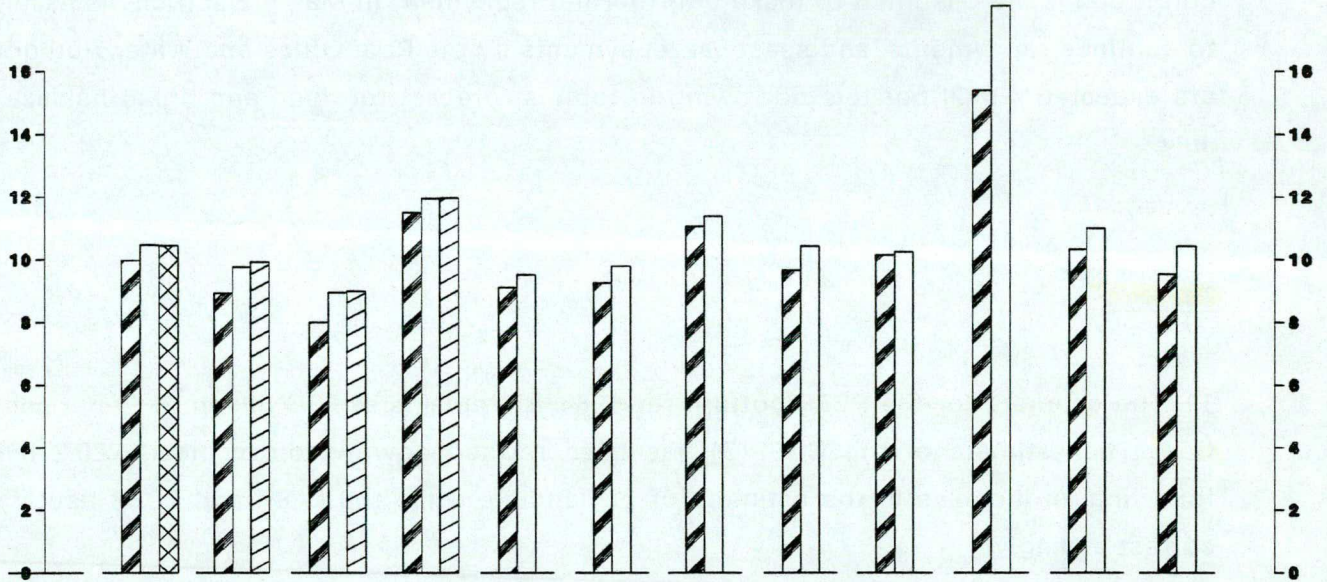
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Chart 4: Components of central government receipts and expenditure

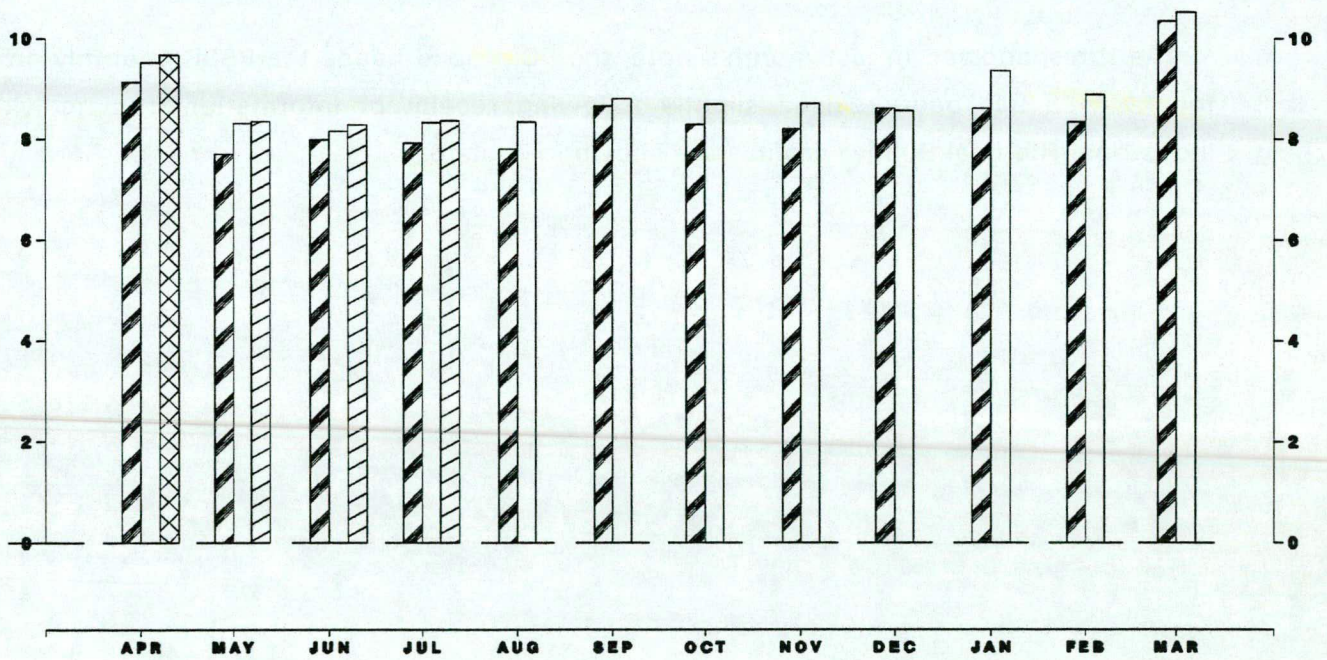
£ billion

-  = 1987-88: Outturns
-  = 1987-88: Latest profiles
-  = 1987-88 Budget forecasts
-  = Outturn in 1986-87

(I) NON OIL TAX AND NATIONAL INSURANCE RECEIPTS



(II) SUPPLY EXPENDITURE



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Table 2: Borrowing requirement monthly profiles May-July
(Budget profiles in italics for comparison)

£ billion

	PSBR		Comprising					
			CGBR(O)		LABR		PCBR	
1987-88								
Apr	1.8	<i>2.4</i>	1.9	<i>1.9</i>	0.4	<i>0.7</i>	-0.5	<i>-0.2</i>
May	0.4	<i>0.7</i>	0.9	<i>1.2</i>	-0.2	<i>-0.2</i>	-0.4	<i>-0.4</i>
Jun	-0.5	<i>-0.6</i>	-0.2	<i>-0.3</i>	-0.4	<i>-0.4</i>	0.1	<i>0.1</i>
Jul	0.2	<i>0.2</i>	0.1	<i>0.1</i>	0.2	<i>0.2</i>	-	<i>-0.1</i>
Cumulative								
Apr	1.8	<i>2.4</i>	1.9	<i>1.9</i>	0.4	<i>0.7</i>	-0.5	<i>-0.2</i>
May	2.2	<i>3.1</i>	2.8	<i>3.1</i>	0.2	<i>0.6</i>	-0.9	<i>-0.6</i>
Jun	1.7	<i>2.5</i>	2.7	<i>2.8</i>	-0.2	<i>0.1</i>	-0.8	<i>-0.4</i>
Jul	1.9	<i>2.7</i>	2.7	<i>2.9</i>	-	<i>0.3</i>	-0.8	<i>-0.6</i>

Figures for April are outturns

Table 3: PSBR for 1987-88 - comparisons with 1986-87 and 1987 Budget profile

£ billion

	1986-87		1987-88		Differences from	
	Outturn		Budget profile	Latest update ⁽¹⁾	1986-87 outturn	Budget profile
	1		2	3	3-1	3-2
Apr	0.7		2.4	1.8	1.1	-0.6
May	1.0		0.7	0.4	-0.6	-0.3
Jun	0.5		-0.6	-0.5	-0.9	0.2
Q2	2.2		2.5	1.7	-0.5	-0.8
Jul	-0.3		0.2	0.2	0.5	-
Aug	1.7		1.6			
Sep	2.2		0.4			
Q3	3.6		2.2			
Oct	-0.2		-1.1			
Nov	-		0.8			
Dec	-1.5		0.8			
Q4	-1.7		0.5			
Jan	-3.7		-5.4			
Feb	-0.4		0.1			
Mar	3.3		4.0			
Q1	-0.8		-1.3			
Cumulative						
Apr	0.7		2.4	1.8	1.1	-0.6
May	1.7		3.1	2.2	0.5	-0.9
Jun	2.2		2.5	1.7	-0.5	-0.8
Jul	1.9		2.7	1.9	0.1	-0.7
Aug	3.6		4.3			
Sep	5.7		4.7			
Oct	5.6		3.6			
Nov	5.6		4.4			
Dec	4.1		5.2			
Jan	0.4		-0.2			
Feb	-		-0.1			
Mar	3.3		3.9			

⁽¹⁾Figures for April are outturns

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**Table 4: Central government transactions – April
outturn and latest forecasts for May–July**

£ billion

	April		Latest forecasts		
	forecast	outturn ⁽¹⁾	May	Jun	Jul
Receipts					
<i>Consolidated Fund</i>					
Inland Revenue	4.6	4.8	3.9	3.8	6.2
Customs and Excise	3.7	3.7	3.6	2.9	3.3
Other ⁽²⁾	0.7	0.2	1.5	2.3	1.0
<i>National Loans Fund</i>					
Interest etc. receipts	0.6	0.3	0.4	0.6	0.4
Total Receipts	9.5	8.9	9.3	9.6	10.8
Expenditure					
<i>Consolidated Fund</i>					
Supply expenditure ⁽³⁾	9.5	9.7	8.3	8.3	8.4
Adjustment to Supply Services basis ⁽⁴⁾	–	0.2	0.2	–0.1	0.1
Other	0.5	0.5	0.5	0.5	0.5
<i>National Loans Fund</i>					
Service of the national debt	1.1	1.1	1.6	0.6	2.0
Net lending	0.3	1.0	0.3	0.2	0.3
Total Expenditure	11.4	12.5	11.0	9.5	11.2
Other funds and accounts (+ increases borrowing) (– reduces borrowing)	0.3	–1.1	–0.3	0.2	–
CGBR	2.2	2.5	1.4	–	0.4
On-lending	0.3	0.6	0.4	0.2	0.3
CGBR(O)	1.9	1.9	0.9	–0.2	0.1

⁽¹⁾Due to time lags in some items reaching their final accounting destination, figures of forecast and outturn may not be strictly comparable for the components identified, but there is no effect on the overall CGBR.

⁽²⁾Includes privatisation proceeds, except where these are temporarily lodged in "other funds and accounts."

⁽³⁾On a cheques issued basis. Supply includes an element of on-lending in the form of public dividend capital etc. It also includes advance payments to the EEC.

⁽⁴⁾Reflects changes in balances of departmental accounts with the Paymaster General, timing and other differences between cheques issued by departments and payments to them from the Consolidated Fund. An offset to this item is included in "Other funds and accounts".

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Table 5: Central government transactions⁽¹⁾ – comparisons for April–July

£ billion

	1986	1987	
	Outturn	Budget forecast	Latest update
Receipts			
<i>Consolidated Fund</i>			
Inland Revenue	18.0	18.3	18.5
Customs and Excise	12.7	13.5	13.5
Other ⁽²⁾	1.9	5.0	4.9
<i>National Loans Fund</i>			
Interest etc. receipts	2.0	2.0	1.7
Total Receipts	34.6	38.7	38.7
Expenditure			
<i>Consolidated Fund</i>			
Supply expenditure ⁽³⁾	32.7	34.3	34.6
Adjustment to Supply Services basis ⁽⁴⁾	0.9	0.2	0.4
Other	1.3	1.9	2.0
<i>National Loans Fund</i>			
Service of the national debt	5.2	5.2	5.3
Net lending	3.4	0.4	1.8
Total Expenditure	43.5	42.1	44.1
Other funds and accounts (+ increases borrowing) (- reduces borrowing)	-2.2	0.2	-1.2
CGBR	6.7	3.5	4.2
On-lending	3.6	0.6	1.5
CGBR(O)	3.0	2.9	2.7

⁽¹⁾Due to differences in treatment of some items in the accounts between the periods/forecasts shown, and time lags in some items reaching their final accounting destination, figures for the components identified may not be strictly comparable.

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Table 6: Borrowing requirement Budget profiles 1987-88
(1986-87 outturns in italics for comparison)

£ billion

	PSBR		Comprising					
			CGBR(O)		LABR		PCBR	
1987-88								
Apr	2.4	<i>0.7</i>	1.9	<i>0.2</i>	0.7	<i>0.7</i>	-0.2	<i>-0.2</i>
May	0.7	<i>1.0</i>	1.2	<i>1.7</i>	-0.2	<i>-0.3</i>	-0.4	<i>-0.4</i>
Jun	-0.6	<i>0.5</i>	-0.3	<i>1.2</i>	-0.4	<i>-0.5</i>	0.1	<i>-0.2</i>
Jul	0.2	<i>-0.3</i>	0.1	<i>-</i>	0.2	<i>-</i>	-0.1	<i>-0.3</i>
Aug	1.6	<i>1.7</i>	1.3	<i>1.2</i>	0.3	<i>0.3</i>	-	<i>0.3</i>
Sep	0.4	<i>2.2</i>	0.4	<i>2.5</i>	-0.1	<i>-0.1</i>	0.1	<i>-0.1</i>
Oct	-1.1	<i>-0.2</i>	-1.0	<i>-0.3</i>	-0.3	<i>-0.3</i>	0.2	<i>0.4</i>
Nov	0.8	<i>-</i>	1.4	<i>0.8</i>	-0.5	<i>-0.5</i>	-0.2	<i>-0.3</i>
Dec	0.8	<i>-1.5</i>	0.5	<i>-1.6</i>	0.2	<i>0.1</i>	0.1	<i>0.1</i>
Jan	-5.4	<i>-3.7</i>	-5.4	<i>-3.5</i>	0.1	<i>0.1</i>	-0.1	<i>-0.3</i>
Feb	0.1	<i>-0.4</i>	0.4	<i>0.1</i>	-	<i>-0.1</i>	-0.3	<i>-0.4</i>
Mar	4.0	<i>3.3</i>	3.0	<i>2.2</i>	1.1	<i>0.9</i>	-0.1	<i>0.1</i>
Cumulative								
Apr	2.4	<i>0.7</i>	1.9	<i>0.2</i>	0.7	<i>0.7</i>	-0.2	<i>-0.2</i>
May	3.1	<i>1.7</i>	3.1	<i>1.9</i>	0.6	<i>0.4</i>	-0.6	<i>-0.6</i>
Jun	2.5	<i>2.2</i>	2.8	<i>3.0</i>	0.1	<i>-0.1</i>	-0.4	<i>-0.8</i>
Jul	2.7	<i>1.9</i>	2.9	<i>3.0</i>	0.3	<i>-0.1</i>	-0.6	<i>-1.1</i>
Aug	4.3	<i>3.6</i>	4.2	<i>4.2</i>	0.6	<i>0.2</i>	-0.6	<i>-0.8</i>
Sep	4.7	<i>5.7</i>	4.6	<i>6.7</i>	0.5	<i>-</i>	-0.5	<i>-1.0</i>
Oct	3.6	<i>5.6</i>	3.7	<i>6.4</i>	0.2	<i>-0.3</i>	-0.3	<i>-0.5</i>
Nov	4.4	<i>5.6</i>	5.1	<i>7.2</i>	-0.2	<i>-0.7</i>	-0.5	<i>-0.9</i>
Dec	5.2	<i>4.1</i>	5.5	<i>5.6</i>	-	<i>-0.7</i>	-0.4	<i>-0.8</i>
Jan	-0.2	<i>0.4</i>	0.2	<i>2.1</i>	0.1	<i>-0.6</i>	-0.4	<i>-1.1</i>
Feb	-0.1	<i>-</i>	0.6	<i>2.2</i>	0.1	<i>-0.7</i>	-0.8	<i>-1.5</i>
Mar	3.9	<i>3.3</i>	3.6	<i>4.5</i>	1.2	<i>0.2</i>	-0.9	<i>-1.3</i>

pmw

From: COLIN MOWL
18 May 1987

[Handwritten mark]
1. MR CASSELL

→ 2. CHANCELLOR

Copy with PPS letter, attached, for:

Mr Norgrove - No. 10

cc List A

List B (distributed at 11.30am, 19 May)

Economic Secretary
Sir P Middleton
Sir T Burns
Mr Sedgwick
Mr Peretz
Mr Watts
Mr Devereux
Mr Ritchie
Mr Clark

Chief Secretary
Financial Secretary
Minister of State
Mr F E R Butler
Mr Moore
Mr Odling-Smee
Mr Scholar
Mr Turnbull
Mrs Brown
Mr Bottrill
Mrs Butler
Mr Culpin

Mr Grice
Miss O'Mara
Mr C W Kelly
Mr Pratt
Mr Briscoe
Mr M Richardson
Mr Cropper
Mr Ross Goobey
Mr Tyrie
Mr Calder - IR
Mr Wilmott - C and E

MONTHLY NOTE ON THE PSBR

I attach a report on the PSBR outturn for April, together with forecasts for the period May-July. The April outturn will be published by press notice at 11.30am on Tuesday 19 May.

The note also presents final monthly Budget profiles for the PSBR and its components for 1987-88, consistent with the FSBR forecast for the year as a whole.

Colin Mowl

COLIN MOWL

PUBLIC SECTOR BORROWING

Summary

- The PSBR for April is provisionally estimated at £1.8 billion. This is about £0.6 billion lower than last month's Budget forecast (Chart 1). Borrowing on central government own account was close to forecast. Local authorities and public corporations each borrowed £0.3 billion less than forecast.
- The April PSBR is £1.1 billion higher than in April 1986 (Chart 2), largely because of lower privatisation proceeds.
- The PSBR is forecast to be about £¼ billion over the next three months, close to the Budget profile.
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Figures in this report are not seasonally adjusted and also may not sum precisely because of rounding.

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£ billion cumulative

- = Estimated outturn in 1987-88
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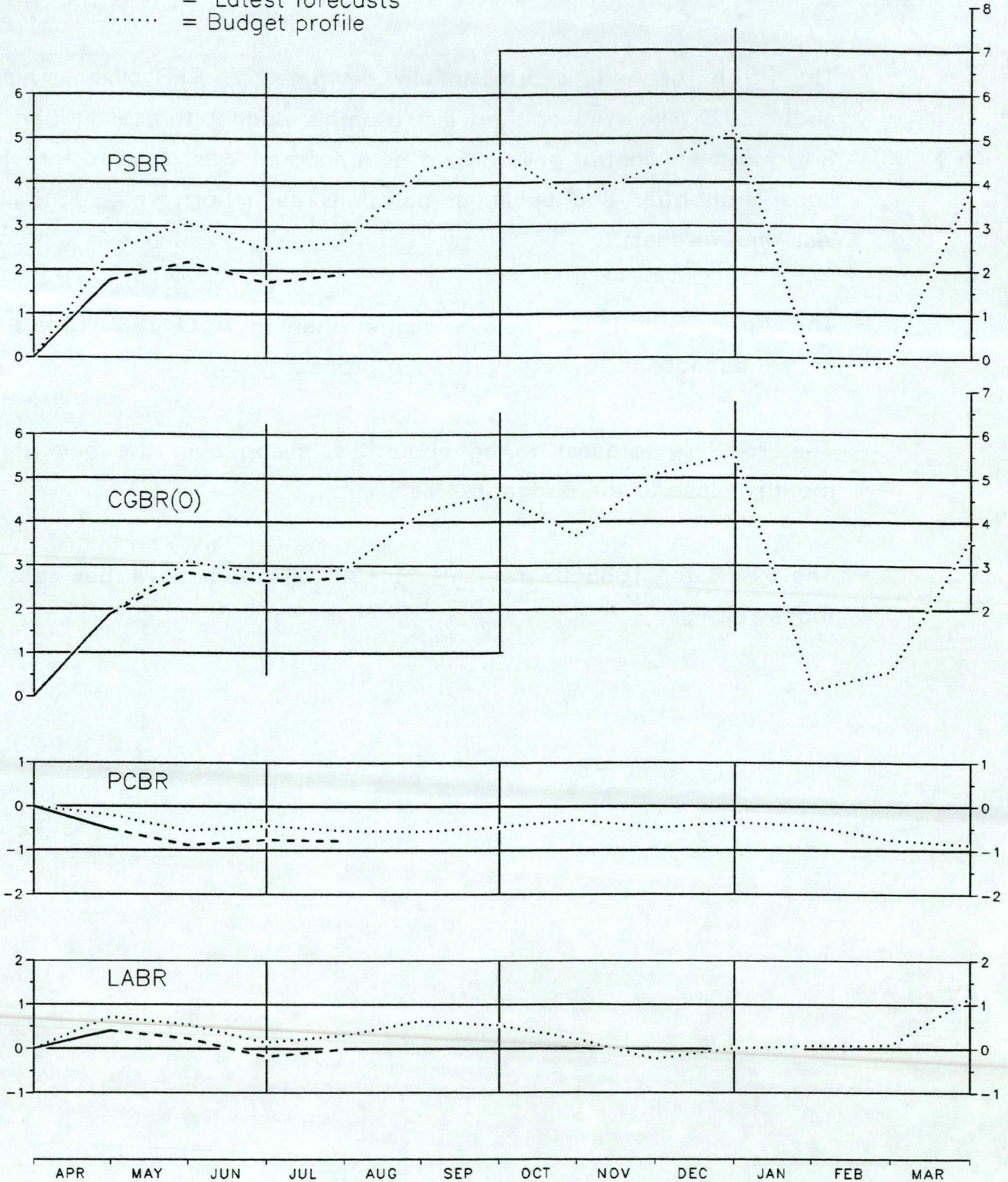


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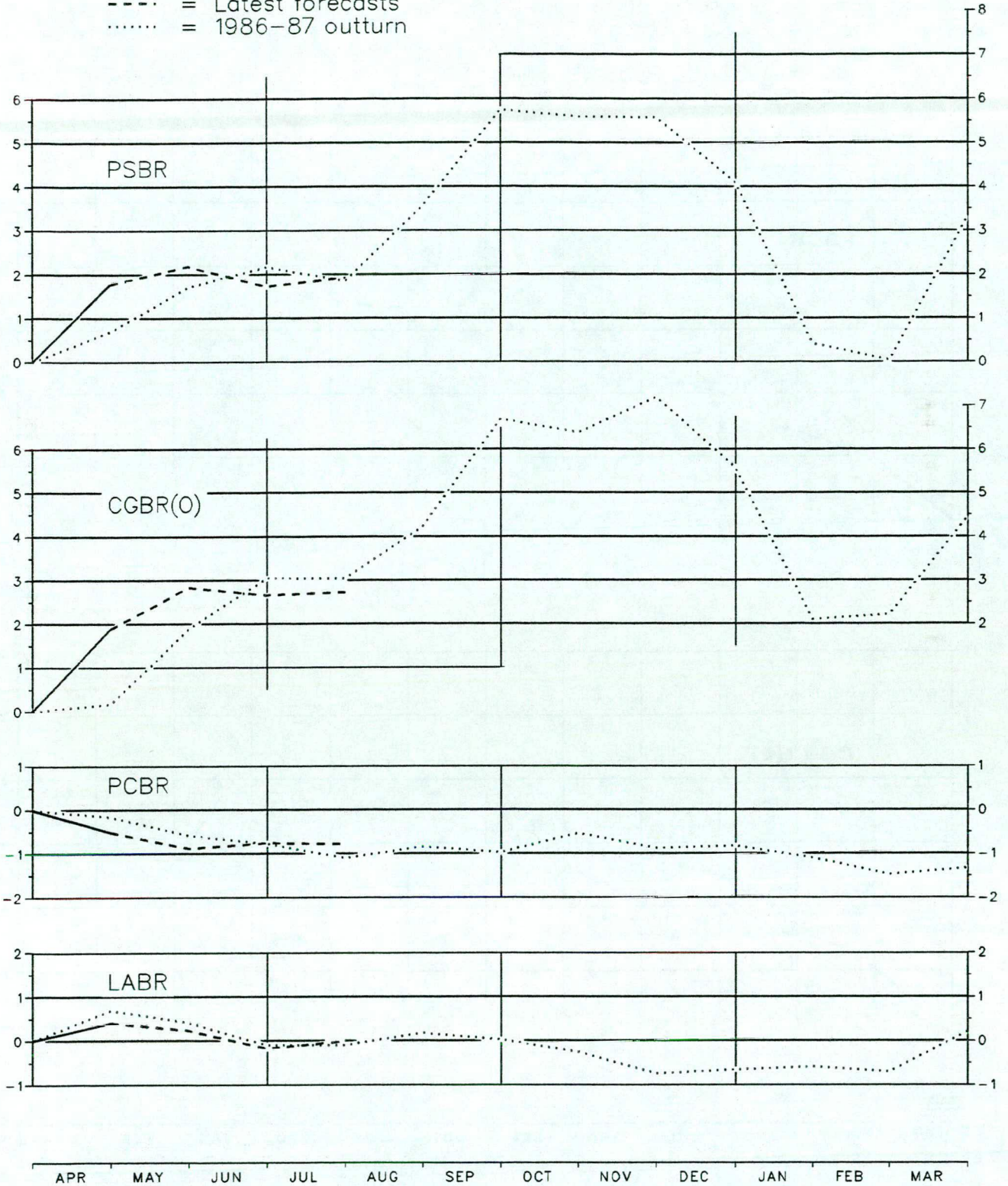
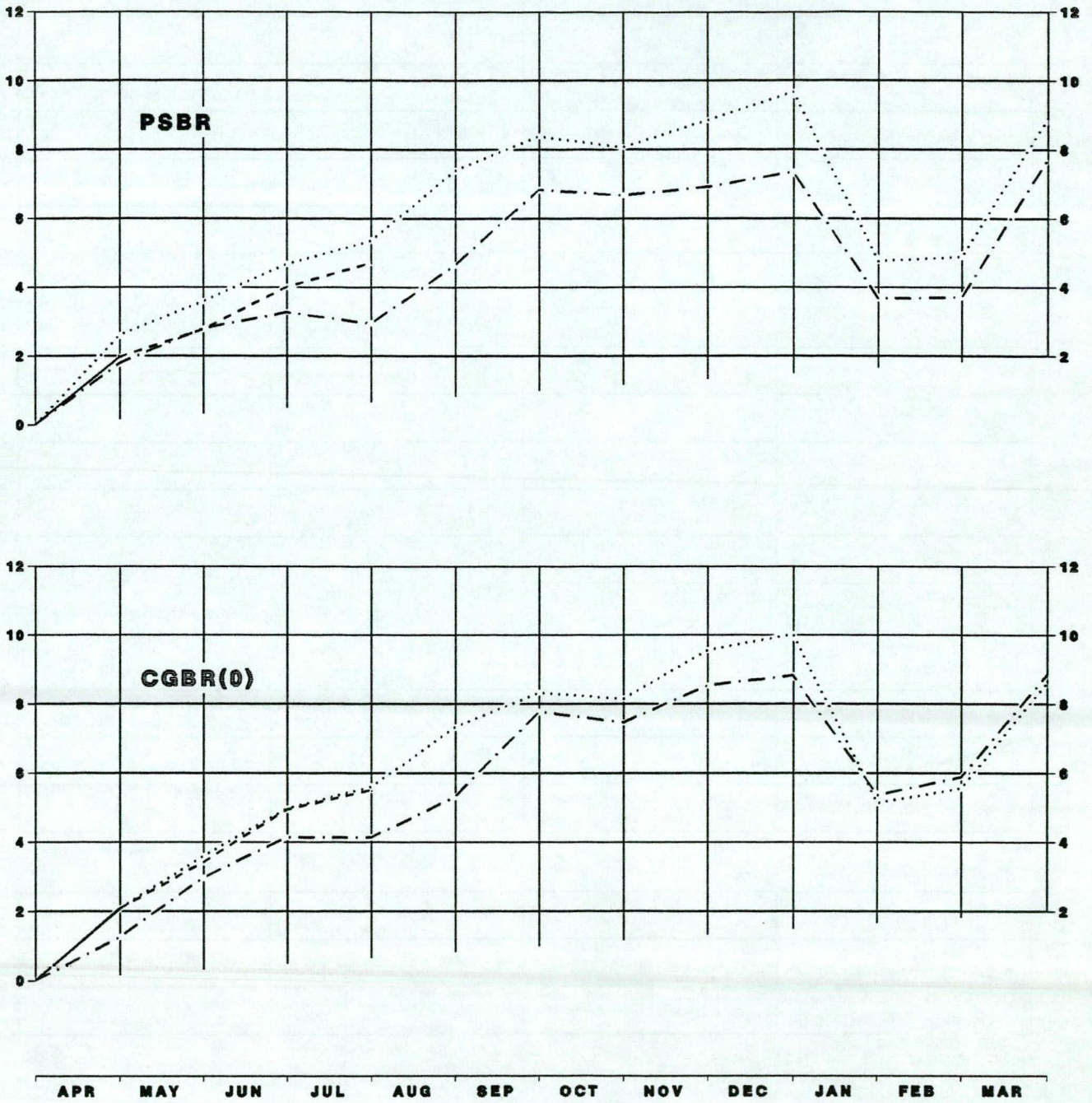


Chart 3: Comparisons excluding privatisation proceeds

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- · - = 1986-87 outturn
- = 1987-88 Budget profiles



Borrowing in April

(Outturn compared with last month's Budget forecast)

1. The provisional estimate of the PSBR in April is £1.8 billion, compared with last month's forecast of £2.4 billion. The differences between forecast and outturn on the individual sub-sectors are shown in the table below.

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£ billion

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Electricity, British Steel and British Rail each borrowed around £0.1 billion less than forecast. Borrowing in the last three months has been much lower than in the corresponding months of 1986.

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- In May, the CGBR(O) is forecast to be £1 billion. High debt interest payments and relatively low Inland Revenue receipts are partly offset by proceeds from the Rolls Royce sale.
- In June, the CGBR(O) is forecast to be in surplus by about £¼ billion, benefitting from the £1¾ billion proceeds from the second call on British Gas.
- In July, the CGBR(O) is forecast to be close to zero. Receipts of Advanced Corporation Tax will exceed £1 billion, but net debt interest payments are very high. The forecast assumes (as in the Budget profile) that the sale of British Airports Authority will raise £½ billion in the month.

9. Local authorities are assumed to show net borrowing close to the Budget profile over the next three months, and hence the cumulative total is assumed to remain about £¼ billion below it.

10. The PCBR in the next three months is forecast to be about £0.1 billion more than in the Budget profile, on account of higher forecast borrowing in July by British Coal. Public corporations are assumed to make a further net repayment in May - Electricity is assumed to continue repayments, and seasonal repayments by the Post Office and Water Authorities are expected. Small positive borrowing in total is forecast for June and broad balance for July.

1986-87





11. The estimate for the PSBR outturn for 1986-87 remains at £3.3 billion, ¾-1 per cent of GDP. The estimate of the CGBR(O) has been revised downwards by nearly £0.2 billion following an increase in the estimate of on-lending, while the LABR and PCBR have risen correspondingly.

1987-88

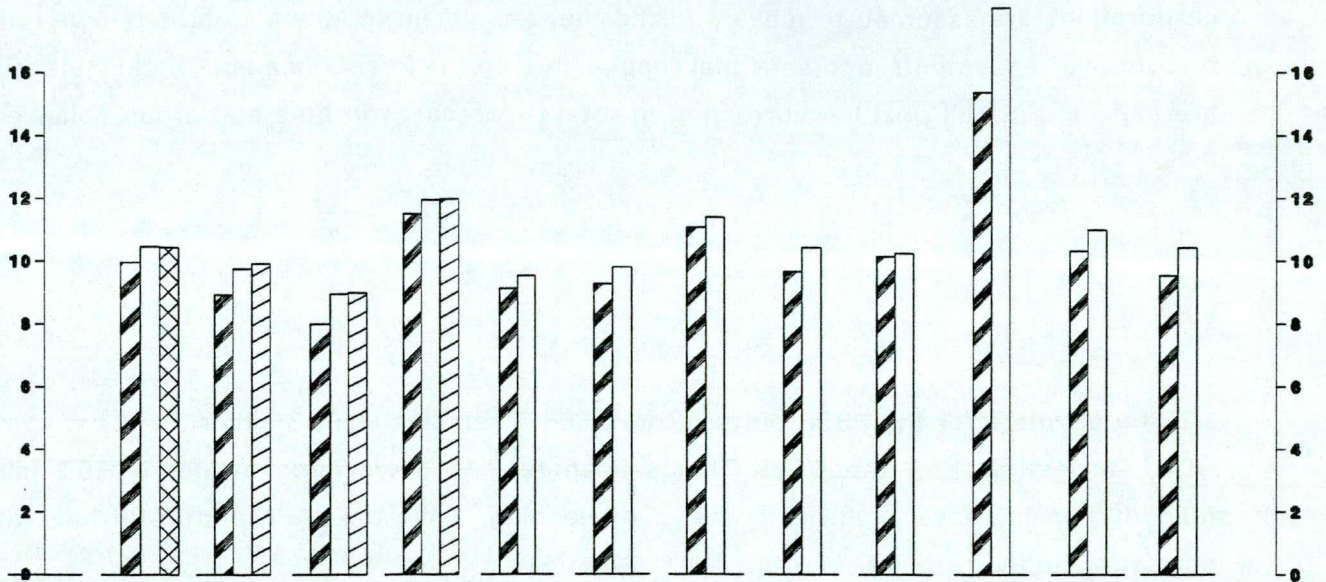
12. As foreshadowed in last month's note, the PCBR (and hence the PSBR) monthly profile for 1987-88 has been revised slightly following receipt of information from individual industries. The final Budget profiles are shown in Table 6.

Chart 4: Components of central government receipts and expenditure

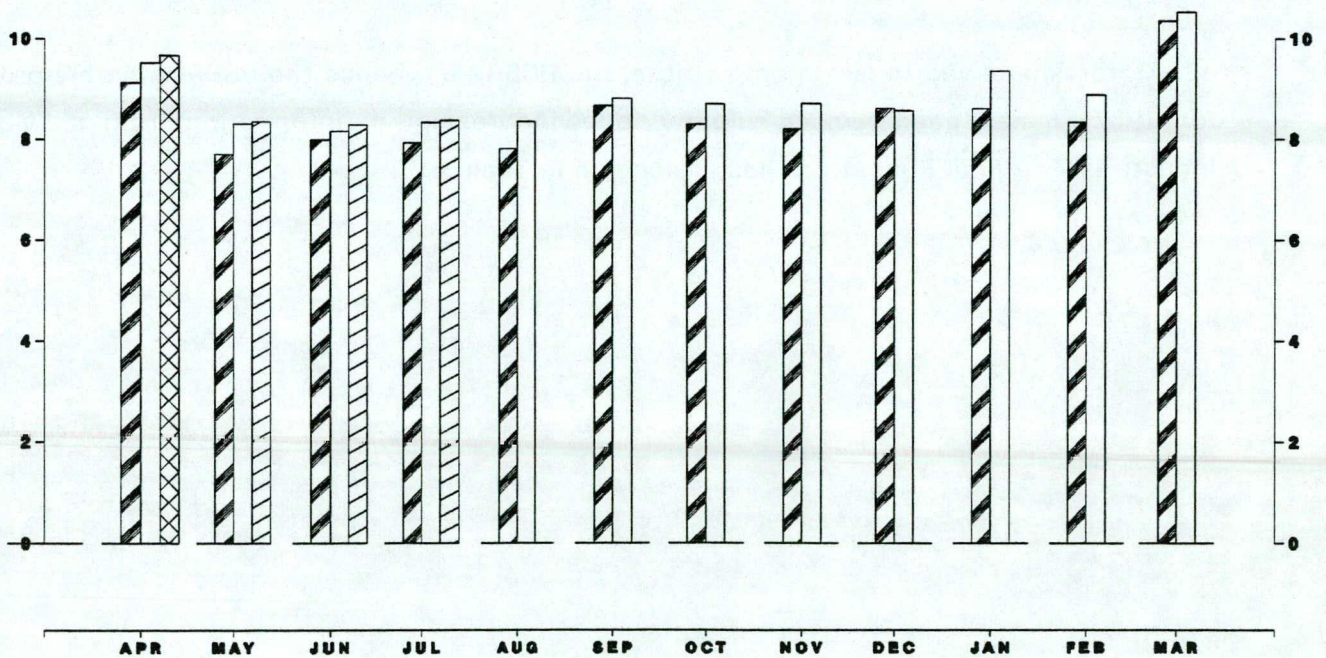
£ billion

-  = 1987-88: Outturns
-  = 1987-88: Latest profiles
-  = 1987-88 Budget forecasts
-  = Outturn in 1986-87

(I) NON OIL TAX AND NATIONAL INSURANCE RECEIPTS



(II) SUPPLY EXPENDITURE



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Table 2: Borrowing requirement monthly profiles May-July
(Budget profiles in italics for comparison)

£ billion

	PSBR		Comprising					
			CGBR(O)		LABR		PCBR	
1987-88								
Apr	1.8	<i>2.4</i>	1.9	<i>1.9</i>	0.4	<i>0.7</i>	-0.5	<i>-0.2</i>
May	0.4	<i>0.7</i>	0.9	<i>1.2</i>	-0.2	<i>-0.2</i>	-0.4	<i>-0.4</i>
Jun	-0.5	<i>-0.6</i>	-0.2	<i>-0.3</i>	-0.4	<i>-0.4</i>	0.1	<i>0.1</i>
Jul	0.2	<i>0.2</i>	0.1	<i>0.1</i>	0.2	<i>0.2</i>	-	<i>-0.1</i>
Cumulative								
Apr	1.8	<i>2.4</i>	1.9	<i>1.9</i>	0.4	<i>0.7</i>	-0.5	<i>-0.2</i>
May	2.2	<i>3.1</i>	2.8	<i>3.1</i>	0.2	<i>0.6</i>	-0.9	<i>-0.6</i>
Jun	1.7	<i>2.5</i>	2.7	<i>2.8</i>	-0.2	<i>0.1</i>	-0.8	<i>-0.4</i>
Jul	1.9	<i>2.7</i>	2.7	<i>2.9</i>	-	<i>0.3</i>	-0.8	<i>-0.6</i>

Figures for April are outturns

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Table 3: PSBR for 1987-88 - comparisons with 1986-87 and 1987 Budget profile

£ billion

	1986-87	1987-88	Differences from		
	Outturn	Budget profile	Latest update ⁽¹⁾	1986-87 outturn	Budget profile
	1	2	3	3-1	3-2
Apr	0.7	2.4	1.8	1.1	-0.6
May	1.0	0.7	0.4	-0.6	-0.3
Jun	0.5	-0.6	-0.5	-0.9	0.2
Q2	2.2	2.5	1.7	-0.5	-0.8
Jul	-0.3	0.2	0.2	0.5	-
Aug	1.7	1.6			
Sep	2.2	0.4			
Q3	3.6	2.2			
Oct	-0.2	-1.1			
Nov	-	0.8			
Dec	-1.5	0.8			
Q4	-1.7	0.5			
Jan	-3.7	-5.4			
Feb	-0.4	0.1			
Mar	3.3	4.0			
Q1	-0.8	-1.3			
Cumulative					
Apr	0.7	2.4	1.8	1.1	-0.6
May	1.7	3.1	2.2	0.5	-0.9
Jun	2.2	2.5	1.7	-0.5	-0.8
Jul	1.9	2.7	1.9	0.1	-0.7
Aug	3.6	4.3			
Sep	5.7	4.7			
Oct	5.6	3.6			
Nov	5.6	4.4			
Dec	4.1	5.2			
Jan	0.4	-0.2			
Feb	-	-0.1			
Mar	3.3	3.9			

⁽¹⁾Figures for April are outturns

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**Table 4: Central government transactions – April
outturn and latest forecasts for May–July**

£ billion

	April		Latest forecasts		
	forecast	outturn ⁽¹⁾	May	Jun	Jul
Receipts					
<i>Consolidated Fund</i>					
Inland Revenue	4.6	4.8	3.9	3.8	6.2
Customs and Excise	3.7	3.7	3.6	2.9	3.3
Other ⁽²⁾	0.7	0.2	1.5	2.3	1.0
<i>National Loans Fund</i>					
Interest etc. receipts	0.6	0.3	0.4	0.6	0.4
Total Receipts	9.5	8.9	9.3	9.6	10.8
Expenditure					
<i>Consolidated Fund</i>					
Supply expenditure ⁽³⁾	9.5	9.7	8.3	8.3	8.4
Adjustment to Supply Services basis ⁽⁴⁾	–	0.2	0.2	–0.1	0.1
Other	0.5	0.5	0.5	0.5	0.5
<i>National Loans Fund</i>					
Service of the national debt	1.1	1.1	1.6	0.6	2.0
Net lending	0.3	1.0	0.3	0.2	0.3
Total Expenditure	11.4	12.5	11.0	9.5	11.2
Other funds and accounts (+ increases borrowing) (– reduces borrowing)	0.3	–1.1	–0.3	0.2	–
CGBR	2.2	2.5	1.4	–	0.4
On-lending	0.3	0.6	0.4	0.2	0.3
CGBR(O)	1.9	1.9	0.9	–0.2	0.1

⁽¹⁾Due to time lags in some items reaching their final accounting destination, figures of forecast and outturn may not be strictly comparable for the components identified, but there is no effect on the overall CGBR.

⁽²⁾Includes privatisation proceeds, except where these are temporarily lodged in "other funds and accounts."

⁽³⁾On a cheques issued basis. Supply includes an element of on-lending in the form of public dividend capital etc. It also includes advance payments to the EEC.

⁽⁴⁾Reflects changes in balances of departmental accounts with the Paymaster General, timing and other differences between cheques issued by departments and payments to them from the Consolidated Fund. An offset to this item is included in "Other funds and accounts".

Table 5: Central government transactions⁽¹⁾ – comparisons for April–July

£ billion

	1986	1987	
	Outturn	Budget forecast	Latest update
Receipts			
<i>Consolidated Fund</i>			
Inland Revenue	18.0	18.3	18.5
Customs and Excise	12.7	13.5	13.5
Other ⁽²⁾	1.9	5.0	4.9
<i>National Loans Fund</i>			
Interest etc. receipts	2.0	2.0	1.7
Total Receipts	34.6	38.7	38.7
Expenditure			
<i>Consolidated Fund</i>			
Supply expenditure ⁽³⁾	32.7	34.3	34.6
Adjustment to Supply Services basis ⁽⁴⁾	0.9	0.2	0.4
Other	1.3	1.9	2.0
<i>National Loans Fund</i>			
Service of the national debt	5.2	5.2	5.3
Net lending	3.4	0.4	1.8
Total Expenditure	43.5	42.1	44.1
Other funds and accounts (+ increases borrowing) (- reduces borrowing)	-2.2	0.2	-1.2
CGBR	6.7	3.5	4.2
On-lending	3.6	0.6	1.5
CGBR(O)	3.0	2.9	2.7

⁽¹⁾Due to differences in treatment of some items in the accounts between the periods/forecasts shown, and time lags in some items reaching their final accounting destination, figures for the components identified may not be strictly comparable.

⁽²⁾Includes privatisation proceeds, except where these are temporarily lodged in "other funds and accounts."

⁽³⁾On a cheques issued basis. Supply includes an element of on-lending in the form of public dividend capital etc. It also includes advance payments to the EEC.

⁽⁴⁾Reflects changes in balances of departmental accounts with the Paymaster General, timing and other differences between cheques issued by departments and payments to them from the Consolidated Fund. An offset to this item is included in "Other funds and accounts".

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Table 6: Borrowing requirement Budget profiles 1987-88
(1986-87 outturns in italics for comparison)

£ billion

	PSBR		Comprising					
			CGBR(O)		LABR		PCBR	
1987-88								
Apr	2.4	<i>0.7</i>	1.9	<i>0.2</i>	0.7	<i>0.7</i>	-0.2	<i>-0.2</i>
May	0.7	<i>1.0</i>	1.2	<i>1.7</i>	-0.2	<i>-0.3</i>	-0.4	<i>-0.4</i>
Jun	-0.6	<i>0.5</i>	-0.3	<i>1.2</i>	-0.4	<i>-0.5</i>	0.1	<i>-0.2</i>
Jul	0.2	<i>-0.3</i>	0.1	<i>-</i>	0.2	<i>-</i>	-0.1	<i>-0.3</i>
Aug	1.6	<i>1.7</i>	1.3	<i>1.2</i>	0.3	<i>0.3</i>	-	<i>0.3</i>
Sep	0.4	<i>2.2</i>	0.4	<i>2.5</i>	-0.1	<i>-0.1</i>	0.1	<i>-0.1</i>
Oct	-1.1	<i>-0.2</i>	-1.0	<i>-0.3</i>	-0.3	<i>-0.3</i>	0.2	<i>0.4</i>
Nov	0.8	<i>-</i>	1.4	<i>0.8</i>	-0.5	<i>-0.5</i>	-0.2	<i>-0.3</i>
Dec	0.8	<i>-1.5</i>	0.5	<i>-1.6</i>	0.2	<i>0.1</i>	0.1	<i>0.1</i>
Jan	-5.4	<i>-3.7</i>	-5.4	<i>-3.5</i>	0.1	<i>0.1</i>	-0.1	<i>-0.3</i>
Feb	0.1	<i>-0.4</i>	0.4	<i>0.1</i>	-	<i>-0.1</i>	-0.3	<i>-0.4</i>
Mar	4.0	<i>3.3</i>	3.0	<i>2.2</i>	1.1	<i>0.9</i>	-0.1	<i>0.1</i>
Cumulative								
Apr	2.4	<i>0.7</i>	1.9	<i>0.2</i>	0.7	<i>0.7</i>	-0.2	<i>-0.2</i>
May	3.1	<i>1.7</i>	3.1	<i>1.9</i>	0.6	<i>0.4</i>	-0.6	<i>-0.6</i>
Jun	2.5	<i>2.2</i>	2.8	<i>3.0</i>	0.1	<i>-0.1</i>	-0.4	<i>-0.8</i>
Jul	2.7	<i>1.9</i>	2.9	<i>3.0</i>	0.3	<i>-0.1</i>	-0.6	<i>-1.1</i>
Aug	4.3	<i>3.6</i>	4.2	<i>4.2</i>	0.6	<i>0.2</i>	-0.6	<i>-0.8</i>
Sep	4.7	<i>5.7</i>	4.6	<i>6.7</i>	0.5	<i>-</i>	-0.5	<i>-1.0</i>
Oct	3.6	<i>5.6</i>	3.7	<i>6.4</i>	0.2	<i>-0.3</i>	-0.3	<i>-0.5</i>
Nov	4.4	<i>5.6</i>	5.1	<i>7.2</i>	-0.2	<i>-0.7</i>	-0.5	<i>-0.9</i>
Dec	5.2	<i>4.1</i>	5.5	<i>5.6</i>	-	<i>-0.7</i>	-0.4	<i>-0.8</i>
Jan	-0.2	<i>0.4</i>	0.2	<i>2.1</i>	0.1	<i>-0.6</i>	-0.4	<i>-1.1</i>
Feb	-0.1	<i>-</i>	0.6	<i>2.2</i>	0.1	<i>-0.7</i>	-0.8	<i>-1.5</i>
Mar	3.9	<i>3.3</i>	3.6	<i>4.5</i>	1.2	<i>0.2</i>	-0.9	<i>-1.3</i>

CONFIDENTIAL

FROM: R J DEVEREUX
 DATE: 2 JUNE 1987

1. MR MOWL *BTM*
 2. CHANCELLOR OF THE EXCHEQUER

cc: Sir P Middleton
 Sir T Burns
 Mr Cassell
 Mr Sedgwick
 Mr Peretz
 Mr Watts (O/R)
 Mr Ritchie

CGBR(O) AND CGBR IN MAY

The provisional outturn for the CGBR(O) in May is £0.3 billion, £0.6 billion lower than last month's forecast. Part of this, possibly half, was due to industrial action (see paragraph 2). The estimate of the outturn is subject to revision before publication on Tuesday 16 June.

2. The main factors reducing borrowing in May below last month's forecast were

- (a) higher Customs & Excise receipts (by £0.1 billion). Industrial action has delayed repayments of VAT worth £0.2 billion, but this has been offset partly by shortfalls elsewhere.
- (b) higher privatisation proceeds (by £0.1 billion) as some shareholders have paid early for the second call on British Gas. (The due date is 9 June).
- (c) lower net payments to the EC (by £0.1 billion) due to higher than expected receipts from the European Social Fund.
- (d) a shortfall on the expenditure side of the account which cannot yet be identified with any certainty. Part of it may be due to industrial action, certainly the funding of social security benefits has been lower than expected. We may be in a position to explain the shortfall more thoroughly once the outturn for Supply expenditure in May is available.

These factors were offset partly by lower National Insurance Contributions (by £0.1 billion).

4 In the first 2 months of 1987-88 the CGBR(O) was £2.2 billion, £0.9 billion lower than the Budget profile. The main factors reducing borrowing were

- (a) higher Inland Revenue receipts (by £0.3 billion) mainly Corporation Tax
- (b) higher Customs & Excise receipts (by £0.1 billion) mainly due to the delay in VAT repayments
- (c) higher privatisation proceeds (by £0.2 billion) due to higher than expected receipts from Rolls Royce and early receipts for British Gas

but, as for May, the main factor is

- (d) a shortfall on the expenditure side of the account (of about £¾ billion) - some of this may be strike related.

These factors have been offset partly by

- (e) lower National Insurance Contributions (by £0.3 billion). The monthly path of NICs is difficult to estimate, but we will be looking at the implications for the future during the June forecasting round.
- (f) higher debt interest payments (by £0.2 billion), partly higher gilt payments and partly lower interest receipts on holdings of commercial bills

3. On-lending to local authorities in May was high (£1.5 billion), but was partly offset by a £0.2 billion repayment of on-lending by public corporations. The CGBR in May was therefore £1.6 billion, bringing the total since 1 April to £4.1 billion.

4. Further analyses of the outturn in May will be given in the net Ministerial note on the PSBR in two weeks time.



R J DEVEREUX

CONFIDENTIAL

CENTRAL GOVERNMENT TRANSACTIONS

£ billion

	May 1987			April 1986-May 1987			April-May 1986
	Provisional outturn	Last month's forecast	Difference	Provisional outturn	Budget profile	Difference	Outturn
Inland Revenue	+ 3.8	+ 3.9	-	+ 8.6	+ 8.3	+ 0.3	+ 8.3
Customs and Excise	+ 3.7	+ 3.6	+ 0.1	+ 7.4	+ 7.3	+ 0.1	+ 6.7
Other own account	- 7.9	- 8.4	+ 0.5	- 18.2	- 18.7	+ 0.5	- 16.6
CGBR (O)	- 0.3	- 0.9	+ 0.6	- 2.2	- 3.1	+ 0.9	- 1.5
On-lending:							
- LAS	- 1.5	- 0.7	- 0.8	- 2.6	- 0.9	- 1.7	- 3.2
- PCs	+ 0.2	+ 0.2	- 0.1	+ 0.7	+ 0.6	+ 0.1	0.2
CGBR	- 1.6	- 1.4	- 0.3	- 4.1	- 3.4	- 0.7	- 4.9

+ indicates a net receipt, or difference which reduces the CGBR.

- indicates a net payment, or difference which increases the CGBR.

CONFIDENTIAL AND PERSONAL

FROM: COLIN MOWL
DATE: 9 June 1987

1. MR CASSELL
2. → CHANCELLOR OF THE EXCHEQUER

cc Sir P Middleton
 Sir T Burns
 Mr Peretz
 Mr Sedgwick
 Mr Ritchie
 Mr Devereux
 Dr Clark

PSBR IN MAY

1. The first provisional outturn for the PSBR in May is a surplus of £0.2 billion, compared with last month's forecast of borrowing of £0.4 billion (see table attached). Available market forecasts are for borrowing of £¼-1 billion, with an average of about £¾ billion. Our estimate is subject to revision before publication at 11.30 am on Tuesday 16 June. On this occasion the local authority component in particular may change.
2. Borrowing on central government own-account in May was provisionally £0.4 billion, £0.6 billion lower than last month's forecast. As explained in Mr Devereux's minute of 2 June, this shortfall was partly due to industrial action delaying repayments of VAT (around £¼ billion). The remaining difference from forecast is spread over a number of items. Lower than forecast borrowing by local authorities was offset by higher than forecast borrowing by public corporations.
3. The PSBR in the first 2 months of 1987-88 was £1.6 billion, £1.5 billion below the Budget profile. Borrowing on central government own-account and by local authorities are each around £¾ billion below profile.
4. The monthly note, presenting updated estimates for May and detailed forecasts for June-August, will be circulated next Monday.

Colin Mowl

COLIN MOWL

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£ billion

	May 1987			April-May 1987			April-May 1986
	Provisional outturn	Last month's forecast	Difference	Provisional outturn	Budget forecast	Difference	Outturn
CGBR(O)	0.4	0.9	- 0.6	2.2	3.1	- 0.9	1.9
LABR	- 0.5	- 0.2	- 0.4	- 0.1	0.6	- 0.7	0.4
PCBR	-	- 0.4	0.4	- 0.5	- 0.6	0.1	- 0.6
PSBR	- 0.2	0.4	- 0.6	1.6	3.1	- 1.5	1.7

CONFIDENTIAL & PERSONAL

CONFIDENTIAL

Rep

FROM: A TURNBULL
DATE: 24 JUNE 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Sir P Middleton
Mr F E R Butler
Mr Anson
Mr Monck
Mr Burgner
Mr Gilmore
Mr Robson
Mr Burr
Mr Gieve
Mr Pratt
Mr Waller

Ch
David is absolutely convinced
PM will not budge on principle of E(ST)
taking decisions on allocations of funds: that
is her idea & she plans to chair every meeting.
But must clearly work & get agreed
guidelines.

TERMS OF REFERENCE OF E(ST)

AA

In the discussion about the terms of reference of E(ST) we had been trying to achieve a relationship with the Survey in which E(ST) took a strategic role in recommending priorities, but the actual negotiations took place in the Survey. E(ST) was to consider S&T spending in June and make recommendations; the Survey would be conducted with the departments in turn; and the results reported back to E(ST) for it to consider whether the priorities which were emerging corresponded with their intentions.

2. We had got to the point of agreeing note setting out a relationship along these lines but with the exception of item (iii) - see Annex. This item suggests a different role for E(ST), ie that a budget for S&T is agreed, including a mini-reserve, with E(ST) itself taking responsibility for allocating funds. The Treasury has been arguing for this item either to be removed on the grounds that it is inconsistent with the relationship envisaged elsewhere in the note; or to be severely restricted in scope.

3. However, events have taken a different course. When the proposals were put to the Prime Minister she herself amended the terms of reference from:

"To consider and keep under review policies and priorities and the allocation between departments of resources for science and technology, both domestically

and for international collaboration."

to

"To review policies and priorities on science and technology and to decide the consequent allocations between departments of resources, both domestically and for international collaboration.

4. By inserting "decide" the Prime Minister has made it clear that she wishes the role of E(ST) to be not merely advisory, but for it, and not the Survey, to be the forum in which S&T allocations are settled. It would have its own budget including the uncommitted provision and would resolve claims against that provision.

5. There are two responses:

i. persuade the Prime Minister that what she envisages will pre-empt Survey decisions and argue for the strategic role for E(ST);

ii. accept her view of what E(ST) should be doing but establish ground rules which will make it work.

6. We continue to have strong reservations about departing from the normal PES procedure. In principle we believe it is wrong for science to be dealt with totally horizontally without reference to the programme objectives it is meant to serve. It is not clear that a reduction in agricultural research justifies more say on health. Equally, brigading all science together closes off some of the options of trading more science for cuts in other parts of the programme. And there are dangers in giving one kind of expenditure a privileged position in the Survey - will capital spending want something similar? Equally, we are sceptical that E(ST) would have much stomach for the kind of arguments that would be necessary to make the alternative of a separate budget work.

7. However, we judge that the Prime Minister is unlikely to be swayed from her view of the role of E(ST), but is likely to

see the force of the objections to the current groundrules. It is clear to us that those in the current note will not work. In particular, the provision in (iii) that departments can argue for a share of the uncommitted provision but if that is unsuccessful can submit bids to the Treasury puts us in double jeopardy and is unacceptable. If E(ST) is to succeed in its role of reallocating priorities it should do so within an established envelope; otherwise it will become a mechanism for generating and accommodating bids.

8. A possible way forward is for you to raise this at your next bilateral. You could take the line that you recognise the Prime Minister's wish that E(ST) should have a role in deciding allocations; that if it worked effectively it could provide a very useful discipline; but that this requires changes to the current draft which is based on the different premise of E(ST) as an input to the Survey. In particular it is essential that all S&T bids should be routed through the Committee and assessed against other S&T spending or the uncommitted provision. There should be no second bite of the cherry. You should warn her that E(ST) would be taking on an important responsibility and that many of the disputes which were previously resolved bilaterally with the Treasury would now come before it.

9. Ideally the uncommitted provision should be constituted by making savings from within existing S&T spending. In practice we judge this to be unrealistic. You could offer, in order to start the process off, to make available a small but rising amount of the existing reserves. However, it should be understood that at the next Survey S&T bids have to be contained within those amounts. S&T cannot come back for a further margin as that would simply generate a ratchet.

10. It is difficult to assess the appropriate size of the uncommitted margin in advance of receiving the bids. We would be able to make a judgement on this sometime during July. You should avoid being drawn on figures but if pressed you could indicate something like 75/150/200, of which no more than two-thirds could be allocated out in the current round, the rest

being held back for in-year bids. This would be on top of the amounts already agreed for Airbus. You will want to accompany this with a warning of the difficulties of the Survey as a whole.

11. The objective of the bilateral could be to confirm that she does want a more active role for E(ST), and if she does, to secure her agreement that E(ST) should work within a strict envelope; to have this minuted out by her office with a request that new guidelines be devised which contain the necessary safeguards on the total level of S&T spending. The new guidelines would also need to deal with the timetable, the problem of defence (where savings in S&T do not become available for transfer to other departments) and the definition of the expenditure covered.

12. I attach a speaking note which you might use at the bilateral. However, as this represents a significant departure from previous practice, you may wish to discuss with the Chief Secretary or officials.

AT

A TURNBULL

CONFIDENTIAL

DRAFT SPEAKING NOTE

I see that in considering the terms of reference of E(ST) you have written in the provision that the Committee itself should "decide the consequent allocations between departments of resources ...". This would give the Committee a more powerful role than merely making recommendations to be acted on in the Survey. I welcome any help you and the Committee can give in setting a budget for S&T spending and then resolving priorities within it.

2. But if E(ST) is to operate effectively it will be important to get the groundrules right. The present version, which was in any case drafted with a more advisory role in mind is not satisfactory. I am sure you will agree that it would be wrong, as the present groundrules allow, for departments to have two bites at the cherry. Paragraph (iii) allows them to argue for a share of the uncommitted provision, but also to make bids of their own to the Treasury. That puts us in double jeopardy and means that there would be no firm envelope. Instead of an exercise in priorities, we would have an exercise in accommodating bids.

3. If there is to be a small and rising uncommitted provision it is essential that:

- all bids are routed through the Committee and there is no second channel;

- the Committee would live within the envelope created and would take on responsibility for resolving competing claims;

- when the next Survey came round there would be no further additions to the margin, in effect the Committee would have had its share of the reserve in advance;

- savings on defence S&T spending which stay with the defence budget would not be available for redeployment elsewhere.

4. Ideally the uncommitted provision should be established by asking all existing S&T programmes to put something into the kitty. But exceptionally the Chief Secretary and I would be prepared to make a contribution to it from the main reserve. [Given the pressures on public expenditure (about which I will want to speak to you separately) this cannot be large, perhaps of the order of 75/150/200, though some proportion of this would need to be held back to cope with in-year bids.]

5. If you do wish to proceed with the more active role for E(ST), could your office minute out this conversation, with a request that the guidelines be re-examined to ensure that they provide for the establishment of a clear envelope within which priorities

should be set. Officials can then get to work quickly to produce this.

TIMETABLE FOR E(ST) DECISIONS AND THE PUBLIC EXPENDITURE SURVEY

The detailed arrangements for interaction between E(ST) and the PES process are as follows:

i. provision for science and technology will be considered by E(ST) in parallel with the early stages of the Public Expenditure Survey;

ii. in the first half of the year, E(ST) will review departmental S&T plans and programmes, taking account among other things of advice received from the proposed Advisory Council on Science and Technology (ACOST);

iii. E(ST) will seek to establish with departments a small but rising uncommitted provision to serve as a flexible margin against departmental bids, but this would not preclude Ministers from putting forward their own additional PES bids for expenditure on science and technology;

iv. by the end of June, E(ST) will seek to reach agreement on priorities for Government expenditure on science and technology in the Survey period. In reaching their conclusions on this, they will consider whether to indicate any transfer between departments which in their view would make it possible to give effect to these priorities; and may also express a view on the appropriate total expenditure provision;

v. the Chief Secretary will take account of E(ST)'s views in his report to the Cabinet in July and they will then inform detailed discussion of programmes in the autumn;

vi. the Chief Secretary should give a general description of the emerging position on science and technology in any report he makes to the Star Chamber or Cabinet on progress of these bilaterals;

vii. in seeking to resolve outstanding differences between the Chief Secretary and Ministers on S&T issues the Star

Chamber will take account of E(ST)'s views and will report on the S&T position when it reports back to Cabinet;

viii. following the Autumn Statement E(ST) will begin a new review of departmental programmes concentrating on the three years to be covered in the coming Survey round;

ix. the Public Expenditure White Paper will include a passage on S&T expenditure.

FROM: A TURNBULL
DATE: 25 JUNE 1987

CHANCELLOR OF THE EXCHEQUER

- cc Chief Secretary
- Sir P Middleton
- Mr F E R Butler
- Mr Anson
- Mr Monck
- Mr Burgner
- Mr Gilmore
- Mr Burr
- Mr Gieve
- Mr Pratt
- Mr Waller
- Mr Kaufmann

TERMS OF REFERENCE OF E(ST)

I understand you wish to minute the Prime Minister before talking to her at one of your bilaterals. I have turned the speaking note submitted yesterday into a minute. It would be helpful if this could go off quickly as Cabinet Office are on the point of sending out the revised terms of reference.

ATB
A TURNBULL

Ch
This is now all overtaken. I had discussed it with D Norgrove, & he in turn discussed it with Bona Uvarov & PM herself. Ureshit is no guidelines and amendment to terms of reference marked in green below. Implies no "uncommitted margins" etc. Should now be compatible with P.E.S. Seems much better.

AA
1/28 N.W. - 1 h/w
1/28 W.M.
1/28

DRAFT MINUTE TO THE PRIME MINISTER

TERMS OF REFERENCE OF E(ST)

I understand that when draft terms of reference for E(ST) were put to you, you amended them to read:

consider

"To review policies and priorities on science and technology and to decide the consequent allocations between departments of resources both domestically and for international collaboration."

This reflects your wish that the Committee should have a more active role rather than one of making recommendations to be acted upon in the Survey. For the same reason you wanted an uncommitted provision.

2. I share your wish to find a mechanism which can get a grip on science and technology spending, and resolve the sort of problems we have had over reallocation. So I welcome your decision, and the Chief Secretary and I will be glad to help get the exercise off to a good start by helping to constitute an uncommitted margin.

funks to our priorities.

are ready to agree to provide a contribution from the main Reserve to constitute an uncommitted margin. We shall need to consider with you what the appropriate size should be.

3. But I am sure you will agree that it would be wrong for departments to be able to argue for a share of (the) uncommitted provision, and but also to make bids

in the light of the other pressures on the Reserve.

of their own to the Treasury as the present groundrules on the relationship between E(ST) and the Survey (attached) imply. That would put the public expenditure figures in double jeopardy and mean that there would be no firm envelope for E(ST) to operate in. Instead of an exercise in establishing priorities, we would have an exercise in accommodating bids.

4. [If there is to be a small and rising uncommitted provision] ^{seems to me} [it is] essential that

- all bids are routed through the Committee and there is no second channel;

- the Committee [would] take responsibility for resolving competing claims within the envelope created, including the uncommitted provision.

[5. Ideally the uncommitted provision should be established by asking existing S&T programmes to put something into the kitty. But exceptionally in the first year the Chief Secretary and I would be prepared to make a contribution from the main Reserve to launch the new arrangements. We would prefer to settle the precise figures when we have a clearer picture of the pressures on the planning totals (though it is already clear that those pressures will be great).]

6. [I would welcome an opportunity to discuss this further at my next meeting with you. However,] I

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understand that you wish to have an early meeting of E(ST). In view of the problem I have outlined above, it would be helpful if the terms of reference could be circulated without the note on the groundrules. At the meeting I hope that you would say that you intend that E(ST) should be a mechanism for resolving priorities within a clearly defined envelope, and that officials should produce groundrules which would achieve this.

7. I am copying this minute to Sir Robert Armstrong.

TIMETABLE FOR E(ST) DECISIONS AND THE PUBLIC EXPENDITURE SURVEY

The detailed arrangements for interaction between E(ST) and the PES process are as follows:

- i. provision for science and technology will be considered by E(ST) in parallel with the early stages of the Public Expenditure Survey;
- ii. in the first half of the year, E(ST) will review departmental S&T plans and programmes, taking account among other things of advice received from the proposed Advisory Council on Science and Technology (ACOST);
- iii. E(ST) will seek to establish with departments a small but rising uncommitted provision to serve as a flexible margin against departmental bids, but this would not preclude Ministers from putting forward their own additional PES bids for expenditure on science and technology;
- iv. by the end of June, E(ST) will seek to reach agreement on priorities for Government expenditure on science and technology in the Survey period. In reaching their conclusions on this, they will consider whether to indicate any transfer between departments which in their view would make it possible to give effect to these priorities; and may also express a view on the appropriate total expenditure provision;
- v. the Chief Secretary will take account of E(ST)'s views in his report to the Cabinet in July and they will then inform detailed discussion of programmes in the autumn;
- vi. the Chief Secretary should give a general description of the emerging position on science and technology in any report he makes to the Star Chamber or Cabinet on progress of these bilaterals;
- vii. in seeking to resolve outstanding differences between the Chief Secretary and Ministers on S&T issues the Star

Chamber will take account of E(ST)'s views and will report on the S&T position when it reports back to Cabinet;

viii. following the Autumn Statement E(ST) will begin a new review of departmental programmes concentrating on the three years to be covered in the coming Survey round;

ix. the Public Expenditure White Paper will include a passage on S&T expenditure.



CHIEF SECRETARY	
REC.	26 JUN 1987
ACTION	Mr Mountfield
COPIES TO	EX Lt Peter Middlets Mr Butler Mr Geoffrey Little Mr Anson Mr Lavelle Mr Burgess Mr Turnbull

FCS/87/139

CHIEF SECRETARY, TREASURY

*At X, I have
won 'success' such
that, she agreed to their
plan in response to
Smith's pressure
on the P. 2.*

*Mrs Case Mr P Davis Mr Gieve
Mr Cooper Mr Tyrie*

Public Expenditure Survey - FCO Programmes

1. I have again made a thorough scrutiny of all Diplomatic Wing and ODA programmes and propose this year to deal with them separately. This minute covers the Diplomatic Wing and my proposals are firmly based on continuing restraint of public expenditure. Any savings through increased efficiency or increased revenue will be needed to bridge the gap between the uplift factors and rising costs.

2.

	<u>£ Million</u>		
	<u>1988/89</u>	<u>1989/90</u>	<u>1990/91</u>
The baseline in the three survey years is:-	728.9	745.9	764.5

Bids arising from Agreements at Official Level and from Agreements at the last PES round

(a) Notional interest on Capital raised from British Phosphates Commissioners Assets (BPC)	0.75	0.75	0.75
(b) Baseline adjustment resulting from outturn on Asset recycling	0.6	0.5	-1.3



	<u>£ Million</u>		
	<u>1988/89</u>	<u>1989/90</u>	<u>1990/91</u>
<u>Revised Economic Assumptions:</u>			
Overseas Price Movements (OPM) from 1.10.86 to 31.5.87	-14.47	-14.47	-14.47
<u>Other bids in order of priority</u>	5.92	8.37	7.71
(d) Refurbishment of the Old Public Offices (OPO), and current consequences			
(e) BBC External Services Triennial review of funding (current only)	4.5	8.5	12.5
(f) Follow up to the Prime Minister's visit to the Soviet Union	0.6	0.9	0.9

All bids with the exception of (e) have running cost consequences; I suggest officials settle details when finalising the calculation of OPM next October.

3. My bids are a bare minimum. I will not detain you with those arising from agreements already reached except to note that on present estimates a combination of good housekeeping and the effect of overseas price movements means that for 1988/89 my overall funding requirement is lower than that provided already in the baseline. I hope that this will enable us to dispense with protracted haggling over the essential but modest sums for which I have bid.

4. The first bid is for the Old Public Offices. Ministers have agreed that the FCO should occupy the whole of these premises and that the work of refurbishment should be accelerated. Nicholas Ridley and I have agreed on an apportionment of the costs. The accelerated programme will need the £22 million for which I have



bid, and will show substantial returns. The Government must maintain this Grade 1 listed building, and the accelerated programme will lead to earlier efficiency benefits, including space savings. Rates are expected to increase in the PES period and I have taken account of this.

5. Next, we must settle funding for the BBC External Services in this, the second, three-year funding period. The Government's decision on the domestic licence fees recognised that broadcasting costs were rising faster than those in Government. My bid for current funding is a minimum to support the External Services' output at the presently agreed levels while exploiting investment so far in the audibility programme. On the capital side there is to be an urgent reappraisal of the Orfordness project. Its outcome will affect the BBC capital programme as a whole. I propose, therefore, that if the review cannot reach final results before the PES round is complete we should, exceptionally, defer the reconsideration of the programme to the second year of the triennium and in the meantime carry forward the baseline for capital subject only to the standard uplift.

6. Thirdly the Prime Minister's visit to Moscow has created outstanding opportunities to develop bilateral relations as agreed by OD in 1984. For the current year we shall draw on the flexibility we have, particularly within AUS programme budgets. In future years we need to do more, especially in the field of unofficial exchanges. My bid for the purpose includes a substantial element of £250,000 for the British Council in 1988/89 rising to £600,000 in 1989/90. The value of this enhanced programme is self evident.

7. Having limited my bids so tightly this year I must warn you that changing circumstances mean that I must expect to make more substantial but as yet unquantifiable bids next year:



- (a) there is increasing difficulty in recruiting and holding staff, particularly in clerical grades, in communications, and in the pivotal DS5 (Principal equivalent) grade, where we have lost too many officers with expensively acquired skills. The outcome of our consideration of South East pay and related issues may determine the form of an eventual bid.
- (b) Abroad, diplomatic life in Third World Posts is increasingly unattractive and dangerous. The penalty for the Diplomatic Officer's spouse of being unable to follow a career is felt more keenly than before. The Chancellor has suggested talks at official level.
- X |
- (c) Arms control and disarmament developments are likely to impose new requirements for additional resources, as could further efforts to tackle problems of drugs and of security.
- (d) The British Council received high marks in our Top Management Round. Its resources are fully stretched and further economies could seriously damage our interests. However I want to give the new Director-General time to settle in before reaching firm conclusions.
8. I have restricted this minute, like my bids, to the bare bones. I hope we can keep discussions between us on the subject similarly short and to the point. Meanwhile, the supporting argumentation will be found in the parallel letter from my Principal Finance Officer.

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9. I am copying this minute to the Prime Minister, the Lord President and the Secretary of State for the Environment.

A handwritten signature in black ink, appearing to be 'G. Howe', written in a cursive style.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
26 June 1987

CONFIDENTIAL

FROM: T J BURR
30 June 1987

CHIEF SECRETARY

- cc Chancellor
- Financial Secretary
- Paymaster General
- Economic Secretary
- Sir P Middleton
- Mr F E R Butler
- Mr Anson
- Mr Monck
- Mr Burgner
- Mr Gilmore
- Mr Scholar
- Mr Turnbull
- Ms Seaman
- Mr Waller
- Mr G White
- Mr Cropper
- Mr Tyrie

So long as we spread our funds of university science & an institution, we are one of the best people. Which we ought to allocate more to. Which is a much more important fund.

to Graham's & Amber of Executive of inter alia

E(ST)(87)4: TERMS OF REFERENCE AND COMPOSITION OF ACOST
 E(ST)(87)1: RESPONSE TO HOUSE OF LORDS REPORT ON CIVIL RESEARCH AND DEVELOPMENT

The above two papers are to be considered by E(ST) (in that order) at its first meeting tomorrow, 1 July. The meeting will also be considering the ABRC strategy document (Mr Kaufmann's brief of 29 June), and fiscal incentives for R&D spending (Mr Burgner's brief of 30 June).

2. Prior to discussion of these papers, it is likely that the Prime Minister will want to say something about the work of E(ST). This brief deals with that and then with the two papers.

E(ST) Terms of Reference

3. We understand that the Prime Minister is not being briefed to say anything about the terms of reference of E(ST). But she is likely to say that she wants E(ST) to take a strategic view of R&D priorities, and hopes that Ministers in E(ST) will not be unduly tied to their own particular departmental interests. She will probably say that the next meeting of the Committee

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will consider a paper by Mr Fairclough on R&D priorities.

4. A couple of points may arise out of this. First, remarks might be made about the desirability of increasing science and technology expenditure. International comparisons of public and private sector R&D expenditure are attached at Annex A. They do not suggest an overriding case for increasing publicly funded R&D expenditure, although there is a case for shifting the balance from defence to civil R&D and for increasing industry's own-funded R&D. We recommend, however, that you should not get drawn into substantive discussion, but should suggest that the handling of such questions would best be considered at the following meeting which will be considering R&D priorities. Second, it is possible that questions may be asked about the exact scope of expenditure falling within E(ST)'s remit. There are some significant problems of definition, particularly in the area of technology transfer. You might say that officials are considering the matter.

5. Questions may^{also} be asked about how the E(ST) discussion fits in^{with} the Survey. You will recall that at one stage it looked as if the Prime Minister wanted a mini-survey for science and technology to be conducted by E(ST), complete with its own mini-reserve. But in the light of Treasury misgivings, the Prime Minister has amended E(ST)'s terms of reference to refer to "considering" rather than "deciding" allocations between departments, and no modification of the normal Survey decision taking process is now being suggested (although it will be informed both by E(ST)'s view of priorities and by monitoring of the way in which Survey decisions are impacting on science and technology expenditure). We do not expect that the Prime Minister will want any of these issues reopened at the meeting. What you may need to say is that departments should press on with submitting any science and technology bids to the Treasury in the normal way, and by the deadline of 2 July.

ACOST

6. Following the House of Lords report on "Civil Research

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Development", it has been decided that the Advisory Council for Applied Research and Development (ACARD) should be replaced by a new Advisory Council on Science and Technology (ACOST), with a broader remit. Like ACARD, ACOST will be a major external source of advice to the Government on R&D issues. But whereas ACARD was concerned essentially with applied research and its co-ordination with research funded by DES from the science budget, ACOST will advise on science and technology issues generally, and the co-ordination of activities in the whole of that field.

7. We have no comments to make on the proposed membership of ACOST. On the terms of reference, the main point which we made at official level was that ACOST should not advise on levels of expenditure, but only on expenditure priorities. This point has been taken in the terms of reference attached to the paper, which refer only to "priorities". It is possible that efforts will be made to reinstate "levels". If so, you might say that the Government does not need advisory bodies telling it to spend more money; and you can expect support from the Prime Minister on that point. Such bodies are never going to recommend that less should be spent, and are likely to get into the habit of recommending more. Objection might be raised on the grounds that the Advisory Board for the Research Councils makes recommendations on levels of expenditure. That is regrettably true, but you can point out that it is not something which their terms of reference invite them to do.

8. Although the paper says that the terms of reference have been cleared at official level, there is one other point of ours which has not been taken into account, though more because the Cabinet Office did not have time to do so than because they disagreed. The point is that the terms of reference hardly give ACOST an adequate remit in respect of **private sector** R&D. Reference is made to the application of science and technology for the benefit of the private sector, but not to private sector science and technology as such. We suggested the addition of the following additional item:

"The quality and effectiveness of science and technology

in the United Kingdom, in both the public and private sectors".

We recommend that you should propose the inclusion of these words. They may also be of some use in heading off pressure to reinstate "levels", since they give ACOST a rather wider locus than simply "priorities".

Response to House of Lords report

9. E(ST)(87)1 is a paper by the Chief Scientific Adviser covering, at Annex A, a draft Government response to the report which the House of Lords Select Committee on Science and Technology published last January on "Civil Research and Development". Their recommendations are listed at Annex B to the paper. They argue for a higher profile for science and technology, higher spending by both Government and industry, and more horizontal examination of R&D across programmes. The draft response lays emphasis on the effective management of existing effort in the public sector, the intention that there should be a gradual reduction in the real level of defence R&D, the scope for industry to invest more in R&D, and the strengthened central structure for considering science and technology priorities (essentially E(ST) and ACOST). The text has been agreed at official level and we are content with it.

10. Two points arise, however, from the Chief Scientific Adviser's covering paper. First, he proposes in paragraph 8 that the study of tax incentives for R&D should be published "as a discussion document", and that the question of tax reliefs should remain open for future consideration. The tax study is of course a separate agenda item. On this paper, however, you will need to ensure that

(i) it is clear that the study is not being published as a Green Paper: it is simply being published, not for discussion with a view to a further Government policy statement in due course;

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(ii) E(ST) does not seek to take a decision about tax reliefs for R&D, which is a matter for the Chancellor.

11. Second, in paragraph 12, it is suggested that the response should give greater emphasis to the need to switch resources from defence to civil R&D. Our own view is that the wording of paragraph 12 of the response is satisfactory; and that to go further would run the risk of implying that there should be a greater shift than might be justified on grounds of economy and efficiency. That, in turn, would open the paragraph to MOD counter-attack. We recommend that you should stay with the existing wording.

12. There is one other point which may be raised. It arises on paragraph 11 of the Chief Scientific Adviser's paper. As indicated in paragraph 12, it has been decided to hold defence R&D to the figures in the 1985 defence Long Term Costings. Actual cash spending will depend on the factors which are used to inflate those constant price figures to cash. Paragraph 11 refers to Annex C, which contains figures from the draft Annual Review of Government Funded R&D, together with a footnote explaining that MOD would like to use a much higher factor than the GDP deflator to convert their figures from constant prices to cash. They want to use price increases of 5½ per cent a year, which are about 2 per cent higher than the assumed increase in the GDP deflator. It is likely that the Secretary of State for Defence will seek endorsement of this approach. We recommend that you decline to agree, making the point that cash planning does not make this kind of specific allowance for relative price changes on particular programmes. The issue can be left to be sorted out between officials who are preparing this year's Annual Review. (These figures are not for inclusion in the Government's response to the House of Lords Report.)



T J BURR

R & D EXPENDITURE IN THE
UK AND OTHER COUNTRIES

% GDP 1983*

	UK	US	JAPAN	FRANCE	W.GERMANY
Total R&D expenditure	2.28	2.70	2.56	2.15	2.57
Govt. exp. on R&D	1.33	1.18	0.61	1.41	1.14
Govt. exp. on civil R&D	0.67	0.42	0.60	0.95	1.03
Industrial own funding of civil R&D (estimate)	0.9	1.5	1.9	0.8	1.5
Total civil R&D exp.	1.6	1.9	2.5	1.7	2.5

Source: OECD

*The latest year for which data is available and international comparisons made.



CHIEF SECRETARY	
REC.	- 1 JUL 1987
TO	Miss Coad
	CX Sir Peter M... Mr Butler Sir Geoffrey L... Mr Lavelle Mr Bourne Mr Bruce Mr Mountfield

Unacceptable
Figs/growth @
was low: was 5
take at 1/2
open 1/25
on work.

Mr Gieve Mr Cropper
Mr Tyne

FCS/87/143 *Mr Turnbull Mr P. Davis*

CHIEF SECRETARY

Public Expenditure Survey - Overseas Development Administration

1. In accordance with the revised public expenditure timetable, this minute sets out my bids for the programmes controlled by the ODA. In summary these are:-

		<u>£ Million</u>		
		<u>1988/89</u>	<u>1989/90</u>	<u>1990/91</u>
A.	Aid Programme	75	150	230
B.	Aid Administration	1.75	2.075	2.6
C.	Superannuation Vote:			
	(War Service Credit)	6	6	6

Provision will need to be made for a new ODA vote within the aid programme to cover the Chancellor's Sub-Saharan debt initiative, but the bid I propose covers its cost, as well as the cost of two items that John Macgregor and I left unresolved - the World Bank's General Capital Increase, and the additional cost of the Aid & Trade Provision Soft Loan facility.

/Aid



Aid Programme

2. We must now, at the beginning of a new Parliament, consider what our overall stance towards aid should be. Existing planned resources are inappropriate for the scale of our economy or, for our objectives overseas. On present plans we shall go into the next election with the worst aid performance of any Western donor (apart from the US whose programme is the largest in absolute terms anyway). As a percentage of GNP, aid will fall steadily further from the 0.32 percent which has just been announced, the lowest ever, to only 0.28 percent in 1990 (compared to 0.52 percent in 1979). This is not consistent with our public commitment to the 0.7 percent UN target. We take pride in having established once again a strong economy, but we shall stand accused of having ducked our international responsibilities. It will be a bad record for a country with such close ties with so much of the developing world, and a short-sighted response to the growing importance of developing countries on the world political scene.

3. We are already on the defensive both domestically and in our discussions with OECD partners. We have objectives to pursue in summit meetings which are far too important for us to be seen as the weak link in the international aid effort. President Mitterrand raised aid performance at Venice and this will happen again: criticism will become more difficult to rebut as time goes by and our aid falls. We are the only country of the summit seven to have cut aid in real terms since 1979, and the only one which plans further to reduce its share of GNP.

/In



In the same way, we are increasingly compared to our EC partners with whom we have to cooperate on Community aid matters and seek common positions internationally. The aid performance for EC donors as a whole is 0.54 percent of GNP. We now have only the fourth largest programme within the Community. I do not believe we should be planning for an aid programme that by 1990 would be smaller in absolute terms than the Dutch, and as a proportion of GNP the lowest of all 8 EC donors. I attach some bar charts which illustrate the dramatic decline in our relative aid performance. Each year the task of getting back to a respectable level gets harder: if we leave it any longer we may fall too far behind other countries ever to catch up. We said we were cutting aid until we could afford to do more. Now that we have a strong economy and sound finances we must honour our word.

4. I do not argue that aid is good for its own sake. It is what we do with it that counts. Our aid is more effective than most; and, because our bilateral aid is so tightly tied to national procurement - more so than any other donor - it plays an important part in meeting our domestic objectives. A substantial part of the increase I propose would be devoted to our bilateral country programmes, and spent on the kinds of goods and services that our manufacturers outside the prosperous South East need to sell. We are already losing markets to competitors whose prices and goods are no better than ours, but whose bilateral aid programmes (eg the French, Germans and Japanese) are several times larger and expanding.



5. The bid I propose is the minimum required for us to hold our own. It would stop a further decline in our aid performance (in 1990 it would achieve 0.33 percent of GNP) and it would be sufficient for us by 1990/91 to say that our aid programme was larger in real terms than under the last Labour government. An increased allocation of this size would enable us partially to restore the value of our bilateral country programmes, where we have direct political and commercial interests. We could also accommodate the cost of Nigel Lawson's debt initiative for the poorer countries, the World Bank's General Capital Increase, essential for dealing with the middle income countries, and the additional amounts required for ATP soft loans, which enable us to win business in the more credit-worthy markets.

Aid Administration

6. The baseline for the Aid Administration Vote (assuming a 2½% increase for 1990/91) is:-

	<u>£ Million</u>		
	<u>1988/89</u>	<u>1989/90</u>	<u>1990/91</u>
	28.417	28.529	29.242
My bid is for	1.750	2.075	2.6

In addition I want the gross running costs provision for the ODA's scientific units adjusted upwards, as follows. The finance for the adjustment is already provided within the existing aid programme.

	<u>£ Million</u>		
	<u>1988/89</u>	<u>1989/90</u>	<u>1990/91</u>
	1.6	0.9	0.22



7. My Principal Finance Officer sets out in his letter the case for these small increases. By far the greater part of them is required, regardless of any increase in the aid programme, to ensure that minimum standards of efficiency and value for money are maintained. We are constantly being pressed by Parliament to do more to ensure aid effectiveness.

Superannuation: War Service Credit

8. Last year, I argued that the time had come to rectify the anomaly whereby former members of the Colonial Service, unlike other public service pensioners, do not receive credit for war service in the calculation of their pensions. Both John Macgregor and Nigel Lawson felt that this was not a sufficient priority in last year's PES, but would raise no objection were I to find the necessary provision from within my existing programmes. That solution is unacceptable. I know from discussions with backbench colleagues last year that they would not wish such a concession to be made at the expense of the aid programme. At the same time, our defence that we could not accommodate this small commitment on grounds of cost is increasingly difficult to maintain, especially if the aid programme expands. I believe that on grounds of equity we should grant this concession. I am therefore renewing my bid for additional resources of £6 million a year over the PES period. We would also need to mount a special exercise to identify eligible pensioners and recalculate their benefits: we estimate that this would require an addition to the Aid Administration Vote of perhaps £0.2m in 1988/89, beyond the amount set out in my bid above.



9. I am sending a copy of this minute to the Prime Minister, the Lord President and the Secretary of State for Trade and Industry.

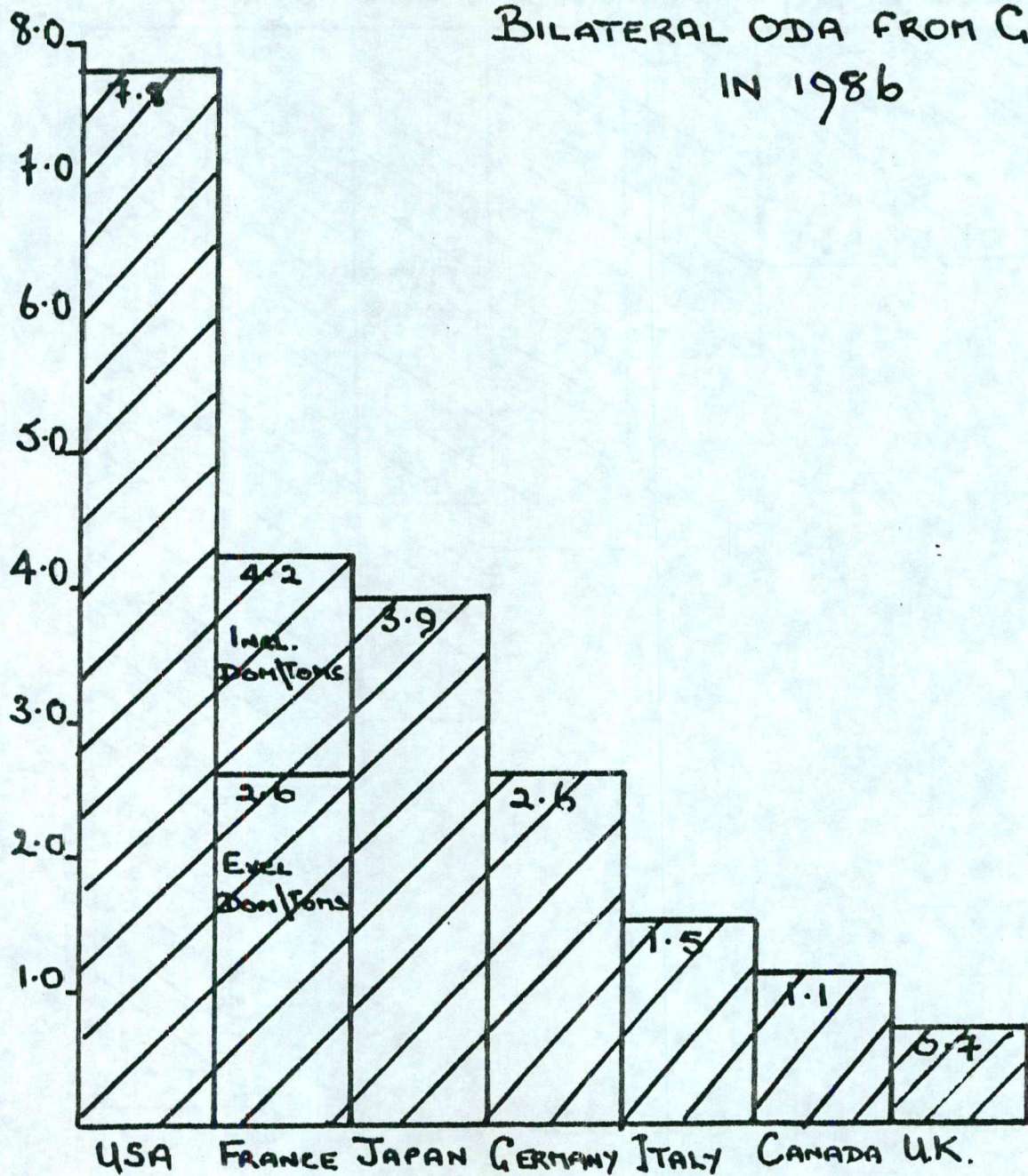
A handwritten signature in black ink, appearing to be 'G. Howe', written in a cursive style.

(GEOFFREY HOWE)

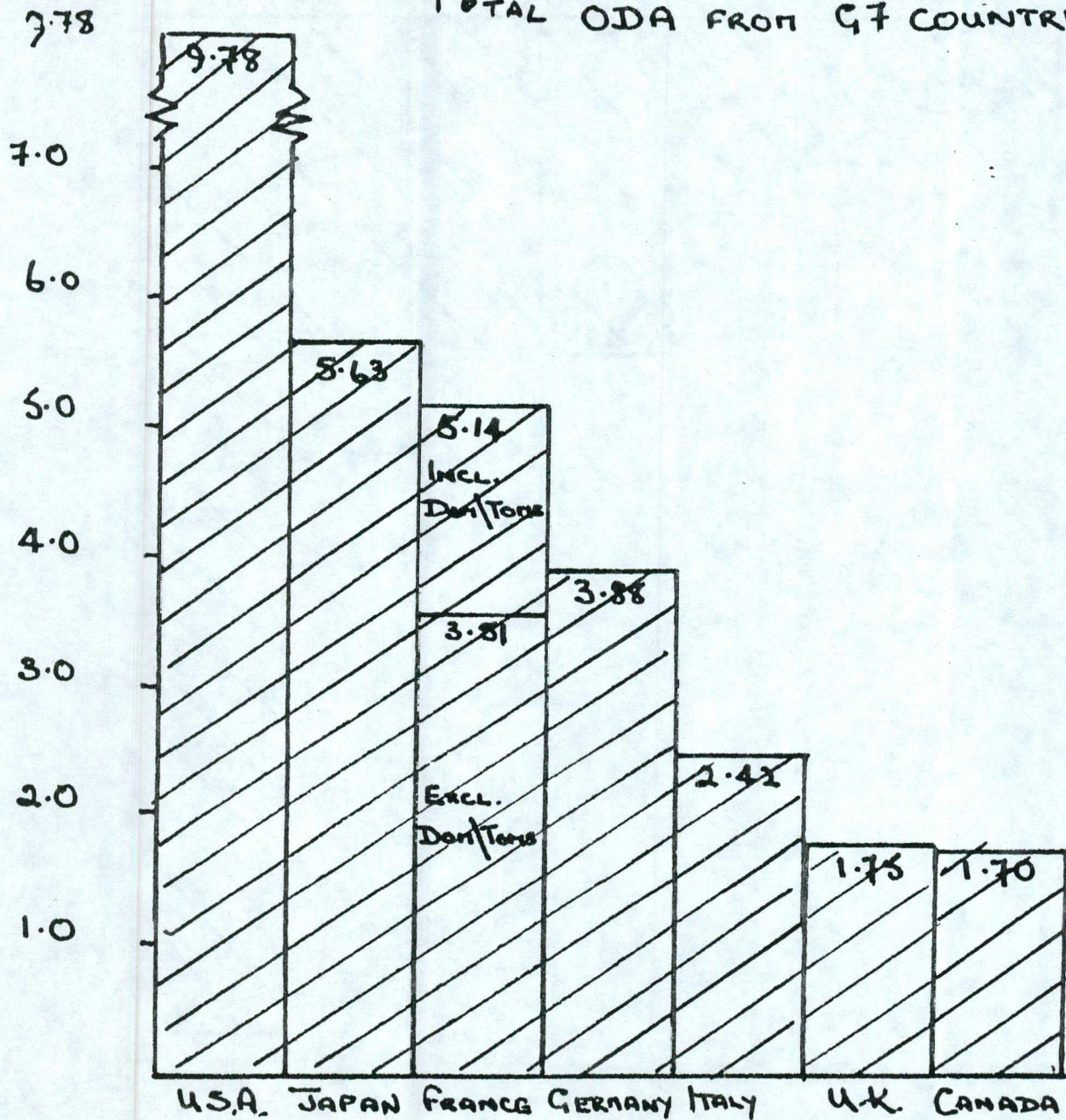
Foreign and Commonwealth Office
1 July 1987

BILATERAL ODA FROM G. 7 COUNTRIES IN 1986

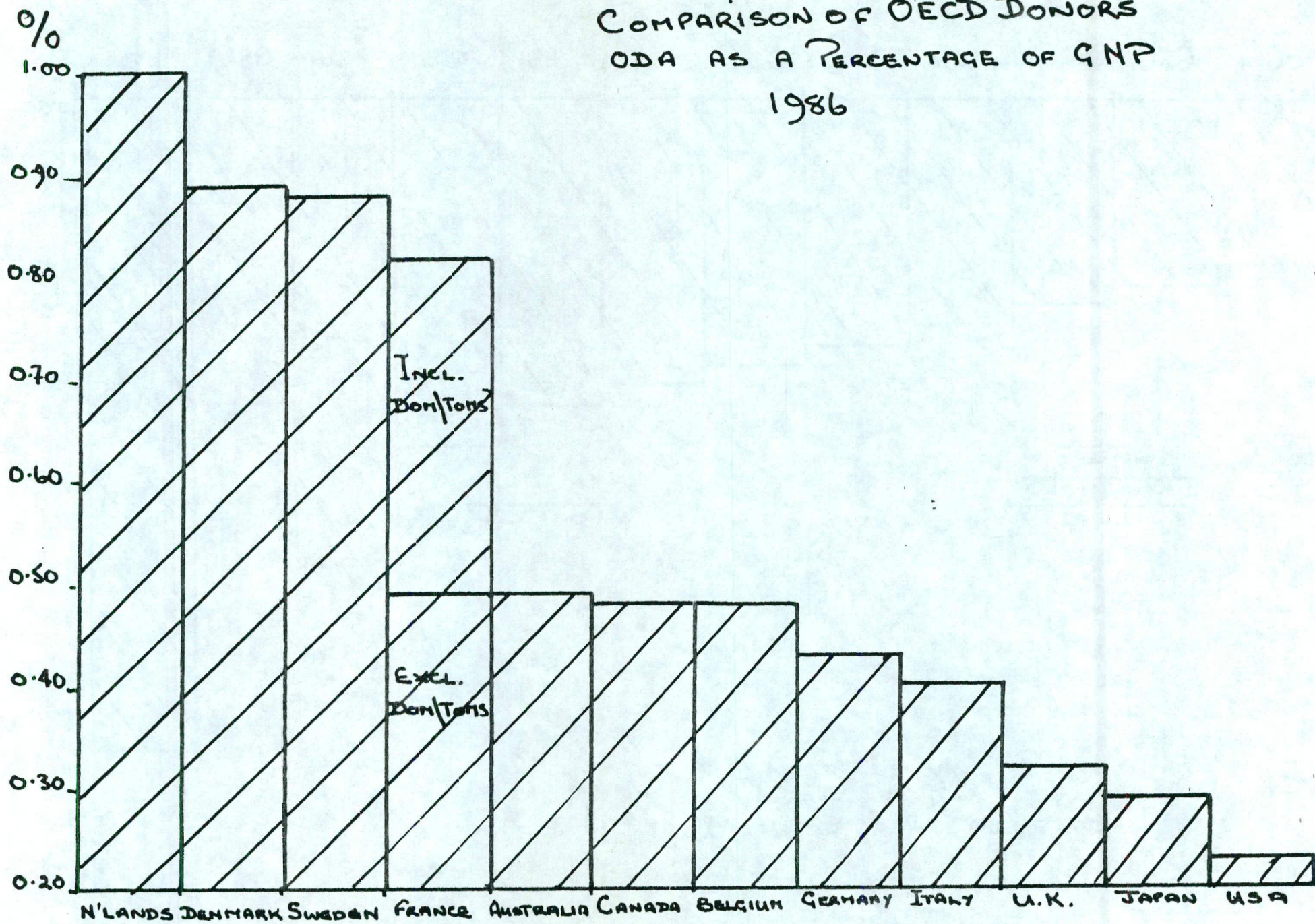
\$'s BILLIONS



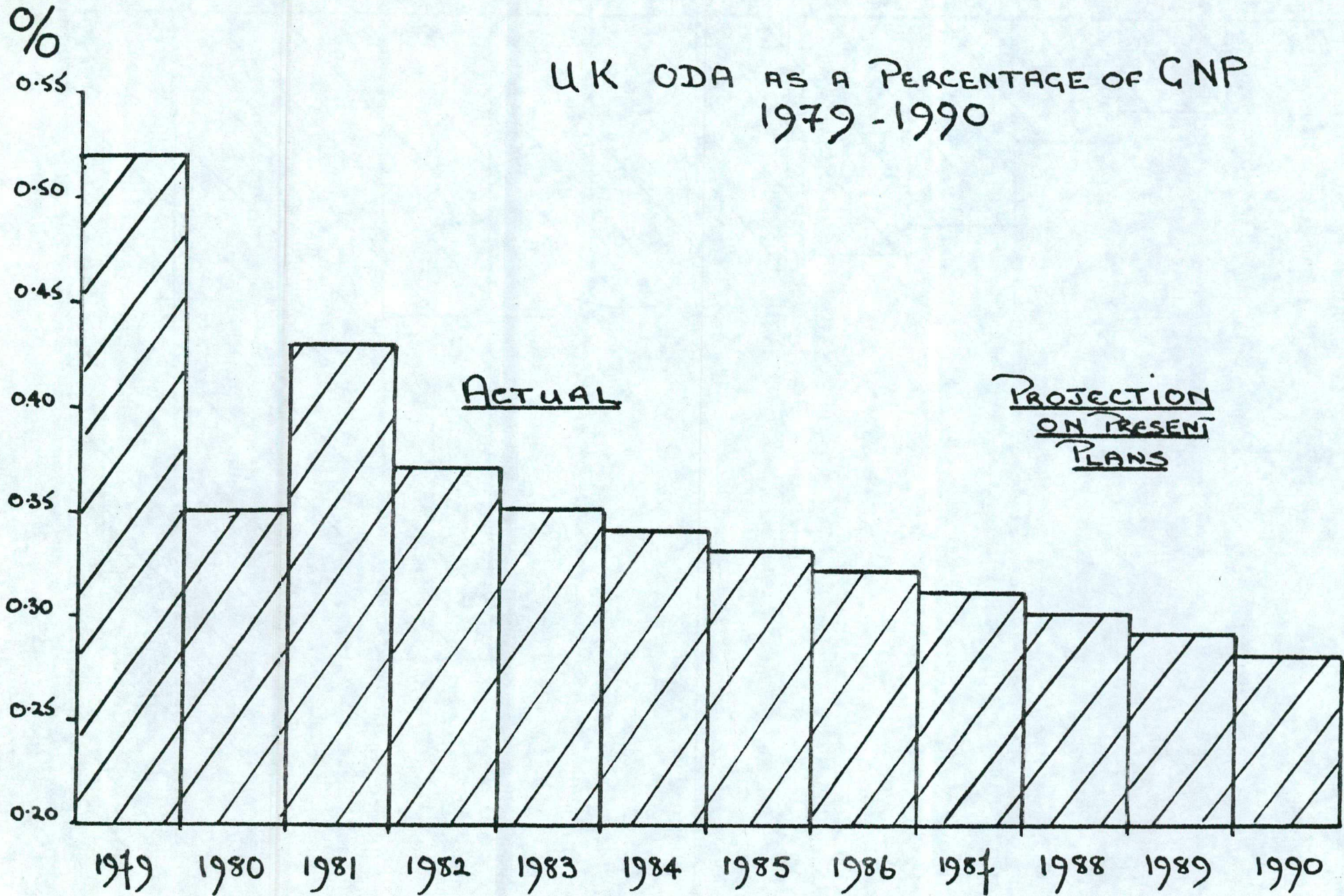
TOTAL ODA FROM G7 COUNTRIES IN 1986 (2'billions)



COMPARISON OF OECD DONORS ODA AS A PERCENTAGE OF GNP 1986



UK ODA AS A PERCENTAGE OF GNP 1979 - 1990



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FROM: R J DEVEREUX

DATE: 2 July 1987

1. MR MOWL *see note at end*
 2. CHANCELLOR OF THE EXCHEQUER *RFM*
- Nigel*
- ✓*

cc Sir P Middleton
 Sir T Burns
 Mr Cassell
 Mr Sedgwick
 Mr Peretz
 Mr Watts
 Mr Ritchie

CGBR(O) AND CGBR IN JUNE

The provisional outturn for the CGBR(O) in June is a surplus of £0.6 billion. Last month's forecast was for zero borrowing. Customs and Excise receipts were £0.4 billion higher than forecast following the decision to make special arrangements to collect some of the Excise duties delayed by industrial action. This effectively brought forward revenue that we had forecast for July. Inland Revenue receipts were £0.2 billion higher than forecast: information about this increase is still to come. The estimate of the outturn is subject to revision before publication on Thursday 16 July.

2. In the first 3 months of 1987-88 the CGBR(O) was £1.7 billion, £1.1 billion lower than the Budget profile. $\frac{1}{4}$ billion of the shortfall is strike related: lower VAT repayments (by $\frac{1}{4}$ billion) have more than offset a shortfall in excise duties and VAT on imports (of £1 billion). Other factors reducing borrowing were

- (a) higher Inland Revenue receipts (by £0.4 billion) at least partly Corporation Tax
- (b) higher privatisation proceeds (by £0.2 billion) mainly due to higher than expected receipts from Rolls Royce.

but the main factor is

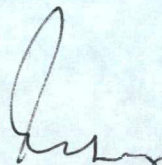
- (c) a shortfall on the expenditure side of the account, excluding debt interest, of about $\frac{3}{4}$ billion.
- W*

These factors have been offset partly by

- (d) higher interest payments net of interest and dividend receipts (by £0.3 billion).
- (e) lower National Insurance Contributions (by £0.2 billion). The latest forecast for 1987-88 as a whole is £½ billion higher than the Budget forecast. In our view, the current shortfall probably reflects the difficulties in forecasting the monthly path of NIC receipts rather than carrying implications for the forecast of the whole year.


3. On-lending to local authorities and public corporations in June totalled £0.5 billion. The CGBR in June was therefore close to zero, bringing the total since 1 April to £4.1 billion.

4. Further analyses of the outturn in June will be given in the next Ministerial note on the PSBR in two weeks time.



R J DEVEREUX

Although the CGBR is £¾ billion (strike adjusted) below profile most of the extra receipts for 1987-88 in the summer economic forecast are still to come through. The undershoot so far is mainly on the expenditure side, but the new economic forecast assumes that this will be more than reversed over the year as a whole.



COLIN MOWL

CONFIDENTIAL AND PERSONAL
CENTRAL GOVERNMENT TRANSACTIONS

£ billion

	June 1987			April-June 1987			April-June 1986
	Provisional outturn	Last month's forecast	Difference	Provisional outturn	Budget profile	Difference	Outturn
Inland Revenue	3.9	3.7	0.2	12.5	12.1	0.4	11.8
Customs and Excise	3.0	2.6	0.4	10.4	10.2	0.2	9.5
National Insurance Contributions (GB)	2.3	2.2	-	6.4	6.6	- 0.2	6.2
Privatisation proceeds	1.7	1.7	-	2.4	2.2	0.2	1.1
Other receipts (a)	0.3	0.3	-	0.9	0.9	-	0.9
Net debt interest payments	-	-	-	- 1.4	- 1.1	- 0.3	- 1.3
Net payments to EEC	- 0.1	- 0.1	-	- 0.3	- 0.4	0.1	- 0.2
Other expenditure (b)	- 10.5	- 10.5	- 0.1	- 32.5	- 33.1	0.6	- 31.0
CGBR(O)	0.6	-	0.6	- 1.7	- 2.8	1.1	- 3.0
On-lending to LAs	- 0.4	- 0.1	- 0.3	- 3.0	- 0.9	- 2.1	- 3.4
On-lending to PCs	- 0.1	-	- 0.1	0.6	0.5	0.1	0.1
CGBR	-	- 0.1	0.2	- 4.1	- 3.2	- 0.9	- 6.4

(a) including changes in bank deposits

(b) net of certain receipts

+ reduces borrowing

- increases borrowing

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ELIZABETH HOUSE
YORK ROAD
LONDON SE1 7PH
01-934 9000

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CHIEF SECRETARY	
REC.	- 2 JUL 1987
Mr Burr	
CX Sir Peter M. Adkins	
Mr Butler Mr Anson	
Mr Luce Mr Gilmore	
Mr Turnbull Mr Gieve	

Mr Cropper Mr Tyrrie.

Handwritten notes in red ink:
We will have
to do something
for schools
a good one
(S.P.) terms

Rt Hon John Major MP
Chief Secretary to the Treasury
HM Treasury
Parliament Street
London SW1P 3AG

Handwritten signature: John Major

2 July 1987

PUBLIC EXPENDITURE SURVEY 1987

1. We have to raise standards in education. The electorate expects us to do so. Carrying our policies forward to a successful conclusion does not depend entirely on money. But progress will only come about if the schools, colleges, universities and research councils have a sound financial base.
2. I do not control the major element of my programme - nearly £14 billion out of £16.6 billion - which is spent by local authorities. My control will increase through the substantial shift of resources from the local authority sector into my Vote programme as I become responsible for funding polytechnics and some colleges and schools. This is a matter of transfer only, and these increases in my Vote programme should not be regarded as additional bids.
3. I have reviewed the rest of my Vote programme in accordance with the guidelines. We must provide additional resources for universities and science and to secure improvements in educational buildings and equipment. As I mentioned in the discussions before the election, there are some limited costs in taking forward our new policies. I am considering further the extra costs for grant maintained schools to which I referred in my minute of 6 April to the Prime Minister and shall write later to you about these if a PES bid is needed. In addition, I want to pursue some important initiatives directed specifically towards the problems of inner cities.
4. Leaving aside transfers, the agreed bids for university academic pay and AIDS research, and the bid for Erasmus, which it has been agreed should be considered separately, my additional bids - which are not listed in any particular priority order - are as follows:-

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£ million (rounded)

	1988-89	1989-90	1990-91
Universities	121	131	146
Polytechnics and Colleges Sector	13	22*	22*
Voluntary Colleges	11	12	13
Student Awards	11	24	29
Science	121	160	183
Special initiatives for inner cities	9	13	13
Maintained Sector Capital Expenditure	180	195	225
National Curriculum	12	25	36
IT in Schools	3	3	3
Expansion of the Assisted Places Scheme	0	1	4
DES Running Costs	11	18	23
	<u>492</u>	<u>604</u>	<u>697</u>

* £20m from 1989-90 onwards is offset by increased VAT revenue.

Universities

	£ million		
	1988-89	1989-90	1990-91
Restructuring	85	85	90
Medical Education	12	17	22
Equipment	10	15	20
New initiatives	10	10	10
Open University	<u>4</u>	<u>4</u>	<u>4</u>
	121	131	146

5. The universities are in a bind. They cannot afford to keep all of their current staff and yet cannot find the severance costs of getting rid of them. Reserves are fast being exhausted; annual deficits are running at an estimated £50m a year; and money will be frittered away on paying for the cost of overdrafts. Those universities with strong management are staying afloat only by keeping crucial posts vacant at the expense of quality. John Harvey-Jones who is now Chancellor at Bradford has said that in his considered judgment it would be better to shut the institution down than to force through the measures which would be necessary on present financial plans.

6. We cannot go on like this. Unless we get things right, there is no prospect of fulfilling the economic need for highly qualified manpower which we set out in the White Paper "Meeting the Challenge" in April. The universities consistently overstate

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their needs, and the UGC's bid to me included items which should properly be met within the existing baseline. I have disallowed such claims. But we must find a realistic basis for setting plans for university funding not just for next year but for the next three years.

7. There is a way forward which will maintain the pressure on universities to be more efficient while helping to deliver our policy objectives. The universities need to lose nearly 2500 academic staff - nearly as many again as between 1981 and 1984 - and to replace a proportion of these to support necessary restructuring and rationalisation. That will involve a three-year programme, with two linked objectives. The first is to enable staff to be shed in good order. The second objective is to recruit the right academic staff for the developments we must encourage for the 1990s, such as the concentration of expensive research in fewer centres. My bid is to provide a restructuring fund, managed by the UGC and with regular reports to me on progress against plans. Allocation of funds would be strictly in keeping with academic plans approved by the UGC, to ensure that the right staff are shed and that replacements are in line with our priorities. This programme will enable us to get the universities back on to a sound financial footing.

8. In addition we need to increase provision for medical education to restore standards and sustain patient care given by academic staff in the National Health Service. I need limited extra funding too for technological equipment; for new initiatives in areas such as manufacturing systems engineering, privatisation of business education and more professional fund raising; and for the Open University.

Polytechnics and Colleges Sector

	£ million		
	1988-89	1989-90	1990-91
Transitional costs	13	2	1.5
VAT (offset by matching receipts)	<u>0</u>	<u>20</u>	<u>20</u>
	13	22	21.5

9. We need to ensure that the management of polytechnics and colleges are equipped to take over their new responsibilities from the day on which assets are transferred to them. I am aiming for 1 April 1989. In the 6 months or so before then - when they will continue to be maintained by local authorities - they will need to set up systems of financial control and personnel management and to have access to their own legal and financial advice. Simultaneously I shall need to meet the costs of establishing the Polytechnics and Colleges Funding Council (PCFC) and the Education Assets Board (EAB). These transitional costs are shown in the table above.

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10. After Vesting Day, institutions' own administration will be covered by the saving of their contribution to local authorities' central services. But I shall then need, on a continuing basis, to compensate the polytechnics and colleges in the new sector for liability to VAT. While this compensation of some £20 million a year will represent a net increase in public expenditure, the commensurately higher return to the Government in VAT receipts means that there will be no change in the PSBR.

11. I should also flag the strong probability that I may have to make a further bid if local authorities' behaviour between now and Vesting Day stores up financial problems for the transferring institutions, whether through asset stripping, failure to sustain capital expenditure on buildings and equipment or other means. I shall take whatever steps are open to me to protect institutions. But there are limits to what I can achieve. At this stage I cannot make any sensible estimate of the remedial expenditure that may be necessary.

Voluntary and Grant-Aided Colleges

	£ million		
	1988-89	1989-90	1990-91
	10.9	12.1	12.7

12. The voluntary colleges have reduced their unit costs by 15% in real terms in the last five years. Their student-staff ratios have already fallen below the level appropriate for training teachers to the minimum standards required. The present baseline implies a further reduction in unit costs and worsening of the student-staff ratio. Unless the baseline is increased we face two possible consequences. First, some of the colleges will cease to be able to provide teacher training and other higher education which meets the requirements of the validating bodies and criteria we have set for initial teacher training courses. Secondly, a small number of colleges which are already in financial difficulties are likely to face insolvency. Either of these outcomes will result in a bitter public row with one or both of the churches - 19 of the 32 voluntary and grant-aided colleges are church foundations - and threaten an essential element in our teacher training plans. We must act to forestall these consequences in 1988-89 so that the colleges can join the new polytechnics and colleges sector on a sound financial footing.

Student Awards

	£ million		
	1988-89	1989-90	1990-91
	11.5	23.9	28.8

13. My bid caters for the increase in student numbers we expect to be eligible for mandatory awards; takes account of the Treasury's revised forecast of GDP deflators in fixing the level of fees; provides for maintenance increases in line with the new

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GDP deflator figures; and provides compensation from April 1989 for the impact of the Scottish community charge on English and Welsh students studying in Scotland. The introduction of the community charge for England and Wales will have implications for student awards which we shall need to consider in due course.

14. By the time of the next Survey I would hope to have brought forward to colleagues the results of the Review of Student Support. Meanwhile the main purpose of my bid is to keep the present system running on a viable basis.

Science

	£ million		
	1988-89	1989-90	1990-91
Essential underpinning	30	38	42
Government commitments	12	21	7
Strategic reshaping of the science base	<u>79</u>	<u>101</u>	<u>134</u>
	121	160	183

15. During our first two terms of office, we steadily reduced funding for the Science Budget relative to our growing national wealth. Our plans provide for a further reduction. Indeed, for the first time ever, cash provision next year is planned to reduce slightly. In contrast, our major competitors are committed to greater investment in science and technology as essential for survival in an increasingly competitive world economy. The ABRC is pressing that we increase investment in science to provide for restructuring and strategic priorities.

16. The first element of my bid provides only for the minimum level of cash needed to ensure that we can maintain the present level of science. If we do not provide this, there will be further damaging cuts by the Research Councils. I also need additions for our other policies, notably for Antarctica in accordance with the Prime Minister's decisions. The main component here is replacing the RRS John Biscoe on the basis recorded in Mr Powell's letter of 5 March 1987. Finally, I want to press ahead more rapidly with restructuring the science base. Greater selectivity and concentration are essential if we are to provide the science the nation needs at a price it can afford. The ABRC has put forward exciting and radical proposals which I am studying. But I shall need money for restructuring university research and to sustain the quality of our science capability for response in selected fields of national interest during that restructuring. In particular, we must hold on to our very best scientists.

17. I know you will ask me about CERN. I am studying Professor Abragam's interim report which we have just received. Your officials have a copy. CERN is taking too much of the Science Budget. On present expenditure plans I would expect to have to advocate withdrawal. But our future relationship with CERN is

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not a matter to settle solely, even primarily, on expenditure grounds. Scientifically it is probably the most successful collaboration in the world, held in immense esteem by our Continental partners. Withdrawal would have repercussions far beyond particle physics and other science. It is a subject we must discuss with colleagues in the autumn, perhaps in E(ST). If possible we should aim for an agreed Government view by the time of our bilateral.

Special initiatives for inner cities

	£ million		
	1988-89	1989-90	1990-91
	9	13	13

18. If our policies for the inner cities are to succeed, we shall need to find ways of mobilising local communities to help themselves. This is where the education service can help - not only through special initiatives to tackle problems in inner city schools but also in continuing education and the youth service. I have a range of special initiatives in mind but am constrained by the powers available to me for taking them forward. I may want to return to that. Meanwhile I set down here some important initiatives which could be taken forward quickly with additional Vote expenditure:

- (a) One of the key problems in inner city schools is the difficulty of providing them with the really good teachers they need. Two small scale developments in East London and Leicester point the way forward. They link good quality teacher training institutions with particular schools, provide support and in-service training for teachers in the schools and - most importantly - encourage good new teachers during their initial training to develop relevant expertise and to seek work in inner city schools. I propose to build on these successful developments by establishing similar work in six other centres, at a cost of £2 million in 1988-89 and £3 million in each of 1989-90 and 1990-91.
- (b) I want to mount pilot schemes in about 10 LEAs to give 300 indigenous young people, black and white, the opportunity to do youth work and to train as youth leaders in their own communities. The LEAs themselves would contribute 30 per cent of the cost, and I have no doubt that this scheme could stimulate self-help in just those depressed communities we most want to reach.
- (c) In adult and continuing education, I want to increase support for Adult Literacy Centres and for 'partnership' courses for adult retraining provided in collaboration with local industry.

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Maintained Sector Capital Expenditure

£ million		
1988-89	1989-90	1990-91
180	195	225

19. The condition of school buildings is getting steadily worse. We face - not least in many of our inner cities - a legacy of outdated buildings from previous generations. And across the country as a whole we face the ever-increasing costs of replacing roofs and boilers which have reached the end of their planned lives in buildings put up twenty or so years ago.

20. I shall shortly have to publish the results of the national survey of county and controlled school buildings which was commissioned by Keith Joseph. That survey points plainly to the need for substantial spending to remedy defects in the structure of these buildings and to bring them up to the required educational standards. There is every indication that the condition of the aided school stock is even worse.

21. This state of affairs has come about because of long-term under-investment. Our own record is not good. Since 1979 local authority capital expenditure on schools has fallen by a quarter in real terms. Before the next election we must make a large-scale improvement in the state of our school buildings; and we need to start now. My bid will allow us to begin an improvement programme, which I shall want to focus on the inner cities as a contribution to our broader efforts there. And it will allow us to invest on sorely-needed improvements in the Church schools.

22. Further and higher education buildings are little better than the schools: much teaching takes place in unsuitable and uneconomic temporary accommodation, and buildings put up in the 60s and 70s suffer the same problems as the schools. There is however another priority in further education to which I attach at least as great importance: the need to provide for a realistic level of investment in equipment. The inability of colleges and polytechnics, at current levels of investment, to renew obsolescent equipment has been identified as a major and increasing problem by employers, validating bodies, HMI and DTI. As in the case of the schools, my bid will allow us to start putting right the deficiencies in further and higher education buildings and equipment.

23. In 1988-89 my bid would allow me to allocate £463 million to local authorities: £294 million from the existing baseline plus £169 million arising from the local authority component of the bid. Officials have agreed that bids should be adjusted to preserve that level of allocations in the light of information we shall shortly receive on outturn in 1986-87: I welcome that arrangement. Without an addition to my programme on this scale the anger at the state of education buildings and equipment which many of us met during the campaign will continue, and I shall have no answer to offer once the survey of school accommodation is published.

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The National Curriculum

£ million		
1988-89	1989-90	1990-91
12	25	36

24. Our proposals for a national curriculum are vital to improving standards in schools. I circulated the details before the election. The main increase in expenditure is for the new assessment and testing regime. Apart from that, limited increased costs arise from the research and development work needed to establish and then to maintain the national curriculum; from the statutory National Curriculum Committee which will advise me on it; and from evaluation of this radical new initiative and the impact it makes in schools.

IT in Schools

£ million		
1988-89	1989-90	1990-91
3	3	3

25. I am seeking an additional £3m each year to support activity in the field of schools IT. You will know that I believe the time is right - educationally and technologically - for a major new thrust in this area. We are clear now that IT has a great amount to offer, as an instrument for learning, in almost any area of the curriculum; and though the initiatives of recent years have ensured that almost every school now has at least one micro in it, the availability of hardware and professional expertise is still a long way short of what is needed if all pupils are to use IT in the ordinary processes of teaching and learning across the curriculum as a whole. I have therefore designed a comprehensive strategy, using a variety of levers, aimed at securing those educational benefits through wider pupil access to the technology and better support - in terms of high quality training and teaching materials - for teachers.

26. I have as you know the agreement of colleagues to proceed with an extension of Education Support Grant to pay for advisory teachers to take IT across the curriculum and an increase in the amount of hardware itself. I am also working on a better focussing of INSET grants in this area. My bid complements those initiatives directly, and is specifically designed to ensure their quality, in particular by providing for the cost of monitoring and evaluation.

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Assisted Places Scheme

£ million		
1988-89	1989-90	1990-91
0.3	0.7	3.6

27. Our manifesto committed us to expand the Assisted Places Scheme to 35,000 places. That means that to reach our target over the next seven years we shall need to provide some 200 additional places in England each year. I plan to begin the expansion in September 1988. My bid also covers the realistic needs of the scheme in 1990-91.

Departmental running costs

£ million		
1988-89	1989-90	1990-91
11.4	18.2	23.1

28. Keith Joseph and I both made clear to John MacGregor last year our conviction that the Department was seriously under-resourced for its running costs. In my letter of 26 September I accepted only with extreme reluctance the compromise we reached in discussion on the 1986 PES. As a result I had to postpone staff recruitment and important work. We now have a mandate to put into effect the major programme of educational reform approved by Cabinet before the election which will place great demands on my Department over the next three years or so - not only in respect of detailed policy development work but also major legislation on a wide range of matters and considerable administrative activity on subsequent implementation. We have trimmed activities and re-deployed staff where we can but as a small department our room for manoeuvre is limited. I have written to you separately about 1987-88. For 1988-89 onwards there can be no question of absorbing the extra workload within our present ceiling of 2,450 posts. The pressure will shift over the PES period, being high in the first year on the transfer of polytechnics from LEAs and the Interim Advisory Committee on teachers pay and building up later on Grant Maintained schools. The effect of this pattern of activity is that we shall need around 125 extra posts throughout. There will also be substantial extra non-pay costs, not only for the new initiatives, in particular the move to a national curriculum, but also for our prospective move to refurbished premises in Westminster.

29. My bid is designed

- i. to meet the costs of a staffing level which can effectively carry out existing essential functions as well as work up, deliver and disseminate our new policies - which we judge to be of the order of 2575 in each of the Survey years;

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- ii. to make adequate provision for the non-pay current and capital costs of the new policy initiatives, new accommodation, and restoring activities such as the explanation of policy which have been postponed but cannot be held back any longer; and
- iii. to make full provision for the present and likely future pay costs of the existing staff of the Department. Since I cannot absorb the new work which needs to be done within the existing staff it follows that I have no scope for absorbing the effects of inadequate provision for meeting their future pay costs.

AGREED BIDS AND ERASMUS

	£ million		
	1988-89	1989-90	1990-91
University academic pay	56	71	73
AIDS research	6	8	8

30. Since the end of the last survey we have announced additional funding for university academic pay and for AIDS research. On university academic pay, I have asked Sir Mark Richmond and his colleagues from the Committee of Vice-Chancellors and Principals to report to me on the significant progress which I understand is being made to meet the conditions on appraisal, probation and promotion set out in my statement of 23 January 1987. I should be glad to know that you can agree to transfer the agreed sums from the Reserve to my programme: I shall of course seek your agreement, on the basis of progress on meeting the conditions, before making the funds available to the universities. I should also be glad to have your confirmation that you will meet the agreed bid for AIDS research.

ERASMUS

	£ million		
	1988-89	1989-90	1990-91
	2.7	5.0	6.2

31. In May John MacGregor endorsed a basis for dealing in the Survey with the EC Budget commitment resulting from agreement by the member states in Brussels to the European Commission's proposals for a European Community action scheme for the mobility of university students (ERASMUS). The bid now comes to you for separate consideration on the basis agreed by John MacGregor.

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TRANSFERS INTO VOTE EXPENDITURE

32. Our policies for higher education and for GM schools will necessitate a major but self-balancing shift of resources out of local authority current expenditure into the Vote programme from 1989-90. There will need to be further discussions between our officials about the timing and scale of these changes. On the basis of my present plans I envisage transfers of the order of:

	£ million		
	1988-89	1989-90	1990-91
Polytechnics and colleges sector -	-	840	870
GM schools -	-	30	95

The figures for the polytechnics and colleges sector include transitional provision for the phasing-out of topping up and for important non-advanced FE work in the transferring institutions. There will be of course need to be in addition a shift from local authority capital funding into my Vote programme to meet the needs of the institutions. The estimate for GM schools is necessarily tentative: the amount to be transferred will depend on the number of schools which opt out in each year. It too will need to include a capital element. Arrangements will be made to neutralise the effect of these transfers on the burdens carried by tax and rate payers.

FLEXIBILITY

33. As last year, in addition to the bids I have set out above I must also ask for a modest degree of flexibility within my overall programme once we have agreed the totals between us. I shall need to take account of new priorities and calls on resources - for example, additional activity on AIDS education and measures to combat teacher shortage - which would not in themselves merit substantive bids because of their size; and as last year I would propose to deal with those demands by appropriate redeployment.

34. I can sum up by saying that I see my bids as unavoidable in the light of our commitments to the electorate.

35. I am copying this letter to the Prime Minister, the Lord President and to the Secretaries of State for Scotland, Wales, Northern Ireland, the Environment, Employment, and Trade and Industry. Copies also go to the Secretaries of State for Social Services and for Foreign and Commonwealth Affairs, who have an interest in the matters discussed in paragraphs 8 and 16-17 respectively.


KENNETH BAKER

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FROM: COLIN MOWL
DATE: 8 JULY 1987

1. MR CASSELL
2. CHANCELLOR OF THE EXCHEQUER

cc Sir P Middleton
Sir T Burns
Mr Peretz
Mr Sedgwick
Mr Ritchie
Mr Devereux

Thanks

PSBR IN JUNE

The first provisional outturn for the PSBR in June is a surplus of £0.6 billion, compared with last month's forecast of a surplus of £0.2 billion (see table attached). Market forecasts of the PSBR in June are not yet available. Our estimate is subject to revision before publication at 11.30 am on Thursday 16 July.

2. Borrowing on central government own-account in June was provisionally a surplus of £0.6 billion, £0.6 billion lower than last month's forecast. As explained in Mr Devereux's minute of 2 July, this shortfall was mainly due to the receipt of £0.4 billion of Customs and Excise receipts which the forecast had assumed would be delayed by industrial action. In the event special arrangements were made to collect the duties in question. Inland Revenue receipts were £0.2 billion above last month's forecast.

3. The LABR in June is provisionally zero net borrowing compared with last month's forecast of a repayment of £0.4 billion. The PCBR in June was also zero, compared with forecast borrowing of £0.2 billion.

4. The PSBR in the first 3 months of 1987-88 was £0.8 billion, £1.7 billion below the Budget profile. Central government own account borrowing is just over £1 billion below profile and the LABR and PCBR are each about £¼ billion below profile.

5. The monthly note, presenting updated estimates for June and detailed forecasts for July-September, will be circulated next Wednesday.

Colin Mowl

COLIN MOWL

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	June 1987			April-June 1987			April-June 1986
	Provisional outturn	Last month's forecast	Difference	Provisional Outturn	Budget forecast	Difference	Outturn
CGBR(O)	-0.6	-	-0.6	1.7	2.8	-1.1	3.0
LABR	-	-0.4	0.4	-0.2	0.1	-0.3	-0.1
PCBR	-	0.2	-0.2	-0.7	-0.4	-0.3	-0.8
PSBR	-0.6	-0.2	-0.4	0.8	2.5	-1.7	2.2

FROM: COLIN MOWL
DATE: 14 JULY 1987

CHANCELLOR OF THE EXCHEQUER

cc Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell o/r
Mr Sedgwick
Mr Culpin
Mr Pickford
Mr Ritchie

OK (hp p9)

DRAFT PRESS BRIEFING ON PSBR IN JUNE

I attach the draft press briefing on the PSBR in June.

2. The estimate of the PSBR in June to be published on Thursday is a surplus of £0.8 billion, a £0.2 billion bigger surplus than the first internal estimate in my minute of 8 July. The downward revision is to the PC and LA components.

Statement for Reuters

3. The proposed on-the-record Treasury Statement to Reuters, which they do not always put on the screen, but also forms the overall line to take for IDT, is as follows:-

"The PSBR in June is provisionally estimated as a surplus of £0.8 billion. Privatisation proceeds were £1.7 billion. Excluding privatisation proceeds borrowing in the first three months of 1987-88 was slightly below that in the same period last year."

This formulation has been discussed with IDT.

Civil Service Industrial Action

4. The briefing offers no estimates of the effects of the Civil Service industrial action on the PSBR but is confined to the qualitative comments that the net impact to end-June is quite small and that the distorting effects should be largely unwound by the end of July. We propose to go no further than this partly to avoid the precedent of quoting figures but also because the estimates are uncertain.

5. The repayment supplements arising from the delay to VAT repayments (less than £0.1 billion) are being paid this month. We propose to give no estimate of them at this stage.

Privatisation Proceeds

6. As has been the practice since your request in May the briefing gives details of known future privatisation proceeds (with the introduction of a new table last month the press notice now gives figures for past proceeds). PE's advice is that no estimates should be given for BAA until the sale is completed.

Outside Forecasts

7. We now have a fairly full list of City forecasts for the PSBR in June (12 in all). Most have surpluses in the range £½-1½ billion with the majority towards the top of the range. The two exceptions are Phillips and Drew and Greenwells who have deficits of £1½ billion and £½ billion respectively. We suspect that P and D have overlooked the second British Gas call. Excluding P and D and Greenwells the average forecast is a repayment of £1¼ billion.

Conclusions

8. We should be grateful for:

- (i) comments on the statement to Reuters
- (ii) comments on the press briefing.

Colin Mowl

COLIN MOWL



Ch.

The short answer to your question about the DES copy list is that all the recipients got Mr Baker's original bidding letter.

This is because they all have an interest in the DES programme, viz:

Sir G Howe - ERASMUS

Mr Moore - Academic staff in NHS

Mr Ridley - LA capital expenditure

Mr Fowler - Training

Ld. Young - science/technology

Mr Rifkind, Mr Walker,

Mr King - regional implications.

Maybe,
but technically
unworkable.

JF
5/8

CONFIDENTIAL



*c.c. Chancellor
Sir Peter Middleton
Mr Butler Mr Brown*

*Mr Love Mr Turnbull Mr Burt
Mr Gilmore Mr Greve Miss S. Walker
Mr S. Kelly*

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Kenneth Baker MP
Secretary of State for Education and Science
Department of Education and Science
Elizabeth House
York Road
London
SE1 7PH

Dear Ken,

I am puzzled by the copy letter for which I am responsible. It is a copy of the letter to the Chancellor. I am sorry for the error.

31 July 1987

PUBLIC EXPENDITURE SURVEY 1987: EDUCATION AND SCIENCE

Thank you for your letters of 2 and 27 July. Following the Cabinet discussion on 23 July, I am writing to propose an agenda for our bilateral meeting in September.

... The enclosed table sets out the key figures for our discussion. It has been discussed between our officials and is therefore, I hope, an agreed starting point. If any changes are needed to reflect later information I hope these can be agreed between our officials and a revised table circulated before we meet.

The table sets out the various increases you have proposed. As I made clear in the Cabinet discussion, very substantial reductions in additional bids or offsetting changes in policy will be needed on your programme as well as others in order to fulfil the remit agreed by Cabinet and to hold to the policy of reducing public expenditure as a proportion of national income as set out in the White Paper. Your letter acknowledges that successful implementation of our education policies does not depend entirely on money. A key tenet of our whole approach to government is to get away from the easy path of simply spending more; and to insist on value for money from all public expenditure, existing as well as new, and on a rigorous view of priorities. Yet you present me, on a programme of nearly £4 billion, with bids approaching 20 per cent of the baseline by the end of the survey period. These bids cover every part of your programme, and come on top of the substantial increase in provision already announced for local authority current expenditure.

First, then, I am disappointed that you have explicitly declined to indicate priorities between your bids and that the scope you see for identifying ways in which additional spending

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could be offset by economies and improved efficiency elsewhere in your baseline is limited only to very minor items. We cannot sensibly consider your programme on that basis. We must focus our discussion on a rigorous examination of priorities within it. I shall therefore want to discuss with you the priority you attach to your bids relative to your existing areas of spending and to each other.

I hope, however, that before we reach that stage you will agree to look again at your bids and consider whether they can be scaled down, and indeed whether they are all necessary. I am surprised, for example, by the size of your bids on higher education. Your department's own figures show that per capita spending in the UK, even after disregarding student awards, is 16 per cent higher than in France and 38 per cent higher than in West Germany. Even so you are now bidding to add £121 million (or 8 per cent) to this programme in the first Survey year although the provision for that year includes the £127 million (or 9 per cent) which my predecessor agreed to add to it less than a year ago to cover both pay restructuring and the "level funding" for which you were then arguing. Your bid for maintained schools capital expenditure would increase existing provision by no less than 45 per cent in the first year. That is in spite of the fact that local authority schools' maintenance (which I know is sensitive) comes out of current provision which has already been settled. And for aided schools it comes on top of the increase of nearly 20 per cent agreed in last year's Survey. The greater part of your science bid (£79/£134 million - amounting in itself to 12-19 per cent of the science baseline) seems to be for policies which you have not yet espoused: I return to this below.

Among your minor bids, I find it difficult to accept, for example, that in a baseline of some £4 billion you cannot absorb the additional expenditure you propose on the Assisted Places Scheme and on IT in schools. As your officials will know, we are proposing to postpone the impact of the EUROPE arrangements for a year until the 1988 Survey: so we will not need to consider your ERASMUS or FRAMEWORK bids now.

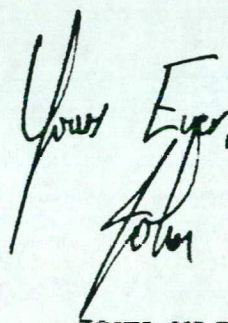
I am also disappointed by the lack of material specifying the objectives of the extra spending you propose, the targets to be achieved, and the measures on which subsequent evaluation would be based. The establishment of targets is important not only in examining the case for bids, but also as part of our wider efforts to improve the budgeting and management of public spending. Some of your bids are premature in this respect. That on the national curriculum was submitted in advance of the detailed discussions which have since taken place in E(EP). I made clear in that context my concern about what seem to me to be unnecessarily expensive and heavy-handed proposals for the control of qualification and examinations. Your bid for GM schools, in your separate letter of 27 July, is in advance of discussion of the details of the scheme agreed in E(EP), and is anyway of the order which I ought to be entitled to look to you to absorb. Especially since there will be no expenditure under the scheme in 1988-89, I propose that we should not consider that bid further in this Survey.

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I shall want to look very closely at your science bid in the light of my predecessor's letter of 15 May to Paul Channon, which made clear that a bid could not be considered without firm proposals on the objectives to be achieved and the means of achieving them within a set timescale. Your bid is not sufficiently specific on these issues. I hope that our officials can pursue this, and the need to set clear objectives for all your bids for extra spending, in advance of our bilateral. I shall not be willing to recommend to Cabinet bids where the benefit to be obtained has not been clearly demonstrated.

Cabinet agreed that aggregate running costs should grow no faster than public expenditure generally, and that for 1988-89 we should aim to constrain the overall increase over the baseline to less than half the total of bids made. This tight envelope will need to accommodate the volume pressures on some departments. We shall need to consider your Survey bids in the light of the outcome on your bid for additional provision in 1987-88. On that my letter of 13 July acknowledged the need for some increase in DES manpower to cope with the new initiatives. I understand that our Permanent Secretaries have discussed this and a satisfactory agreement has now been reached. For the longer-term, we shall need as part of the Survey to discuss plans for improving efficiency, measured by information relating costs to outputs wherever possible, both in 1988-89 and over the later years, with a view to reducing very substantially the extra provision you have sought. I suggest that our officials should discuss the position before we meet; but I hope you will do everything possible to assist in reaching the Cabinet's target.

I am copying this letter to Geoffrey Howe, John Moore, Nicholas Ridley, Norman Fowler, David Young, Malcolm Rifkind, Peter Walker and Tom King.

A handwritten signature in black ink, appearing to read 'John Major', written in a cursive style.

JOHN MAJOR

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TABLE FOR AGENDA LETTER
Department of Education and Science

£ million
except
where
stated

	1987-88	1988-89	1989-90	1990-91
A. Expenditure baseline				
A1 Universities	1,663.7	1,716.2	1,764.2	1,808.3
A2 Voluntary colleges	100.4	103.8	106.4	109.1
A3 Science	657.5	666.9	681.6	698.6
A4 Student awards	741.1	758.1	779.6	799.1
A5 (i) LA capital	364.4	353.1	360.5	369.5
(ii) Vol. schools capital	53.9	54.6	54.8	56.2
A6 Assisted places scheme	49.3	55.1	59.0	60.5
A7 Running costs	58.3	59.5	60.9	62.4
A8 Other (ie balancing items)	67.2	83.3	99.2	101.7
TOTAL	3,755.8 ¹	3,850.6	3,966.2	4,065.4
B. Proposed Additions				
B1 Universities		121.0	131.0	146.0
B2 Polytechnics and colleges ²		13.0	22.0	21.5
B3 Voluntary colleges		10.9	12.1	12.7
B4 Science		119.0	158.0	181.0
B5 Student awards		11.5	23.9	28.8
B6 (i) LA capital		145.0	135.0	175.0
(ii) Vol. schools capital		35.0	60.0	50.0
B7 National curriculum		12.3	24.7	36.3
B8 Assisted places scheme		0.3	0.7	3.6
B9 Inner cities initiatives		9.0	13.0	13.0
B10 Grant maintained schools		-	1.3	2.1
B11 IT in schools		3.0	3.0	3.0
B12 Academic pay (already agreed)		56.0	71.0	-
B13 Academic pay		-	-	73.0
B14 AIDS research (already agreed)		6.0	8.0	-
B15 AIDS research		-	-	8.0
B16 Running costs		10.3	13.3	18.1
B17 Admin capital		1.1	4.9	5.0
TOTAL		553.4	681.9	777.1
C. Proposed Reductions				
NONE				

¹ 1987-88 baseline increased by £43.3 million for Academic pay, £2.5 million for AIDS research and £15 million for Science

² £20 million per annum will be offset by VAT receipts from 1989-90 onwards

D. Gross Running Costs (per cent changes on previous year)

(i) Baseline		60.1(3.1)	61.6(2.4)	63.1(2.5)
(ii) Department's Proposal		70.4(20.8)	74.9(5.6)	81.2(8.4)

	1.4.86	1.4.87	1.4.88	1.4.89	1.4.90	1.4.91
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E. Manpower

Baseline	2,413	2,420	2,450	2,450	2,450	2,450
Proposed Additions	-	-	123	133	125	125
Proposed Reductions	-	-	-	-	-	-

CONFIDENTIAL AND PERSONAL

FROM: R J DEVEREUX
DATE: 4 August 1987

1. MR CASSELL
2. CHANCELLOR OF THE EXCHEQUER

cc Sir P Middleton
Sir T Burns
Mr Sedgwick (o.r)
Mr Peretz
Mr Mowl (o.r)
Mr Watts
Mr Ritchie

CGBR(O) AND CGBR IN JULY

The provisional outturn for the CGBR(O) in July is a surplus of £0.5 billion. Last month's forecast was for borrowing of £0.1 billion. The main differences were on receipts: National Insurance Contributions were £0.2 billion higher than forecast, and Customs and Excise net receipts were £0.3 billion higher (largely because of lower than expected VAT repayments). Most of the effects of industrial action at Customs and Excise appear to have unwound in July, but the shortfall on VAT repayments this month may imply that there are some small effects still to come through. The estimate of the CGBR(O) outturn is subject to revision before publication on Tuesday 18 August.

2. In the first 4 months of 1987-88 the CGBR(O) was £1.2 billion, £1.7 billion lower than the Budget profile. The main factors reducing borrowing were

- (a) higher Inland Revenue non-oil receipts (by £0.4 billion) mainly Corporation Tax.
- (b) higher Customs and Excise receipts (by £0.3 billion), largely VAT.
- (c) higher privatisation proceeds (by £0.3 billion) mainly higher than expected receipts from Rolls Royce and British Airports Authority and lower costs, so far, in respect of the second call on British Gas.
- (d) higher national insurance contributions (by £0.1 billion).
- (e) a shortfall on the expenditure side of the account, excluding debt interest, of about £¾ billion.

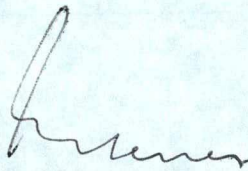
These factors have been offset partly by

Why? — good question

(f) higher net debt interest payments (by £0.2 billion).

3. On-lending to local authorities and public corporations in July was close to zero. The CGBR in July was therefore a surplus of £0.4 billion. The CGBR since 1 April totals £3.6 billion.

4. Further analyses of the outturn in July will be given in the next Ministerial note on the PSBR in two weeks time.



R J DEVEREUX

CONFIDENTIAL AND PERSONAL
CENTRAL GOVERNMENT TRANSACTIONS

£ billion

	July 1987			April-July 1987			April-July 1986
	Provisional outturn	Last month's forecast	Difference	Provisional outturn	Budget profile	Difference	Outturn
Inland Revenue	6.2	6.2	-	18.7	18.3	0.4	18.0
Customs and Excise	3.4	3.0	0.3	13.8	13.5	0.3	12.7
National Insurance Contributions (GB)	2.5	2.3	0.2	9.0	8.9	0.1	8.4
Privatisation proceeds	0.6	0.5	0.1	3.0	2.7	0.3	1.1
Other receipts (a)	0.3	0.3	-	1.2	1.2	-	1.1
Net debt interest payments	- 1.5	- 1.5	-	- 2.9	- 2.7	- 0.2	- 2.8
Net payments to EEC	- 0.2	- 0.1	- 0.1	- 0.5	- 0.5	-	- 0.3
Other expenditure (b)	- 10.8	- 10.9	0.1	- 43.3	- 44.2	0.8	- 41.3
CGBR(O)	0.5	- 0.1	0.5	- 1.2	- 2.9	1.7	- 3.0
On-lending to LAs	- 0.1	- 0.2	0.1	- 3.1	- 1.0	- 2.0	- 3.5
On-lending to PCs	-	-	0.1	0.6	0.5	0.2	- 0.1
CGBR	0.4	- 0.3	0.7	- 3.6	- 3.5	- 0.1	- 6.7

(a) including changes in bank deposits
(b) net of certain receipts

+ reduces borrowing
- increases borrowing

From: J ODLING-SMEE

12th August 1987

CHANCELLOR OF THE EXCHEQUER

cc Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr Cassell
Mr Evans
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mr S Davies
Mr Grice
Mr S Matthews
Mr Melliss
Mr Mowl
Mr Riley
Mr Bredenkamp
Mr Kelly
Ms Turk
Mr Cooper
Mr Franklin
Mr Cropper

THE CYCLICALLY-ADJUSTED PSBR

We have been updating our estimates of the cyclically-adjusted PSBR, and comparing them with other published estimates. The attached note presents the main conclusions and surveys the various arguments that have been made about how cyclically-adjusted measures of the PSBR should be used in policy and economic analysis. The conclusions are summarised on the first three pages.

2. Also attached is a longer paper which goes into some of the technical arguments in a little more detail, in a form suitable for discussion with economists and others outside government.

3. No decisions are required. The note is for general information and the longer paper for those who need more detail.

John 09

J ODLING-SMEE

THE CYCLICALLY-ADJUSTED PSBR

This note presents our latest estimates of the cyclically-adjusted PSBR since the mid-1960s and compares them with other published estimates. It then surveys the various arguments that have been made about how cyclically-adjusted measures of the PSBR should be used in policy and economic analysis. These fall under three headings, with the cyclically-adjusted PSBR being advocated as:

- a target for fiscal policy
- a measure of discretionary fiscal policy changes
- a measure of the impact of fiscal policy on demand and activity

2. The main conclusions are:

- in recent years when growth has been fairly steady our measure of the cyclically-adjusted PSBR has been close to the actual PSBR (Chart 1). The cyclical adjustments for earlier years do not exceed about 1% of GDP and are generally less than this (paragraphs 4-11);
- other estimates of the cyclical adjustment tend to be larger than ours, which has led people to draw policy conclusions which we do not agree with (see below). Those of the OECD and the NIESR, for example, are 3%-4% of GDP for the 1980s, and the cyclically-adjusted PSBRs are sometimes negative (paragraph 11);
- the differences between their measures and ours are mainly attributable to different estimates of trend output, but partly also to different estimates of the effects of a given output gap on the PSBR. We assume that trend output can be represented by a line passing through the middle of the actual output series (Chart 2). Both the OECD and the NIESR use estimates of potential output which show little slowdown after 1973 and hence a very large output gap in the 1980s (paragraphs 7-8);

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- changes in the cyclically-adjusted PSBR have dominated changes in the PSBR due to the automatic stabilisers, as measured by the cyclical adjustment itself (Chart 3);
- the cyclically-adjusted PSBR has tended to move in a pro-cyclical way, sometimes because of the effects of unexpected changes in variables such as interest rates, oil prices or tax receipts and sometimes as the result of conscious acts of policy - such as in 1980-81 and 1981-82 when priority was given to supporting the disinflationary stance of monetary policy rather than to stabilising cyclical fluctuations in the economy (paragraphs 12-13);
- the cyclically-adjusted PSBR may be useful as a benchmark for describing and monitoring the stance of fiscal policy over the cycle and for assessing its sustainability over the medium term. In particular, it could help us judge what short-term fluctuations in the PSBR around its medium-term path might be desirable (paragraphs 14-18);
- the argument that fiscal policy has been much too tight since at least 1981 because some measures of the cyclically-adjusted PSBR are negative is based on the erroneous assumption that a level of potential output much higher than actual output was (and is) achievable in the short term (paragraph 19);
- the cyclically-adjusted PSBR is not a useful measure of discretionary fiscal policy changes because it is affected by many things outside the government's control (eg unexpected changes in interest rates, oil prices or tax receipts) and because the government's acquiescence in changes in the automatic stabilisers is as much an act of fiscal policy as changing tax rates is (paragraphs 20-21);
- the cyclically-adjusted PSBR is not a useful measure of the impact of fiscal policy on demand because the automatic stabilisers themselves have effects on demand which are not dissimilar from those of other aspects of fiscal policy (paragraphs 22-23);

- a number of studies have found a strong correlation between changes in a measure of the cyclically-adjusted PSBR and subsequent changes in output or employment. This has been used to argue that the fall in the measure in 1979-81 was a major cause of the recession and faster output growth could be achieved by expanding fiscal policy. But biases in the measures of the cyclically-adjusted PSBR that have been used have probably led to an over-estimation of the impact of fiscal policy on output (paragraphs 24-26).

3. The remainder of this note sets out the arguments in a little more detail. The attached paper presents them in a form suitable for discussion with economists and others outside government. Also attached is our last public statement on the subject in the February 1981 issue of the EPR.

Measures of the cyclically-adjusted PSBR

4. The cyclical adjustment is a measure of that part of the PSBR that is attributable to cyclical deviations in output from some benchmark level. There are two stages involved in calculating cyclical adjustments to the PSBR. First, an assessment must be made of the gap between output and the benchmark level. Secondly, an estimate must be made of the effect of this "output gap" on revenues and public expenditure. Both stages of the calculation pose considerable, though in practice not insuperable, difficulties.

5. There are two broad types of methodology for determining the output gap. The first is to relate output to some measure of potential output, or the "natural rate" of output: underlying this methodology is a notion of "equilibrium" output and employment. The second is more mechanical, and involves essentially drawing a trend line through the output series so as to produce a "mid-cycle" level of output.

6. The potential output or "natural rate" method poses very considerable conceptual and measurement difficulties. It is highly dependent on the precise definition of equilibrium and the underlying economic model. And there is no reason to suppose that the output gap will average out to zero over a complete cycle.

used for the calculation. Our estimates use the Treasury model to calculate cyclical effects on the PSBR, on the assumption that monetary policy is non-accommodating over the cycle and the pattern of expenditure remains broadly unchanged. On this basis a 1% increase in output relative to trend reduces the PSBR by about $\frac{1}{2}$ % of GDP in the first year, and nearly $\frac{1}{2}$ % in the second year - very similar to the numbers quoted in the February 1981 EPR.

11. Our estimates of the cyclically adjusted PSBR are shown in Chart 1 alongside the actual PSBR and estimates based on the OECD and National Institute methodologies. On our estimates the cyclical adjustments never exceed about 1% of GDP, and are generally much less than this. In recent years, given comparatively steady growth of output, the adjustments have been close to zero. In general the adjustments are much smaller than those made by other institutions: those of the OECD and NIESR, for example, are in the range 3%-4% of GDP for the 1980s, and the cyclically-adjusted PSBRs are sometimes negative. The difference between the estimates is mainly attributable to the different estimates of benchmark output (Chart 1); the estimates of the effects of a given output gap on the PSBR are relatively less important.

12. The main feature of the estimates of year-to-year changes in the cyclically-adjusted PSBR in Chart 3 is that these changes dominate changes in the PSBR due to the automatic stabilisers. Secondly, the cyclically-adjusted PSBR has tended to move in a pro-cyclical way. In the recession years of 1966-67, 1971-72, 1975-76, 1980-81 and 1981-82, when Chart 3 shows that the automatic stabilisers were contributing to an increase in the PSBR, the cyclically-adjusted PSBR was actually falling. The converse, an increase in the cyclically-adjusted PSBR in peak years, occurred in 1973-74, 1979-80 and 1983-84 but not in 1968-69.

13. The pro-cyclical movement of the cyclically-adjusted PSBR was not necessarily a conscious act of policy. Some of it resulted from other factors such as unpredicted changes in oil prices, interest rates, exchange rates, or revenues. But sometimes policy was deliberately designed to counteract wholly or in part the effects of

in 1980 and 1981 was cited as justification for raising the PSBR path in the 1981 MTF; the 1984 MTF mentioned the cyclical position of the economy as one of many factors to be taken into account in setting the PSBR path. One way to do this would be to aim to keep to a smooth path for the cyclically-adjusted PSBR over the cycle. The actual PSBR would move countercyclically as the automatic stabilisers operated, and this would help to damp fluctuations in output, money GDP and credit.

17. But there is no particular reason to believe that the precise scale of the resulting PSBR fluctuations will be appropriate. The tax and benefit system were not designed primarily with that in mind. And monetary policy also has a role to play in stabilising economic fluctuations. The Government has to decide on the relative weight to be given to monetary and fiscal stabilisers, taking into account both the state of the economy and the relative desirability of stabilising tax and benefit rates rather than interest rates. Sometimes it might make sense to allow the PSBR to fluctuate by more over the cycle than would be consistent with a constant cyclically-adjusted PSBR, and sometimes by less.

18. However, in general it is likely that the desired path of the cyclically-adjusted PSBR should be smoother than that of the unadjusted PSBR. This suggests that it could be useful as a benchmark for describing and monitoring the stance of fiscal policy over the cycle, as well as for assessing its sustainability over the longer term. We would not, however, recommend going so far as to express fiscal policy objectives in terms of the cyclically-adjusted PSBR because of the disadvantages of relying on an uncertain and potentially controversial measure. But the same objectives can be achieved by presenting the PSBR path in the MTF as we do now, namely as the average path over the cycle about which we are prepared to see some fluctuations in response to cyclical movements in output.

19. It is sometimes argued that fiscal policy has been too tight in the 1980s because the cyclically-adjusted PSBR has, on some measures, been negative. This can be countered as follows. First, one notes that it depends on the assumption that potential output is

be the right adjustment to make. And it is anyway hard to believe that all individuals and firms make decisions entirely independently of variations in their cash flow: higher social security payments and lower taxes do at least partly cushion the effects of a downturn in activity on spending.

23. The second argument is that focusing on the actual PSBR when trying to estimate the impact of fiscal policy on demand is likely to be misleading because of the feedback from changes in activity. The true relationship is likely to be obscured because higher output reduces the PSBR and conversely for lower output. It is certainly important to take account of feedbacks - both discretionary and automatic - in assessing the effect of fiscal policy on demand, and there are appropriate econometric techniques for doing so. But there is no reason to argue that automatic changes in the PSBR have entirely different effects from all other changes - for example that they have zero effects - or that the cyclically-adjusted deficit gives a better indication ex post of the fiscal impact on demand.

24. Economists have used estimates of the cyclically-adjusted PSBR as measures of the stance of fiscal policy in studies of movements in aggregate demand or output. A significant role for fiscal policy in this sense has often been found, and this has provided the basis for claims that fiscal policy was a major cause of the recession in 1979-81.

25. However, there are reasons for believing that the strength of the apparent link between output and the cyclically-adjusted PSBR is partly spurious as it results from biases in measuring the cyclical adjustment. In particular, those measures which assume a high level of potential output greatly exaggerate the increase in the cyclical adjustment in those years when attainable output growth was slowing down perhaps because structural unemployment was rising. In addition, the size of the cyclical adjustment effect associated with any given change in output is usually over-estimated because the measures assume that:

- (a) the automatic stabilisers operate in full whereas in practice discretionary fiscal policy appears to have at least partly offset them;

Economic Progress Report



Published by the Treasury

No. 130 February 1981

The impact of recession on the PSBR

This article explains how fiscal policy is set, how estimates of the public sector borrowing requirement (PSBR) are derived from the setting of fiscal policy, and how economic developments, especially the recession in 1980, affect the PSBR. The PSBR is what the public sector needs to borrow to make up the difference between its cash expenditure and its total receipts. The public sector comprises central government, local government and public corporations (including the nationalised industries). 'Fiscal' policy means policy on both taxation and public spending.

Public expenditure

The Government's first medium-term plans for public expenditure, at constant prices, were set out in the White Paper (Cmnd. 7841) published on Budget Day, 26 March 1980, *The Government's Expenditure Plans, 1980-81 to 1983-84*. These plans covered government departments, local authorities, and public corporations and included the programmes for individual services, a contingency reserve and debt interest.

Over a wide area of public expenditure, cash limits for spending in 1980-81 were set in early 1980 in order to superimpose cash controls over the plans at constant prices (i.e. the volume plans). The contingency reserve is also operated as a control, setting an upper limit on decisions to incur additional expenditure in volume terms.

Some programmes are not subject to cash limit control, mainly those, such as social security benefits, where the Government set the rates of benefit, and expenditure is determined in the short-term by the number of qualifying applicants. Such 'demand-determined' expenditure accounts for about one-third of the total. Debt interest payments reflect the level and structure of past borrowing and past and present interest rates, and cannot be controlled directly.

The planning total of public expenditure – as defined in line 13 of table 1.1 in Cmnd. 7841 – is the sum of programmes, the contingency reserve, total borrowing by the nationalised industries, and a general allowance for shortfall,* less special sales of assets, all expressed in constant prices. Table 1 shows the plans for 1980-81, as they were in Cmnd. 7841, expressed in 1979 Survey prices (which were a mixture of prices ranging from late 1978 prices to estimated 1979-80 prices). On average, actual prices are estimated to have been some 30 per cent higher, giving a total of some £100 billion (including debt interest).

Table 1 PUBLIC EXPENDITURE
1979 SURVEY PRICES, 1980-81

Programmes	£ bn.
Central government (including government finance for the nationalised industries)	51½
Local authorities	17½
Certain public corporations	1
Expenditure on programmes	70
Contingency reserve	1
Special sales of assets	½
General allowance for shortfall	1
Planning total after shortfall	69½
Debt interest	3½

The outcome for public expenditure in volume terms depends on:

- policy, i.e. the observance of the control totals;
- for the demand-determined categories, divergences between expected and actual levels of demand, including those affected by economic developments (such as unemployment);
- any volume shortfall below the planning totals, whether induced by inflation turning out higher than allowed for when the cash limits were set or for other reasons.

The outturn for public expenditure in cash terms depends on the observance of cash controls; on factors (b) and (c) above; and on the impact of inflation on areas of expenditure not subject to cash limits.

Expected outturn

An estimate of the expected outturn of the volume of expenditure (the planning total) in 1980-81 will be given in the next White Paper on government expenditure. In total, the volume of expenditure has been greater than planned, with: extra spending on defence; higher expenditure on unemployment and other social security benefits and some special employment measures as a result of the fast rise in unemployment; and there is a risk that the local authorities will prove to have overspent on current account, despite the Government's measures to ensure that their spending is within the planned level. Moreover, the expectation of a general

*The amount by which actual spending falls short of plans.

Economic models

Most of these recession effects are captured in models of the economy, such as the Treasury model, which embodies a detailed specification of public sector activities. Such a model can be used to estimate the effects of a change in output on the finances of the public sector. The results will depend on:

- the origin of the change in output (for example, a fall in demand for goods by individuals or companies);
- the policy response of the public sector (for example, any moves to keep the national insurance fund in balance); and
- the response of the private sector (for example, the extent to which companies try to reduce their holdings of stocks of goods in response to a fall in demand) embodied in the model.

On the basis of these assumptions, simulations can be made with an economic model (see, for example, Government Economic Service Working Paper No.34). The effects given by the current version of the Treasury model are as follows, starting in 1980-81.

Table 3

EFFECTS ON THE PSBR, OF A 1 PER CENT FALL IN OUTPUT DUE TO:

	A	B
	higher personal sector savings (lower consumers' expenditure)	Worse trade performance (lower exports)
	£ billion	
First year	+0.8	+0.5
Second year	+1.3	+0.9

In case A, the main contribution to a higher PSBR in both years comes from lower receipts, especially of expenditure taxes. Public expenditure is higher because of the rise in unemployment and the increase in debt interest payments as a result of the higher borrowing. The numbers in case A are larger than those in case B, mainly because consumers' expenditure has a higher tax content than exports. The effects get larger in the second year mainly because of the lagged response of unemployment to lower demand and because some tax receipts, especially those of corporation tax, become due only after a time lag. The calculations make the following assumptions about government policies:

- Public expenditure on demand-determined items (such as unemployment benefit) increases; and the extra expenditure is not charged to the contingency reserve.
- The national insurance fund, after the first year, is assumed to balance by increasing the contribution rates in order to pay for the larger number of people claiming NI benefits.
- Nationalised industries' external financing limits are increased to offset part of the shortfall in their sales revenues; and (contrary to policy) the extra public expenditure is not charged to the contingency reserve.
- Apart from these three elements, expenditure and taxation plans are unchanged; and interest rates and exchange rates are assumed not to change.

PSBR in 1980-81

These experiments with economic models attempt to provide estimates of PSBR effects which are generally valid (though the £ million figures depend on the ruling price level).

Recently, however, attention has focussed on 1980, and its particular circumstances. Two questions have been raised:

- What would the PSBR have been in 1980-81 if there had been no recession?
- What would the PSBR have been in 1980-81 if the recession had been as expected in official forecasts made at the time of the Budget?

The answers to both questions require precise definitions of recession, and its consequences. Recession, usually defined in terms of output and unemployment, may describe a situation where output falls, or where output falls relative to some past trend, or where unemployment rises. It is important to specify which consequences of recession are to be taken into account. For example, there was a large fall in both profit margins and wage settlements in 1980: most estimates, including those given here, assume a response of wages and prices typical of the past 10 or 15 years, rather than the actual response, so far as it can be judged, in 1980.

No recession in 1980-81. Total output in 1980-81 looks like being about 4 per cent lower than in the previous financial year. It would be possible to construct (in a number of different ways) a hypothetical picture of the UK economy in which output in 1980-81 was constant – as a result of some combination of higher demand or more profitable supply in the private sector. The differences between this picture of 1980-81 and what actually took place could then be taken as estimates of the effect of recession upon the economy, and on the PSBR in particular. The simulations quoted above suggest that a 4 per cent difference in total output would have an effect on the PSBR ranging from £2 billion to over £4 billion.

Recession as forecast at Budget time. A comparison between the forecast of the public sector accounts made at Budget time and the latest estimates can throw light on recession effects. Latest estimates suggest that the fall in output between the financial years 1979-80 and 1980-81 may turn out to be 2 per cent more than forecast at the time of the 1980-81 Budget. Events in 1980 may be looked at from the broader perspective of financial surpluses and deficits. At Budget time, the public sector was expected to reduce its financial deficit at the expense of a larger deficit in the private sector. In the event, the private sector, particularly companies, moved quickly by shedding labour and stocks to improve its position, and so forcing the public sector into larger deficit and pushing the overseas sector into deficit. The recession was thus deeper than expected and reflected to a much greater extent than expected a fall in domestic demand, rather than a deterioration in net trade.

PSBR revision

Analysis of the differences in income tax receipts, expenditure tax receipts, social security benefits etc. can attempt to separate out effects due to recession. Any division will be rough and ready: in particular it will be difficult to distinguish between (i) errors in forecasting total output; that is, the extent of the recession and (ii) errors in forecasting particular aspects of the 1980-81 recession (including larger than normal falls in manufacturing output and employment).

For all the difficulties, this method of approaching the problem takes explicit account of the circumstances of 1980, and provides a rough estimate of the effect on the PSBR of the changed view of output and unemployment. In his statement to Parliament on 24 November, the Chancellor of the Exchequer indicated that, of the upward revision to the PSBR since the Budget, over £1½ billion could be ascribed to the effect of the recession being deeper than expected. This estimate was derived from the method outlined in this section: direct simulations on the Treasury model, including those set out here, might have suggested a lower figure. The difference



ELIZABETH HOUSE
YORK ROAD
LONDON SE1 7PH

Page
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only on student
loan - no X.

The Rt Hon John Major MP
Chief Secretary to the Treasury
HM Treasury
Parliament Street
London SW1P 3AG

01-934 9000 CHIEF SECRETARY	
18 AUG 1987	
Mr Burr	
10 CX Sir Peter Muddleton	
Mr Butler Mr Anson	
Mr Vice Mr Tunbridge	
Mr Lyman Mr Green	

17 August 1987

John Major

Mr Hoare Mr S Kelly Mrs S Walker

PUBLIC EXPENDITURE SURVEY 1987

Thank you for your letter of 31 July. I am afraid I cannot accept it as a basis for our discussion on 8 September. It contains too many misconceptions and oversights.

Of course I accept the need to seek changes in Government policy that will enable us to keep total public expenditure within the agreed guidelines. That agreed objective must be respected. So must our agreed objectives for education. The Treasury cannot ignore the fact that the Government has just won a General Election on the basis of a manifesto which was very explicit about our education policies and gave education a much higher priority than it had before. During the Election campaign I repeatedly said "There is no iceberg in our manifesto. There is no hidden agenda". We cannot now introduce a new set of policies. In any case the reform programme to which we have committed ourselves is so wide-ranging that I do not believe that either the DES or the education service as a whole could cope with more.

By all means let us keep up the pressure for enhanced value for money - for example in universities - by the means which are already an established part of Government policy; but we have to be realistic about the possible speed of change. I made allowance for the savings that I thought it realistic to expect in the assessment which preceded my PES bids.

X | There is one area where I believe we could secure advantage from a new policy which would be fully consistent with our manifesto. That is a shift of student support from grants to loans. This reform is now obstructed by the Treasury's refusal to apply to student loans the accounting rules which they have agreed should be applied elsewhere - for example to the Small Firms Guarantee Scheme.

In two places in your letter you say that you are entitled to expect me to absorb the cost of expenditure which you apparently agree I will have to incur. I do not follow your reasoning. My programme is not large enough to do what the Cabinet has decided should be done. It is irrational for the Treasury to argue that there are some extra costs which can by their nature be absorbed and others that by their nature cannot. It is all money: and the total is too small.

I do not understand either your complaint about the lack of objectives. My officials have sent yours no fewer than 12 letters setting out the objectives of my bids in detail. Did they not show you those letters? My officials have also sent yours a table of bids with output and performance measures for each, as requested in the Guidelines; and they have sent detailed material on measures and targets for baseline expenditure, which is currently being discussed.

UNIVERSITIES

I now turn to some of your comments on specific bids. In the case of my universities bid the key element is a targetted programme of restructuring. Such a programme is very desirable to complement our science policies - see below - and to secure a more efficient and effective university system for the future. But in any case the fact is that it is essential if we are to avoid doing serious damage to the quality of the best institutions and provoking the collapse of some of the lesser ones before the next Election. My officials are sending yours the first full analysis by the UGC's professional staff of the universities' financial forecasts. It shows that they can only meet the financial targets implied by our expenditure plans at the cost of heavy staff losses - at least as great as the 10% already lost since 1980 - and deficit financing in the intervening years. The position is as serious in some of the top-flight research universities as it is for the smaller institutions.

I am ready to look with you at international comparisons of spending on higher education. This should not be on the basis of the selective figures quoted in your letter however but by using relevant yardsticks for comparing efficiency. Your figures for spending per head of populations are affected by irrelevant factors such as population age structure. Instead we should use figures for spending per qualified student. These also show an apparent disparity between the UK and France and Germany, but your officials seem to have overlooked the uncertainty and volatility of all international comparisons of education expenditure, where extraneous factors such as exchange rates can influence the figures. The DES publication to which you refer could only conclude that "the cost per qualifier ... was ... of the same order of magnitude as in Germany, Italy and France". It also pointed out that it was less in the UK than in the Netherlands, USA and Japan. Better measures of our relative efficiency are low wastage and economy of throughput. Our higher education has much lower drop-out

rates than France and Germany with correspondingly less waste to the economy in terms of the contribution foregone by those who enter higher education and fail to complete the course. It also achieves in three years what other countries take four, five or more years to accomplish, when students are also lost to the productive economy.

LOCAL AUTHORITY CAPITAL

Referring to my bid for more spending on local authority expenditure, you comment on the size of percentage increase on my baseline. But this is not the proper measure by which to judge the case; rather we need to look at the scale of unmet need. For schools, the baseline is barely adequate to meet essential statutory and contractual obligations: indeed, because of the maldistribution of capital receipts, some LEAs may face problems in doing even as much as this. There is virtually no scope for work to remedy basic structural defects and deficiencies: the evidence of the school buildings survey shows a gap of over one billion pounds between estimated need and our assessment of what on present plans LEAs are likely to spend by September 1991. Increased revenue expenditure on maintenance is a symptom of what is wrong: LEAs are forced to spend more just because capital programmes do not allow them to replace roofs, make buildings watertight and replace worn out heating systems. FHE too faces acute problems as an unavoidable result of the increase in the size of the building stock that took place in the 1960s and early 1970s: twenty to thirty years on, these buildings need substantial renewal. And on present plans, spending per student on equipment in FHE will fall substantially below a level which is already inadequate. Failure to invest here will seriously damage the ability of institutions to prepare students for careers in commerce and industry. We must make a start on these problems.

SCIENCE

My science bid is based on policies which we as Government determined and promulgated during our first two terms of office. Paragraph 2 of Cmnd 9849 and paragraphs 3.18-3.19 of Cm 114 provide the most succinct recent summary. I enclose copies. Since we took office again we have reaffirmed our main policy thrusts and announced major improvements in the Government's central arrangements for science and technology in our response to the House of Lords Select Committee, Cm 185. In that response we committed ourselves (paragraph 16) to developing our policies more fully and pressing forward with their implementation.

You refer back to John MacGregor's pre-Election letter to Paul Channon. The main elements of a strategy for the Science Base as a whole exist. They need developing, especially the issue of how - and how fast - the university research base should be differentiated. A crucial step in this will be our response to the ABRC Strategy Document. After the consultative period I shall be preparing proposals to put to colleagues. Nevertheless certain requirements, and their associated costs, are already very clear. My Science Bid does have clear objectives - as stated in the letter from Mr Clark to Mr Gilmore of 7 July. And I can and will ensure that new money provided is put to the intended purposes.

I understand your insistence on demonstrable benefit. But the benefits to the UK of investment in science accrue over time and are often not predictable in detail. You will have seen George Guise's eloquent and stimulating analysis of this, circulated by David Norgrove on 27 July. I quote: "The greatest economic benefits of scientific research have always resulted from advances in fundamental knowledge rather than the search for answers to specific applied problems." We shall return to these themes in E(ST). But I take it that we are agreed that, for the Science Budget, the development of output measures will take time. I am pleased to learn that your officials are joining in our work with the Research Councils on this.

NATIONAL CURRICULUM

As to my bid to back our national curriculum policies, these resources are not required to implement our proposals on control of qualifications and syllabuses, where we are simply putting onto a statutory footing the existing work of the Secondary Examinations Council. They are for quality control - paying the costs of external moderation of teachers' assessment and testing, which is an integral part of our proposals for the national curriculum and crucial to its delivery. You say that you want more effective evaluation of spending: this bid is for the machinery to ensure that we can get reliable data about pupil performance and the basis for a continuous evaluation of our curriculum policies.

GM SCHOOLS

Finally you say that we should not consider my bid for GM schools further because there will be no expenditure in 1988-89. I find this a very surprising suggestion for the Treasury to advance. The Public Expenditure Survey must contain a valid costing of Government policies over the whole of the forecast period. It is Government policy that GM schools should be introduced and therefore the next White Paper and the November Statement ought to take account of that cost.

I have written at length because I want to make it clear that I have considered carefully how far my bids are necessary. As I said I do accept that we need to take hard decisions in order to hold to the Cabinet's policy on public expenditure. But I also believe that we must have the means to put our important policies into effect.

I am copying this letter to the other recipients of yours.

*Y
h
m
t*

CONFIDENTIAL



FROM: A C S ALLAN

DATE: 1 September 1987

MR ODLING-SMEE

cc: Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Cassell
Mr Evans
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mr S Davies
Mr Grice
Mr S Matthews
Mr Melliss
Mr Mowl
Mr Riley
Mr Cropper

THE CYCLICALLY-ADJUSTED PSBR

The Chancellor was grateful for your minute of 12 August and the attached paper on the cyclically adjusted PSBR. He thought it poured a useful douche of cold water on both the practical usefulness of the so-called cyclically adjusted PSBR and the alleged effect of PSBR changes on output.

ACSA

A C S ALLAN



CHIEF SECRETARY	
REC.	10 SEP 1987
ACTION	Mr Mountfield
TO	EX - Sir Peter Middleton
	Mr R Butler Sir G Lutter
	Mr Anson Mr Landelle
	Mr Burgner Mr Turnbull
	Mrs Case Mr P Davis

FCS/87/185

CHIEF SECRETARY, TREASURY

Handwritten notes in red ink:
 - x products
 - But we do
 - SSA
 - Mr P Davis
 - Mr G Lutter
 - Mr Anson
 - Mr Landelle
 - Mr Burgner
 - Mr Turnbull
 - Mrs Case
 - Mr P Davis

Handwritten names:
 Mr Kemp
 Mr Peinling
 Mr Giere
 Mr Gopper
 Mr Tyrrie
 Mr Call

Public Expenditure Survey: The Aid Programme

*Not copied to us
copy now attached*

1. Thank you for your letter of 4 August in preparation for our meeting, now planned for 15 September, to discuss my public spending proposals. I want to respond before the meeting to what you say about the size of the aid programme; it is important that our discussions start from a shared perception of what it is appropriate for us to be aiming for, in the light of our growing economic strength and of the aid programmes which are being achieved by our competitors.
2. Naturally I cannot accept that my bid is "impossible". You are best placed to see the overall public spending picture and the difficulty of staying within the agreed total. I know, from personal experience, the way in which certain large demands tend to pre-empt the available margin. But we have agreed that the growth of the British economy justifies some increase in overall public spending, and the aid programme is less than 1% of the total: so an aid programme that also grows at the same rate as the economy should not axiomatically be regarded as impossible.
3. Furthermore, many people would find it difficult to accept that the best performing economy in Europe will, by 1990, give less than the Dutch, and, as a proportion of GNP, less than any other EC donor (including Ireland). Your



offer merely to maintain the programme in real terms would mean falling so far back as never to catch up thereafter. All across the developing world important commercial and political objectives are drifting beyond our reach as our influence wanes. Furthermore, we shall need by 1990/91 to have a defensible record on aid: when we meet, therefore, we must try to reach agreement on how much aid, as a proportion of GNP, we should plan now to be giving then. Like other donor countries we have of course lived for years with the 0.7% target. But as Mitterrand's intervention at the Venice Summit showed, those who are not making any progress towards it are going to be increasingly on the defensive. We are the only donor planning to move further away from it. We have now had to accept an UNCTAD resolution which requires us to make more effective efforts to reach 0.7%: continually moving away from it would not be consistent with that.

4. Although I do not see this as central to what I am seeking, I did mention to Nigel Lawson last week that the treatment you have proposed for his sub-Saharan debt initiative is not within the spirit of his agreement that the cost would not be a charge on the existing aid programme, given that we have made so much of the fact that we are planning at least to maintain the programme in real terms. My offer to absorb it was of course in the context of an aid programme which holds its own as a proportion of GNP: I could not absorb any of it, or anything else - such as an enhanced IMF Structural Adjustment Facility, which you mentioned, or the growing cost of ATP soft loans, which I mentioned - within a programme that is unchanged in real terms.



5. I hope we will not have to spend too much time when we meet on the other details. What I am seeking on running costs is so small that we ought to be able to leave it to officials to settle, though I must make it clear that we cannot "absorb", as you put it, further costs: the ODA is no longer able to squeeze more functions and costs into its running cost limits. The present squeeze is already leading to loss of efficiency and value for money. I am prepared to put on one side for the moment my bid for extra resources for war service credit for Colonial pensioners, so that we can concentrate on the fundamental issue: the size of the aid programme itself.

A handwritten signature in black ink, appearing to be 'G. Howe', with a horizontal line underneath.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
10 September 1987

Pages
pseFROM: P MOUNTFIELD
DATE: 2 October 1987

CHIEF SECRETARY

cc Chancellor
Sir P Middleton
Mr F E R Butler
Sir G Littler
Mr Lavelle
Mr Anson
Mr Turnbull
Mr P Davis
Mr Gieve
Mr Cropper
Mr Tyrie

PUBLIC EXPENDITURE SURVEY 1987: FCO/ODA

The Foreign Secretary's minute of 1 October is a very disappointing response to your letter of 29 September. Although he failed to catch you after Cabinet yesterday, as he intended, this point may come up in the margins of the Conference next week, and you might like a fuller brief, and a draft reply, as well as the one-pager which is being supplied as part of a series.

Background

2. At the bilateral, it was left that:

a. The Diplomatic Wing bids would be discussed between officials and an agreed recommendation made to Ministers. Sir G Howe's exact words were that 'officials should beaver away' and I specifically asked whether the beavers were to have their tails tied behind their backs: he agreed that they would not. In short, both his PFO and I thought we had plenipotentiary powers, and agreed a package which he has now disowned. This has seriously undercut the PFO's position within the FCO, and on that score alone we should try to stick to the original deal. Moreover, Sir G Howe continues to argue that the FCO's main programme is in some sense sacrosanct, and that everything required for the BBC

should come on top of that. If we are to have any realistic hope of holding the FCO programme in future years, you must refute this now. We recommend that you do not give way on the £0.5 million at this stage and that, even at a future stage, you should only concede it if necessary as part of an overall settlement. To reinforce your position we suggest that you signal the intention to return to the question of FCO manpower next year. Our intention is to prepare for that by taking advantage of opportunities presented, for example, by the FCO staff inspection programme, the revision and development of their Management Plans for Efficiency Gains and any discussions of the affordability of the Foreign Secretary's proposed improvements in the pay and conditions of Diplomatic Service Staff.

b. It was also agreed that the ODA running costs (and aid administration vote) should be considered by officials. The ODA finance officer was extremely tough (on instructions) over this, and dug in his heels, on comparatively small amounts. I tried to reach agreement by offering to meet about 60% of the bid on aid administration, and the full costs of the Scientific Unit, the latter on the basis that we would examine, with ODA, the scope for reducing costs in the last two Survey years. The Units face particular difficulties with the recent IPCS pay settlement and the disruption caused by relocation: also ODA - who meet their costs from the Aid Programme - consider them good value for money, are prepared to meet their additional costs, and consider they compare favourably with other government scientific institutions. Nonetheless, the Unit's plans for efficiency savings are less acceptable than those for the aid administration side, where considerable savings have been found. Overall, we thought the offer a fair one, but ODA are still looking for an additional £250,000 in each year for aid administration. It should be possible to reach agreement if we move somewhat towards ODA's position, and I suggest you accept the Foreign Secretary's suggestion that officials should try again. On tactics, I suggest we should offer only a one year deal for the Scientific Units,

and examine their comparative efficiency and scope for savings in time to inform the next Survey. If ODA are willing to accept this we could allow ourselves some leeway on aid administration. The Foreign Secretary has offered to reduce his requirement in 1988-89, so we should be able to agree a smaller addition than £250,000 for that year; and if so we might go to the full £250,000 (which would probably be necessary) for the other 2 years. If you are content, we will proceed on this basis.

c. On the Aid Programme itself, there is deadlock. You considered whether to meet Mr Patten and seek a private deal, but I understand Lord Whitelaw advised against this. Sir G Howe now suggests the same thing. You may wish to keep your powder dry, and the draft letter below assumes you will do so. However, in case the subject comes up in the margins next week, you should be warned of two problems. The first is that the Action Aid (part of the regular aid lobby) has planned a big meeting, in London, on Monday, timed to get publicity just before the conference. Some of us will be going, and can report the reactions later. You will be able to judge the strength of feeling at the conference itself. But do not pay too much attention to Sir G Howe's rhetoric about the 0.7% UN target: the language that the Chancellor accepted in the communique of the Commonwealth Finance Ministers goes no further than the usual formulae on such occasions, and is totally non-committal. Moreover, the UK is in a strong negotiating position at present, because of the Chancellor's initiative, and the very negative reactions of other countries (including the US and FRG) so there is no need to be ashamed of our position.

The second point concerns the GDP deflator, and its effect on any settlement which attempts to hold the programme constant in real terms. The recommendations which are going to the Chancellor, ahead of the PEWP, assume a higher rate of inflation next year than we have so far built in to our briefing. The effects are to make it more expensive to concede a settlement which holds the aid programme steady in real terms. You will

not want to show your hand on this, particularly as the Chancellor has not yet decided what assumption to use in the PEWP. You should therefore aim at a cash settlement. But you will probably want to ensure that, if the tacit assumption is that the programme will be maintained in real terms, your bottom line is high enough to accommodate the latest forecasts. The figures in the table below show that the minimum offer that could now be relied on to keep the programme constant in real terms is 27/33/40 (line 3 (ii)). The offer you have already been considering of 30/50/70 would amply cover this. An offer of that size (plus the costs of the Chancellor's debt initiative) is probably as far as you need go.

Conclusion

3. It will be useful to get your views firmly on record before any informal meetings with the Foreign Secretary or Mr Patten. I therefore attach a draft which might go before the weekend or on Monday morning.

RM

P MOUNTFIELD

DRAFT**FROM: CHIEF SECRETARY****DATE: October 1987****FOREIGN SECRETARY****PUBLIC EXPENDITURE SURVEY 1987: FCO/ODA**

Thank you for your minute of 1 October.

2. I would be content for our officials to make a further attempt to reach agreement on ODA running costs, and I welcome your readiness to see what you can do to reduce your requirement in 1988-89.

3. But I am disappointed that you are seeking to reopen the agreement which they reached on the Diplomatic Wing. I thought we had agreed that they would have full powers to settle so long as some ground was given on either side. I am very reluctant to agree to the additional £500,000 which you are seeking in 1988-89. I was ready to give way on the manpower reductions I proposed, if we could endorse the official settlement. You are now asking me for a further concession of effectively the same kind. As you know, I remain concerned about the argument that diplomatic expenditure should not make its proportionate contribution to relieving the pressures which face us in keeping us to our agreed expenditure strategy. I shall want to return to this question in next year's Survey.

4. On the aid programme, I note what you say but I remain of the view that in all the circumstances the offer I have made is a reasonable one and I do not see how I can improve on it.

AID PROGRAMME BID: COST OF ILLUSTRATIVE OPTIONS

	1987-88	1988-89	1989-90	1990-91
1. Baseline	1235 (1240)*	1275	1315	1348
2. ODA Bid		75	150	230
<u>SUM REQUIRED TO KEEP:</u>				
3. (i) Constant in real terms		15 (offered in agenda letter)	20	27
(ii) Constant real terms if GDP deflator rises to 5% in 1988/89		27	33	40
4. (i) Constant real terms plus 1%		27	46	67
(ii) As (i) + effect of rise in GDP deflator to 5% in 1988/89		39	59	80
5. (i) Programme at 0.32 per cent of GNP (latest 1986 figures)		104	147	194
(ii) Programme at 0.32 per cent if GNP increase is 1% above forecast in 1988/89		116	160	209

* The baseline figure is adjusted up to 1240 to take account of what the 1987-88 figure would have been had the aid programme been maintained in real terms from its 1986-87 level - it wasn't, as the GNP deflators was adjusted upward after the baseline was set. The real terms figures are estimated on this revised baseline.

CONFIDENTIAL

FROM: P MOUNTFIELD

DATE: 13 October 1987

CHIEF SECRETARY

cc PS/Chancellor ✓
Mr F E R Butler
Mr Turnbull
Mr Davis
Mr Gieve
Mr Hansford
Mr May
Mr Tyrie
Mr Call

1987 PES: MEETING WITH MR PATTEN ON WEDNESDAY 14 OCTOBER

You are to meet Mr Patten, at 12.15 tomorrow, to try and reach agreement on the running cost elements of the Foreign Secretary's bid. Mr Patten will also wish to explore informally the possibility of settling the aid programme before Star Chamber. He is bringing his Private Secretary and his PFO; so, if you agree, I will support you.

2. On running costs, the formal position remains as set out in my submission of 2 October, namely that officials met but were unable to agree, despite the fact that we offered to meet the full costs of the Scientific Units bid and around 60% of the bid for aid administration. ODA are looking for additions of about £250,000 a year, although the Foreign Secretary offered to reduce his requirement in the first year. Officials have not met again formally to discuss the matter, as we waited upon your agreement for us to move towards ODA.

3. However I have explored with ODA's PFO the kind of additional money they might be prepared to settle for, should we wish to move. On this basis, I think agreement could be reached by giving them an extra £150,000, £200,000 and £250,000 over the three years, on top of what we offered at the meeting of officials. If agreement were to be reached along these lines the cost would be higher than our original forecast outcome. That said, I do not think we will be able to get away with very much, if anything, less, nor do I think it worth while pursuing small savings at the possible expense of souring relations when the most important element of ODA's bid - the aid programme - remains to be settled.

4. If you were to reach agreement with Mr Patten on this basis, it would be important to ensure that ODA agree to a joint review of the efficiency of the Scientific Units, to be carried out in time to inform the next PES round. We have discussed this at official level and there should be no objections. If however you wish to be tougher, you might also wish to explore whether Mr Patten would accept a one year deal for the Scientific Units, with future provision subject to the outcome of the review. He is likely to resist but it may be worth trying.

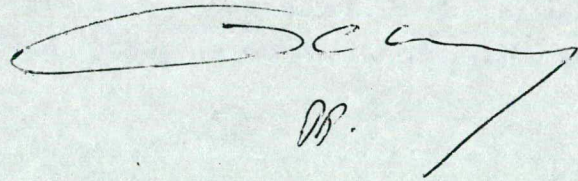
5. The attached table shows the figures implied in accepting the ODA's position.

6. On the aid programme, Mr Patten will wish to explore whether you are prepared to move from your existing offer to provide a 'real terms' increase of £15 million/£20 million/£27 million and in addition to meet the costs of the Chancellor's debt initiative. His officials have made it clear to me that he has no authority to reach a deal on this without consulting the Foreign Secretary, who is still in Vancouver (but smoke signals could be sent if a deal looks possible). He is unlikely to be able to persuade the Foreign Secretary to accept any offer you might wish to make which does not go a very long way towards their bid of £75 million/£150 million/£230 million. Unless the sums were to be well above the £30 million/£50 million/£70 million which we suggested ^{when} you were considering an offer following the bilateral, it appears inevitable that the bid would have to go to Star Chamber.

7. In the circumstances there appears little to be gained from revealing that kind of offer, namely a cash offer sufficient to provide some real growth in the programme (with the costs of the Chancellor's initiative regarded as an extra). Rather you might try to tease out how soft their bid is, while merely saying that you will be prepared to look again at your offer with a view to seeing if you can provide for some additional growth in the programme, size unspecified.

8. Mr Patten is likely to focus on the broad argument over the size of the aid programme in relation to the health and growth of

the economy, and the need to have a defensible position on aid before the next election. His officials accept, and I think he will, that the deal is a cash one. If the GDP deflator proves to be higher than the 4% he is assuming, the deal will be worth less in real terms. (The table in your Core Briefing^{for the Chamber} shows you how far you need to go, for deflators of 4½% and 5%, to maintain some growth in real terms. But you will not want to show your hand on this, as the Chancellor has not yet decided which figure to use.) He may however refer to costs which are likely to arise over the period, and which will be unavoidable calls on the programme, thereby dissipating the sums that can be spent on bilateral programmes. If he does, I suggest you merely note that the costs and timing of certain elements, for example the World Bank General Capital Increase, remain to be settled, and that you would expect any final agreement to include all calls on the aid programme over the period.



P MOUNTFIELD

seen by Mr. Mountfield in
draft and approved.

POSSIBLE SETTLEMENT ON ODA RUNNING COSTS

	1988-89	1989-90	£ million 1990-91
1. <u>Aid Administration</u>			
Offer	1.150	1.5	2.05
of which RC	0.850	1.150	1.7
Bid	1.75	2.075	2.6
of which RC	1.45	1.725	2.25
New Baseline with Offer	28.96	29.27	30.8
% increase on previous year	5.3%	1%	5.2%
2. <u>Scientific Units</u>			
Offer	1.932	0.884	-0.246
Bid	1.932	0.884	-0.246
New Baseline with Offer	13.73	12.18	11.25
% increase on previous year	8.1%	-11.3%	-7.3%
3. <u>Total Offer</u>			
Total Offer (running costs)	2.78	2.03	1.45
Forecast Outcome	2.4	1.8	1.17
4. <u>Total Baseline (rounded)</u>			
Now	39.9	39.5	40.5
With Offer	42.7	41.5	42.0
% increase on previous year	6.2%	-2.8%	+1.2%

CONFIDENTIAL



ELIZABETH HOUSE
YORK ROAD
LONDON SE1 7PH
01-934 9000

CONFIDENTIAL

Handwritten notes in red ink:
[CST] Mr. [unclear] Mr. [unclear]
Mr. [unclear] Mr. [unclear]
Mr. [unclear] Mr. [unclear]
Mr. [unclear] Mr. [unclear]
Mr. [unclear] Mr. [unclear]

The Rt Hon John Major MP
Chief Secretary
HM Treasury
Parliament Street
LONDON
SW1P 3AG

CHIEF SECRETARY	
REC.	29 OCT 1987
TO	Mr Burt
FROM	Mr [unclear], Mr [unclear]
	Mr [unclear], Mr [unclear], Mr [unclear] Mr [unclear]
	Mr [unclear], Mr [unclear], Miss [unclear], Mr [unclear]
	Mr [unclear], Mr [unclear], Mr [unclear], Mr [unclear]
	Mr [unclear]

29 October 1987

Handwritten signature: John Major

PES 1987: STUDENT AWARDS

We had a word before Cabinet this morning about student awards. I said that I would write to you about the costs involved.

The cost of bridging the gap between the baseline provision for a 2.5% increase next year in the value of the mandatory award and a 4.0% increase is £6.5 million in 1988-89. The outcome of the Survey means that I have been able to find £1 million of that difference from the resources available to me. It would, of course, be possible to make adjustments to the parental contribution scales to reduce the remaining gap, but any additional burden we place on parents would be over and above an average increase in parental contributions between this year and next year in line with the rise in average earnings, which we have already assumed in our calculations.

The question of how far we could make further adjustments to the parental contribution scales must be a matter of judgement. Ideally I doubt that we should go beyond finding another £0.5 million from that source. I therefore hope that in the light of our conversation you will be able to provide an additional £5.0 million for each of the Survey years, which would enable me to fund a 4.0 per cent increase in the value of the mandatory award without too damaging a further imposition on parents.

Handwritten signature: [unclear]

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PERSONAL AND CONFIDENTIAL



CC-0X, MR BUTLER
Mr ANSON, Miss PEARSON
Mr TURNBULL, Ms BOYS
Mr GIBBER, Mr STRONG
Mr FINE, Mr CANN

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon John Moore MP
Secretary of State for Social Services
Department of Health and Social Security
Alexander Fleming House
Elephant and Castle
London
SE1 6BY

12
RS

Handwritten in red ink:
A. J. Jones
A. J. Jones

Handwritten initials:
D. A.

23 October 1987

1987 PUBLIC EXPENDITURE SURVEY: HEALTH

I regret very much that we seem to have a further matter to resolve on the Health programme. I am writing to you on a personal basis because, despite the scope for misunderstandings in discussions on the detail of public expenditure programmes, I am quite certain in this case that there should have been no room for genuine misunderstanding.

On 14 July, John James wrote to Penny Boys, giving details of the assumptions that underlay your bids. He wrote:

"You asked about the assumptions we had made about the use of the cost improvement programme... You will note that we have assumed that half of the CIP in each year would be required to meet specific costs of pay awards"

This seems quite clear cut and was not retracted at any stage. A table accompanying this letter showed the sum available for pay on this basis as £71 million in 1988-89.

Moreover the whole question of how to treat future pay was considered in some depth by our officials in the period following this letter and our first bilateral meeting on 14 September. A paper jointly agreed by officials

PERSONAL AND CONFIDENTIAL

was produced as the basis for our bilateral discussions setting out the position and discussing options. It was the intention that this paper should be submitted to each of us. I certainly received and read a copy myself. Paragraph 12 of that paper said, in relation to the cost improvement programme:

"DHSS considers that at most half the programme should continue to be deemed to be available for pay; DHSS consider that any higher figure runs the risk of damaging the programme".

The clear implication was that DHSS accepted that half the proceeds would be available - the qualification was solely whether any higher figure than half would be tenable.

We met on 14 September and discussed, amongst other matters, your bid for future pay. As recorded in the minutes - which were agreed with DHSS - I myself said that I had in mind earmarking a sum which would, together with an extra sum from the cost improvement programme, provide for future pay. I mentioned the possibility of increasing the proportion of CIP proceeds. In the discussion your officials confirmed that no more than half of CIPs had been used for pay in previous years. At no time at that meeting was it proposed that there be a lower - or no - contribution from the cost improvement programme.

At no subsequent stage was there any warning from your Department that we were not proceeding on a shared assumption that half the CIP proceeds would be available for pay. Precedent over the last 3 years, the documents I have cited, and my own clear recollection of our discussion confirm me in my belief that there should have been no misunderstanding. It has been claimed that a question John James asked about access to the Reserve after allowing for the £50 million specific addition, was intended to establish that the understanding on the use of CIP proceeds had been removed. If I may say so, this is a rather oblique way to seek to establish the point. If there was any question of retracting the previously agreed assumption on the use of cost improvement programme proceeds, I would have thought your officials would have challenged it directly there and then.

I hope therefore that you can, on reflection, confirm the settlement we reached bilaterally, as set out in my letter of 19 October.

*John/ This is a bore for both of us.
You must have your mind on the U/R
National + you know my SES timescale!*

We must, I think, resolve this without delay.

*Yours Ever,
John*

John

JOHN MAJOR

CONFIDENTIAL

Papers
PseFROM: T J BURR
2 November 1987

CHIEF SECRETARY

cc Chancellor
Mr F E R Butler
Mr Anson
Mr Gilmore
Mr Hawtin
Mr Turnbull
Mr Gieve
Mr Kaufmann
Mr Tyrie
Mr Call

PES 1987: STUDENT GRANTS

You spoke to Mr Baker before Cabinet last week about the adequacy of the Survey provision for student awards in the light of the upward revision of the price forecast for the coming year, from 4 to 4½ per cent. He then sent his letter of 29 October, in which he seeks an additional £5 million for each of the Survey years in order to permit a 4 per cent uprating of student grants with only minimal hold back on the uprating of the parental contribution scale.

2. The arithmetic of the £5 million figures starts from the fact that the Survey baseline provides for an increase of 2½ per cent in student grants. An extra £6½ million would be needed to increase that to 4 per cent. Mr Baker has already switched £1 million of that from elsewhere in his programme. He also proposes to shave less than ½ per cent off the uprating of the parental contribution scale, which would mean that an extra £½ million of the cost fell on parents rather than on DES. That would leave the £5 million figure which Mr Baker asks you to give him.

3. We have pointed out to DES that they were content to manage within their Survey provision until they heard about the change in the price forecast; and that it would only take an extra £2 million to match the ½ per cent increase in the forecast. Their Principal Finance Officer accepted this, and said that he would be prepared to recommend Mr Baker to accept a figure of £2 million if that was all you wished to offer him. He claimed

**

X
unsatisfactory. It is
possible that the grant
given up by 4%.
That is the condition
attached to the £2m
allowance.
XX

that Mr Baker had only asked for more than £2 million because he thought you might feel that a 4 per cent uprating could only be managed with an addition of £2 million by letting too much of the cost fall on the parental contribution.

4. DES would normally reckon to uprate the parental contribution scale in line with average earnings, and would therefore be thinking in terms of an uprating of 7½ per cent. The actual uprating which would be consistent with a student grant increase of 4 per cent, if DES receive additions of between £2 million and £5 million (taking account of the £1 million already transferred within the programme) is as follows:

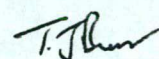
Addition (£million)	2	3	4	5
Increase in parental contribution scale (%)	5¾	6	7	7½

Thus a £2 million addition would mean that the increase in the parental contribution scale was held to nearly 2 per cent less than the increase in average earnings over the past year, though only ¾ per cent less than the forecast 6½ per cent increase in earnings over the coming year. A £5 million addition, on the other hand, would permit an increase which was almost in line with the increase in earnings over the past year.

5. We believe that an increase of 5.75 per cent in the parental contribution scale should be defensible. It would be well in excess of the increase in prices, and not very far below the prospective increase in earnings. We therefore recommend that you should offer Mr Baker an addition of £2 million, which would also permit a 4 per cent uprating of the student grant.

6. In responding to questions following the Autumn Statement, DES do not propose to say more than that an announcement about student awards will be made shortly (normally by December). Their Ministers will want to consider carefully exactly how to pitch the increases in both the grant and the parental contribution scale, and do not want to say anything now which could limit their room for manoeuvre.

7. I attach a draft reply.



T J BURR

10. X

CONFIDENTIAL

DRAFT LETTER

FROM: CHIEF SECRETARY

TO : SECRETARY OF STATE FOR EDUCATION AND SCIENCE

PES 1987: STUDENT AWARDS

Thank you for your letter of 29 October.

2. My particular reason for raising this with you was the increase in the price forecast for the coming year, since that could obviously affect your judgement of the appropriate uprating of student grants next year. But I do not see why it should lead you to increase the uprating by more than $\frac{1}{2}$ per cent compared with what might otherwise have been necessary. That would cost ~~only~~ an extra £2 million. I hope, therefore, that you will be prepared to accept an addition of no more than that in each of the Survey years. I understand that this would enable you to increase the student grant by about 4 per cent and the parental contribution scale by $5\frac{1}{4}$ per cent. That would seem to me to be adequate in the circumstances.

~~Mr Allan~~ - Transcripts -
See my amendment on p 6
as discussed.

prep

CE

FROM: MISS C EVANS

DATE: 10 December 1987

MR A C S ALLAN

SIR PETER MIDDLETON

SIR TERENCE BURNS

- cc Chief Secretary
- Sir Geoffrey Littler
- Mr Anson
- Mr Kemp
- Mr Cassell
- Mr Scholar
- Mr Turnbull
- Mr Sedgwick
- Mr Odling Smee
- Mr Peretz
- Mr R I G Allen
- Mr Pickford
- Miss O'Mara
- Mr Hudson 13/2
- Mr Cropper
- Mr Tyrie
- Mr Call

a
I have marked some
editing things.

So have I. AJ

TCSI CHANCELLOR'S EVIDENCE : 9 DECEMBER

I enclose the transcript of the Chancellor's evidence to the Committee.
Could you return to me, with corrections marked clearly in red, by noon
tomorrow please.

*I have got an extension to post things
Monday morning.*

CEvans

MISS C EVANS

TRANSCRIPT: For instructions on its use, see below.

Ev 2

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HOUSE OF COMMONS
MINUTES OF EVIDENCE
TAKEN BEFORE
THE TREASURY AND CIVIL SERVICE COMMITTEE
WEDNESDAY 9 DECEMBER 1987

THE RT HON NIGEL LAWSON, MP
SIR PETER MIDDLETON, KCB and SIR TERENCE BURNS

Evidence heard in Public

Questions 108-198.

USE OF THE TRANSCRIPT

1. Members and prospective witnesses to whom the transcript is sent in strict confidence, under the authority of Mr Speaker and the Committee, are asked to note that the text is unpublished and that its use should be governed by the guidelines in the following paragraphs.
2. Members receive copies for the purpose of correcting questions addressed by them to witnesses, and are asked to send any corrections to the Committee Clerk as soon as possible.
3. Prospective witnesses receive copies in preparation for any evidence they may subsequently give.
4. This is an uncorrected and unpublished transcript of evidence taken in public and reported to the House.
5. No public use should be made of the text.

WEDNESDAY 9 DECEMBER 1987

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Members present:

Mr Terence L Higgins, in the Chair
Mr Anthony Beaumont-Dark
Mr Nicholas Budgen
Mr Neil Hamilton
Ms Joyce Quin
Mr Giles Radice
Mr Brian Sedgemore
Mr John Townend
Mr David Winnick

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Examination of Witnesses

THE RIGHT HON NIGEL LAWSON, a Member of the House, Chancellor of the Exchequer, SIR PETER MIDDLETON, KCB, Permanent Secretary and SIR TERENCE BURNS, Chief Economic Adviser, HM Treasury, examined.

Chairman

108. Mr Chancellor of the Exchequer, we are very glad indeed that you are able to come before us and give evidence this afternoon. It is a very long time since our predecessor committee had the opportunity of taking evidence from you and reporting to the House, something which generally speaking is regretted. We have been out of action for so long when so many interesting, not to say exciting, events have been taking place. It is perhaps appropriate that we should therefore begin our evidence-taking session on the Autumn Statement. No doubt this Committee, like its predecessor, will wish to pursue some other aspects of policy, particularly with regard to the European Economic Community and

with regard to international monetary affairs. Indeed of course the Autumn Statement takes place against the background of very turbulent markets, both domestically and internationally. What we want to do this afternoon is see how policy has developed in the period since our predecessors last took evidence from you and to seek to ascertain what the opportunities and perhaps the dangers are in that context. Thank you very much indeed for coming, together with your officials. It is normal to ask whether you wish to make an opening statement. I do not know whether you do or not.

(Mr Lawson) I share your regret that this Committee has been out of action for so long. The least I can do in the circumstances is to make no opening statement and give you the maximum time for your questions.

Chairman: I am sure that will be generally appreciated. It will not have escaped your notice that the composition of the Committee has changed somewhat since we last met, no doubt due to another exciting event. I therefore have much pleasure in calling on Ms Joyce Quin to open the questioning.

Ms Quin

109. Thank you, Chairman. It is quite a responsibility for a new girl like myself to set the ball rolling in this particular session. I should like to ask one or two questions about the projected growth rate and the consequences of that on the economy as a whole and particularly the link between that and unemployment. GDP is forecast to grow by $2\frac{1}{2}$ per cent in 1988 which is a drop from the growth of 4 per cent this year. I should like to ask the Chancellor whether he sees any change in that forecast as a result of any events since the Autumn Statement was published.

(Mr Lawson) The forecast was made as part of the Autumn Statement and was made after the stock market collapse in mid October, so we did, to the best of our ability, take that into account. We shall be making a new forecast before the Budget, on which the Budget decisions will be based. There is no forecast in between times. The $2\frac{1}{2}$ per cent growth to which you allude ^(Implies equivalent to growth) is of ~~course~~ 3 per cent for the non-oil economy: it is worth bearing that in mind. ^{There was} ~~With~~ only one year in the whole of the 1970s when growth of the non-oil economy exceeded 3 per cent, ~~and~~ ^{the} a decline from the 4 per cent which is forecast for ~~this~~ current year ~~with~~ is hardly surprising. ~~because~~ 4 per cent is in my judgment above our long-term sustainable growth rate.

110. Nonetheless what consequences do you think a lowering in the growth rate will have for unemployment? Are you confident that unemployment will continue to fall?

(Mr Lawson) I am never confident about forecasting or indicating the trend of unemployment: it is extremely difficult to do so. My best guess, [^] and in recent years we have had a fairly good track record, [^] is that unemployment will indeed continue to fall in 1988.

111. One of the things which concerns me is that in paragraphs 1.48 and 1.49 of the Autumn Statement you talk about increases in productivity but are such increases in productivity consistent with a fall in unemployment if in fact fewer people are going to be producing more and at the same time there is this slightly lower growth rate?

(Mr Lawson) Yes, ^{clearly} they are consistent, ^{otherwise} I would not have made those remarks, nor would they have appeared in the Autumn Statement. What is useful is to look at the breakdown

(, Show a No Autumn Statement,

~~which is there~~ between manufacturing and non-manufacturing. ~~You see there that~~ ^(as you will see,) the really rapid growth of productivity, is in manufacturing; in non-manufacturing the growth of productivity is very much less. It is non-manufacturing where the vast bulk of the jobs are at the present time and where, I would judge, the vast bulk of the growth in jobs is going to come from.

112. Would that not mean an even greater contrast in unemployment rates between different parts of the country, given that certain parts of the country still have quite a high manufacturing sector in their economy as opposed to other more prosperous areas of the country?

(Mr Lawson) What is encouraging, if you look at what has happened to unemployment over the past year, is that it has been coming down in all ~~parts of the country, all~~ regions ^{of} ~~in~~ the country. Indeed, from memory - although I stand to be corrected - the sharpest falls have been in Wales and the North West, ^{The} West Midlands as well, I ^{point out} ~~say~~ for the benefit of Mr Beaumont-Dark.

113. I am sorry that you did not mention my own area in that which is of course the North East.

(Mr Lawson) I did say all regions, which includes the North East.

114. Given the Chancellor's concern with growth would he say that he is placing more emphasis on growth now than on controlling inflation or is he placing similar weight on both factors?

(Mr Lawson) What has been demonstrated during the whole of the time that this Government have been in office is that by giving the highest priority to bringing down inflation, ~~you in fact~~ ^{we have} created ~~the~~ ^{we have ed} conditions that are beneficial to growth. There are other things ~~you~~ ^{we have ed} need to do which are beneficial to growth, of course.

particular
[as well] on the supply side. It is not a question of which is more important because there is no conflict, [There is no conflict] partly because ~~the~~ low inflation is beneficial to growth but [there is] also ~~no conflict~~ because one is a question of the macro-economic *policy and* demand side, *while* the other is *a question of* micro-economic policies and the supply side. Improving the performance of the economy through supply side ~~improvements~~ *policy* is in no sense an alternative to [the policy of] pursuing an anti-inflationary overall policy: they go together.

115. What do you feel is the long-run sustainable growth rate if it is not 4 per cent? What would you aim for?

(Mr Lawson) That is very difficult to say but if I had to pluck a round number I would choose three. *per cent for near North Sea output* Sir Terence Burns is a much greater economist than I would ever aspire to be and perhaps he would like to add to that.

(Sir Terence Burns) I am very grateful for that vote of confidence. I have nothing to add.

Chairman: I hope this does not have inflationary consequences for pay settlements.

Mr Winnick

116. I think I heard you correctly but perhaps you will correct me if I did not. I think you said that the Government have a good track record on unemployment.

(Mr Lawson) In predicting unemployment trends in recent years, I said.

117. And you said unemployment is falling and you do not want to give a forecast. Can we work on the basis that by the end of this Parliament's life, 1991 or 1992, unemployment will be no more than when your administration took office?

(Mr Lawson) I do not know. I do not know what the level of unemployment will be by the end of this administration; that is looking an awful long way ahead.

118. This Parliament, but I put the two together.

(Mr Lawson) I still do not know the answer, I am afraid.

119. Are there any indications that unemployment will fall so substantially that it will be around the same mark, namely 1.5 million as when your administration took office?

(Mr Lawson) I really do not know; it might be higher, it might be the same, it might be lower. I really cannot tell. I do not think anybody can forecast unemployment that time ahead. It is quite impossible and it is only a fraud who would pretend to do so.

120. Therefore those who say that unemployment is not likely to be less than 2 million, you would say you will not forecast any further.

(Mr Lawson) If they say it is unlikely to be less than 2 million I say they are talking through their hats because they simply do not know.

Chairman

121. In paragraph 1.43 of the Autumn Statement it says "For the first time since 1983, unit labour costs in manufacturing in the other major industrial countries have on average risen faster than in the UK". You predict a similar pattern of events in 1988.

(Mr Lawson) Yes.

122. We were not quite clear why you took that view, particularly in terms of wage settlements and productivity and so on.

(Mr Lawson) We took it on the evidence we have of the trends of manufacturing output, ~~and~~ the trends of wages and ~~also~~ what is happening to employment ~~trends and~~ ⁱⁿ manufacturing in ^{the UK and} the various ^{other} countries. ~~[It does seem to be happening that way.]~~ That is not led us to take that view.

This is obviously partly because manufacturing in the United Kingdom is ~~clearly~~ very vigorous and strong now and growing very well. It has got itself much more efficient. If we take our major European competitor, ~~Germany~~ ^{Germany}, for example, their industry now has become very sluggish indeed. Therefore, although it is the case that pay is going up considerably faster in this country than in Germany it is also the case that manufacturing output ^{and productivity} is going up very much faster ^{here} too.

123. That statement was presumably made at a time when the exchange rate was somewhat lower than it is at the moment. You do not think it necessary to revise the view of competitiveness in the light of that?

(Mr Lawson) As I said to Ms Quin, ^{and} we will be publishing a new forecast ~~as~~ as you well know Mr Chairman because you were also Chairman of the previous Committee, ~~and probably the one before that, I cannot remember; or a member of it at any rate,~~ ^{will be} in the runup to the Budget, on which Budget decision, to some extent ~~are~~ based. We do not make a forecast inbetween times. Inbetween times it is true that ~~things can change,~~ a number of things can change. It is probably unwise to pluck out one particular element from the various things that might have changed.

(Sir Terence Burns) These are not figures which have been corrected for exchange rate changes, these are the growths in costs expressed in domestic currencies.

Chairman: I was not absolutely clear about that and I am grateful to you for clarifying it.

Mr Townend

124. You have told the Committee on several occasions that the Government's policy on public spending is to reduce this as a percentage of GDP. In your Table 2.1 of the Autumn Statement I note that in 1988-89 and 1989-90 as a percentage of GDP spending is going to stay static. If, unfortunately despite the efforts of yourself and other finance ministers, the world goes into recession, is there a possibility that growth might fall and you will then be faced with the alternatives of either maintaining the Government's policy of reducing spending as a percentage of GDP or cutting expenditure itself. What would be your reaction in that situation?

(Mr Lawson) In the first place I see no sign at the present time of the world going into recession. All the recent figures that we have had so far ^{do} admittedly relate to the period before the stock market collapsed ^{and} ~~seem~~ ^{But they all} to show growth rather stronger than was thought to be at the time, for example, when the IMF staff were making their forecasts for the Annual Meeting in September. ~~For example~~ growth in Japan is a good deal stronger, ~~the~~ growth in the United Kingdom is probably stronger too, ~~the~~ growth in the United States is almost ^{certainly} stronger than it was thought to be. ~~It~~ ^{then} ~~would say that probably,~~ from recollection, the IMF staff report for the Annual Meeting ~~was~~ ^{ad} suggesting for the major countries a real growth of something like $2\frac{1}{2}$ per cent on average this year. Many people at the Meeting said that looked a bit high. In the light of the latest figures if anything it probably erred on the low side ~~and~~ ^{has been} growth ~~was~~ stronger. Therefore, any slowing down there,

maybe as a result of the stock market collapse and associated events, is from a more vigorous base. ^{Am} The surveys of ^{business} confidence not merely in this country, where there have been some very striking CBI surveys but ^{also} in ^{other} most countries ^{to support text.} would tend ^{to forecast} Obviously at this stage of forecasting it is ^{It is} obviously very difficult as I said in ^{at the time of} the Autumn Statement, ^{and} ^{But even then} everything which has happened since I made the Autumn Statement ^{has tended to make} the prospect of a world recession ^{stem} less likely. As to your question about how we would react in terms of public expenditure if there were to be ^{a world recession} one, I really ^{to} would have to say that is a hypothetical question. I would have to form a judgment at the time were that to happen. Rather than peering into an uncertain future, what ^{it} is instructive to do is to look at what has actually happened. If you take the past five years up to this year - we are pretty well through this year and have ^{so} an ^{a good} idea of the ⁱⁿ ^{that} ^{so} ^{a good} ^{an} ^{idea} ^{of} ^{the} ^{output} ^{this} ^{year} - you will see in four out of those five years, including each of the last three, ^{that} ^{public} ^{expenditure} ^{has} ^{fallen,} ^{that} ^{is} ^{general} ^{government} ^{expenditure} ^{excluding} ^{privatisation} ^{proceeds,} ^{to} ^{make} ^{fair} ^{comparisons,} ^{has} ^{fallen} as a share of GDP. To find a previous five-year period when that happened you have to go back to the Atlee Government of the 1940s, when of course they were unwinding from high levels of wartime expenditure. That does show the degree to which we have succeeded in getting public expenditure under control, unlike our predecessors. The other thing I would say, as I believe was said on Monday when you asked the same question, is that our policy of getting public expenditure down as a share of GDP has to be understood in a medium-term context, as indeed all our policies have to be understood.

125. Has the Treasury modified its estimate of GNP growth in the G7 countries since the stock market crash?

(Mr Lawson) No. We have made no new forecast. Obviously we have watched the situation all the time but we have made no new forecasts since the forecast which was published in November with the Autumn Statement.

126. Not even an internal one that you do not wish to tell us about?

(Mr Lawson) No.

127. You have quite rightly stressed the strength of the British economy. Were you surprised at the extent of the stock market crash in London? The market fell in percentage terms more than Wall Street despite the fact that we all know America has got fundamental economic problems and considerably more than Japan where the PE ratios were extremely high. Why do you think our market fell so much more than the others in view of the strength of the economy?

(Mr Lawson) The slight oddity, what everyone found most unexpected, ^{has been} ~~was~~ the relative strength of the Tokyo market, bearing in mind that that was, prior to that, considered to be the most highly ^{valued} ~~priced~~ market, ^{one of the} ~~The~~ price/earnings ratios were the highest. I am not an expert on the Tokyo stock market so I cannot say anything more about that. A lot depends on what your base date is ~~[because ours has risen very fast.]~~ If you compare where the markets are ^{interest} ~~[I am taking]~~ the closing prices yesterday ^(HW) compared with a year ago, you find that Tokyo is up 23 per cent, London ^{is} ~~exactly~~ where it was a year ago, Wall Street ^{is} down 3 per cent, ^{and} Frankfurt ^{is} down 37 per cent. If you take different base dates you

get different figures obviously and different comparisons. I understand what you are driving at and I would say that there are two factors here. First of all, we live much more in a global marketplace than we ever did before. This is ^{true} not simply ~~the~~ ~~case~~ ^{also} in terms of the financial market but in terms of the companies whose shares are quoted on the market ^{themselves} operating in a global marketplace. That is one factor. The other factor is that when shares ^{suddenly} appear to be going down you find very few buyers, that is what happens in any bear market and that happens in whichever country you happen to be.

128. That does not really explain the difference between Wall Street and the UK.

(Mr Lawson) What I am suggesting is that I do not believe there is a scientific explanation of stock market prices at any particular moment in time; it depends on sentiment and the curious psychology of markets. I am a profound believer in markets and the market economy because I believe that any other system is infinitely worse. It is not because I think that markets are infallible. I think it was Winston Churchill who said that he was a staunch supporter of parliamentary democracy because all the alternatives were very much worse. It applies to parliamentary democracy certainly, and it applies to the market economy as well.

Mr Beaumont-Dark

129. It seems from the figures that we now have that the country's finances, for which you as Chancellor take a great deal of credit, have never been in better fettle in the last 20 years, which is a splendid thing. Your policy, is it not - which is overall a sensible one - is that you wish to see taxes reduced all things being reasonably equal over the next year or two?

(Mr Lawson) Thank you very much for your kind remarks.

The objective of reducing taxation, particularly income tax, is not specific to the next year or two, it is a general objective of policy which has to be seen in the medium-term context.

130. If we were to reduce direct tax by two pence that is about £2,500 million.

(Mr Lawson) Is that a question?

131. Yes. I am just asking you for clarification.

(Mr Lawson) Yes, ^{you have is} absolutely right, ~~Yes, yes, yes indeed,~~ ^{as} yes. We have ^{the ready reckoner} ~~to help.~~ ^{to help.} ^{makes clear.} In Mr Anker's statement

132. It shows that we read what you send to us, is that not a good thing?

(Mr Lawson) I knew you did that.

133. It is for the sake of those who have not had the benefit of reading your excellent document that we put the things clear.

(Mr Lawson) Right.

134. Could I turn to the issue which is a profound issue, not in a pejorative sense, but it is said that the iron hand of the Chancellor, ^{which} is a compliment to any of us, is behind all the expenditure plans that we have and that obviously one of the most important things to anybody is that however much money you have got in your pocket it is not much good if you are not alive. It is true that since 1979 this Government - and no other government can take as much credit as this Government can on its National Health Service expenditure - has increased expenditure on the National Health Service 31 per cent in real terms and that is a vast sum of money. Is it not a problem that even if it is 31 per cent increase in real terms, if you have an illness and it is not treated, whatever

the percentage you are 100 per cent dead? The point I want to bring to you is a serious one because it does affect us all as human beings. In 1960 we were the fifth highest proportion of GDP spent upon health. In spite of all these sums that we have spent - and I pay tribute to the sums going up by 31 per cent in real terms - we are now fourteenth. In the plans - if you see your own plans, as I am sure you have - by 1990 it is going to go down as a percentage from 5.3 to 5.1 per cent. Which do you think is more important: that we reduce direct taxation or we, bluntly, one way or the other - and I agree that is open to conjecture and to debate which is important debate - have as people properly ^{to} fund the National Health Service of this country?

(Mr Lawson) As you yourself pointed out, we have increased spending on the Health Service very substantially in real terms and we have also engaged in a campaign which has got a lot more scope to go further to get better value for the money we ~~do~~ spend in the National Health Service, by improved management and in other ways. In particular, I announced in the Autumn Statement a very substantial ^{increase} increase in expenditure on the National Health Service, over and above the figures in the ^{early} plans for England and Wales, of some £710 million in 1988-89. ~~You understand that~~ ^{my} ~~primary~~ ^{primary} concern on the public expenditure side is with the totality of public expenditure and getting value for money in public expenditure; it is more ^a ~~the~~ collective Government decision as to what the priorities are within that. We have, however, been able to reduce taxes, and I hope we shall continue to be able to do so, while increasing and continuing to increase expenditure on the Health Service and ^{on} health care in real terms.

135. This is one of the great debates of our time and it is not in any sense of being clever because I recognise, as people recognise, that these vast sums have been spent. So it is not a matter of trying to score points - would I off my own Government anyway? This is seriously not in any pejorative sense. If you take the problems of the hospital service where, to take my own Selly Oak hospital, 75 per cent of the costs are basically on staffing. It is right that it will be so because if hospitals are not a person to person business what is? If you look at the figures, and many of us are involved in it, if the wage increases had been properly funded, the proper wage increases last time which nurses had ...

Let us face it, this Government have done more for nurses' wages than any other government since the war, so that is also a factor. This is the paradox in which we live. More has been done under this Government than ever yet the funding of it has ended up with the regional health authorities somehow or other losing out because of that by £600 million. If you take my own area, which is only representative of the country, no doctor is talking about being given an open-ended cheque. The pejorative view of some people is that doctors are asking to be given blank cheques and they sign them at the end of the year. That is not so. What they are saying is that the kind of sums they want to balance the books for the year just ending, for this whole country, is somewhere about one quarter of one penny tax decrease, something like £300 million. The kind of sums needed for the next year, not to enhance it but to make it sensible, are somewhere about an extra £700 million; I agree on top of the sum you have given already. Is it not better that instead of being pinned to the wall by one crisis after another and one proper

story after another, that we do one of two things: we fund it properly now in the short term and then look at in great depth in the long term. I concede we cannot go on for ever but the crisis is now. If you did have to choose between one penny off instead of two pennies off - I do not think you would have to with the figures you have got - we could genuinely get the best of both worlds. Is that not better, is that not more in the interests of people in the short term and the long term?

(Mr Lawson) Let me say this to you, Mr Beaumont-Dark. I accept entirely the importance of the issue that you have raised and the sincerity with which you address it. I am rather doubtful about some of the figures which you have quoted. For example you said that the nurses' award last year required ~~them~~ ^{(No state / Health Service) Health Authorities} to find £600 million ~~from those sources.~~ ^(their own resources.) That simply is not so. ~~Quite apart from the fact that~~ ^(incidentally,) it is worth pointing out, that we have as a Government given the nurses and the ^{allied} professions ~~and allied medicine~~ ^[pay] a review body, which no previous government have done and which we have given to no other body of workers, because of the tremendous importance ~~we attach to this,~~ ^(The nurses, the health service. To reach body) they recommended this year ~~an~~ ^(increase for nurses) average of 9 per cent. We accepted that in full and that was a lot more than the $3\frac{3}{4}$ per cent ^{increase} which we had pencilled in for the National Health Service and the various health authorities. Indeed there was an extra £292 million that had to be found. Of that £292 million, £262 million or 90 per cent was taken from the ~~reserve~~ ^{what used to be called the contingency reserve} and only 10 per cent had to be found from ~~their~~ ^{health authorities'} own budgets. ^{are}

136. The nurses and the nursing profession / obviously going to have a proper increase in salaries in the next 12 months. Will you give one guarantee, that that wage increase this time will be

properly and fully funded and not taken off the already strained resources of the regional health authorities of this country? It is a simple question to which I hope there is a good simple answer.

(Mr Lawson) No, I cannot give you any blanket undertaking without having any idea of what the review body will recommend.

137. Someone has got to pay it.

(Mr Lawson) It has got to be paid but it is better to stick to the known facts rather than conjecture about the future. This year, when ^{the review body recommended} ~~they awarded~~ a very substantial increase, which we accepted in full ^{and} without any staging, ~~the whole thing at one time,~~ 90 per cent of ^{the extra money went} ~~that~~ was new money taken out of the reserve and only 10 per cent, only £30 million, had to be found by ^{the health authorities} ~~them~~ from their cost improvement programmes.

Chairman: We must now move to much broader issues.

Mr Radice

138. Obviously like many other members I am not particularly happy with the Chancellor's answers and I do not think the Royal College of Physicians will be either. Could I turn to overall economic policy. Obviously your Autumn Statement, as you said yourself, has been very much overshadowed by the stock market crash and by the dangers of a world recession, particularly following the fall in the value of the dollar which the London Business School, whose findings I believe you very much respect, said has been exporting recession to the rest of the world. Both you and the Prime Minister have been urging the Japanese and the West Germans to take compensatory action, but would you not agree that the United Kingdom, which, as you have been telling the Committee, is a very strong economy but which has much higher real interest rates than

either the Japanese or West Germans and, as you also admit, a higher level of unemployment, is actually also in a good position to take compensatory action if that is needed. How do you see the stock market crash? How has it affected the British economy and what kind of action do you think ought to be taken?

(Mr Lawson) We are playing our full part in world economic growth. We have the fastest economic growth of all the major countries in the world. I do not know whether we shall have the fastest rate next year but we shall certainly be well above average. ~~And~~ of course we have reduced interest rates by $1\frac{1}{2}$ per cent since the stock market collapse in the middle of October: ~~We~~ ^{we} are playing a very full part. ^{them, too.} As regards Japan, their economy is also growing at a very healthy rate. They have taken the measures they said they would take and their economy is an extremely flexible and efficient ^{one} ~~economy~~ ^{which is moving} and they are going ahead very well. Our complaints about the Japanese are that they still do not open their markets for consumer goods to imports in the way that they should do. ~~As regards Germany,~~ Germany has a bigger problem. Growth in Germany is very slow, around $1\frac{1}{2}$ per cent, but they have taken a number of ~~measures~~ ^{new} measures. ~~Their~~ ^{at} interest rates now are the lowest level since the present Federal Republic came into existence, and they have some substantial tax cuts coming into effect from 1 January. We shall have to see how ~~the~~ ^{their} ~~economy~~ ^{the economy} responds. My own view is that the German problems really lie on the supply side ~~and~~ in their own interests they need to make improvements there ~~and~~ ^{for example} ~~privatising~~ ^{by} more and ^{by} getting rid of a lot of the subsidies that they have and using the money for reductions in taxation. It would not mean

they would have to borrow any more. ^{they need} ~~just getting rid of the~~
~~subsidies and using that money for reductions in taxation and~~

~~having an improved supply performance that way and in other ways.~~]

As far as the United Kingdom is concerned we have played our full part as far as real interest rates are concerned. Our real interest rates are higher than some countries and lower than others: we are about the average for G7.

139. You do not think there is any further room to reduce interest rates.

(Mr Lawson) Obviously interest rates are something which I watch carefully all the time and when I think they ought to go up they go up and when I think they should come down they come down.

Mr Budgen

140. I thought they were decided by markets.

(Mr Lawson) No, that would be an abandonment of monetary policy and that I am not prepared to do.

Mr Radice

141. I am sure colleagues would like to follow up what you said about interest rates but just turning to the public sector borrowing requirement I notice that when you came before the Committee/ ^{earlier this} year at the time of the Budget you said that you saw a 1 per cent PSBR as a kind of modern equivalent of the balanced budget. That was your concept of what the PSBR's role was. Do you think that in present circumstances following the stock market crash

there is a role for the PSBR as an anti-cyclical device? Your adviser, Sir Terence Burns, implied that he could see circumstances in which the PSBR would play that kind of role.

(Mr Lawson) Of course there is a relationship between the PSBR and the economic cycle. May I refer you to a speech I made when I was Financial Secretary to the Treasury at a 'Financial Times' conference in London on 21 January 1980.

142. I keep your collected works under my pillow.

(Mr Lawson) I went into that there and it is something which has always been part of ~~one's~~^{my} thinking ~~clearly~~.

143. So in fact you always have been a Keynesian.

(Mr Lawson) No, it is nothing to do with Keynes.

I advise you to read the speech because you clearly do not keep my works to hand, which may be one of the reasons why you have such difficulty.

144. Perhaps you would like to read it out to the Committee.

(Mr Lawson) I drew there the distinction between the Keynesian approach, which was to use the PSBR to have an effect on the cycle, and what I was talking about which was the way in which the cycle affects the PSBR.

145. So you do not believe there is any room for anti-cyclical budgetary spending?

(Mr Lawson) No, certainly not. I will take a decision on the PSBR at the time of the Budget and I am not going to take that decision now. I set out more recently in my speech to the Lombard Association what I thought was the right way in which to set fiscal policy and the PSBR. What I would certainly not do is try in any way to boost activity in this country by what you describe as contra-cyclical spending. ~~[I think I should like to repeat something which I said a little while ago.]~~ You seem to have as the premise of your question the assumption that the world is going into recession.

I have to say that on all the evidence before me I see no sign of that: a slowing down of the rate of growth maybe, but not a recession.

Chairman

146. Might I intervene for a moment. I well remember the speech to which you refer.

(Mr Lawson) I knew you would.

147. I always mark particular ones you wrote entirely yourself. Could I just clarify one point. Mr Radice referred to the views which you expressed at a previous hearing after the last Budget about what was in effect a modern equivalent of a balanced budget doctrine. Of course the figures for the outturn are now significantly less - I think I would be right in saying - than those which would be consistent with that doctrine, that is to say you picked a figure of 1 per cent whereas in fact we are down to one quarter of one per cent now. Do you think that requires any adjustment?

(Mr Lawson) No, it does not necessarily ^{require any adjustment} at all, for two reasons. First of all, this ^{modern equivalent of the} ~~doctrine of~~ balanced budget is ~~one~~ where you reached ^{the} a point where, even if there were no inflation at all, the debt/income ratio would be falling rather than rising, ~~gently falling~~. That is a sustainable position, whereas ^{an} indefinitely rising ^{ratio will} means you get into all manner of difficulties. There would not be any problems ~~in the first place by~~ ⁱⁿ having a PSBR which ~~is~~ ^{was} slightly less than that. What we have demonstrated in recent years - and this bears on Mr Beaumont-Dark's concerns - is that within an overall objective for public expenditure, if your burden of debt interest is lower, then pro tanto you have more scope for increasing expenditure on programmes. The other thing - which comes back to what

Mr Radice was saying - is that in so far as the cycle will have an impact on the PSBR - the PSBR is unlikely to be an absolutely straight line - then I think it would be quite normal to expect it to be below the "balanced budget" line this year, and it may well be - ~~but~~ ^{though} I have not taken a decision - that it could be lower than the 1 per cent next year; ^{or} it may ~~well~~ be that the 1 per cent is appropriate. ^{certainly} I would not like to see it any higher than that.

Mr Winnick

148. Could I preface my questions by saying that though there is not time I was far from satisfied with your answers to Mr Beaumont-Dark on the National Health Service. I represent a West Midlands constituency and there is an acute crisis of hospital beds. Whilst not wishing to be personal, as I understand it no member of the Cabinet, including yourself, actually uses the National Health Service.

(Mr Lawson) I have never known you satisfied with any answer. ~~It is worth pointing out that~~ as it happens, on the rare occasions I need anything I use the National Health Service, but that has not got anything to do with ~~anything or~~ ^{the} policy issues. It is interesting to note ~~from the figures here~~ ^{that, so far as health spending is concerned,} that the West Midlands had a cash increase this year, 1987-88 over 1986-87, of 9.3 per cent, which is quite substantial.

149. I would ask other questions but clearly you are not aware of what is happening on the ground now. You have made mention today that you did not expect a world recession but you also said - correct me if I am wrong - in an interview on "Weekend World" that if in fact - I am summarising - there was such a recession you would take steps to protect Britain from the effects. What steps did you have in mind?

(Mr Lawson) Sound management of the economy does enable you to avoid the worst effects of whatever may be happening. It does not mean ~~obviously~~ that you can be totally immune, but you can avoid the worst effects. ~~[We have had experience of that:]~~ We had experience of that when there was a dramatic collapse of the oil price, for example. We were affected by that far less than other major oil producers. It is a question of sound and skilful economic management.

150. Would that have any effect on your proposals - or what you have in mind if not firm proposals - for the reduction in income tax?

(Mr Lawson) I cannot tell you whether there will be scope for a reduction in income tax in the next ~~budget~~ budget or not. I will have to judge that at the time.

151. The Bank of England Quarterly Review states that in the aftermath of the stock market crash awkward questions have been posed for monitoring policy. Is that your view?

(Mr Lawson) Yes, the conduct of monetary policy and economic policy generally is never easy: one just has to do one's best.

152. And we have seen the effects of that "best". As regards the position over credit, there is increasing concern - perhaps you will tell us if you share that concern - over the amount of credit facilities available and the amount of debt which is accumulating, and I am not referring to mortgages. If you take aside mortgage repayments does the position over domestic credit worry you at all?

(Mr Lawson) It is interesting that if you do take aside mortgages you find there has been no growth of ~~private~~ ^{personal} sector borrowing as a percentage of GDP at all. If you take the

period from 1979-80 to 1986-87, which is the last year for which we have figures, you find that there has been a ~~rapid growth~~ substantial growth in mortgage borrowing, from 3.2 per cent of GDP to 7.1 per cent of GDP. If you take all other ~~private~~ ^{Personal} sector borrowing, other than mortgages, it has gone from 4.7 per cent of GDP to 4.1 per cent of GDP. I do not want to make too much about that decline: it has been pretty well a flat line throughout, a pretty constant percentage of GDP which originally was higher than mortgage borrowing. It is mortgage borrowing which has ~~been~~ ^{shown} the big increase.

153. There was a "Panorama" programme on Monday. Perhaps you did not see it. I confess I was here and did not see it. It dealt with the difficulties which an increasing number of people are facing as a result of credit expansion and the manner in which there is no control. You know very well how the banks and other lending institutions virtually beg people to borrow and put forward all kinds of reasons why loans should be taken out. Do you think that is a desirable state of affairs?

(Mr Lawson) It is a free country and I believe that lenders should be free to lend and borrowers should be free to borrow. I do not believe that it makes sense to have all the morass of restrictions and controls which at various times in the past we have had, and which incidentally can be nearly always circumvented by those who are good at that sort of thing. What is ~~a~~ desirable ~~move~~ is the move to set up a national credit register so that ~~you~~ ^{lenders} can find out ~~if you are a lender,~~ when someone comes along to borrow, whether they have borrowed a lot from other lenders as well. One of the problems has been the chap who ~~goes to one source and~~ borrows a little bit ~~there~~ ^{here} and

to another source and borrows a little bit there and so on. Each ~~thing~~^{loan} does not seem very ~~much~~^{large} compared with his income but the cumulative amount is very considerable. The development of a national credit register, which the lending institutions are developing, is desirable. There is another ~~reflection which~~ I ~~always have and~~^{point which} I notice, ~~this~~, as you no doubt do, from constituents who come to one's surgery with their problems. Despite all that is written about the banks' refusal to lend money and how wicked this is, I have to say that over some years now that I have been a Member of Parliament, I ~~found~~^{have} far more people get into trouble from banks lending too much than banks lending too little. ~~It~~ is a free country and the only way in which I would seek to influence things at all is through the level of interest rates. But

154. When you emphasise that this is a free country, we are aware of the fact though it may come as a surprise to you, Chancellor.

(Mr Lawson) I am glad we have something in common.

155. I trust that you are as keen to defend that freedom as I am. After all, when it comes to other matters restrictions are imposed even by Conservative governments, be it in transport matters and the rest and planning controls. No one argues because those controls exist. Britain is a less than free country so I do not quite get the logic of your point. What would you say to the view that much of the buoyancy of the economy in the last few months, certainly in the pre-election period, was in fact as a result of domestic borrowing and credit.

(Mr Lawson) That was not so at all. For example, we were talking earlier about the very marked strength of, and growth in, manufacturing output. I do not see any connection between that

rapid growth of manufacturing and the sharp increase there has been in mortgage lending for example.

156. You are not suggesting that the manufacturing position is at all satisfactory are you?

(Mr Lawson) The manufacturing position is healthier than it has been for as long as I can remember.

157. You must have a very odd view of that.

(Mr Lawson) I have to say that is the view of manufacturing industry itself, as confirmed by a whole series of CBI surveys. ~~Probably~~ the manufacturers themselves ^{are likely to} ~~may~~ be a better judge of the state of manufacturing industry than you are.

158. It may be that there has been some recovery, which I do not doubt, from the worst recessions, from the 1979-81 period.

(Mr Lawson) It is not just a question of the quantitative figures it is also the quality. Manufacturing industry today is much more efficient and much more profitable than it has been for a very long time. That is important, ~~It is not just~~ ^{partially} when you are looking to the future, ~~as we all are doing,~~ because that is what ~~this is.~~ ^{matters.}

Mr Winnick: There are more manufactured items brought into the country than we export.

Mr Sedgemore

159. Some shrewd observers in the City have been saying that your mega-mouth diplomacy at the Mansion House has made an impossible position worse in the world financial markets. They argue that you created a needless row with the Americans and that has held up a G7 meeting and that you led dealers around the world to believe that there would be an early G7 meeting and that has not happened and that has added to the uncertainty in the

world stock markets since then. How would you respond to those criticisms and indeed to my belief that in a crisis the Chancellor of the Exchequer of the UK should at least pretend to statesmanship?

(Mr Lawson) If any observers hold that view I certainly would not call them shrewd.

160. In September, just a few days before the world stock markets went spinning into a crash and the Louvre Accord was blown to smithereens in as far as it concerned exchange rates, you made a speech to the International Monetary Fund. You see I read all your speeches. You made a speech to the International Monetary Fund saying that the Louvre Accord was a wonderful mechanism. Would you modestly agree that that was a monumental judgmental error and once again you were telling dealers around the world that central banks and central governments were going to defend these exchange rate bands which were indefensible and that therefore you were actually in that speech one of the causes of the crash.

(Mr Lawson) It is a wonderful thought that if only I had not made that speech the stock markets would have gone on and on and on and up and up and up. Others will consider and judge the plausibility of that proposition. The speech, however, was not in the terms in which you characterise it. What the speech

- and it does bear reading and it is clear that you have not read it - was pointing out ^{was} the ~~taste~~ ^{CASE} for what I called managed floating. That case I believe is as strong today as it was then, and I believe there is a wide acceptance of that around the world. I do not believe it is a view unique to myself.

161. You have anticipated my next question which was whether we were going to stay with managed floating. Are we going

to change the bands in which we are going to manage the float?

(Mr Lawson) As you pointed out, there has not yet been a meeting of the G7. When there is a meeting of the G7 no doubt that is one of the matters which we shall discuss.

162. Do you think that dollar interest rates should be increased to support the dollar or reduced to limit the risk of recession?

(Mr Lawson) As I pointed out in answer to earlier questions, the American economy ^{clearly} in the period leading up to the stock market collapse was going ahead really strongly. ^{clearly} ~~On~~ ^{in the} third quarter there was a growth of 3 per cent; ^{on a year ago; that} ~~this was an~~ acceleration from the second quarter. In my opinion ~~the Americans showed~~...I hesitate now, as you hear, because I do not want to be accused of mega-mouth diplomacy so I am not really sure whether Mr Sedgemore wants me to discuss American policy because he seems to be upset when I do it at the Mansion House... I do think ~~they~~ ^{the Americans} have a problem. They have a problem ~~not merely with the present rates of interest,~~ not merely with the ~~problem of~~ the dollar which is a real problem, for them just as much as anyone else, but also with the financing of their twin deficits if interest rates are not at an adequate level.

163. There has been some intervention in the exchange rate markets recently, has there been any question of Britain moving out of dollars into Deutschmarks and in effect not really supporting the dollar but actually mitigating losses? I ask you a question I asked Sir Terence Burns.

(Mr Lawson) Our reserves are in different currencies. It is not the policy to reveal in what currencies they are.

Obviously, however, the dollar is the greater part of our foreign currency reserves if you look at the gross picture, but I am not going to give you the figures. Something which is sometimes overlooked is that the overwhelming proportion of our overseas liabilities are also denominated in dollars. If you look at the net position the balance between dollars and other currencies is very much more even, ~~in fact it is very even.~~

164. Are you not going to answer my question?

(Mr Lawson) About the figures? No, I am not.

165. About moving out of dollars into Deutschmarks.

(Mr Lawson) No. We never publish, and never have done, the transactions we make across the foreign exchanges.

166. What has been the reason for not sterilising the intervention?

(Mr Lawson) ~~The reason I gave in my speech at the Mansion House [and that is that]~~ at the present time, following the stock market collapse, I ^{do} ~~did~~ not think that it would be sensible to take that amount of liquidity out of the market ~~[at that time]~~. ~~change in~~ Ultimately the policy remains over a period of time, but not necessarily in this same financial year, ~~to fund the intervention,~~ ^{I am talking about} ~~that is to say the~~ net intervention, because you may well find over a period that there is intervention the other way which unwinds intervention that you have done in the first direction. So what needs to be funded is obviously the net.

(Sir Peter Middleton) I want to make a point on your earlier question about losses. It is as well to have it on the record. The object of exchange rate policy of course is not to make short run profits on the reserves or anything like that, it is to support exchange rate policy. Obviously if you conduct your

affairs reasonably you would expect to be in a pretty good position over a period but it would be over a period and not in relation to your current transactions.

(Mr Lawson) There is another point to add to that.

On the general question of the profitability or the losses I agree entirely with what Sir Peter Middleton said about the object of intervention in the foreign exchange markets. People did have maybe a feeling that intervention was bound to result in losses, thinking of times in the past when the pound ~~has been~~^{was} going down and down, it ~~has been~~^{when was} a one-way movement and there ~~have been~~^{were} vain attempts to prevent ~~that but at the end of the day~~^{(interview 15) it} obviously you lose money if you intervene in those circumstances. ~~if~~^{It is very difficult} however, you are in a situation ~~which~~^{where you have large cyclical surpluses;} we have certainly seen in the case of the dollar against other currencies, including the pound, going right down in 1977-78-79, then right up again to an enormous peak in 1985 and now down again. When you have this cyclical movement then, although it is very unlikely that you will actually be buying your dollars right at the bottom of the market and selling them all right at the top, nevertheless you will tend to be doing your buying ~~near~~^{around} the bottom half and you will also be doing your selling around the top half. This means that you are in those circumstances more likely than not to make a profit. But that is not the purpose of the exercise.

167. Could you tell me what the effect of the intervention on broad money M3 is and does it matter, does M3 matter any more?

(Mr Lawson) Certainly broad money ~~liquidity~~^{or} matters ~~and~~³ we watch it carefully as one indicator among others and certainly it is true that the ~~increase in liquidity as a result~~^{effect of intervention} of intervention

which has not been sterilised or funded is to increase ^{liquidity.} ~~it~~. Quite honestly a better indicator of broad money nowadays is M4 rather than M3. If you look at the growth of M4 over the years from say 1979 to 1987 what you see is a remarkable stability of the growth of broad money.

Chairman

168. I am rather wondering what M4 was doing between 1970 and 1974.

(Mr Lawson) Growing faster I suspect but I do not have the figures here.

169. Could we be clear. The effect of intervention has been in fact to increase the quantity of broad money. Is that right?

(Mr Lawson) Yes.

170. Could you quantify it at all?

(Mr Lawson) No, because we do not reveal, either by the frontdoor or the backdoor, the extent to which we have been intervening.

(Sir Peter Middleton) What is more it is difficult to quantify anyway because the effect is not one/ ^{for} one, it depends on the counter parties to the intervention.

Mr Hamilton

171. We seem to have picked on a level of DM3 to the pound throughout this year as the level around which sterling should fluctuate within narrow bands. Can you tell me whether that indicates that we are now effectively part of the exchange rate mechanism of the EMS and whether it might not be more appropriate for the pound to be at a lower level rather than where we are now?

(Mr Lawson) The answer to the first question is no, it does not indicate that we are part of the exchange rate mechanism of the EMS. The answer to your second question is more complicated. It is a matter of judgment. If I may quote an extract from what I said at the press conference following the Louvre meeting in Paris on 20 February this year, ~~I said that~~ we have had quite a sizeable fall in the exchange rate against non-dollar currencies, which was a necessary adjustment in response to the collapse of the oil price. I made it clear some months ago that I thought it had gone far enough and I did not want to see the pound fall any further. By the same token, I have no wish to see a substantial rise, and a period of stability would suit us very well. At the time I said that the Deutschmark/sterling rate was 2.79. It is now about 2.99, ~~and~~ that is compatible with what I said then. That gives you an indication of my thinking, but it is a matter of judgment based on the adjustment that I thought it was right to allow in the light of the oil price collapse and that it should not go any further.

172. I know there is an argument/^{that} changes in the exchange rate can influence the rate of inflation: I do not fully understand it myself but I can see that there might be an argument for that in relation to the dollar. Does it really hold good in relation to the Deutschmark?

(Mr Lawson) The relationship ^(with the Deutschmark) is a rather different one. ~~Certainly changes in the exchange rate - you can look at what is happening [in this context] better [at the effective rate, or the exchange rate index as I believe it is now called. That does have an effect on inflation and Sir Terence Burns will explain that to you if you would like an explanation. As far as the Deutschmark is~~ ^{in your terms, in this context,} ^{in terms of}

concerned, the more significant relationship with inflation is that Germany has, perhaps largely because of its historical experiences both in the 1920s and in the immediate post war period, a deep distrust of inflation and a very strong anti-inflationary track record. As I was indicating, they have problems on other fronts at the present time but not on that front. Therefore keeping the pound in line with the Deutschmark is likely to be over the medium term a pretty good anti-inflationary discipline.

Mr Radice

173. In your Mansion House speech - so you can see I do read your speeches very carefully - you said that there should be no doubt of our commitment to maintain a stable exchange rate with the rate against the Deutschmark being of particular importance. This is the Chancellor speaking. A couple of weeks later I read an interview with the Prime Minister and she said this. There is no specific range - speaking about exchange rates. We are always free, we are not confined to any particular limits and I do not like us to be. She goes on to say that at the moment everyone is geared to the Deutschmark save us. The Deutschmark at the moment is slightly deflationary. That means that the whole of Europe is geared to a slightly deflationary policy. We have not been so geared and we have had a greater degree of freedom in relation to both the dollar and the Deutschmark. I think that I am grateful for that. It seems to me that there is a slight difference of emphasis at least between the Chancellor and the Prime Minister.

(Mr Lawson) The main point the Prime Minister was making was the point that has already been elucidated by

Mr Hamilton, namely that we are not within the exchange rate mechanism of the EMS. If you want any further elucidation of the Prime Minister's remarks, I suggest you invite her to appear before this Committee.

174. So you do not totally agree with what the Prime Minister said.

(Mr Lawson) ~~No, no,~~ I agree entirely that we are not members of the exchange rate mechanism of the EMS.

Mr Radice: I do not think that is quite what she said. She went on to say something a bit stronger than that.

Mr Sedgemore

175. Is that a formal rebuke?

(Mr Lawson) No, it is a statement of fact.

Chairman: We will have to consider the position of the First Lord of the Treasury.

Mr Hamilton

176. Can I follow up the question of whether in fact we have been intervening more against the Deutschmark than appears from the published figures as our reserves are denominated in dollars. I cannot myself see why it would really make very much difference whether we revealed these figures or not. Could you explain why it is and perhaps always has been the policy not to reveal the makeup of the reserves according to the particular currencies that are held?

(Mr Lawson) Yes, it always has been the policy and it is, I suppose, ^{done} for the same reason that private operators in markets do not tell other people precisely what they are up to: you can operate more effectively that way. It is a simple practical issue.

The second point I would make is that the Americans still have - and this is something Mr Budgen and I agree on - a problem of financing their twin deficits. They have got to do that by attracting private flows. For that reason, they may well need to put up interest rates.

Chairman: Ms Quin has one particular area she felt had not been covered, if you can spare a moment or two.

Ms Quin

197. It relates to one of the domestic aspects of the stock market fall, namely the Government's privatisation programme. Given the experience with the BP share offer does this mean that the Government have now re-evaluated the likely benefits from the privatisation programme? In the Autumn Statement it estimates the net proceeds from privatisation as being £5 billion a year. Has this figure now been changed? What is the likely shortfall in privatisation receipts as a result of the BP experience?

(Mr Lawson) There is no change in the Government's commitment to privatisation and wider share ownership and that programme will continue ~~(and)~~ Indeed the only change, the most important single change, that there has been since 15 October is the announcement that we are going to privatise ~~the~~ British Steel Corporation. ~~As for the figures and shortfalls this year, obviously that depends to some extent on the extent to which we have takers for the buy-back offer for BP. Until that offer is closed we will not know what takers we have had and we will not know what the figures are.~~
as soon as practicable.
agree

Mr Radice

198. So it was a bit of a shambles.

Donald
Mr Don Reagan to Mr James Baker III. They had different views, and
the result ~~is~~ ^{was} that the Americans were then prepared to join in
concerted intervention, which made it a practical proposition in a
way that it had not been hitherto. So that was really the watershed
and that is why there is this difference to which you rightly point.

196. The other loose end is that as far as the dollar is
concerned we speak of intervention interest rates for fiscal policy.
You were putting forward some cogent arguments a few minutes ago
as to reasons why the United States - taking all the facts into
account - should raise interest rates. But in fact, following the
Wall Street crash, interest rates there have fallen. There is
obviously a policy dilemma here. I was not quite clear whether you
were saying that you disapproved of the fall in interest rates
which took place earlier.

(Mr Lawson) One would expect the American economy to be
most affected by a sharp fall in stock market prices because of the
extent of shareholding in the United States economy and the nature
of that economy. I can understand that they were very anxious in
the immediate aftermath to show that there was going to be enough
liquidity and there was not going to be a problem from a lack of
liquidity. What is going to be necessary is first of all an
adequate interest rate differential between ^{the} United States and other
countries. Recently other countries have put their interest rates
down. As I mentioned, the German rate is down to the lowest
level in their history and it is most unlikely that it will go down
any further. Any further widening of differentials, ~~in fact~~
if that be needed, will have to be ^{produced by} American interest rates going up.

can have intervention or one can use interest rates or one can use fiscal policy. Two points. First point. As far as intervention is concerned, at the time when you were answering the question to which you referred, the Committee was fairly clear that intervention was being used to smooth movements in the exchange rate, whereas now it does seem to be on an increasing scale and over a prolonged period being used to influence exchange rates. Is that so?

(Mr Lawson) Yes, indeed. The date of this ^{change, known,} was ~~28 January~~ 1985. ~~[The thing changed.]~~ ^{As} I tried to explain in ^{this} my speech at the IMF in September this year in Washington, ^{which} ~~it~~ was as much intended as an explanation of what had been going on, what had happened and why, as it was a prescription for the future, ~~but the~~ ¹⁹⁸⁵ thing changed completely at the Plaza meeting in September and the pre-planning for the Plaza. Since then we have been in ^{an} ~~this~~ era of managed floating, in which intervention has been used on a far larger scale. The reason for the change ^{at that time} ~~there~~ was a change in United States policy, because there is no way, I believe, that concerted intervention can be effective unless the United States is playing a full part in it, because they are so important. ~~The~~ United States policy had hitherto been to have no part in intervention in any serious way at all. I do not want to exaggerate the role of intervention: the role of intervention is limited and monetary policy, interest rate policy, is more important. Nevertheless it has a role but it can only work if the United States play a full part. Two things really came together. First of all the ~~very very huge~~ enormous rise into the stratosphere of the dollar, ^{second} and ^{US} the change in Treasury Secretary from

the 10 per cent figure, ^{though} ~~but~~ clearly ^{these dollar holdings} ~~they~~ are at the moment of a lower value than they were at the time that they were bought. On the other hand, as Sir Peter Middleton pointed out earlier, you have to take a longer view than a view of a few weeks or even months, ~~and~~ it may well be that when the time comes for those dollars to be sold they will actually be sold at a higher price and a profit will be made. Furthermore, the prime objective of intervention policy is not to make a profit: that is a useful guide to whether you are being sensible or not but that is not the objective. If I may quote a question I was asked, a very sensible question I was asked, before the predecessor committee in January 1985. "Are not you taking away some of the weapons/ ^{that} these distinguished technicians employ" ^{that} is the Bank of England "if you allow it to be said on your behalf that you will not use the interest rate weapon or you will not intervene at certain levels in the exchange markets. You have relatively little power and if you give an impression that you are not prepared to use the few levers at your command do not you then restrict your room for manoeuvre?" (Mr Lawson) I have never given that impression, nor do events bear it out". The interesting thing is that the questioner was Mr Budgen.

Chairman

195. Time is running on and it may be that the policies of this Committee or even Mr Budgen change as well as those of the Government. Could I just tie up two loose ends from what Mr Budgen was saying, not that he ever leaves any loose ends. In relation to the dollar, clearly what happened to the dollar/ ^{and} in the US economy is of very great concern to us who are concerned about the British economy. Essentially in relation to the dollar one is saying one

United States that they were no longer - ^{and} I am not saying this ^{now} in any ~~form~~ ^{SPINT} of criticism but just a statement of fact - prepared to raise interest rates any further ^{time they} ~~and~~ were afraid of their economy tipping into recession. There was the implicit feeling therefore, though that was subsequently denied, that they were not supporting the Louvre agreement. That had a bad effect on the markets but it would not have had that dramatic effect on the markets had it not been for the fact that they were ripe for a fall anyway.

193. Do you agree that the fall might have been smoother if it had not been preceded by a substantial increase in interest rates?

(Mr Lawson) No. The Americans needed to put up their interest rates. They ~~have~~ ^{did} not put them up very much but they needed to put up their interest rates, which were on the low side in real terms. Indeed even more so, given the need to finance their deficits. They had to raise interest rates ^{then} ~~and~~ they may have to do so again in my judgment.

Chairman: Mr Budgen usually has six "one more" questions. I think he has one more to go before he reaches that limit.

Mr Budgen

194. You do agree do you not, firstly that after the Louvre the contracting parties bought \$90 billion and that after the crash they all collectively lost not less than 10 per cent on that investment of \$90 billion.

(Mr Lawson) I cannot confirm the ^{\$90 billion} figure, which I suspect is a trifle on the high side. ~~but~~ I do not know what the total amount was that the various central banks around the world ~~had~~ bought in dollars. ^{Now do I} ~~But~~ you cannot necessarily ~~take~~ ^{accept}

about Northern Ireland and interfere in the domestic affairs of the United Kingdom?

(Mr Lawson) If I may say so that is a rather silly question, but it is a matter of fact that American Congressmen of Irish descent frequently do make speeches about British policy in Ireland.

191. Do you think our right to tell them to mind their own business has now been diminished by your actions?

(Mr Lawson) What we need to tell them is the truth about the position in Northern Ireland, just as it is right to speak the truth about the world economy.

Chairman: We are going very wide of the issues.

Mr Budgen

192. Is it right that American interest rates were increased by about 2 $\frac{1}{2}$ per cent after the Louvre agreement and before the crash? Would you concede that may have been a factor in precipitating the crash?

(Mr Lawson) I do not think it was. It is very difficult always to say, even with the benefit of hindsight, what has caused some dramatic turnaround in the world stock markets. Two factors are certainly important, though there may have been others. First is the fact that the bull market had gone on for a very very long time and prices really had run ahead of themselves and the markets were ripe for a correction. Indeed the peak was not in October; ~~it~~ ^{markets} had already come down a bit from ~~the~~ ^{their peaks in} summer. ~~[The peak in the stock markets was during the summer.]~~ But then what ~~did happen after the market had been ripe for a correction, what~~ did disturb people, was the view put about in the

(Mr Lawson) In the first place, these are not just American domestic affairs, they are matters of importance to the whole world economy. In the second place America has always accepted, whether in the field of economic policy or the field of defence policy or whatever, ^{that} because America is of so much greater weight on the world scene than any other country, ~~that~~ her policies are commented on internationally in a way that other countries' are not. That I suppose is what being a super power means. In the second place I rather like the idea, the rather pleasant conceit, that if I had not spoken out nobody would have known there was anything wrong.

(Sir Peter Middleton) It is a fact that very similar things have been said by practically every other country and most international organisations in this field.

(Mr Lawson) Yes, indeed. Mr Paul Volker ^o during his time as chairman of the Federal Reserve made some extremely trenchant criticisms as well. To be fair, the Americans have taken some steps to reduce their budget deficit which they are now at this very moment seeking to get through Congress.

190. Assume for a moment that you were a person in America of Irish descent who took a great deal of interest in the affairs of Northern Ireland and you wished to press your American politician to interfere in the affairs of Northern Ireland, perhaps with a view to creating a united Ireland. Might not an American politician say "Well the British Chancellor of the Exchequer has been offering us a lot of advice in very public and forceful terms about the way in which we run our domestic affairs. Would it not now, on the precedent of that, be possible for us to offer advice

Mr Budgen

188. If the dollar falls then it is likely that the purchasers of dollar securities will be less inclined to purchase them and that surely means then that the Americans are left with a disagreeable choice between printing more money and raising taxes, are they not, because they cannot borrow properly?

(Mr Lawson) The obvious way out would be to raise interest rates, which would have a double effect, both ^{aspects} of which would be reassuring to the holders of the private funds who they need to attract. Obviously they have to attract overseas private funds and for some little while they will have to do that. If they raise their interest rates, that is likely to have a stabilising effect on the dollar as people will be less afraid of the decline you are talking about, the capital loss; secondly, it will give them a better return on their investment, so on both grounds that is likely to attract the funds. *Re need.*

189. If on the other hand you tell the Americans to do something and they do not do it and the doing of that thing is regarded by the international financial community as being important, whatever the demand may be, is there not a danger that those who are to lend money to the Americans may say at the margin that Mr Lawson has told them to cut their deficits and they have not cut their deficits. "We do not understand whether these things are important but we notice that it has not been done and perhaps we shall not lend them as much money as we would otherwise do". That in fact creates just the instability that you by your intervention in American domestic affairs are trying to avoid.

✓ - payp

FROM: COLIN MOWL
DATE: 18 January 1988

PS/CHANCELLOR ✓

CW/ to note

mpw
18/1cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Sedgwick
Mr R I G Allen
Mr Bush
Mr Ritchie
Miss Chapman**PSBR IN DECEMBER**

As Miss Chapman explained on the telephone there has been a last minute revision to the PSBR in December to be published tomorrow, compared with the figure I reported on Friday (Draft Press Briefing on PSBR in December). The PSBR in December now rounds to £0.2 billion compared with Friday's figure of £0.3 billion. This revision will be incorporated in the final version of the press briefing to be circulated later today. In the meantime however you might like to have the following summary of the figures to be published:

Borrowing Requirements - £ billion

	<u>Apr-Dec 1986</u>	<u>Apr-Dec 1987</u>	<u>Dec 1987</u>
Central government on own account	5.7	-	-0.5
Local authorities	-0.6	0.4	0.7
Public corporations	-0.9	-0.8	0.1
PSBR	<u>4.2</u>	<u>-0.4</u>	<u>0.2</u>
PSBR (excluding privatisation proceeds)	7.5	4.7	0.4

Colin Mowl

COLIN MOWL

Table 3: PUBLIC SECTOR BORROWING REQUIREMENT EXCLUDING PRIVATISATION PROCEEDS

Cumulative £ billion

	Central government on own account			Local authorities borrowing requirement			Public corporations borrowing requirement			Public sector borrowing requirement		
	1985-86	1986-87	1987-88	1985-86	1986-87	1987-88	1985-86	1986-87	1987-88	1985-86	1986-87	1987-88
	Apr	1.1	1.3	2.1	0.8	0.7	0.5	-0.2	-0.1	-0.4	1.8	1.9
May	2.5	3.0	2.9	0.8	0.4	0.1	-0.4	-0.5	-0.4	2.9	2.9	2.6
Jun	4.0	4.2	4.1	0.5	-0.1	0.2	-0.5	-0.7	-0.5	3.9	3.4	3.8
Jul	5.0	4.2	4.3	0.8	-0.1	0.4	-1.2	-1.0	-0.8	4.5	3.0	3.9
Aug	6.2	5.3	5.7	0.9	0.2	0.3	-1.2	-0.8	-0.9	5.9	4.7	5.1
Sep	6.8	7.8	6.0	1.1	0.0	0.6	-0.7	-0.9	-0.7	7.3	6.9	5.9
Oct	6.7	7.5	4.8	0.7	-0.3	0.2	-0.5	-0.5	-0.8	7.0	6.8	4.2
Nov	8.2	8.6	5.4	0.1	-0.7	-0.3	-0.3	-0.9	-0.9	7.9	7.0	4.2
Dec	9.7	8.9	5.1	0.4	-0.6	0.4	-0.2	-0.9	-0.8	9.9	7.5	4.7
Jan	5.1	5.5		0.5	-0.6		-0.2	-1.1		5.4	3.8	
Feb	5.2	6.0		0.4	-0.7		-0.6	-1.5		5.1	3.8	
Mar	7.0	9.0		1.7	0.2		-0.2	-1.4		8.5	7.8	

Note: Figures may not sum precisely because of rounding.

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From: ALLEN RITCHIE
19 January 1988

MR R.I.G. ALLEN - IDT

MR LANG - CSO Press Office

cc List A

List B

(distributed at 11.30am, 19 January)

Chancellor
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Monck
Mr Scholar
Mr Peretz
Mr Sedgwick
Mrs Butler
Mr Grice

Mr Mowl
Miss O'Mara
Mr Pickford
Mr Bush
Mr Franklin
Mrs Todd
Mr R Evans
Miss Chapman
Mr Mansell - CSO
Mr Richardson - CSO
Mr Wright B/E
Mr Gray - No 10

Mr C.M. Kelly
Mr Cropper
Mr Tyrie
Mr Call
Mr Ko - IR
Mr Balley - C and E

BRIEFING FOR 19 JANUARY PSBR PRESS NOTICE

The PSBR figures for December will be published at 11.30am on 19 January. The provisional outturns, together with figures for the first nine months of 1986-87 and 1987-88, are shown in Table 1. Cumulative figures for the PSBR and its components for 1985-86 and 1986-87 are shown in Table 2 overleaf. Table 3 shows outturns excluding privatisation proceeds.

Table 1: Borrowing requirement outturns

£ billion

	Apr-Dec 1986	Apr-Dec 1987	Dec 1987
Central government on own account	5.7	-	-0.5
Local authorities	-0.6	0.4	0.7
Public corporations	-0.9	-0.8	0.1
PSBR	4.2	-0.4	0.3
Memo: PSBR (excluding privatisation proceeds)	7.5	4.7	0.5

Note: Figures may not sum precisely because of rounding.

Table 2: PUBLIC SECTOR BORROWING REQUIREMENT – Comparison with the last two years

Cumulative £ billion

	Central government on own account			Local authorities borrowing requirement			Public corporations borrowing requirement			Public sector borrowing requirement		
	1985-86	1986-87	1987-88	1985-86	1986-87	1987-88	1985-86	1986-87	1987-88	1985-86	1986-87	1987-88
	Apr	1.1	0.2	1.9	0.8	0.7	0.5	-0.2	-0.1	-0.4	1.8	0.8
May	2.3	1.9	2.2	0.8	0.4	0.1	-0.4	-0.5	-0.4	2.7	1.8	1.9
Jun	2.7	3.1	1.7	0.5	-0.1	0.2	-0.5	-0.7	-0.5	2.6	2.3	1.4
Jul	3.6	3.1	1.4	0.8	-0.1	0.4	-1.2	-1.0	-0.8	3.1	1.9	1.0
Aug	4.6	4.2	2.3	0.9	0.2	0.3	-1.2	-0.8	-0.9	4.3	3.6	1.7
Sep	5.1	6.7	2.0	1.1	0.0	0.6	-0.7	-0.9	-0.7	5.6	5.8	1.9
Oct	5.0	6.5	1.5	0.7	-0.3	0.2	-0.5	-0.5	-0.8	5.3	5.7	0.9
Nov	6.2	7.3	0.6	0.1	-0.7	-0.3	-0.3	-0.9	-0.9	6.0	5.7	-0.7
Dec	7.4	5.7	0.0	0.4	-0.6	0.4	-0.2	-0.9	-0.8	7.6	4.2	-0.4
Jan	2.9	2.2		0.5	-0.6		-0.2	-1.1		3.2	0.5	
Feb	2.9	2.3		0.4	-0.7		-0.6	-1.5		2.8	0.1	
Mar	4.3	4.5		1.7	0.2		-0.2	-1.4		5.8	3.4	

Note: Figures may not sum precisely because of rounding.

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13. Revisions to last month's estimates

Line to take

PSBR for April to November revised upwards by £0.4 billion since last month. LABR revised up by £0.5 billion, reflecting revisions to data on LA short-term financial assets. PCBR revised down by £0.1 billion.

Allen Ritchie (270-5029)
PSF Division, HM Treasury

Line to take

Provisional outturn for supply expenditure in December £8.9 billion. Total April-December 1987 (provisional £76.9 billion) up 3½ per cent on same period last year. Excluding advance contributions to EC Budget paid from supply in 1986-87, increase is 4½ per cent.

10. Central Government Borrowing

Background

CG own account borrowing in December, surplus of £0.5 billion. Total for April-December, zero borrowing. (1986-87, £5.7 billion). Privatisation proceeds, April-December, £5.1 billion (1986-87, £3.3 billion).

Line to take

Excluding privatisation proceeds, CG own account borrowing over April to December lower by £3.8 billion than same period last year.

11. Local Authorities

Background

Local authorities (provisionally) recorded borrowing of £0.7 billion in December (borrowing of £0.1 billion in December 1986). Local authorities recorded borrowing of £0.4 billion during first nine months of 1987-88. (Surplus of £0.6 billion for same period in 1986-87). Some revisions to earlier months - see Q.14.

Line to take

LABR for first 9 months of 1987-88 around £1 billion higher than for same period in previous year. Borrowing in December unusually high, but should not put too much weight on one month's figures.

12. Public Corporations

Background

Public corporations (provisionally) borrowed £0.1 billion in December. Surplus of £0.8 billion over April to December. (Surplus of £0.9 billion, April-December, 1986 - but aggregate then included BGC, BA).

Line to take

PCBR so far in 1987-88 little different from last year.

Line to take

Consolidated Fund Receipts in April to December £76.2 billion, 10½ per cent up on same period last year. Includes some privatisation proceeds. Excluding privatisation proceeds receipts up by 8½ per cent.

7. Inland Revenue Receipts

Background

Inland Revenue receipts in December £5.3 billion. Total for April-December £42.7 billion, (11 per cent up on same period last year). FSBR forecast for year as whole was a rise of 7½ per cent on 1986-87. More detailed monthly figures will be published later in Financial Statistics, Table 3.13. No forecast of total Inland Revenue receipts given in Autumn Statement, but stated that North Sea revenues £0.6 billion higher, income tax about £½ billion higher and Corporation tax about £¾ billion higher than in FSBR.

Line to take

Receipts in April-December £42.7 billion, 11 per cent up on same period last year.

8. Customs and Excise Receipts

Background

Customs and Excise receipts in December £3.8 billion. Total for April-December £33.1 billion, (7½ per cent up on same period last year). FSBR forecast for year as whole was a rise of 6½ per cent on 1986-87. More detailed monthly figures will be published later in Financial Statistics, Table 3.14. No forecast for Customs and Excise receipts given in Autumn Statement, but stated that VAT about £½ billion higher than in Budget forecast.

Line to take

Receipts in April-December £33.1 billion, 7½ per cent up on same period last year.

9. Supply Expenditure

Background

FSBR gave a figure for provision for supply in 1987-88 but not a forecast of outturn because public expenditure Reserve was not allocated to individual components of expenditure, (but public expenditure total used in PSBR forecast assumed that the Reserve was fully spent).

4. Privatisation proceeds in 1987-88

Background

Privatisation proceeds so far this year £5.1 billion, compared with £3.3 billion in same period last year. Autumn Statement figure for 1987-88 as a whole £5 billion, unchanged from FSBR forecast. Costs of privatisations offset the gross privatisation proceeds, so ~~quite feasible that~~ total for year as whole could be lower than cumulative total to end-December. No further instalments from earlier privatisations scheduled for the remainder of 1987-88.

Line to take

Privatisation proceeds in December £0.2 billion, mainly reflecting redemption by BT of preference shares held by government.

5. Effect on PSBR of BP share support scheme

Background

BP share support scheme closed on 6 January. Treasury press notice on 7 January said that cost of Issue Department purchases of BP shares was around £27 million (around 39 million shares at 70p each). Purchases to end-December - counted in December PSBR - around £12 million.

Line to take

Negligible effect on PSBR.

6. Consolidated Fund Revenues

Background

Press notice shows that Consolidated Fund (CF) revenues in first nine months of 1987-88 were 10½ per cent higher than in the same period last year, comprising 11 per cent increase in Inland Revenue receipts, 7½ per cent increase in Customs and Excise receipts, and 19 per cent in "other revenues". "Other revenues" include privatisation proceeds when they are transferred into Consolidated Fund - these amounts may differ from total privatisation proceeds given in table 5 of press notice. Proceeds received by HMG are usually transferred to Consolidated Fund with a lag.

No forecast of Consolidated Fund revenue given in Autumn Statement, but total taxes on income, expenditure and capital in 1987-88 forecast to be £2.3 billion higher than in FSBR. These were forecast in the Autumn Statement to increase by 8¾ per cent compared with 7 per cent in the FSBR. See Autumn Statement para 1.57 for composition of additional receipts.

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(Until 11.30am 19 January 1988)

SUMMARY OF LINE TO TAKE

PSBR in December provisionally borrowing of £0.3 billion. Excluding privatisation proceeds, PSBR for first 9 months of 1987-88 was £4.7 billion, about £2¾ billion lower than in equivalent period in 1986-87.

1. December PSBR

Background

City forecasts of December PSBR cover a wide range from borrowing of £1.0 billion to a surplus of £0.5 billion. Average is borrowing of £0.4 billion.

Line to take

Not useful to look at one month's figures. But December outturn affected by early receipt of nearly £½ billion of mainstream corporation tax due on 1 January.

- NB also local authorities borrowing, at £0.7 billion, was unusually high for December.

2. PSBR, April-December

Line to take

Excluding privatisation proceeds, PSBR in first 9 months of 1987-88 was £4.7 billion, about £2¾ billion lower than in equivalent period in 1986-87. PSBR April to November revised up, by £0.4 billion from last month's estimate [See Q.13].

3. PSBR undershoot on Autumn Statement forecast for 1987-88?

Background

Forecast for 1987-88 revised in Autumn Statement to £1 billion, (£3 billion lower than forecast at Budget time). Some City commentators have said that this is still an over forecast and that PSBR likely to be in surplus for 1987-88.

Line to take

Too early to say whether PSBR will
~~PSBR could well~~ turn out lower - or higher - than AS forecast of £1 billion. Average error on PSBR forecasts for current financial year made in autumn is ½ per cent GDP, or £2½ billion. *Always* ~~still~~ considerable uncertainties about outturn in ~~remaining~~ *final* three months. New forecast in Budget.

6. We should be grateful for comments on the statement to Reuters and draft press briefing during the course of Monday morning.

Colin Mowl

COLIN MOWL

FROM: COLIN MOWL
DATE: 15 January 1988

CHANCELLOR OF THE EXCHEQUER

cc Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Sedgwick
Mr R I G Allen
Mr Bush
Mr Ritchie
Miss Chapman

DRAFT PRESS BRIEFING ON PSBR IN DECEMBER

I attach the draft press briefing on the PSBR in December.

2. The estimate of the PSBR in December to be published on Tuesday is £0.3 billion. This is £0.2 billion higher than the first estimate I reported on 12 January. The upward revision to the April-November PSBR is now £0.4 billion, £0.1 billion more than the revision I reported earlier.

3. Available City forecasts cover a wide range from borrowing of £1 billion to a surplus of £½ billion, with an average of borrowing of £½ billion. The outturn may therefore not be a major surprise but is likely to be seen as another good figure, especially if analysts emphasise the "low" CGBR(0) figure and discount the unusually high LABR.

4. The proposed Treasury statement to Reuters and overall line to take for IDT is as follows:

"PSBR in December provisionally borrowing of £0.3 billion. Excluding privatisation proceeds, PSBR for first 9 months of 1987-88 was £4.7 billion, £2¾ billion lower than equivalent period in 1986-87."

The statement, which has been discussed with Mr Scholar and IDT, is along similar lines to those we have made in recent months.

5. The monthly note on the PSBR, which as you know also goes to No.10, will be circulated on Monday. It will give further details of the latest outturns but, in line with the practice this time last year, will not contain a forecast for the remaining three months of the year. The note will explain that a new forecast of the PSBR in 1987-88 will be given in the Treasury's winter economic forecast.

Thanks. OK (subject to Wilson's change to LABR for 1986-87). Look for 1986-87 like an average. What is assumption?

Assume No forecast for 1986-87?

4. We need to write to the Clerk correcting this reference to the personal sector. Figures for the personal sector alone in fact show a rise in borrowing other than in the form of mortgages as a percentage of GDP between 1979-80 and 1986-87. I attach a table (Annex 7) compiled by Mr Hurst which shows that they rose from 1.7% in 1979-80 to 2.0% in 1986-87.

5. I attach a draft reply to the Clerk which sets the record straight. It also reminds him that the correct private sector designation was used both in your remarks to the Committee during the 1987 Budget enquiry and in the Supplementary Note.

6. The suggested draft reply to Chris Smith explains that the figures you gave to the Committee referred to the private, not the personal, sector and refers him to the Supplementary Note. It would be possible to publish with the Answer a revised version of Table 1 from the Supplementary Note, but we do not recommend that: the revisions to the figures are small, as the draft answer says. Since it is likely that Mr Smith is interested in personal sector borrowing the draft also refers him to Table 9.3 of Financial Statistics (Annex 8). If we do not point him to these he may claim that we are being evasive about these figures. The draft reply also mentions that the Committee has been told about the error in the published evidence.

7. Are you content with the attached draft letter to the Clerk and reply to Chris Smith?

C Evans

MISS C EVANS

✓ ps. I should be grateful if your office could check with me to ensure that the Clerk receives his letter before we release the answer.

From: MISS C EVANS

15th January 1988

1. MR ODLING-SMEE *Most unfortunate. We obviously have to admit to the mistake. We must hope that those worried about the growth of personal sector indebtedness do not try to exploit it.*
2. CHANCELLOR OF THE EXCHEQUER

cc Sir Peter Middleton
Mr Scholar
Mr Peretz
Miss O'Mara
Mr Hurst
Mr Holgate

Parliamentary Clerk
(Annex 1 only)

TCSC EVIDENCE

Thanks. OK. V. considers J.M. 15/1

A telephone query from the Commons Research Department has brought to light a mistake in the published version of your evidence to the Treasury and Civil Service Select Committee on the Autumn Statement. Chris Smith, MP, has tabled a written PQ on the source and breakdown of the numbers which you quoted (Annex 1).

2. Page 20 of the evidence (copy attached - Annex 2) includes a question from David Winnick about "domestic credit other than mortgage borrowing". You replied using a table showing the trend in private sector borrowing as a proportion of GDP, split between mortgages and other borrowing. A copy of the table is attached (Annex 3).

3. These figures accord with the definition of borrowing used in Chart 2.4 of the 1987 FSBR (the 'frog' chart (Annex 4)), with your remarks about the rate of growth of private sector borrowing in your evidence to the Committee on the 1987 Budget, Q187-190, copy attached, (Annex 5) and in the Supplementary Note (Annex 6) which we sent to the Committee after that Budget enquiry. (Due to subsequent revisions in the figures the numbers you gave are slightly different from those in Annex 6 but they tell the same story.) The definition includes both borrowing by the personal sector and some borrowing by industrial and commercial companies. The transcript of your evidence correctly recorded your description of the figures as referring to the private sector. But you changed the reference on your draft to read 'personal' sector and I regret I did not check this change when transferring these corrections on to the copy sent back to the Committee.

flag
A

CONFIDENTIAL AND PERSONAL

	December 1987			April-December 1987			April-December 1986
	Provisional outturn	Last month's forecast	Difference	Provisional outturn	Budget forecast	Difference	Outturn
CGBR(O)	- 0.6	0.2	- 0.7	-	5.5	- 5.5	5.7
LABR	0.7	0.2	0.5	0.2	-	0.2	- 0.6
PCBR	- 0.1	0.2	- 0.2	- 0.9	- 0.4	- 0.6	- 0.9
PSBR	0.1	0.5	- 0.4	- 0.7	5.2	- 5.9	4.2
PSBR excluding privatisation proceeds	0.3	0.7	- 0.4	4.4	9.7	- 5.3	7.5

CONFIDENTIAL AND PERSONAL

FROM: COLIN MOWL
DATE: 12 January 1988

- MUS 12/11
1. MR SCHOLAR
 2. CHANCELLOR OF THE EXCHEQUER

cc Sir P Middleton
Sir T Burns
Mr Peretz
Mr Sedgwick
Mr Ritchie
Mrs Todd
Miss H Chapman

PSBR IN DECEMBER

The first provisional outturn for the PSBR in December is borrowing of £0.1 billion, £0.4 billion lower borrowing than forecast last month. The estimated outturn is subject to revision before publication at 11.30 a.m. on Tuesday 19 January.

2. There has also been an upward revision to the LABR and PSBR in April-November of £0.3 billion.

3. The provisional outturn for the CGBR(O) in December is a surplus of £0.6 billion, compared to the first estimated outturn of a surplus of £0.8 billion given in Mrs Todd's minute of 5 January. The revised outturn is £0.7 billion lower than last month's forecast, mainly as a result of higher than expected Inland Revenue receipts.

4. The LABR in December was £0.7 billion, £0.5 billion higher than forecast. This is an unusually large figure for December. The PCBR in December was a surplus of £0.1 billion, compared to last month's forecast of borrowing of £0.2 billion.

5. The PSBR in the first 9 months of 1987-88, a surplus of £0.7 billion, is £5.9 billion below the Budget profile (largely lower than expected CG own account borrowing) and £4.9 billion below the level of the PSBR for the same period of 1986-87. Excluding privatisation proceeds, the PSBR in the first 9 months of 1987-88 was £5.3 billion below profile and about £3 billion below the level for the first nine months of 1986-87.

6. The monthly note, presenting updated estimates for December, will be circulated next Tuesday. As usual at this time of the year the note will not present any forecasts. A new forecast of the PSBR in 1987-88, taking into account the April-December outturn and prospects for January-March, will be included in the economic forecast to be circulated at the end of next week.

Colin Mowl

COLIN MOWL

purp

FROM: JILL RUTTER
DATE: 8 January 1988

APS/CHANCELLOR

CC:
PS/Financial Secretary
PS/Economic Secretary
PS/Paymaster General
Sir Peter Middleton
COGPEC
Mr R I G Allen
Mr Gieve
Mr Dyer
Mr Tyrie
Mr Call
Miss Walker
Mr G White

PUBLICATION OF THE 1988 PUBLIC EXPENDITURE WHITE PAPER

Thank you for your minute of 7 January recording the Chancellor's view that it might be preferable to publish the Public Expenditure White Paper on 20 January.

2 The Chief Secretary had himself already come to this conclusion and I have now discussed with Messrs Turnbull and Gieve who see no problems in postponing publication by one day. I have therefore written to Paul Gray at No. 10 to inform him and the rest of Whitehall that the great day will be 20 January.

LONDON

JILL RUTTER
Private Secretary

CONFIDENTIAL AND PERSONAL
CENTRAL GOVERNMENT TRANSACTIONS

£ billion

	December 1987			April-December 1987			April-December 1986
	Provisional outturn	Last month's forecast	Difference	Provisional outturn	Budget profile	Difference	Outturn
Receipts							
Inland Revenue	5.3	4.7	0.6	42.7	39.9	2.9	38.4
Customs and Excise	3.8	3.9	- 0.1	33.1	32.7	0.4	30.8
National Insurance Contributions	2.0	2.1	- 0.1	19.9	19.7	0.2	18.7
Privatisation proceeds	0.2	0.2	-	5.0	4.5	0.6	3.3
Interest and Dividends	0.8	0.7	0.1	6.4	6.6	- 0.2	6.4
Other receipts	1.0	0.8	0.3	3.5	2.8	0.6	2.9
Total	13.0	12.2	0.8	110.6	106.1	4.5	100.4
Expenditure							
Debt interest payments	0.7	0.7	-	11.6	11.7	- 0.1	11.4
Departmental expenditure (a)	11.6	11.7	- 0.1	98.8	100.0	- 1.1	94.6
Total	12.3	12.4	- 0.1	110.4	111.7	- 1.3	106.1
CGBR(O)	- 0.8	0.2	- 0.9	- 0.2	5.5	- 5.8	5.7
CGBR(O) excluding privatisation proceeds	- 0.6	0.3	- 0.9	4.8	10.0	- 5.2	8.9
On-lending to LAs	- 0.1	0.1	- 0.2	3.3	1.6	1.8	3.6
On-lending to PCs	0.2	- 0.1	0.3	- 0.5	- 0.2	- 0.3	-
CGBR	- 0.7	0.2	- 0.9	2.6	6.9	- 4.3	9.3

(a) on a cash basis, net of certain receipts

+ = higher receipts, and higher borrowing, higher expenditure
- = lower receipts, and lower borrowing, lower expenditure

5 In the first 9 months of 1987-88 the CGBR(0) was a surplus of £0.2 billion. The Budget profile was for borrowing of £5.5 billion.

The main factors reducing borrowing were:

- (a) higher Inland Revenue receipts (by £2.9 billion) mainly Corporation Tax (largely non-oil but also some extra North Sea MCT), Income Tax (mainly on PAYE), petroleum revenue tax and stamp duties;
- (b) higher Customs and Excise receipts (by £0.4 billion), mainly VAT;
- (c) higher privatisation proceeds (by £0.6 billion), mainly higher than expected receipts from Rolls Royce and earlier receipt than forecast of redemption of BT preference shares;
- (d) higher other receipts (by £0.6 billion), £0.3 billion of which is due to increase on the balance held on the EEC's No.1 Account.
- (e) a shortfall on departmental expenditure of £1.1 billion.

6. On-lending to public corporations in December totalled £0.2 billion. This was partly offset by a £0.1 billion repayment of on-lending by local authorities. The provisional CGBR in December was therefore a surplus of £0.7 billion. The CGBR since 1 April totals £2.6 billion.

7. Further analyses of the outturn in December will be given in the next Ministerial note on the PSBR in two weeks' time.

Phin Todd

MRS P TODD

There are a number of reasons for a cautious interpretation of the provisional outturn for December:

- (i) the greater than usual likelihood of revision
- (ii) the probably temporary nature of the rise in EC balances
- (iii) the vast amount of tax receipts due in January, some of which could have come in early.

Even allowing for these factors, however, the outturn is surprisingly low and is further confirmation that we are heading for a healthy PSBR surplus in 1987-88.

Colin Mowl

COLIN MOWL

CONFIDENTIAL AND PERSONAL

FROM: MRS P TODD
DATE: 5 January 1988

1. MR MOWL *see note at end*
2. CHANCELLOR OF THE EXCHEQUER

cc Sir P Middleton
Sir T Burns
Mr Anson
Mr Scholar
Mr Sedgwick
Mr Peretz
Mr Watts
Mr Ritchie

John

CGBR(O) AND CGBR IN DECEMBER

The provisional outturn for the CGBR(O) in December is a surplus of £0.8 billion. Last month's forecast was for borrowing of £0.2 billion. The estimate of the CGBR(O) outturn is subject to revision before publication on Tuesday 19 January.

2. The provisional outturn for December is more likely to be revised than that for other months. It assumes £450 million unallocated receipts contained within "other" receipts. These receipts are seasonally high in December, largely reflecting the high levels of Inland Revenue taxes (particular Corporation Tax) due at the beginning of January which are in the process of clearing through the banking system at end December. The actual outturn amount of these unallocated receipts will be known by 12 January and Mr Mowl's minute to you then on the provisional PSBR in December will detail any revisions to the CGBR on account of this item.

3. The main differences from last month's forecast are higher Inland Revenue receipts (by £0.6 billion) and higher other receipts (by £0.3 billion) mainly due to an increase in the balances held on behalf of the European Community (by £0.2 billion). Complete information on the additional Inland Revenue receipts is still to come. However it appears that part of the increase may be due to early receipts of Corporation Tax due in January. Building Society Composite Rate Tax receipts in December also appears to be higher than forecast. We will be examining the figures further in conjunction with the Inland Revenue. The unexpected increase in EC balances is likely to be temporary and unwound in the near future.

4. There has been little effect on the CGBR(O) in December from the repurchase of BP shares. By the end of December some 17 million shares had been repurchased at a cost of £12 million. This cost has been netted off the December figure for privatisation proceeds.



1/12/87

CH/EXCHEQUER	
REC.	17 DEC 1987
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pmp

Foreign and Commonwealth Office

London SW1A 2AH

17 December 1987

Dear Alex

1988 Public Expenditure White Paper

Thank you for circulating a copy of Volume 1 of the 1988 White Paper with your letter of 11 December. We have no specific comments on the volume.

We have also now received a proof copy of the FCO departmental chapter from Volume 2 of the White Paper. Our Finance Department are in touch separately with Treasury officials about one or two final amendments to this.

Yours ever

R N Culshaw

(R N Culshaw)
Private Secretary

Alex Allan Esq
PS/Chancellor of the Exchequer

(Mr Lawson) No, it was not a shambles at all, it was a very successful device in very difficult circumstances.

Chairman: Chancellor, we are very grateful to you for giving us evidence over a prolonged period and to Sir Terence and Sir Peter for their help, also to Mr Turnbull who was so helpful the other day. We hope to report before Christmas and I understand a debate is likely to take place on the Autumn Statement after that. We also understand that the Public Expenditure White Paper is likely to be published fairly early in the New Year and no doubt Mr Turnbull and the Chief Secretary will be able to assist us. We are very grateful to you all for being so generous with your time.

Mr Budgen

177. The Louvre agreement. Let us assume for a moment that the Louvre agreement had not taken place. Is it true, firstly, that it is very likely that the dollar would have fallen?

(Mr Lawson) The Louvre agreement, as you know, was about a great deal more than exchange rates. I know that you certainly have read it and you no doubt have a copy to hand as I do somewhere among these papers.

178. Paragraph 10, the last two sentences.

(Mr Lawson) I am not talking about paragraph 10, I am talking about paragraphs 1-9 which were not about exchange rates. There was ^{the} one paragraph, which was an important paragraph, I am not trying to downplay it, which was about exchange rate stability. It is quite possible, ~~[yes it is quite possible]~~ that had the Louvre agreement not been concluded then the dollar might have fallen.

179. Secondly, if the dollar had fallen ---

(Mr Lawson) Sorry: the dollar might have fallen further. It is worth pointing out that this process of international collaboration, ~~and what~~ ^{which} I described as managed floating in my speech in September in Washington, really began with the Plaza Agreement in September 1985. There of course we felt that ~~it was right that the dollar should fall.~~ ^{and} The dollar had gone too high ~~and it ought to fall.~~ It fell very substantially, ~~[it fell]~~ to the point where both the Deutschmark and the yen had risen by 50 per cent in a period of less than 18 months ~~[which is a very marked change]~~ by the time we got to the Louvre, ~~and~~ ^T that was when we thought that a period of stability would be desirable in order to allow the ^{fall} effects of the very marked/~~that~~ had already taken place to work through

in the most benign climate.

180. Perhaps the correct way to put it would be that the fall would not have been arrested.

(Mr Lawson) The fall might have gone further.

181. If the fall had gone further that would have had an effect in reducing the Americans' deficit on their balance of trade, would it not?

(Mr Lawson) There is a lot of misconception here.

~~The~~ I am sorry but you asked me a question. I listened patiently to your question. I am now going to give an answer and you are going to listen patiently and with your customary good manners to me. Right? ^{It is helpful to} ~~If you~~ look at what ^{has} ~~had~~ been happening to American exports and imports, goods and services, in volume terms between the third quarter of 1986 and the third quarter of 1987, which is the most recent quarter for which we have figures? [!] in the third quarter of 1986 American exports were rising ~~[this is all]~~ in volume terms ² at the rate of 5.3 per cent on a year earlier? ³ ~~and~~ American imports ^{we're rising} by 13.8 per cent, massively more. If you now go to the third quarter of 1987 you find the precise reverse: American exports are growing at a rate of 13.4 per cent, ^{whereas} American imports are growing at a rate of 5.2 per cent. A very marked change. That was entirely the result, in so far as exchange rates had an influence, of the movements prior to the Louvre agreement. The most recent movement we are talking about cannot have affected these figures. ^{BWL The US} ~~Because they~~ started with a position where imports were growing very much faster than exports, ^{so} ~~even though~~ the lines were gradually moving together and eventually crossed, they took some time before they did cross. I Indeed it was not

until the second quarter of this year that you had ^{US} exports growing in volume terms ^{facts} ~~higher~~ than imports ^{mis} in the United States. That ^{clearly} really showed a very significant adjustment but it needed to go a great deal further. I have to say that the main way in which that needed to be taken further was for the Americans, whether by increasing their interest rates ^{and/or by} ~~or whatever way they chose~~ cutting their budget deficit ~~if that would have an effect~~ ^{by} cutting the public spending, ^{or increasing taxes} ~~whatever it is~~, or probably both ~~to~~ ^{to} reduce the growth of domestic demand, ^{their} because there is no way, ~~and~~ British governments in the past have found ~~it~~ ^{that}, you can seek salvation ~~through~~ ^{from} a balance of trade difficulty through devaluation if you have not made room for ~~the further~~ growth of exports by cutting back your rate of growth of domestic demand. That is what they needed to do, in my judgment ~~my very fallible judgment~~ rather than to have the dollar going down a great deal further. They are now in a position where they have unemployment down below 6 per cent, the lowest figure it has been in the United State since 1980. The economy is really going as fast as ^{it} ~~they~~ sustainably can at the present time, if not faster. Therefore, the idea that ^{the US} ~~they~~ can solve ~~their~~ ^{its} problem ~~in those circumstances~~ simply by dollar devaluation is misguided.

182. I am not suggesting it would have solved their problems.

(Mr Lawson) And it would have created other problems which devaluations always cause.

183. It certainly would have created other problems but it would have had this effect, would it not? It would have been a factor at any rate for reducing the deficit on their balance of trade. You cannot deny that, can you?

(Sir Peter Middleton) There are two points there.

The fact that the exchange rate is lower clearly would have some effect at some stage but of course the whole point about a fall in the exchange rate as the Chancellor said is that it allows your economy time to adjust. If it is falling continuously what you get is uncertainty, not a period of adjustment, so you do need a period during which the adjustment can actually take place.

184. I understand that and there are arguments about both political and social cohesion which may be put in jeopardy if an exchange rate falls very fast. The point I am simply making is that as a mere mechanical factor if the exchange rate falls it must have an effect on reducing the deficit on the balance of trade.

(Mr Lawson) Not necessarily. If it is associated with a rise in inflation then that can wipe out the benefit which you are seeking to get from the ~~deflation.~~ ^{devaluation.} In this country in the past we have had examples of that.

185. On the second deficit which you advised them about, ^{it} their budget deficit, /is to a very large extent financed by the Japanese, is it not?

(Mr Lawson) It is perfectly true that the Japanese have bought large amounts of dollars ~~securities.~~ ^{securities.}

186. Something like 30-40 per cent.

(Mr Lawson) I think it is a smaller percentage than that but certainly in the past the Japanese have bought a lot of dollar securities, yes.

Chairman

187. "In the past" are the effective words.

(Mr Lawson) That is right. [~~Quite right.~~]