PO-CH/NL/0528
PART B

Part. B.

SECRET

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Begins: 11/7/88.
Ends: 30/7/89.

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PO CH/NL/0528.
PT.B.

Chancellor's (Lawson) Papers:
The Public Expenditure Cabinet
For the 1989 Survey.

DD's: 25 Years

15/3/96.

PO CH/NL/0528. PT.B.

CABINET OFFICE PAPER

The following Cabinet Office papers have been removed from this file. If you require access to these papers please contact the Cabinet Office.

Reference	Date of Paper
C(88)10 COPY NO 13	11 JULY 1988

gep1.ip/cabinet/chx

CONFIDENTIAL

FROM: J MACAUSLAN
DATE: 11 JULY 1988

A few drafting changes. But she will want to add her own words,

CHANCELLOR

cc: Chief Secretary
Sir P Middleton
Mr Anson
Sir T Burns
Mr Monck
Mr Phillips
Mr Luce
Mr Odling-Smee
Mr Turnbull
Mr Gieve
Mr Richardson
Miss Walker
Mr Call

Ch

OK? Gives framework for PM, though I imagine she will want to go stronger on current a/c dangers / prompted by size of bids etc. Can discuss with her @ bilateral on Wednesday.

AA

PUBLIC EXPENDITURE CABINET: 14 JULY:
SPEAKING NOTE FOR THE PRIME MINISTER

1. In recent years we have offered the Prime Minister a speaking note for the public expenditure Cabinet. I now attach a note which she could use for the meeting on Thursday.

2. If you and the Chief Secretary were content with the draft, your office could send it over to No 10, with a copy to George Monger at the Cabinet Office.

J MACAUSLAN

gep1.ip/draft/spk PM

CONFIDENTIAL

pl type final

DRAFT SPEAKING NOTE FOR THE PRIME MINISTER

1. The Chancellor's paper describes the ~~fruits~~ success of our policies - in particular, eight years of steady growth which is now producing an upsurge in investment. That investment is the foundation of growth to come; it is built on business confidence, high profitability, and financial stability. If we stick to the policies that have yielded these results, steady growth will continue.

current account

2. But if we lose our grip now, the economy could take a very much worse course. The ~~trade~~ deficit can be financed, but only so long as we retain the confidence of the markets - especially the foreign exchange markets. And ~~to control~~ inflation has got kept in check — some by ~~we must be prepared to~~ tightening ~~tighten~~ monetary conditions as and when necessary and some by keeping firm control of public expenditure.

3. To sustain confidence we must stick very close to the planning totals, and demonstrate that we will continue to keep growth of public spending below that of the economy. If we do not, we will be (seen) thought to have abandoned our pledge to reduce the burden of taxation, and to have built our expenditure plans on incautious economic projections. We would be risking expenditure cuts later in the Parliament. This is the trap that Governments fell into in the 1960s and 1970s. ~~We promised the electorate we would do better.~~

We simply cannot afford bids on anything like the scale proposed by spending Ministers. They

4. ~~Holding firm to our policies means that the bids~~ must be cut back, and ~~policy~~ substantial savings found. This will mean difficult decisions. But our strength has been not ducking difficult decisions. There must be a thorough review of the options across the whole range of spending, not just within bids, but within baselines as well.

NH6/49M

SECRET

Pl redo

SPEAKING NOTE FOR THE PRIME MINISTER

1. The Chancellor's paper describes the success of our policies - in particular, eight years of steady growth which is now producing an upsurge in investment. That investment is the foundation of growth to come; it is built on business confidence, high profitability, and financial stability. If we stick to the policies that have yielded these results, steady growth will continue.

2. But if we lose our grip now, the economy could take a very much worse course. The current account deficit can be financed, but only so long as we retain the confidence of the markets - especially the foreign exchange markets. And inflation has to be kept in check - ~~some~~ both by tigher tening monetary conditions as and when necessary ad by keeping ~~from~~ firm control of public expenditure.

3. To sustain confidence we must stick very close to the planning totals, and demonstrate that we will continue to keep growth of public spending below that of the economy. If we do not, we will be seen to have abandoned our pledge to reduce the burden of taxation, and to have built our expenditure plans on incautious economic projections. We would be risking expenditure cuts later in the Parliament. This is the trap that Governments fell into in the 1960s and 1970s.

4. We simply cannot afford bids on anything like the scale proposed by spending Ministers. ~~They~~ bids must be cut back, and substantial savings found. This will mean difficult decisions. But our strength has been not ducking difficult decisions. There must be a thorough review of the options across the whole range of spending, not just within bids, but within baselines as well.

NH13/23A

CONFIDENTIAL

Pzg

FROM: A P HUDSON
DATE: 11 July 1988

CHANCELLOR

cc PS/Chief Secretary
Mr Anson
Mr Turnbull
Mr Gieve
Mr A.C.S. Allan

FIRST ORDER QUESTIONS, 14 JULY: LINE TO TAKE ON PUBLIC EXPENDITURE CABINET

We agreed that it would be useful to have a form of words ready on the Public Expenditure Cabinet, for use at Questions on Thursday. This note follows discussion with Mr Allan and Mr Gieve.

2. You thought it should be something like this:

"One of the fundamental reasons for Britain's economic success has been firm control of public expenditure, which has fallen steadily, as a share of GDP, since 1982-83. This - and our supply side reforms - has enabled us to eliminate Government borrowing altogether, cut tax rates at all levels of income, and increase spending on priority programmes. At Cabinet this morning, we agreed that public expenditure should continue to fall, as a share of GDP, over the next three years".

3. The best opportunity to volunteer this line looks to be on question 7, on inflation. Should we ask Mr Greg Knight MP to ask a supplementary such as:

"Does my RHF agree that firm control of public expenditure is an essential part of the fight against inflation?".

4. However, it is possible that the Opposition will raise the subject before that. For instance, Mr Winnick has Question 2 on the balance of payments, and may ask about the relative impact of tax cuts and public spending increases on the current account, with reference to the Cabinet meeting. That could no doubt be brushed aside, though it would be rather more difficult if, say,

Gordon Brown came in on the same tack. If pressed, Ministers dealing with the early questions could be ready to use the agreed form of words if necessary.

... 5. I attach some more detailed briefing prepared by Mr Gieve for use, if necessary, either at Questions or in press briefing.

6. Once you are happy with all this material, we will circulate it to all Ministers.

APH

A P HUDSON

ADDITIONAL BRIEFING ON PUBLIC EXPENDITURE CABINET

1. If you can afford £4 billion tax cuts (for the rich) why can't you afford more for the health service, social security, etc (for the poor)?

The fact is that we have reduced tax rates for all tax payers, eliminated Government borrowing, and increased the real level of spending on priority services like health to their highest levels ever. Our expenditure plans allow for further real growth in the next three years. [Don't make the poor rich by making the rich poor].

2. MTFS showed £3 billion fiscal adjustment for 1989-90. Given buoyant tax revenues, the real figure is higher still. Is none of this to be used for expenditure increases and all of it for tax cuts?

The aim for the Survey is to keep expenditure on a sustainable medium term path. As our plans show, this will allow continuing real growth. [These MTFS projections are illustrative only. Much too early to judge what room if any there may be for tax reductions in the next Budget. That will depend on the economic situation at the time].

3. Budget forecasts of tax revenues will be exceeded, so why not increase expenditure also?

Quite wrong to adjust expenditure to use up whatever revenues happen to arise in any year. This would be disruptive for programmes and harmful to the economy. Our plans will continue to be set on basis of medium term prospect.

Gordon Brown came in on the same tack. If pressed, Ministers dealing with the early questions could be ready to use the agreed form of words if necessary.

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APH

A P HUDSON

NH13/23A

CONFIDENTIAL

Mr [illegible]. Over a two pts. I have shortened x ~~the [illegible]~~ the supply questions. ✓

FROM: A P HUDSON
DATE: 11 July 1988

CHANCELLOR

cc PS/Chief Secretary
Mr Anson
Mr Turnbull
Mr Gieve
Mr A.C.S. Allan

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3. The best opportunity to volunteer this line looks to be on question 7, on inflation. Should we ask Mr Greg Knight MP to ask a supplementary such as:

Yes. But have someone else [illegible] to say it, in case he doesn't

"Does my RHF agree that firm control of public expenditure is an essential part of the fight against inflation?".

4. However, it is possible that the Opposition will raise the subject before that. For instance, Mr Winnick has Question 2 on the balance of payments, and may ask about the relative impact of tax cuts and public spending increases on the current account, with reference to the Cabinet meeting. That could no doubt be brushed aside, though it would be rather more difficult if, say,

NH13/25A No.
Pl amend.
AH

CONFIDENTIAL

ADDITIONAL BRIEFING ON PUBLIC EXPENDITURE CABINET

1. <u>If you can afford £4 billion tax cuts (for the rich) why can't you afford more for the health service, social security, etc (for the poor)?</u>

The fact is that we have reduced tax rates for all tax payers, eliminated Government borrowing, and increased the real level of spending on priority services like health to their highest levels ever. Our expenditure plans allow for further real growth in the next three years. [Don't make the poor rich by making the rich poor].

2. <u>MTFS showed £3 billion fiscal adjustment for 1989-90. Given buoyant tax revenues, the real figure is higher still. Is none of this to be used for expenditure increases and all of it for tax cuts?</u>

The aim for the Survey is to keep expenditure on a sustainable medium term path. As our plans show, this will allow continuing real growth. ~~[These MTFS projections are illustrative only.~~ Much too early to judge what room if any there may be for tax reductions in the next Budget. ~~That will depend on the economic situation at the time].~~

3. <u>Budget forecasts of tax revenues will be exceeded, so why not increase expenditure also?</u>

No new forecast now. But even if true,

Quite wrong to adjust expenditure to use up whatever revenues happen to arise in any particular year. This would be disruptive for particular programmes and harmful to the economy. Our plans will continue to be set ~~on basis of medium term prospect.~~ in medium term context.

NH13/23A

CONFIDENTIAL

FROM: A P HUDSON
DATE: 11 July 1988

CHANCELLOR

cc PS/Chief Secretary
Mr Anson
Mr Turnbull
Mr Gieve
Mr A.C.S. Allan

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2. You thought it should be something like this:

> "One of the fundamental reasons for Britain's economic success has been firm control of public expenditure, which has fallen steadily, as a share of GDP, since 1982-83. This - ~~and~~ Together with our supply side reforms - has enabled us to eliminate Government borrowing altogether, cut tax rates at all levels of income, ~~and increase~~ while increasing spending on priority programmes. At Cabinet this morning, we re-affirmed this strategy and agreed that public expenditure should continue to fall, as a share of GDP, ~~over~~ throughout the next three years".

3. The best opportunity to volunteer this line looks to be on question 7, on inflation. Should we ask Mr Greg Knight MP to ask a supplementary such as:

> "Does my RHF agree that firm control of public expenditure is an essential part of the fight against inflation?".

4. However, it is possible that the Opposition will raise the subject before that. For instance, Mr Winnick has Question 2 on the balance of payments, and may ask about the relative impact of tax cuts and public spending increases on the current account, with reference to the Cabinet meeting. That could no doubt be brushed aside, though it would be rather more difficult if, say,

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6. Once you are happy with all this material, we will circulate it to all Ministers.

APH

A P HUDSON

NH13/25A CONFIDENTIAL These sums were committed in last Autumn P/E round ~~before any~~ reductions were made in tax. Nor are our tax cut concentrated on ~~the rich.~~

ADDITIONAL BRIEFING ON PUBLIC EXPENDITURE CABINET

1. <u>If you can afford £4 billion tax cuts (for the rich) why can't you afford more for the health service, social security, etc (for the poor)?</u> The plain fact is that we increased expenditure on the Health Service by £[ ] last year ~~on Social Security by £[ ]~~ ~~to take these programmes to~~ their highest levels ever.

The fact is that we have reduced tax rates for all tax payers, eliminated Government borrowing, and increased the real level of spending on priority services ~~like health to their highest levels ever~~. Moreover, Our expenditure plans allow for further real growth in the next three years. ~~[Don't make the poor rich by making the rich poor]~~.

2. <u>MTFS showed £3 billion fiscal adjustment for 1989-90. Given buoyant tax revenues, the real figure is higher still. Is none of this to be used for expenditure increases and all of it for tax cuts?</u>

The aim for the Survey is to keep expenditure on a sustainable medium term path. As our plans show, this will allow continuing real growth. [These MTFS projections are illustrative only. Much too early to judge what room if any there may be for tax reductions in the next Budget. That will depend on the economic situation at the time].

3. <u>Budget forecasts of tax revenues will be exceeded, so why not increase expenditure also?</u>

Quite wrong to adjust expenditure to use up whatever revenues happen to arise in any year. This would be disruptive for programmes and harmful to the economy. Our plans will continue to be set on basis of medium term prospect.

The plain fact is that this year we increased expenditure on the Health Service by £[ ] & on Social Security by £[ ] to take these programmes to their highest levels ever. Moreover, our expenditure plans allow for further growth in the next 3 years. These sums were committed to public expenditure before any reductions were made in tax. Nor have our tax cuts concentrated on the rich. We have PTO reduced tax rates for all tax payers at all levels of income.

mjd 3/10m

SECRET

MP

FROM: MISS M P WALLACE
DATE: 11 July 1988

MR TURNBULL

cc PS/Chief Secretary
Mr Anson
Mr Phillips
Mr Monck
Mr Odling-Smee
Mr Gieve
Mr MacAuslan
Miss Walker

PUBLIC EXPENDITURE CABINET: LINE TO TAKE

The Chancellor was grateful for your minute of 8 July. He had a number of detailed comments on the Q&A briefing.

Positive (i), first tiret - amend to read: "Is being achieved. Even excluding privatisation proceeds, share in 1988-89 will be the lowest since the early 1970s. Has fallen continuously over 6 year period from 1982-83, the longest sustained fall since the 1950s." Also amend fourth tiret to read: "Has been crucial to strength of economy."

Positive (ii), amend second sentence to read: "Share of public spending, excluding privatisation proceeds, in national income...."

Defensive (ii), amend second and third sentences to read: "Final decisions on planning totals always follow the examination of programmes in bilaterals and final public expenditure Cabinet, which also takes into account new economic forecast in November."

Defensive (iii), amend "no" to read "not at all".

Defensive (vi), add at end: "This happens every year: nothing new."

Defensive (viii), amend to read: "Wholly wrong to enter into spending commitments for three years ahead on basis of growth in economy in 1987 and 1988 which is above the sustainable medium-term trend."

<u>Defensive (ix)</u>, replace with "No new forecast until Autumn Statement."

<u>Defensive (xiii)</u>, amend answer to read: "An estimate will be published in the usual way in the Autumn Statement in November. We know already of some large claims on £3½ billion Reserve eg local authority current expenditure (£1 billion for England), Rover (£0.65 billion), NHS pay (£0.75 billion), housing benefit (£0.1 billion). But also some shortfalls expected elsewhere. Purpose of setting planning total is to stay within it."

2. Subject to these comments, and any the Chief Secretary may have, the Chancellor is otherwise content.

MPW

MOIRA WALLACE

CabLine

SECRET

FROM: A TURNBULL
DATE: 11 JULY 1988

PS/CHANCELLOR

cc PS/Chief Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Phillips
Mr Odling-Smee
Mr Gieve
Mr MacAuslan
Mr Richardson

PUBLIC EXPENDITURE CABINET: LINE TO TAKE

I attach a revised version of the Q&A briefing to support the post-Cabinet "communique". It incorporates comments from the Chancellor and the Chief Secretary.

2. Could you arrange for it and the communique, which is unchanged from my minute of 8 July, to be sent over to No 10 for clearance. Could you also send a copy to Richard Wilson in the Cabinet Office so that the text of the communique can be worked into the Prime Minister's briefing.

3. The Chancellor suggested adding "continuously" after "has fallen" in positive (i), first tiret. We have tried to avoid describing the fall as continuous or in every year, as nit pickers may point to a small hiccup in 1984-85 created by the coal strike. We have judged that the looser formulation of "sustained fall" is acceptable.

AT

A TURNBULL

NH6/42M

SECRET

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

11 July 1988

Paul Gray Esq
10 Downing Street
LONDON SW1

cc PS/Chief Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Phillips
Mr Odling-Smee
Mr Gieve
Mr MacAuslan
Mr Richardson
Mr Turnbull.

INGHAM LINE

Dear Paul,

PUBLIC EXPENDITURE CABINET: LINE TO TAKE

The Chancellor and the Chief Secretary have been considering what might be said after the Public Expenditure Cabinet. They suggest the following: -

> "The Cabinet had its usual July discussion of public expenditure today. It agreed that public spending should be held as close as possible to the existing planning totals so that the share of public spending in national income should continue to decline steadily over the 3 Survey years. With this objective, the Chief Secretary will hold bilateral discussions in the Autumn. In the light of these, the Government will take decisions on individual programmes and the planning totals, and these will be announced, as usual, in the Autumn Statement in November.

The Chancellor would be grateful to know if the Prime Minister is content with this.

... I also attach some question and answer briefing for use after the Cabinet.

I am copying this letter to Bernard Ingham, and to Richard Wilson (Cabinet Office).

Yours,

Moira.

MOIRA WALLACE
Private Secretary

Q AND A BRIEFING

Positive points

(i) Government's consistent objective has been that public spending should take a declining share of national income. Dates back to 1979 Manifesto.

- Is being achieved. Even excluding privatisation proceeds, share in 1988-89 lowest since the early 1970s. Has fallen over 6-year period from 1982-83, the longest sustained fall since the 1950s.

- Public spending under control. Over last 4 years has grown about 1 per cent a year in real terms while economy has grown at 3½ per cent a year.

- Has enabled public borrowing to be reduced and tax rates cut.

- Has been crucial to strength of economy.

(ii) Cabinet agreed that this successful approach must be sustained. Share of public spending, excluding privatisation proceeds, in national income must continue to fall from position reached this year.

(iii) Cabinet has not set new planning totals. Existing totals (£167.1 billion in 1989-90 and £176.1 billion in 1990-91) remain in force. Objective of bilaterals is to stick as closely as possible to them.

Defensive points

(i) Are you admitting that planning totals cannot be held and will be increased?

Cabinet has made no decisions on new planning totals. These are never revised in July. So existing totals remain. But when position is reviewed in the autumn, Cabinet may decide some change is justified but it has agreed to keep any adjustment as small as possible.

(ii) Why no decision now?

Cabinet has made a decision - to stick to the policy of reducing expenditure in relation to GDP. Final decisions on planning totals always follow the examination of programmes in bilaterals and final Cabinet, which also takes account of new economic forecast in November.

(iii) Giving up on public expenditure control?

Not at all. We have reduced public spending as a proportion of GDP steadily since 1982-83. Cabinet has decided to continue on that path which means public spending will have to be kept below growth of national output.

(iv) With economy overheating wrong time to be adding to expenditure?

Government is determined to prevent overheating. One reason why Cabinet agreed to stick as close as possible to existing plans.

(v) If do raise planning total, what remains of cash planning?

All planning is done in cash - no funny money. Presumption that programmes do not receive automatic adjustment for movement in prices, whether specific or general, remains firmly in place. All additions to programmes have to be argued for. It does not rule out an increase in the planning total if consistent with wider objectives. Totals were raised in last two Surveys but real growth still below that of economy as a whole and objective of declining GGE/GDP ratio has been achieved.

(vi) What do bids come to?

Total of bids has no relevance since Cabinet has agreed they cannot be afforded and that they must be scaled down or savings found. This happens every year; nothing new.

(vii) Could accommodate very large increases and still remain within ratios set out in last White Paper. If money GDP this year is higher than forecast could add to plans and stay within figures in FSBR.

No question of spending up to a level implied by any particular ratios. We propose to stick as close as possible to the planning totals. Ratios are used as an indicator of general direction of policy, not to provide specific targets. If, for example, money GDP is higher because prices are higher would be wrong to make automatic adjustment to plans.

(viii) Why not allow spending plans to benefit from faster growth? In wanting to reduce ratio from whatever if has reached you are operating a ratchet.

Wholly wrong to enter into spending commitments for three years ahead on basis of growth in economy in 1987 and 1988 which is above the sustainable medium-term trend.

(ix) How much higher will money GDP be this year?

No new forecast until Autumn Statement.

(x) Very tough round expected this year? Will Star Chamber be needed?

Star Chamber now an established part of the system but not always needed, eg last year when all programmes settled bilaterally. All rounds are tough, this will be no exception.

(xi) Can you confirm that Mr Parkinson will chair Star Chamber if it is required?

Yes.

(xii) Including privatisation proceeds is a fiddle?

We recognise special nature of privatisation proceeds so we deliberately measure expenditure as a ratio of GDP without deducting the proceeds.

(xiii) **What is likely outturn in 1988-89?**

An estimate will be published in the usual way in the Autumn Statement in November. We know already of some large claims on £3½ billion Reserve eg local authority current expenditure (£1 billion for England), Rover (£0.65 billion), NHS pay (£0.75 billion), housing benefit (£0.1 billion). But also some shortfalls expected elsewhere. Purpose of setting planning total is to stay within it.

SECRET

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

cc CST
Sir P Middleton
Mr Anson
Sir T Burns
Mr Monck
Mr Phillips
Mr Luce
Mr Odling-Smee
Mr Turnbull
Mr Grieve
Mr MacAuslan
Mr Richardson
Miss Walker
Mr Call

12 July 1988

Paul Gray Esq
10 Downing Street
LONDON SW1

Dear Paul,

PUBLIC EXPENDITURE CABINET

... I enclose a speaking note for the Prime Minister for Thursday's Cabinet, which she may wish to discuss with the Chancellor at tomorrow's bilateral.

I am copying this letter to Richard Wilson (Cabinet Office).

Yours,

Moira.

MOIRA WALLACE
Private Secretary

SPEAKING NOTE FOR THE PRIME MINISTER

1. The Chancellor's paper describes the success of our policies - in particular, eight years of steady growth which is now producing an upsurge in investment. That investment is the foundation of growth to come; it is built on business confidence, high profitability, and financial stability. If we stick to the policies that have yielded these results, steady growth will continue.

2. But if we lose our grip now, the economy could take a very much worse course. The current account deficit can be financed, but only so long as we retain the confidence of the markets - especially the foreign exchange markets. And inflation has to be kept in check - both by tightening monetary conditions as and when necessary and by keeping firm control of public expenditure.

3. To sustain confidence we must stick very close to the planning totals, and demonstrate that we will continue to keep growth of public spending below that of the economy. If we do not, we will be seen to have abandoned our pledge to reduce the burden of taxation, and to have built our expenditure plans on incautious economic projections. We would be risking expenditure cuts later in the Parliament. This is the trap that Governments fell into in the 1960s and 1970s.

4. We simply cannot afford bids on anything like the scale proposed by spending Ministers. The bids must be cut back, and substantial savings found. This will mean difficult decisions. But our strength has been not ducking difficult decisions. There must be a thorough review of the options across the whole range of spending, not just within bids, but within baselines as well.

CHANCELLOR BRIEFING

jc9

From: J ODLING-SMEE
12th July 1988

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Sir Peter Middleton
Mr Anson
Sir Terence Burns
Mr Monck
Mr Phillips
Mr Luce
Mr Moore
Mr Sedgwick
Mr Turnbull
Mr Gieve
Mr Hibberd
Mr MacAuslan
Mr Dolphin
Ms Evans
Mr Ritchie
Miss Simpson
Miss Walker

Ch/ You might like preliminary look at briefing and esp 2 speaking note for yr use.

12/7

BRIEFING ON ECONOMIC PROSPECTS FOR CABINET, 14 JULY

I attach the following speaking notes and briefs:

- J Speaking note on the economy and policy
- K Speaking note on public finances
- L Domestic economy: supplementary brief
- M Public sector finances: supplementary brief
- N World economy
- O Tax burden
- P Construction industry.

2. Mr MacAuslan submitted briefing material on public expenditure on 8 July.

JO-S

J ODLING-SMEE

CONFIDENTIAL

J. SPEAKING NOTE ON ECONOMY AND POLICY

Economy

Stronger growth this year, especially in investment, than foreseen at Budget time:

	FSBR Table 3.12	Cabinet paper table
GDP	3	4
Consumers' expenditure	4	6
Fixed investment	6½	11
Exports	3	2
Imports	6½	9
Current balance (£bn)	- 4	- 9
RPI (Q4) (ex. MIPs)	4	5½ (4½)
GDP deflator (financial year)	4½	5½

See Brief L (and P on construction) for latest indicators.

Contributing to increase in current account deficit and inflationary pressures.

Current account deficit wholly different from 1950s and 1960s because not associated with excessive Government expenditure and borrowing. Consequence of private sector behaviour: rising investment, good for economy and, in time, current account; fall in saving, which will reverse itself. Both reflect confidence in economy and our policies.

Inflation more of a worry. No serious capacity shortages except construction (Brief P). But inflation likely to be higher (partly mortgage interest rates).

Policy

Increases in interest rates in recent weeks (Brief L) show determination to keep inflation under control.

Monetary policy needs to be supported by sound fiscal policy, with decisions on expenditure and taxation set in medium-term context - part of today's task. Need to reduce tax burden over medium term, still much higher than 1978-79 (Brief O).

Must show same determination on spending restraint as on monetary policy. Our credibility, confidence of investors and tax objectives all depend on it.

K. SPEAKING NOTE ON PUBLIC FINANCES

1987-88 saw a Public Sector Debt Repayment - a PSDR -for only second time since beginning of 1950s. Early indications for 1988-89 - monthly figures available for April and May - suggest that PSDR for this year could be larger than last year's, and above that forecast at Budget-time.

Illustrates very substantial progress we have made during our period in office in reducing public sector borrowing. We have moved from a borrowing requirement of approaching 5% of GDP in 1979-80 to a debt repayment of 3/4% of GDP in 1987-88 - and may even do better in 1988-89 (Brief M).

This success a result of firm control of public expenditure. Ratio of GGE to GDP - excluding privatisation proceeds - has been reduced from over 46% four years ago to under 42 % in 1987-88 **(Brief D)**.

Have made important changes in the structure of taxation - in particular lower income tax rates - aimed at improving the supply performance of the economy. But as yet no significant reduction in the overall tax burden. Taxes and NICs amounted to 38% of GDP in 1987-88 - four percentage points higher than in last year of previous government **(Brief O)**.

Now is not the time to relax our control on public spending. Likely PSDR for this year represents reasonable fiscal stance, in present circumstances. No case for a looser fiscal policy. And in longer-term need to get the tax burden down. Key is continuing tight control on public spending - and further reductions in the ratio of GGE to GDP.

K

BRIEF L - DOMESTIC ECONOMY

The attached tables summarise recent developments on domestic demand, inflation, interest rates, labour market and the balance of payments.

2. Key features are:

- **Consumers' expenditure** still growing rapidly; no sign of deceleration, may even be accelerating;

- **Investment** is picking up strongly;

- **RPI inflation** (even allowing for MIPS) seems to be picking up strongly, certainly faster than expected at Budget time;

- Figures to be published at **11.30 am, Thursday 14 July** show **manufacturing output** up 6.4 per cent in three months to May compared to same period a year earlier. Growth in year to 1988Q1 also revised up, from 5.9 per cent to 6.4 per cent. **Manufacturing productivity** continuing to grow apace, up 6.6 per cent in three months to May on same period a year earlier;

- **Labour market** continuing to tighten. Figures to be released at **11.30 am Thursday 14 July** show 40,000 fall in **UK unemployment (adult, seasonally adjusted)** to 2.375 million (8.4 per cent). **Total employment** rose 144,000 between 1987Q4 and 1988Q1; now 523000 higher than year earlier.

L

I Latest indicators of domestic demand

(a) Consumer Spending

	Consumers' expenditure: £ billion 1980 prices	Consumers' expenditure: % change on year earlier
1987Q1	41.50	4.5
Q2	42.28	4.4
Q3	43.29	5.6
Q4	43.86	6.2
1988Q1	44.44	7.1

	Retail sales volumes: 1980=100	Retail sales volumes: % change on year earlier
1987Q1	125.5	5.1
Q2	128.6	5.8
Q3	131.7	6.6
Q4	133.4	5.6
1988Q1	135.3	7.8
1988 Jan	134.9	9.1
Feb	135.3	6.7
March	135.5	7.5
April	136.4	5.0
May	136.8	8.3

(b) New Car Registrations

	UK Registrations: 000's (seas adj)	UK Registrations: % change on year earlier
1987Q1	159	5.3
Q2	164	3.1
Q3	176	10.7
Q4	175	10.1
1988Q1	176	10.7
Jan	181	13.8
Feb	172	6.2
Mar	175	14.4
Apr	166	12.9
May	193	12.9

Percentage of new car registrations imported

Quarterly/Monthly 1987-1988		Annual 1980-1987	
1987Q1	50	1980	56
Q2	49	1981	55
Q3	50	1982	57
Q4	51	1983	57
1988Q1	53	1984	57
April	54	1985	57
May	54	1986	54
		1987	56

(c) Private Housing starts and completions (GB)

	Starts		Completions	
	000's	% change on year earlier	000's	% change on year earlier
1987Q1	47.6	15.5	42.5	10.4
Q2	45.5	4.1	42.8	6.7
Q3	48.1	3.0	43.2	4.6
Q4	50.1	12.6	42.3	-2.1
1988Q1	56.7	19.6	49.1	15.5
1988 Jan	22.0	63.0	18.0	36.4
Feb	18.0	0.6	16.4	17.1
Mar	16.7	2.5	14.7	-0.7
April	18.8	29.7	15.8	11.3
May	17.1*	3.6	14.7*	3.5

* preliminary estimates; likely - on recent experience - to be revised upwards.

(d) Fixed Investment

Investment - Percentage changes on year earlier
of which:

	Total	Manufacturing	Selected services Industries	Total Businesses
1985	3.1	14.7	11.4	6.2
1986	-0.3	-5.0	-1.4	-3.2
1987	3.9	4.1	23.4	4.7
1987 Q1	2.7	-7.9	11.1	-2.0
Q2	4.4	9.9	13.4	7.2
Q3	1.7	4.9	8.8	3.8
Q4	6.9	11.3	19.7	9.9
1988 Q1	10.8	7.2	14.0	9.4
June DTI Investment Investment Survey Outlook for 1988		16.0	+10.0	

(e) Index of Production (1980=100) — Percent changes on year earlier

	Production and construction (Div 1-5)	Production Industries (Div 1-4)	Manufacturing (Div 2-4)	Energy & Water (Div 1) oil & gas extraction	Energy & Water (Div 1) other	Construction
1987 Q1	3.6	2.5	4.2	- .5	-2.1	11.1
Q2	2.9	2.5	5.0	-2.3	-4.7	5.3
Q3	3.9	3.3	6.8	-6.9	-1.5	8.0
Q4	5.0	4.2	5.5	-0.3	2.3	9.9
1988 Q1	4.2	3.1	6.4	-5.4	-4.5	10.2
Latest three months on same period year earlier						
February		3.8	5.9	- 2½	-2½	
March		3.1	5.9	- 5¼	-4¾	
April		2.7	5.1	- 4¼	-3	
May*		**3.5***	**6.4***	**- 5¼***	**-1***	

*** Not published until 11.30 am, Thursday 14 July.**

The July figure for industrial production is likely to fall on account of accident to Piper Alpha.

II Inflation: percent changes on year earlier

	RPI		Manufacturers Output Prices		GDP Deflator
	All items	excl. MIPS	All items	excl, food, drink and tobacco	
1987 Q1	3.9	3.7	4.1	4.1	3.6
Q2	4.2	3.7	3.6	4.5	4.8
Q3	4.3	3.6	3.6	4.6	5.1
Q4	4.1	4.0	3.9	4.8	5.3
1988 Q1	3.4	3.7	4.0	4.8	5.1
Q2	4.2	4.5	4.4	4.9	n/a
1988 Jan	3.3	3.7	3.8	4.8	
Feb	3.3	3.6	3.9	4.8	
Mar	3.5	3.8	4.1	4.8	
April	3.9	4.2	4.3	4.8	
May	4.2	4.4	4.3	4.8	
[June	4.6*	4.7-4.8]*	4.6	4.9	

* NOT TO BE USED. All items RPI not published until 11.30 am Friday 15 July. The figure of 4.6 is our reading of DEmp's RPI Outlook note of 6 July. RPI excluding MIPS is HMT estimate based on incomplete information. It is liable to revision.

III Interest Rates

Interest Rates

	Base Rates		Mortgage Rate
1987 Q1	10.81		12.25
Q2	9.36		11.58
Q3	9.6		11.27
Q4	9.18		11.00
1988 Jan 1-Feb 1	8.5	1988 Jan	10.27
Feb 2-Mar 16	9.0	Feb	10.26
Mar17-Apr 10	8.5	Mar	10.26
Apr11-May 17	8.0	Apr	10.26
May18-Jun 2	7.5	May	9.75
Jun 3-June 6	8.0	June	9.75
Jun 7-June 22	8.5		
Jun23-July27	9.0		
Jun28 July 4	9.5		
July 4-	10.0		

IV Labour Market Recent Developments

	Unemployment UK, Adult seasonally adjusted* (000s)	(per cent)	Manufacturing employment UK, s.a (000s)	Total employment UK, s.a (000s)	Vacancies (unfilled) s.a. excl. Community Programme (000s)
1987Q1	3078	10.8	5397	24784	211
Q2	2978	10.5	5398	24927	227
Q3	2839	10.0	5394	25037	239
Q4	2645	9.4	5388	25163	262
1988Q1	2534	9.0	5393	**25307****	248
Jan	2565	9.1	5393		249.5
Feb	2504	9.0	5391		245.5
Mar	2504	8.9	5391		245.5
Apr	2453	8.7	5377		253.7
May	2415	8.6	**5381****		255.5
June**	**2375****	**8.4****			**255.2****

* The unemployment rate is constructed on the new workforce in employment basis to be presented by DEmp on Thursday 14 July at 11.30 am.

**** These figures not published until 11.30 am Thursday 14 July**

V Current Account balances: Recent figures £ billion

	1987 Year	1987 Q1	Q2	Q3	Q4	1988 Q1	Mar	Apr	May
Manufactures	-6.5	-0.7	-1.6	-2.1	-2.1	-2.9	-0.5	-0.9	-1.3
Oil	4.2	1.2	1.0	0.9	1.1	0.9	0.2	0.3	0.2
Other goods	-7.2	-1.7	-1.7	-1.9	-2.0	-2.0	-0.7	-0.6	-0.6
Total visibles	-9.6	-1.2	-2.3	-3.1	-3.0	-4.0	-1.0	-1.2	-1.7
Invisibles	8.1	2.2	2.1	2.2	1.6	1.2	0.4	0.5*	0.5*
Current Account	**-1.6**	**1.0**	**-0.2**	**-0.9**	**-1.4**	**-2.8**	**-0.6**	**-0.7**	**-1.2**

* Invisibles figures for April and May are CSO projections.

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PUBLIC SECTOR FINANCES - SUPPLEMENTARY BRIEF

(a) Statistics on PSBR

	PSBR		PSBR excluding privatisation proceeds	
	£billion	Percent of GDP	£billion	Percent of GDP
1952	0.8	5	0.8	5
1954	0.4	2	0.4	2
1956	0.6	2¾	0.6	2¾
1958	0.5	2	0.5	2
1962	0.5	1¾	0.5	1¾
1963-64	1.0	3¼	1.0	3¼
1967-68	2.0	4¾	2.0	4¾
1968-69	0.4	¾	0.4	¾
1969-70	-0.6	-1¼	-0.6	-1¼
1971-72	1.0	1¾	1.0	1¾
1973-74	4.3	5¾	4.3	5¾
1975-76	10.3	9¼	10.3	9¼
1978-79	9.2	5¼	9.2	5¼
Average 1974-75 to 1978-79	8.2	6¾	8.3	6¾
1979-80?				
1980-81	12.5	5¼	12.9	5½
1983-84	9.7	3¼	10.8	3½
1984-85	10.1	3	12.2	3¾
1985-86	5.7	1½	8.4	2¼
1986-87	3.4	1	7.9	2
1987-88	-3.5	- ¾	1.6	½
Average 1979-80 to 1987-88	7.3	2¾	9.2	3¼
1988-89 (FSBR forecast)	**-3.2**	**- ¾**	**1.8**	**½**
	-7.2	-1½	-2.2	-½

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(b) 1988-89 PSBR Outturn to date (monthly figures).

	April to May Outturn 1987-88	April to May Outturn 1988-89	Difference
	£ billion	£ billion	£ billion
PSBR	+ 1.9	- 1.8	- 3.7
PSBR excluding privatisation proceeds	+ 2.5	+ 1.0	- 1.5
CGBR (0)	+ 2.2	- 2.0	+ 4.2
LABR	+ 0.1	+ 0.9	+ 0.8
PCBR	- 0.5	- 0.6	- 0.1

Privatisation proceeds in April-May 1988 £2.7 billion compared with £0.7 billion in same period 1987.

(c) International Comparisons

General Government financial balances as percentage of nominal GNP

	1979	1983	1985	1986	1987	1988
UK	3.3	3.4	2.9	2.7	1.5	0.6
US	-0.5	3.8	3.3	3.5	2.4	2.3
Japan	4.7	3.7	0.8	1.1	0.2	0.3
West Germany	2.5	2.5	1.1	1.2	1.7	2.6
France	0.7	3.2	2.9	2.9	2.3	2.5
Italy	10.1	10.7	12.6	11.6	10.6	10.2
Canada	2.0	6.9	7.0	5.5	4.6	3.3
Total of above countries (G7)	1.7	4.1	3.4	3.4	2.5	2.4
EC	3.7	5.3	5.2	4.7	4.1	4.2
Total OECD	1.8	4.2	3.4	3.4	2.5	2.4

Source: OECD data and forecasts for 1988 except for UK where 1987 is latest CSO estimate of outturn and 1988 is Treasury Forecast consistent with FSBR. UK Deficit in 1988 now expected to be lower than implied FSBR forecast.

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(d) Fiscal Adjustments in 1988 MTFS (to achieve PSBR of zero)

		£ billion	
	1989-90	1990-91	1991-92
Fiscal adjustment from previous years	-	3	4
Annual Fiscal adjustment	3	1	1

CONFIDENTIAL

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PUBLIC EXPENDITURE CABINET, 14 JULY

THE WORLD ECONOMY

1. Real GNP growth in the G7 countries picked up strongly in the second half of 1987 and the first quarter of 1988. It is expected to moderate a little in the second half of 1988, but GNP is still expected to be 4 per cent higher in real terms in 1988 than in 1987. The latest published OECD and IMF forecasts are for lower growth. They were finalised before the strength of activity at the turn of the year was fully appreciated, and are certain to be revised up. In 1989 growth is expected to be closer to potential.

Table 1: Forecast Summary

Percentage change on a year earlier	1987	1988 WEP	1988 OECD	1989 WEP	1989 OECD
Major 7 Real GNP	3	4	3	2¾	2½
Major 7 Domestic Demand	3	4	3	2½	2½
Major 7 Industrial Production	3¼	6½		4¼	
World trade - total	5	9	7	5	6
- manufactures	6	10	8	5	7

Note: WEP = Treasury June 1988 forecast.

OECD = OECD Economic Outlook (June 1988, but forecast finalised in early May).

2. The recent strengthening of activity has not been confined to the G7, but appears to be a world wide phenomenon. With imports into the Asian NIEs growing strongly and other developing countries' imports also recovering a little, **world trade** growth has also picked up. Growth of 9 per cent in 1988, if achieved will match the previous peak in 1984. Unlike then, when US imports dominated, this year's growth will be evenly spread.

N

Table 2: World Import Growth

Percentage change on a year earlier	1986	1987	1988	1989
Developed economies	8	6	9	5
of which:				
US	14	5	8	-
Japan	13	8	14	8
EC(6)	6	7	8	5
OPEC	-22	-10	7	1
NIEs	19	23	18	12
Other developing economies	-3	-	7	4
Total	5	5	9	5

3. The strengthening of world activity has been accompanied by a strong recovery in non-oil commodity prices.

Table 3: Economist Commodity Price Index (SDRs)

	Percentage changes over year to June 1988
All-items	46
Food	28
Non-food agriculturals	14
Metals	95

With activity expected to continue to grow strongly, further rises in non-oil commodity prices are likely during the second half of 1988. Oil prices have not responded to the strengthening of activity and remain lower than one year ago.

4. So far rises in commodity prices have not been reflected in any pick up in consumer price inflation. The weakness of commodity prices in 1986 was never fully reflected in final prices - businesses preferred to expand margins. Now that commodity prices have recovered, margins appear to have been squeezed.

5. Latest figures show that consumer price inflation in the major seven remains just under 3 per cent. A modest pick up to around 4 per cent is forecast for 1989 - especially in the US and Japan where capacity utilisation is approaching previous peaks. There is a risk of higher inflation if:

i. commodity prices are significantly higher than expected (whether because demand is stronger or because of supply-side factors - eg drought in the US);

ii. oil prices, which have fallen in the last year, finally respond to increased activity;

iii. rapid growth of liquidity outside the US (following large scale intervention last year to support the dollar) feeds more strongly into increased expenditures and thence increased inflation;

iv. there is no tightening of US policy as rates of capacity utilisation continue to increase.

6. The <u>current account imbalances</u> of the US, Japan and Germany remain large, but have started to decline, particularly in relation to GNP.

<u>Table 4: Current Account Balances, $bn (% GNP)</u>

	1986	1987	Latest 12 months
US	-141 (-3.3)	-161 (-3.6)	-152 (-3.4)
Japan	86 (4.4)	87 (3.6)	83 (3.3)
Germany	38 (4.2)	44 (3.9)	43 (3.6)

7. Following its rise over the last fortnight, the <u>dollar's exchange rate</u> is now about 10 per cent lower against the yen and sterling since the Louvre Agreement. But it is trading at broadly the same rates against EMS currencies as it was in February 1987.

8. <u>Short-term interest rates</u> in Germany rose 1 percentage point in the last two weeks in response to a tightening of policy by the Bundesbank. Market rates in the US rose in March/April by about ¾ per cent. But in Japan interest rates have barely moved for over a year.

IF2 DIVISION
HM TREASURY
6 July 1988

BMEF 0

TAX BURDEN

Overall burden

1. Real increase in taxes 1978-79 to 1988-89:

	£ billion (1986-87 prices)
Taxes on income and capital (inc.North Sea ACT set-off)	11.3
North Sea taxes	1.9
Taxes on expenditure	21.1
Total taxes	34.3
NICs	8.9
Total taxes and NICs	**43.2**

2. Tax burden up more than 4 percentage points since 1978-79. Even if stick to public expenditure planning totals, maintain a balanced budget, and use the resulting fiscal adjustment to cut income tax, tax burden in 1990-91 still likely to be above 1978-79 level.

Total taxes (inc. LA rates) and NICS as a percentage of GDP at market prices

	inc.N.Sea	excl.N.Sea*
1964-65	29.2	29.2
1973-74	33.2	33.2
1978-79	33.8	34.2
1981-82	39.3	38.7
1987-88 (estimated outturn)	37.9	37.7
1988-89 (forecast)	37.9	37.7
1991-92 (MTFS projections)	36.2	36.1

* Non North Sea taxes and NICs as a percentage of Non North Sea GDP.

Burden on individuals

3. Share of earnings taken in income tax and NICS up since 1978-79 for a married man on 67 percent or less of average earnings. Share for a man on average earnings more than double that in early 1950s:

Percentage of earnings paid in income tax and NICs by a married man with no children

Multiples of average male earnings	½	¾	1	2
1950-51	5.9	9.5	12.1	23.5
1973-74	16.2	22.5	25.6	28.2
1978-79	16.0	23.8	27.8	31.4
1988-89	17.9	23.3	26.0	27.8

4. Average nurse pays over £50 a week in income tax and NICS; average teacher pays £75 a week.

	£ per week		
	Earnings	Income tax and NICs	Tax and NICs as a percentage of earnings
Primary School teachers (married; contracted out)	295	75.5	25½
Nurses (registered; single contracted out)	195	50.7	26
Average male earnings (married; contracted in)	245	63.6	26

5. Including indirect taxes, married man on average earnings still pays nearly 40 per cent of earnings in tax and NICS:

Percentage of earnings paid in income tax, NICs and indirect taxes (excluding LA rates) by a married man with no children

Multiples of average male earnings	¾	1
1978-78	36.5	39.6
1988-89	37.1	39.3

6. Tax threshold for a married man lower relative to average earnings than in 1973-74.

Income tax threshold as a percentage of average male earnings

	Single	**Married**
1950-51	28.6	45.7
1973-74	26.4	34.3
1978-79	20.4	31.8
1988-89	20.5	32.2

7. **Tax cost of extra expenditure**

Each £1.4 billion extra expenditure is equivalent to 1p on basic rate in 1988-89 (£1.5 billion 1989-90).
Each £1.2 billion extra expenditure is equivalent to 1 percent point on VAT rate in 1988-89 (£1.3 billion in 1989-90).

International Comparisons

8. UK burden well above US and Japan, though below many EC countries.

	Tax and social security contributions as a percentage of GDP 1986
UK	39.1
Netherlands	46.1.
France	45.1
West Germany	37.4
US (1985)	29.2
Japan (1985)	28.0

[NB: These figures are on a receipts basis; those in paras 1-2 were on an accruals basis.]

9. Despite basic rate cuts, UK starting tax rate still high by international standards; UK threshold relative to average earnings about average for developed countries, but well above US.

Starting tax rates and thresholds for a married man with no children.

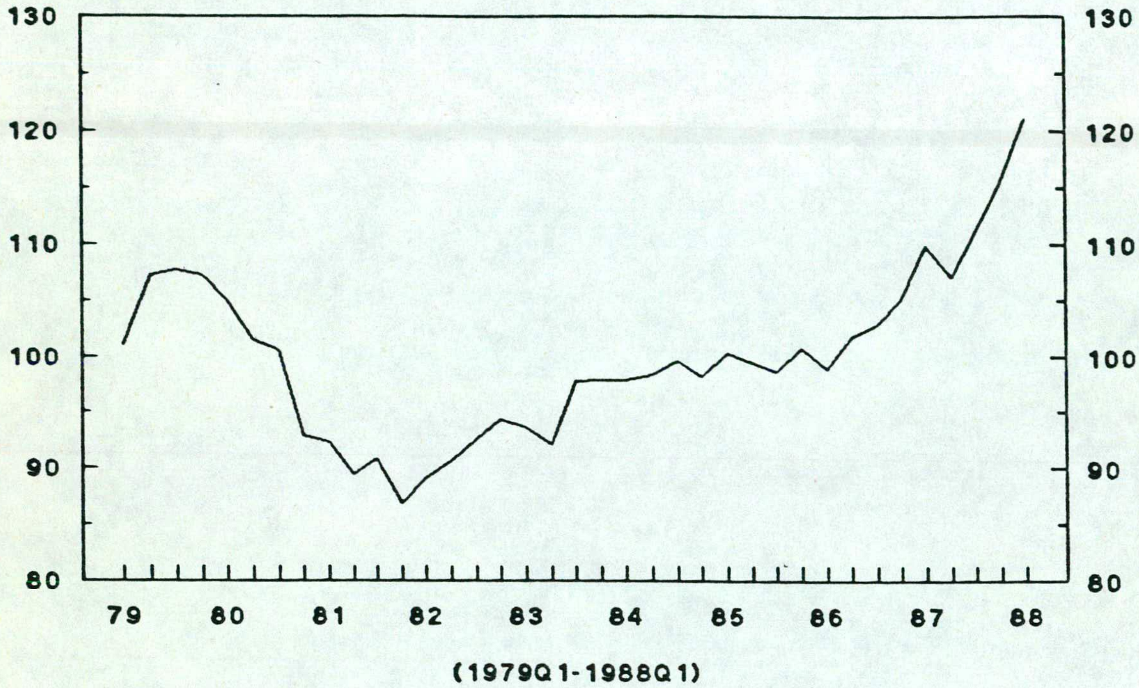
	Tax rate (%)	**Tax plus social security rate (%)**	**Threshold £**
UK (1988-89)	25	30	4095
Italy (1987)	22	28	3565
France (1986)	19	31	6330
West Germany (1987)	22	36	3370
Japan (1987)	11	20	4590
USA (1987)	11	18	4320

ETS Division
6 July 1988

IEF P: CONSTRUCTION SECTOR

Output

OUTPUT OF THE CONSTRUCTION INDUSTRY (1980=100)



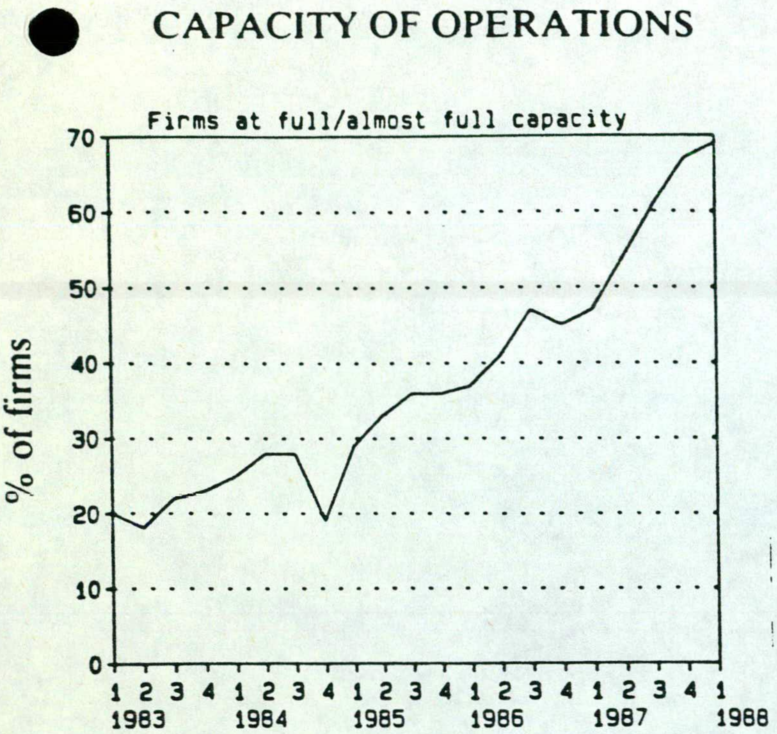
- Output rose by 8½ per cent in 1987 to highest level for fifteen years, after severe slump in 1980 and 1981 (output fell by cumulative 16 per cent) and only patchy recovery over 1983-86 (average annual growth 2½ per cent compared with 3½ per cent for total output).

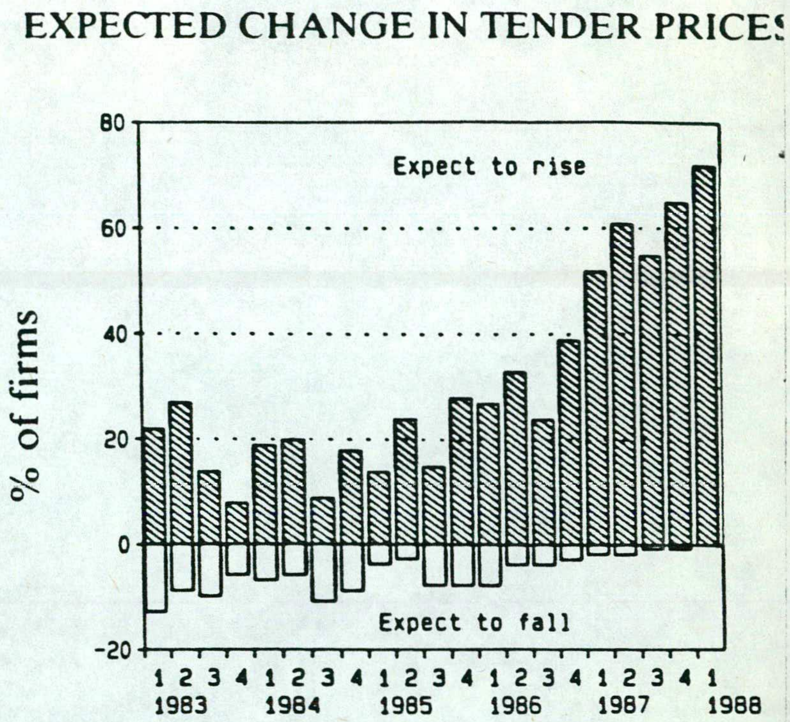
- Output likely to rise further 8-10 per cent in 1988.

- June DTI Investment Intentions Survey points to strong growth in new commercial building (manufacturing expected to be up 33 per cent, selected service industries up 9 per cent).

P

Capacity Indicators





- Building Employers Confederation (BEC) Survey (March 1988) reported 70 per cent of firms operating at capacity, compared with 47 per cent a year ago (see chart).

- Construction materials prices rising at 5½-6½ per cent per annum, 1-2 per cent faster than manufacturing input prices.

- DoE statistics point to strong rise in tender prices; in year to 1987Q2 (latest available) new tender prices rose by 12½ per cent, after falling 3 per cent in 1986.

- BEC Survey (see chart above) indicates that 72 per cent of firms expect to raise prices (52 per cent in March 1987).

Material shortages

- Stocks of bricks (relative to production and deliveries in 1987) lowest for fifteen years.

- FT June 16 reports Blue Circle importing some cement and, along with other producers, raising prices (copy attached)

- BEC Survey reports 64 per cent of firms citing material shortages as causing delays, up 16 per cent on year earlier. But only 5 per cent report serious delays.

Labour shortages

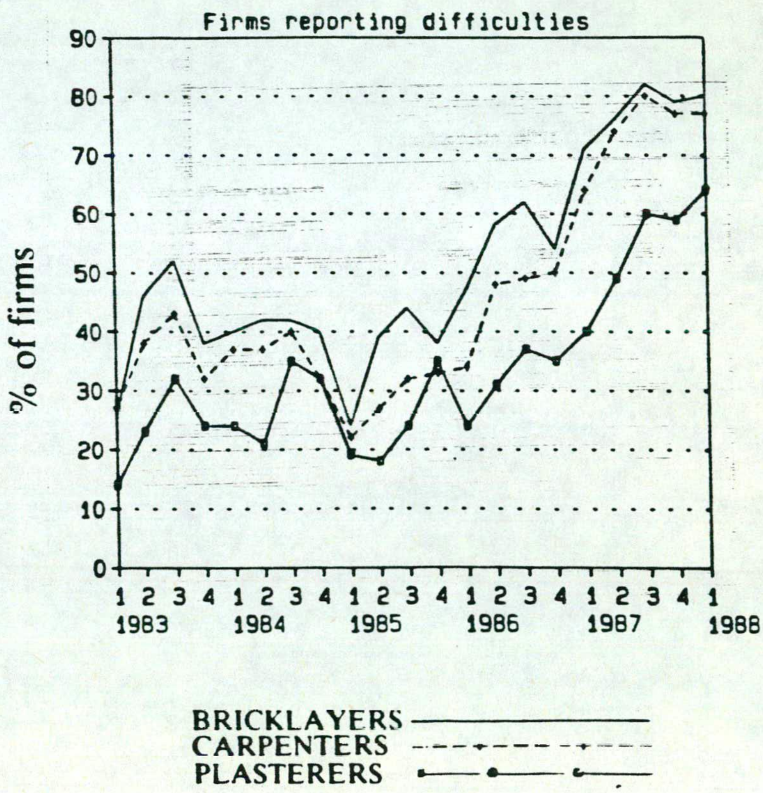
Construction Employment and Productivity (% changes)

	Employment	Productivity
1979	3.9	-3.1
1980	1.2	-6.6
1981	-5.4	-4.9
1982	-3.2	5.2
1983	0.2	3.9
1984	2.5	0.8
1985	-0.5	1.9
1986	-0.6	2.8
1987	4.2	4.0

FIRMS REPORTING DIFFICULTIES (%)
(Latest Figures only)

	Brick-layers	Carpen-ters	Plaster-ers
Scotland	43	56	01
Northern	47	51	47
North Western	68	65	37
Liverpool	77	74	57
Yorkshire	70	66	59
Midland	85	85	80
Eastern	83	84	66
South Wales	43	45	48
South Western	85	88	72
Southern	86	84	71
London	97	77	75
Nat Contractors	93	86	78
Total	80	77	64

LABOUR AVAILABILITY



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SECRET

FROM: S J PICKFORD
DATE: 31 OCTOBER 1988

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Anson
Sir T Burns
Sir G Littler
Mr Monck
Mr H Phillips
Mr Scholar
Mr Culpin
Mr H P Evans
Mr Odling-Smee
Miss Peirson
Mr Sedgwick
Mr Turnbull
Mr Gieve
Mr J Hibberd
Mr S Matthews
Mr MacAuslan
Mr McIntyre
Mr Mowl
Mr Riley
Mr Patterson
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call
GJ/003

Menu

A: recent economic developments
B: economic prospects
C: fiscal prospects
D: NICs
E: international comparisons

CABINET: TUESDAY 1 NOVEMBER

There have been a number of changes to the briefing I submitted on Friday.

2. I attach, for you and the Chief Secretary, a complete set of revised briefs (changes are sidelined). For copy addressees I attach copies of the pages affected by these changes.

Stephen Pickford

S J PICKFORD

a
You already have much A this, some in earlier versions
I shall make sure Paul Gray pops out & rings us as soon as discussion finishes
[initials]

A

BRIEF A

UK ECONOMY : RECENT DEVELOPMENTS

(i) Retail price inflation

- Annual increase of 3.4 per cent in 1986, 4.2 per cent in 1987, and 4.4 per cent in first 9 months of 1988.

- Risen from 3.3 per cent in January 1988 to 5.9 per cent in September. But excluding mortgage interest payments, rise is from 3.7 per cent in January to 5.2 per cent in September.

(ii) GDP and components (1985 prices)

percentage changes from previous period

	1981H1 to 1988H1 average annual rate	**1988Q2 on 1988Q1**	**1988Q2 on 1987Q2**
Consumers' expenditure	3½	½*	5½*
General government consumption	1	0	0
Fixed investment	5	4	10½
Exports of goods and services	4	3½	3
Imports of goods and services	7½	7	14
GDP(A)	3	½	4

* provisionally estimated to have risen by over 2 per cent between 1988Q2 and Q3 to level 5½ per cent higher than a year earlier.

(iii) Industrial production : in 3 months to August 1½ per cent higher than in previous 3 months, nearly 4½ per cent up on a year earlier, and over 12 per cent higher than 1979 H1.

(iv) Manufacturing output: in 3 months to August nearly 3 per cent higher than in previous 3 months, nearly 7 per cent higher than a year earlier, and 8½ per cent up on 1979 H1 peak. Manufacturing productivity up 7½ per cent in year to 3 months to August.

(v) Company sector

- Industrial and commercial company (ICC) profits (excluding North Sea oil companies) up 24 per cent in 1988H1 on year earlier. More than trebled in nominal terms since 1980 and more than doubled in real terms.

- For non-North Sea ICCs, profitability over 10 per cent in 1987. Manufacturing profitability over 9 per cent in 1987. In both cases, risen every year since 1981, now highest since 1969.

(vi) Fixed investment :

	per cent changes			
	1988Q2 on			
	1988Q1	1987Q2	1981Q1	1979H1
Total fixed investment	3.8	10.5	46.0	28.2
Manufacturing investment	9.5	13.1	41.8	3.0

(vii) Construction output:

- Unchanged between 1988Q1 and Q2 but nearly 12 per cent higher than year earlier.

- Construction orders in 3 months to September down 3 per cent on year earlier (if Channel Tunnel project excluded).

(viii) Retail sales volume in 3 months to September 6 per cent higher than year earlier.

(ix) Current account

- Deficit of £2.5 billion in 1987, around ½ per cent of GDP, and £9.8 billion, 3 per cent of GDP, in first 9 months of 1988.

- Non-oil export volumes of goods (excluding erratics) in 1987 up 6½ per cent on 1986. In 1988Q3 up 6 per cent on a year earlier.

- Non-oil import volumes of goods (excluding erratics) in 1987 up 8½ per cent on 1986. In 1988Q3 up 15 per cent on a year earlier.

(x) Employment up by over 2 million since March 1983; on rising trend for over 5 years. Employees in employment risen for 21 successive quarters, by over 1 million in total.

(xi) Unemployment level : 2,267,000 (8.0 per cent of working population) in September 1988. Seasonally adjusted total fell 6,000 in September; over last 12 months fallen by 505,000. Fallen for 26 months in succession. Fallen in all regions over past year.

(xii) Underlying rate of increase in average earnings risen from 8½ per cent at start of 1988 to 9¼ per cent in August. This rise mainly accounted for by high overtime payments and performance-related bonuses, as well as effect of nurse's pay settlement. But pay settlements have also edged up as labour market conditions have tightened.

(xiii) Unit wage and salary costs in manufacturing in 3 months to August up 0.7 per cent on year earlier. In whole economy risen 4.4 per cent in year to 1988Q2.

P Patterson
EB Division (Ext 5207)
28 October 1988

B

SECRET
until 1 November 1988
then UNCLASSIFIED

B ECONOMIC PROSPECTS

Factual

(i) - For main points of AS forecast, see table 1 at Annex.

- For comparisons with recent official forecasts, see table 2 at Annex.

(ii) Output

percentage changes on year earlier

	Outturn 1987	Forecast 1988	Forecast 1989
GDP (average measure)	4	4½	3
GDP (A) excluding oil	4½	5	3½
Manufacturing output	6	7	4½

NB: Rounded to nearest ½ per cent

(iii) Inconsistencies in national accounts: In year to first half of 1988 expenditure measure of GDP rose 2½ per cent, compared with 4½ per cent for income measure and 6 per cent for output measure.

(iv) Comparison with independent forecasts:

percentage increase on year earlier	Autumn Statement 1988	Autumn Statement 1989	Average of independent forecasts (October) 1988	Average of independent forecasts (October) 1989
GDP	4½	3	3.7	2.4
Consumers' expenditure	5½	3½	5.4	3.0
Fixed investment	12	5½	9.7	4.3
Exports of goods and services	1½	5½	1.7	4.6
Imports of goods and services	12	4½	9.8	5.6
RPI inflation (Q4)	6¼	5	5.6	5.1
Current account (£ billion)	-13	-11	-10.7	-10.6
PSDR (£ billion, financial years)	10	not published	6.7	6.0*

* PSDR figures for 1989-90 published by independent forecasters reflect various assumptions about tax changes in the Budget.

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(v) Fixed investment

	£ billion at 1985 prices 1987	percentage change on year earlier 1988	1989
Business investment	41.1	13½	7½
of which: manufacturing	10.1	18	10
Private dwellings (1)	15.2	13	2½
General government (1)	8.1	½	2½
Total fixed investment	**64.2**	**12**	**5½**

(1) excludes purchases/sales of council houses.

(vi) RPI inflation

	Weight in 1988	Outturn 1987Q4	Forecast 1988Q4	Forecast 1989Q4
		percentage changes on year earlier		
Food	16¼	3½	3¼	3¼
Nationalised industries	5½	2¼	7¼	6¼
Housing	15¼	7	16¼	7
Other	63	3¾	4½	4¾
Total	**100**	**4**	**6¼**	**5**

NB: Rounded to nearest ¼ per cent.

(vii) Manufacturing unit labour costs growth kept down by rapid growth of productivity. But forecast to rise in 1988 by ¾ per cent.

(viii) Unemployment should continue to fall over next year, though probably at slower rate than recently.

(ix) Balance of payments:

£ billion

Balances on	Manufactures	Other	Oil	Invisibles	Current balance
1987	-7½	-7	4	7½	-2½
1988 Partly forecast	-13	-8	2½	5½	-13
1989 Forecast	-11½	-7½	2	6	-11

(x) North Sea oil prices and exchange rate assumed to remain close to recent levels.

Positive

(i) Average annual growth likely to turn out at over 3 per cent in 8 years to 1989, compared with 2 per cent annual growth in 1970s. Seven years to 1988 have seen combination of strong and steady growth not seen since War.

(ii) GDP growth likely to moderate to around 3 per cent in 1989, close to average between 1981 and 1987.

(iii) 1988 and 1989 forecast to see substantial increases in fixed investment.

(iv) Manufactured export volumes to rise over 8 per cent in 1989, in line with projected growth of world trade.

(v) Healthy growth of manufacturing productivity.

(vi) Unemployment should continue to fall over year ahead.

TABLE 1

ECONOMIC PROSPECTS: SUMMARY

Per cent changes on a year earlier unless otherwise stated

	1987	Forecast 1988	Forecast 1989	Average errors from past forecasts[1]
GDP and domestic demand at constant prices				
Domestic demand	4½	6	3	1
of which:				
Consumers' expenditure	5	5½	3½	1¼
General government consumption	1	½	-½	¾
Fixed investment	5½	12	5½	2¼
Change in stockbuilding (as a percentage of GDP)	0	0	0	¾
Exports of goods and services	5½	1½	5½	2¼
Imports of goods and services	7½	12	4½	2¾
Gross domestic product	4	4½	3	¾
Manufacturing output	6	7	4½	2
Balance of payments current account (£ billion)	-2½	-13	-11	4¼
Inflation				
Retail price index (Q4 on Q4)	4	6¼	5	1¾
GDP deflator at market prices (financial year)	5¼	6¼	5	1¾
Money GDP at market prices (financial year)	10	11	8	1¾
£ billion	424	471	508	
PSDR (financial year)				
£ billion	3½	10		3
as a per cent of GDP	¾	2		½

1 The errors relate to the average differences (on either side of the central figure) between Autumn Industry Act forecasts and outturn over the last ten years and apply to the forecasts for 1989, except for the PSDR where they apply to the forecasts for 1988-89.

TABLE 2

Comparisons of official forecasts

(a) Output (Non-oil in brackets)

	per cent change on year earlier 1987	1988	1989
GDP			
- 1987 Autumn Statement	4 (4½)	2½ (3)	not app
- 1988 FSBR	4½ (5)	3 (3½)	2½ (3)*
- 1988 Autumn Statement	4 (4½)	4½ (5)	3 (3½)
Manufacturing output	**1987**	**1988**	**1989**
- 1987 Autumn Statement	5	3½	not app
- 1988 FSBR	5½	5	3½*
- 1988 Autumn Statement	6	7	4½

* 1989H1 only

(b) Inflation — per cent change on year earlier

RPI	**1987Q4**	**1988Q4**	**1989Q2**	**1989Q4**
- 1987 Autumn Statement	4	4½	not app	not app
- 1988 FSBR	4	4	4	not app
- 1988 Autumn Statement	4	6¼	not app	5
GDP deflator	**1987-88**	**1988-89**	**1989-90**	**1990-91**
- 1987 Autumn Statement	4¼	4½	3½*	3*
- 1988 FSBR	5	4½	4*	3½*
- 1988 Autumn Statement	5¼	6¼	5	3½*

* assumption

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BRIEF C

FISCAL PROSPECTS AND THE PSBR

Factual

a) Changes to PSDR forecast for 1988-89 since Budget

		£ billion
General government expenditure		-2.0
of which:	Planning total	-3.2
	Debt interest	+0.2
	Other adjustments*	+1.0
General government receipts		+3.7
of which	Non-North sea receipts	+3.7
	North Sea revenues	-
Public corporations market and overseas debt repayment		+0.8
PSDR		+6.6

Lower GGE due to lower planning total - mainly reflecting lower social security expenditure as result of falling unemployment, higher local authority receipts from right-to-buy sales, and higher privatisation proceeds.

Higher receipts mainly due to higher economic activity than forecast at Budget time.

* Adjustments to move from the planning total to GGE. There are three types of adjustment:

(a) to deduct market and overseas debt repayment by public corporations (not included in general government);

(b) to move cash transactions onto the national accounts basis (eg VAT refunds and capital consumption);

(c) to include transactions excluded from the planning total for control purposes, but counted as expenditure in the national accounts (eg expenditure by OFTEL and OFGAS).

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b) **Historical statistics on PSBR**

	PSBR			PSBR excluding Privatisation proceeds		PSFD (3)	
	Cash £ billion	Real terms (base year 1987-88 prices) (£ billion)	Ratio to GDP (per cent)	Cash £ billion	Ratio to GDP (per cent)	Cash £ billion	Ratio to GDP (per cent)
1948						-0.3	-2¼
1949						-0.3	-2½
1950						-0.4	-2¾
1951						0.2	1½
1952	0.8	8.6	5	0.8	5	0.6	3½
1953	0.6	6.2	3½	0.6	3½	0.7	4
1954	0.4	3.9	2	0.4	2	0.4	2½
1955	0.5	4.7	2½	0.5	2½	0.4	2
1956	0.6	5.4	2¾	0.6	2¾	0.5	2½
1957	0.5	4.4	2¼	0.5	2¼	0.5	2½
1958	0.5	4.3	2	0.5	2	0.4	2
1959	0.6	4.9	2¼	0.6	2¼	0.6	2¼
1960	0.7	6.0	2¾	0.7	2¾	0.7	2½
1961	0.7	5.8	2½	0.7	2½	0.7	2½
1962	0.5	4.3	1¾	0.5	1¾	0.5	1¾
1963	0.8	6.4	2½	0.8	2½	0.8	2½
1963-64	1.0	8.0	3¼	1.0	3¼	1.1	3½
1964-65	0.9	6.8	2¾	0.9	2¾	0.8	2¼
1965-66	0.9	6.7	2½	0.9	2½	0.6	1¾
1966-67	1.1	7.8	3	1.1	3	1.0	2¾
1967-68	2.0	13.4	5	2.0	5	1.7	4¼
1968-69	0.4	2.3	¾	0.4	¾	0.4	¾
1969-70	-0.6	-3.6	-1¼	-0.6	-1¼	-0.8	-1¾
1970-71	0.8	4.3	1½	0.8	1½	-0.2	-½
1971-72	1.0	4.9	1¾	1.0	1¾	0.7	1¼
1972-73	2.4	11.4	3½	2.4	3½	2.0	3
1973-74	4.3	19.1	5¾	4.3	5¾	3.5	4¾
1974-75	8.0	29.4	9	8.0	9	6.0	6¾
1975-76	10.3	30.1	9¼	10.3	9¼	8.1	7¼
1976-77	8.3	21.5	6½	8.3	6½	7.4	5¾
1977-78	5.3	12.1	3½	5.9	4	6.6	4¼
1978-79	9.2	18.8	5¼	9.2	5¼	8.3	4¾
1979-80	9.9	17.4	4¾	10.3	5	8.1	4
1980-81	12.5	18.6	5¼	12.9	5½	11.6	5
1981-82	8.6	11.6	3¼	9.1	3½	5.5	2
1982-83	8.9	11.3	3¼	9.4	3¼	8.4	3
1983-84	9.7	11.7	3¼	10.9	3½	11.7	3¾
1984-85(1)	10.1	11.6	3	12.3	3¾	13.4	4
1985-86(1)	5.7	6.2	1½	8.4	2¼	7.6	2
1986-87	3.4	3.6	1	7.9	2	8.7	2¼
1987-88	-3.6	-3.6	-¾	1.5	¼	1.4	¼
1988-89	-9.8(2)	-9.2	-2	-3.8	-¾	-4.3	-1
Average 1974-75 to 1978-79	8.2	22.4	6¾	8.3	6¾	7.3	5¾
Average 1979-80 to 1987-88	7.3	9.8	2¾	9.2	3¼	8.5	3

(1) If adjusted for coal strike, PSBR and PSFD ratios to GDP roughy 0.9 per cent lower in 1984-85 and 0.2 per cent lower in 1985-86.

(2) Outturn to September surplus of £3.7 billion.

(3) Public Sector Financial Deficit.

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c) **1988-89 PSBR Outturn to date** (monthly figures)

PSBR excluding privatisation proceeds April - September £4¾ billion lower than in same period of 1987-88.

	April to September 1988-89	Outturn 1987-88	£ billion Difference
PSBR	- 3.7	1.9	- 5.6
PSBR excluding privatisation proceeds	1.2	5.8	- 4.7
CGBR (O)	- 3.3	2.1	- 5.3
LABR	-	0.5	- 0.5
PCBR	- 0.5	- 0.7	+ 0.2

d) **Non-oil tax revenues** buoyant so far in 1988-89. Outturn figures for 6 months, April to September (latest available data):

	£ billion	% change on year earlier
Inland Revenue receipts	28.9	5
Customs and Excise receipts	23.5	13

e) **Share of Non-North Sea Taxes and National Insurance Contributions in Non-North Sea GDP**

1978-79	1987-88	1988-89 (Projection)
34.2	37.8	37.2

Forecast of Taxes and NICs in 1988-89

	1988 Budget forecast	1988 Autumn Statement	£ billion Difference
Income Tax	42.1	42.8	+0.8
Non-NS Corporation Tax	17.3	17.4	+0.1
VAT	26.2	27.3	+1.1
Stamp duties	2.0	2.4	+0.4
Other Non N Sea Taxes	50.3	50.6	+0.3
NICs	31.6	32.2	+0.6
Non North Sea Taxes and NICs	169.5	172.7	+3.3
North Sea Revenues	3.3	3.3	-

f) **International Comparisons**

General government financial deficits as percentage of GDP (deficit shown as a positive number).

	1979	1986	1987	1988
US(1)	- 0.5	3.5	2.3	2¼
Japan(1)	4.7	1.1	0.4	0
Germany(1)	2.5	1.2	1.7	2
France	0.7	2.9	2.4	2¼
Italy	10.1	11.6	10.5	10
Canada(1)	2.0	5.5	4.6	3½
UK(4)	3.3	2.4	1.4	-½
G7	1.7	3.4	2.4	2
EC(2)	3.7	4.8	4.2	3¾
OECD(3)	1.8	3.4	2.5	2½

Source: IMF 'World Economic Outlook', October 1988 for 1987 and 1988, EC Annual Economic Report October 1988 for EC totals, and for OECD 1979, 1986 and OECD totals.

(1) As percentage of GNP

(2) EC(8) before 1980. EC(12) after 1980.

(3) Covers 18 of 24 members

(4) 1988 - Autumn Statement forecast

Positive

1. First time since beginning of 1950's that public sector debt repayment in two consecutive years.

2. PSDR in 1988-89, at 2 per cent of GDP, expected to be highest since beginning of 1950's (the earliest date for which figures on this basis are available).

3. Even excluding privatisation proceeds, PSDR as a percentage of GDP expected to be higher than any year since early 1950's with single exception of 1969-70.

4. Reaping rewards of sticking to our policies of firm expenditure control , within framework of MTFS.

5. No other major country has budget surplus (Japan close to balance). All others have deficits of at least 2 per cent of GDP.

D

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D NATIONAL INSURANCE CONTRIBUTIONS

FACTUAL

i. Main announcements

a. Class 1 rates for employed persons to remain unchanged

b. Lower earnings limit up from £41 per week to £43. Upper earnings limit up from £305 per week to £325. Relationship between LEL, UEL and basic pension set by statute.

c. Limits for reduced rate bands up from £70, £105 and £155 per week to £75, £115 and £165.

d. Treasury supplement (currently 5 per cent) to be abolished, subject to Parliamentary approval, reducing fund income by £1.6 billion.

e. National Health Service allocation increased from 0.95 per cent to 1.05 per cent for employees and from 0.8 per cent to 0.9 per cent for employers. An extra £350 million of planned NHS spending will be financed from NICs rather than taxation.

Positive

i. No increase in class 1 contribution rates for the sixth year running.

ii. Most employees and employers pay little or no more as a result of changes. Low paid employees and their employers will pay less, by up to £2.30 each per week, because of increase in ceilings for reduced rate bands and rise in LEL.

Defensive

i. Why is Treasury Supplement being abolished?

- Supplement not needed in view of high income from contributions and healthy state of NIF.

- General taxation still financing non-contributory benefits at a cost of £20 billion.

- Contributory benefits should be financed by contributions not taxpayers.

ii. Surplus should have been used to raise benefits: National insurance benefits are all being maintained in real terms. Also plans include strong growth in spending on non-contributory benefits.

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ANNEX

NATIONAL INSURANCE CONTRIBUTION RATES 1989-90

Summary of proposals

	Present 1988-89	Proposed 1989-90	Change
Employer's Class 1 (contracted in)	10.45%	10.45%	-
Employee's Class 1 (contracted in)	9%	9%	-
Opted-out married women	3.85%	3.85%	-
Lower earnings limit (Class 1)	£41	£43	+£2
Upper Earnings limit (Class 1)	£305	£325	+£20
Low-paid earnings brackets	£70 £105 £155	£75 £115 £165	+£5 +£10 +£10
Rates payable within low paid brackets	5% 7% 9%	5% 7% 9%	- - -
Class 2 (self employed)	£4.05	£4.25	+20p
Small earnings exception	£2,250	£2,350	+£100
Class 3 (voluntary)	£3.95	£4.15	+20p
Class 4 (self employed profits related)	6.3%	6.3%	-
Lower profits limit (Class 4)	£4,750	£5,050	+£300
Upper profits	£15,860	£16,900	+£1,040

Note: Contracting out rebates remain at 3.8 per cent for the employer and 2 per cent for the employee.

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BRIEF E: INTERNATIONAL COMPARISONS

1. **GDP/GNP growth**

- Growth in UK expected to be above major seven average and EC average in 1988 as in 1987. Growth in G7 and EC expected to moderate in 1989 with UK close to average.

	Percentage change from year earlier		
	1987	**1988 (estimate)**	**1989 (forecast)**
United Kingdom	4.2	4½	3
United States	3.4	4	2¾
Japan	4.2	5¾	4¼
Germany	1.7	3	2
France	2.2	3	2½
Italy	3.1	3	2½
Canada	3.9	4	3¼
Major Seven	3.3	4	3
EC	2.5	3½	2¾

Note: IMF estimates and forecasts except UK (Autumn Statement) and EC (European Commission).

2. Inflation

- UK inflation rate highest in major 7. UK only one of major 7 (apart from Canada) to include mortgage interest payments in inflation measure. UK figures excluding mortgage interest given below.

Inflation Rates of Other Major 7 Countries and EC

Percentage change from year earlier

	December 1987	September 1988	1988 (estimate)	1989 (forecast)
UK	3.7	5.9	5	(see below)
United States	4.4	4.2	4	4½
Japan	0.4	0.6*	1	1½
Germany	1.0	1.4	1¼	2½
France	3.1	3.0	2½	2½
Italy	5.0	4.8	5	5
Canada	4.2	4.1	4	3½
Major Seven	3.4	3.2*	3¼	3½
EC	3.3	3.6*	3½	3¾

Note: IMF forecasts of consumer price inflation except EC, and UK (Autumn Statement)

* August 1988

UK Retail Price Inflation

1988 September		1988 Whole Year		1988Q4		1989Q4	
All items	Excl MIPs*	All items	Excl MIPs*	All items	Excl MIPs*	All items	Excl MIPs*
5.9	5.2	5	4½	6¼	5	5	5

* Excluding Mortgage Interest Payments.
Note: Autumn Statement estimate for 1988 and forecasts for 1988Q4 and 1989Q4

3. Productivity Growth

- Since 1980 productivity growth in UK manufacturing highest among G7.
- Since 1980 whole economy productivity growth in UK about same as Japan, and higher than any other G7 country.

	Manufacturing productivity 1980-87	Whole Economy productivity 1980-87
United Kingdom	5.3	2.7
United States	4.1	0.9
Japan	2.3	2.8
Germany	2.0	1.7
France	2.5	1.9
Italy	3.7	1.9
Canada	3.2	1.5
Major Seven	3.4	1.7

Source: OECD, IMF, CSO

4. Current Account

- UK deficit for 1988 expected to be about the same as US when expressed as percentage of GDP, but US deficit at or ab~~out~~ove 2½ per cent of GDP since 1984.

$ billion (per cent of GDP)

	1986	1987	1988 (estimate)
United Kingdom	0 (0)	- 4 (-½)	- 23 (-2¾)
United States	-141 (3¼)	-154 (-3½)	-129 (-2½)
Japan	86 (4½)	87 (3½)	78 (2¾)
Germany	38 (4¼)	44 (4)	45 (3¾)
France	3 (½)	- 4 (- ½)	- 3 (- ¼)
Italy	3 (½)	0 (0)	- 3 (- ¼)
Canada	- 7 (-1¾)	- 8 (-2)	- 9 (-1¾)
Major Seven	- 20 (-1¼)	- 38 (- ¼)	- 39 (- ¼)

Source: IMF forecasts except for UK (Autumn Statement).

5. Overseas Assets and Reserves

- Of the major countries UK has highest net stock of overseas assets as a percentage of GDP and only Japan has higher reserves as a percentage of imports.

	Net stock of Overseas Assets in 1987		Foreign Exchange Reserves (minus Gold)	
	$ Billion	% of GDP	Aug 1988 $ billion	% of 1987 Imports
UK	**160***	**24**	**42**	**27**
US	-380	-9	37	9
Japan	240	10	89	60
Germany	160	14	59	26
France	-10	-1	29	18
Italy	-40	-6	31	25
Canada	-10	-2	13	15

Source: Bank of England, IMF.

*£90 billion

6. Interest Rates

3 month rates in all the major countries have risen since June. Long run rates have changed very little.

	3-month rates			10-year bond yields		
	One Year ago	June 1988	28.10.88	One Year ago	June 1988	28.10.88
UK	**9.2**	**8.8**	**12.0**	**9.6**	**9.5**	**9.6**
US	7.4	7.6	8.5	8.9	9.2	8.9
Japan	4.8	4.1	4.5	5.2	5.1	4.9
Germany	4.6	3.9	4.9	6.9	6.6	6.3
France	8.2	7.4	8.1	10.2	9.0	8.6
Italy	12.0	11.1	11.6	11.2	10.5	10.7
Canada	8.3	9.3	10.4	10.7	10.0	9.9
Major Seven	7.2	6.9	7.9	8.4	8.3	8.1

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FROM: D SAVAGE (MP1)
DATE: 25 April 1989
x5507

MR ANSON

cc Mr Riley (MP)
Mr Davies (MP1)
Mr MacAuslan (GEP1)
Mr Conaty
MTMP - V2

LONG TERM PROJECTIONS

I attach the note for the Chief Secretary, revised in the light of our meeting last Tuesday.

David Savage

D SAVAGE

SAVAGE
→ ANSON
25/4

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Long Term Projections

This note presents fiscal projections up to the year 2000-01, updating those submitted to the Chief Secretary and the Chancellor by Mr Anson on 19 December 1988. Three alternative cases are considered:

- case A illustrates the implications for the tax burden if the real rate of growth in public spending over the next three years provided for in this year's White Paper were to continue after 1991-92;

- case B calculates the rate of spending growth that would be consistent with a tax burden returning to its 1978-79 level by the mid-1990s;

- and case C calculates the rate of spending growth that would be consistent with a constant tax burden.

2. None of these three cases is of course meant to describe current policy or prescribe what policies should be. The projections are intended simply to illustrate a range of possible trade offs between spending growth and lightening the tax burden.

Assumptions

3. In cases A and B the cash figures for 1989-90 to 1991-92 for expenditure on programmes and for general government expenditure overall are the same (within the margin of rounding to £1 billion) as in the 1988 Autumn Statement, the 1989 PEWP and the 1989 MTFS. The fact that inflation is now expected to be higher than was projected when these cash plans were made will tend to make them more difficult to achieve. On the other hand the outturn for 1988-89 was lower than expected, which permits a somewhat faster growth of cash expenditure in future years (see paragraph 13).

4. We have not used in the projections the MTFS figure for general government expenditure in 1992-93 as this was constrained to a rather low rate of growth - 1 per cent in real terms. Using

this figure would exaggerate the scope for tax reduction (a problem we dealt with in the MTFS by shading down the pre-fiscal adjustment revenue projection for 1992-93).

5. Up to 1992-93 the **PSDR** path is as in the 1989 MTFS; from 1993-94 the budget is balanced. The December exercise assumed an early return to balance by 1990-91 (as in the 1988 MFTS).

6. **Privatisation proceeds** are constant in nominal terms at £5 billion a year (as in the December exercise).

7. **Oil revenues** are as projected in the MTFS up to 1992-93 and thereafter as in last December's exercise. They continue gradually to decline up to the late 1990s and then stabilise at a comparatively low level (0.2 per cent of GDP).

8. Up to 1992-93 **debt interest** is as published in the MTFS; thereafter it has been projected using similar methods to those used in previous long term exercises. With real interest rates declining and the net stock of government debt declining in relation to GDP as GDP grows, net debt interest declines from 2½ per cent of GDP in 1988-89 to 1¼ per cent in 1992-93 and only ½ per cent in 2000-01.

NB

9. The **economic assumptions** are the same as for the MTFS up to 1992-93; thereafter

- output grows by 2½ per cent a year: the assumed slowdown from the 2¾ per cent trend assumed in the MTFS reflects slower growth in the labour force with no offsetting acceleration in productivity.

- inflation continues to decline till 1997-98 when price stability is reached

- real interest rates fall to 3 per cent by 1997-98.

These assumptions are the same as for last December's exercise.

10. The basic assumptions underlying the projections are therefore mostly similar to those used in the December exercise. However the estimated outturn for 1988-89, the base from which the projections are made, has changed substantially. The unexpectedly large PSDR in 1988-89 gives increased scope eventually to lower taxes (from a higher initial level) or raise expenditure (from a lower level). But with the return to a zero PSDR now assumed to be much more gradual, the tax cuts or expenditure increases have to be spread more gradually over a longer run of future years.

11. Finally it should be noted that the projections make no allowance for the effect of the replacement of local authority domestic rates by the Community Charge. This will cause a step increase in 1990-91 in the recorded ratio of public expenditure to GDP by reducing the money value of GDP at market prices.

Results

12. Table 1 summaries the results of the three cases for selected years. More detailed tables of annual figures to 2000-01 are attached to the end of this note.

13. Case A shows the implications for the tax burden of real expenditure on programmes growing at a rate of 3¼ per cent a year after 1991-92. This is the average real rate of increase in the planning total excluding privatisation proceeds over the three years to 1991-92 projected in the 1989 PEWP. In the 1989 MFTS the same cash expenditure figures for 1989-90 to 1991-92 imply slightly faster average real growth of 3½ per cent over the three years as a whole, in spite of higher inflation, because of the lower outturn for 1988-89.

Table 1: Long term fiscal projections: summary of three cases.

	1978-79	1988-89	1991-92	1993-94	1996-97
Real expenditure on programmes growing by 3¼ per cent a year					
Spending on programmes:					
cash (£ billion)	65.7	157.7	196.6	219.3	248.7
real terms*	122.3	147.1	162.6	173.3	190.8
GGE excl privatisation proceeds:					
per cent of GDP	43.2	39.4	38.6	38.4	38.6
Non-oil tax burden:					
per cent of non-oil GDP	34.3	37.4	36.1	35.4	36.1
Tax burden returning to its 1978-79 level					
Spending on programmes:					
cash (£ billion)	65.7	157.7	196.6	215.4	236.4
real terms*	122.3	147.1	162.6	170.2	181.3
GGE excl privatisation proceeds:					
per cent of GDP	43.2	39.4	38.6	37.8	36.8
Non-oil tax burden:					
per cent of non-oil GDP	34.3	37.4	36.1	34.8	34.3
Tax burden constant at its 1988-89 level					
Spending on programmes:					
cash (£ billion)	65.7	157.7	203.8	231.6	257.9
real terms*	122.3	147.1	168.6	183.0	197.8
GGE excl privatisation proceeds:					
per cent of GDP	43.2	39.4	39.9	40.4	39.9
Non-oil tax burden:					
per cent of non-oil GDP	34.3	37.4	37.4	37.4	37.4

*1987-88 prices

14. Up to 1993-94 the non-oil tax burden falls substantially. The disproportionately fast growth in spending on programmes and, to much lesser extents, the declines in oil taxes and privatisation proceeds as percentages of GDP are tending to raise the non-oil tax burden. But these factors are much more than offset by the reduction in the PSDR and the decline in debt interest. From 1993-94, when the budget is balanced and the debt interest burden is declining more slowly, the tax burden gradually rises.

15. Case B shows the levels of expenditure on programmes that would be consistent with continuing to reduce the non-oil tax burden after 1993-94. To get the non-oil tax burden back to its 1978-79 level by 1996-97 would require real expenditure on programmes to grow no faster than 2.2 per cent a year between 1991-92 and 1996-97.

16. Finally, case C shows the levels of expenditure on programmes that would be consistent with holding the tax burden constant at its present (1988-89) level. Merely holding the tax burden constant would allow rapid growth in real spending on programmes of 4.5 per cent a year over the next five years. But after 1993-94 the picture alters. Between then and 1996-97, real expenditure on programmes must grow no faster than 2.6 per cent a year, ie. just fractionally faster than real GDP, if a rise in the tax burden is to be avoided. The decline in net debt interest is tending to permit a faster rate of growth in spending on programmes but this is largely offset by declining privatisation proceeds and oil revenues (as percentages of GDP). The conclusion that for a flat tax burden to be maintained after 1993-94 real expenditure on programmes must grow about in line with GDP holds for any reasonable assumption about GDP growth. Thus were 3 per cent a year GDP growth assumed, real expenditure on programmes could also rise by about 3 per cent a year without raising the tax burden.

17. The basic message is therefore quite simple. Assuming we bring the PSDR back to zero between now and 1993-94, there is room over this period for a fast rate of growth in real spending on programmes without any rise in the tax burden. Thereafter the tax burden will rise if expenditure on programmes rises faster than GDP.

D SAVAGE
MP1

CASE A: REAL EXPENDITURE ON PROGRAMMES GROWING 3.25 PER CENT P.A.

CASH TERMS (BILLION)

	PLANNING TOTAL EXCL PP	DEBT INT PAYMENTS	OTHER ADJ	GGE EXCL PP	GGOVT EXP	NNSEA TAX & CONTR	N SEA TAXES	INTEREST DIVIDEND	OTHER RECEIPTS	GEN GOVT RECEIPTS	PCMOB	PSBR
1973-74	29.3	2.9	-0.3	31.9	31.9	24.9	0.0	1.4	2.0	28.3	0.7	4.3
1978-79	65.7	7.4	1.7	74.8	74.8	58.2	0.6	2.8	4.1	65.7	-0.4	9.2
1986-87	143.8	17.5	7.6	168.9	164.4	142.3	4.8	6.0	6.5	159.7	-1.3	3.4
1987-88	150.9	17.7	8.4	177.0	171.9	156.9	4.7	6.1	6.2	173.8	-1.5	-3.5
1988-89	157.7	18.3	10.2	186.1	179.1	174.1	3.2	6.6	6.9	190.9	-2.1	-13.9
1989-90	172.0	17.1	10.1	199.3	194.3	188.0	2.9	7.0	8.5	206.4	-1.7	-13.8
1990-91	184.4	15.3	10.5	210.2	205.2	195.6	2.6	6.8	8.5	213.6	-1.7	-10.0
1991-92	196.6	14.7	9.5	220.8	215.8	203.8	2.8	6.4	8.6	221.6	-0.2	-6.0
1992-93	208.3	13.7	9.7	231.7	226.7	212.0	2.7	5.8	9.0	229.5	-0.2	-3.0
1993-94	219.3	12.9	10.1	242.3	237.3	220.6	2.2	5.2	9.3	237.3	0.0	0.0
1994-95	229.9	12.0	10.6	252.5	247.5	231.3	1.9	4.6	9.7	247.5	0.0	0.0
1995-96	239.7	11.1	10.9	261.7	256.7	240.7	1.7	4.3	10.0	256.7	0.0	0.0
1996-97	248.7	9.9	11.3	269.9	264.9	249.2	1.6	3.8	10.3	264.9	0.0	0.0
1997-98	256.8	8.9	11.5	277.2	272.2	256.3	1.7	3.6	10.6	272.2	0.0	0.0
1998-99	265.2	8.0	11.8	285.0	280.0	263.9	1.6	3.6	10.9	280.0	0.0	0.0
1999-00	273.8	7.4	12.1	293.3	288.3	272.0	1.6	3.6	11.1	288.3	0.0	0.0
2000-01	282.7	7.0	12.4	302.1	297.1	280.4	1.6	3.7	11.4	297.1	0.0	0.0

PER CENT OF GDP

	PLANNING TOTAL EXCL PP	DEBT INT PAYMENTS	OTHER ADJ	GGE EXCL PP	GGOVT EXP	NNSEA TAX & CONTR	N SEA TAXES	INTEREST DIVIDEND	OTHER RECEIPTS	GEN GOVT RECEIPTS	PCMOB	PSBR
1973-74	39.0	3.9	-0.4	42.5	42.5	33.2	0.0	1.9	2.7	37.7	0.9	5.7
1978-79	38.0	4.3	1.0	43.2	43.2	33.6	0.3	1.6	2.4	38.0	-0.2	5.3
1986-87	37.3	4.5	2.0	43.8	42.6	36.9	1.2	1.6	1.7	41.4	-0.3	0.9
1987-88	35.5	4.2	2.0	41.6	40.4	36.9	1.1	1.4	1.5	40.8	-0.4	-0.8
1988-89	33.4	3.9	2.2	39.4	37.9	36.9	0.7	1.4	1.5	40.4	-0.4	-2.9
1989-90	33.8	3.4	2.0	39.1	38.1	36.9	0.6	1.4	1.7	40.5	-0.3	-2.7
1990-91	34.2	2.8	1.9	39.0	38.0	36.3	0.5	1.3	1.6	39.6	-0.3	-1.9
1991-92	34.4	2.6	1.7	38.6	37.8	35.7	0.5	1.1	1.5	38.8	-0.0	-1.1
1992-93	34.6	2.3	1.6	38.4	37.6	35.2	0.4	1.0	1.5	38.1	-0.0	-0.5
1993-94	34.8	2.0	1.6	38.4	37.7	35.0	0.3	0.8	1.5	37.7	0.0	0.0
1994-95	35.1	1.8	1.6	38.5	37.8	35.3	0.3	0.7	1.5	37.8	0.0	0.0
1995-96	35.3	1.6	1.6	38.6	37.8	35.5	0.3	0.6	1.5	37.8	0.0	0.0
1996-97	35.6	1.4	1.6	38.6	37.9	35.6	0.2	0.5	1.5	37.9	0.0	0.0
1997-98	35.8	1.2	1.6	38.7	38.0	35.8	0.2	0.5	1.5	38.0	0.0	0.0
1998-99	36.1	1.1	1.6	38.8	38.1	35.9	0.2	0.5	1.5	38.1	0.0	0.0
1999-00	36.4	1.0	1.6	39.0	38.3	36.1	0.2	0.5	1.5	38.3	0.0	0.0
2000-01	36.6	0.9	1.6	39.1	38.5	36.3	0.2	0.5	1.5	38.5	0.0	0.0

TAX BURDEN, DEBT RATIO AND EXPENDITURE IN COST TERMS

	GDP (Bn)	NNSGDP GDP(Bn)	TAX BURDEN	NNSTAX BURDEN	GDP DEFLATOR	DEBT	DEBT/GDP	PT EXCL PP AT 1987-88 PRICES PROJECTED	FLAT TAX BURDEN
1973-74	75.1	75.1	33.2	33.2	6.8	N/A	N/A		
1978-79	173.1	169.9	34.0	34.3	10.8	95.3	55.1		
1986-87	385.9	377.9	38.1	37.7	3.4	171.1	44.3		
1987-88	425.6	416.4	38.0	37.7	5.0	171.3	40.2	150.9	150.9
1988-89	472.4	465.9	37.5	37.4	7.2	157.1	33.3	147.1	147.1
1989-90	509.4	502.3	37.5	37.4	5.4	143.7	28.2	152.2	152.2
1990-91	539.4	532.3	36.7	36.7	3.9	133.9	24.8	157.1	160.0
1991-92	571.4	564.2	36.2	36.1	3.0	127.2	22.3	162.6	168.6
1992-93	602.8	595.6	35.6	35.6	2.6	125.7	20.9	167.9	176.6
1993-94	630.2	622.7	35.4	35.4	2.0	125.4	19.9	173.3	183.0
1994-95	655.6	647.8	35.6	35.7	1.5	124.5	19.0	179.0	187.5
1995-96	678.8	670.7	35.7	35.9	1.0	123.9	18.3	184.8	192.6
1996-97	699.2	690.8	35.9	36.1	0.5	121.2	17.3	190.8	197.8
1997-98	716.7	708.1	36.0	36.2	0.0	120.3	16.8	197.0	203.5
1998-99	734.6	725.8	36.1	36.4	0.0	119.3	16.2	203.4	209.2
1999-00	753.0	744.0	36.3	36.6	0.0	118.3	15.7	210.0	214.8
2000-01	771.8	762.6	36.5	36.8	0.0	117.3	15.2	216.8	220.5

CASE B: TAX BURDEN RETURNING TO 1978-79 LEVEL BY 1996-97

CASH TERMS (BILLION)

	PLANNING TOTAL EXCL PP	DEBT INT PAYMENTS	OTHER ADJ	GGE EXCL PP	GGOVT EXP	NNSEA TAX & CONTR	N SEA TAXES	INTEREST DIVIDEND	OTHER RECEIPTS	GEN GOVT RECEIPTS	PCMOB	PSBR
1973-74	29.3	2.9	-0.3	31.9	31.9	24.9	0.0	1.4	2.0	28.3	0.7	4.3
1978-79	65.7	7.4	1.7	74.8	74.8	58.2	0.6	2.8	4.1	65.7	-0.4	9.2
1986-87	143.8	17.5	7.6	168.9	164.4	142.3	4.8	6.0	6.5	159.7	-1.3	3.4
1987-88	150.9	17.7	8.4	177.0	171.9	156.9	4.7	6.1	6.2	173.8	-1.5	-3.5
1988-89	157.7	18.3	10.2	186.1	179.1	174.1	3.2	6.6	6.9	190.9	-2.1	-13.9
1989-90	172.1	17.1	10.1	199.3	194.3	188.0	2.9	7.0	8.5	206.4	-1.7	-13.8
1990-91	184.4	15.3	10.5	210.2	205.2	195.6	2.6	6.8	8.5	213.5	-1.7	-10.0
1991-92	196.6	14.7	9.5	220.8	215.8	203.8	2.8	6.4	8.6	221.6	-0.2	-6.0
1992-93	205.3	13.7	9.7	228.7	223.7	209.0	2.7	5.8	9.0	226.5	-0.2	-3.0
1993-94	215.4	12.9	10.1	238.4	233.4	216.7	2.2	5.2	9.3	233.4	0.0	0.0
1994-95	222.7	12.0	10.6	245.3	240.3	224.1	1.9	4.6	9.7	240.3	0.0	0.0
1995-96	229.7	11.1	10.9	251.7	246.7	230.7	1.7	4.3	10.0	246.7	0.0	0.0
1996-97	236.4	9.9	11.3	257.6	252.6	236.9	1.6	3.8	10.3	252.6	0.0	0.0
1997-98	243.4	8.9	11.5	263.8	258.8	242.9	1.7	3.6	10.6	258.8	0.0	0.0
1998-99	250.2	8.0	11.8	270.0	265.0	248.9	1.6	3.6	10.9	265.0	0.0	0.0
1999-00	257.0	7.4	12.1	276.5	271.5	255.2	1.6	3.6	11.1	271.5	0.0	0.0
2000-01	263.9	7.0	12.4	283.3	278.3	261.6	1.6	3.7	11.4	278.3	0.0	0.0

PER CENT OF GDP

	PLANNING TOTAL EXCL PP	DEBT INT PAYMENTS	OTHER ADJ	GGE EXCL PP	GGOVT EXP	NNSEA TAX & CONTR	N SEA TAXES	INTEREST DIVIDEND	OTHER RECEIPTS	GEN GOVT RECEIPTS	PCMOB	PSBR
1973-74	39.0	3.9	-0.4	42.5	42.5	33.2	0.0	1.9	2.7	37.7	0.9	5.7
1978-79	38.0	4.3	1.0	43.2	43.2	33.6	0.3	1.6	2.4	38.0	-0.2	5.3
1986-87	37.3	4.5	2.0	43.8	42.6	36.9	1.2	1.6	1.7	41.4	-0.3	0.9
1987-88	35.5	4.2	2.0	41.6	40.4	36.9	1.1	1.4	1.5	40.8	-0.4	-0.8
1988-89	33.4	3.9	2.2	39.4	37.9	36.9	0.7	1.4	1.5	40.4	-0.4	-2.9
1989-90	33.8	3.4	2.0	39.1	38.1	36.9	0.6	1.4	1.7	40.5	-0.3	-2.7
1990-91	34.2	2.8	1.9	39.0	38.0	36.3	0.5	1.3	1.6	39.6	-0.3	-1.9
1991-92	34.4	2.6	1.7	38.6	37.8	35.7	0.5	1.1	1.5	38.8	-0.0	-1.1
1992-93	34.1	2.3	1.6	37.9	37.1	34.7	0.4	1.0	1.5	37.6	-0.0	-0.5
1993-94	34.2	2.0	1.6	37.8	37.0	34.4	0.3	0.8	1.5	37.0	0.0	0.0
1994-95	34.0	1.8	1.6	37.4	36.7	34.2	0.3	0.7	1.5	36.7	0.0	0.0
1995-96	33.8	1.6	1.6	37.1	36.3	34.0	0.3	0.6	1.5	36.3	0.0	0.0
1996-97	33.8	1.4	1.6	36.8	36.1	33.9	0.2	0.5	1.5	36.1	0.0	0.0
1997-98	34.0	1.2	1.6	36.8	36.1	33.9	0.2	0.5	1.5	36.1	0.0	0.0
1998-99	34.1	1.1	1.6	36.8	36.1	33.9	0.2	0.5	1.5	36.1	0.0	0.0
1999-00	34.1	1.0	1.6	36.7	36.1	33.9	0.2	0.5	1.5	36.1	0.0	0.0
2000-01	34.2	0.9	1.6	36.7	36.1	33.9	0.2	0.5	1.5	36.1	0.0	0.0

TAX BURDEN,DEBT RATIO AND EXPENDITURE IN COST TERMS

								PT EXCL PP AT 1987-88 PRICES	
	GDP (Bn)	NNSGDP GDP(Bn)	TAX BURDEN	NNSTAX BURDEN	GDP DEFLATOR	DEBT	DEBT/GDP	DECLINING TAX BURDEN	FLAT TAX BURDEN
1973-74	75.1	75.1	33.2	33.2	6.8	N/A	N/A		
1978-79	173.1	169.9	34.0	34.3	10.8	95.3	55.1		
1986-87	385.9	377.9	38.1	37.7	3.4	171.1	44.3		
1987-88	425.6	416.4	38.0	37.7	5.0	171.3	40.2	150.9	150.9
1988-89	472.4	465.9	37.5	37.4	7.2	157.1	33.3	147.1	147.1
1989-90	509.4	502.3	37.5	37.4	5.4	143.7	28.2	152.3	152.2
1990-91	539.4	532.3	36.7	36.7	3.9	133.9	24.8	157.1	160.0
1991-92	571.4	564.2	36.2	36.1	3.0	127.2	22.3	162.6	168.6
1992-93	602.8	595.6	35.1	35.1	2.6	125.7	20.9	165.5	176.6
1993-94	630.2	622.7	34.7	34.8	2.0	125.4	19.9	170.2	183.0
1994-95	655.6	647.8	34.5	34.6	1.5	124.5	19.0	173.4	187.5
1995-96	678.8	670.7	34.2	34.4	1.0	123.9	18.3	177.1	192.6
1996-97	699.2	690.8	34.1	34.3	0.5	121.2	17.3	181.3	197.8
1997-98	716.7	708.1	34.1	34.3	0.0	120.3	16.8	186.7	203.5
1998-99	734.6	725.8	34.1	34.3	0.0	119.3	16.2	191.9	209.2
1999-00	753.0	744.0	34.1	34.3	0.0	118.3	15.7	197.1	214.8
2000-01	771.8	762.6	34.1	34.3	0.0	117.3	15.2	202.4	220.5

CASE C: FLAT TAX BURDEN

CASH TERMS (BILLION)

	PLANNING TOTAL EXCL PP	DEBT INT PAYMENTS	OTHER ADJ	GGE EXCL PP	GGOVT EXP	NNSEA TAX & CONTR	N SEA TAXES	INTEREST DIVIDEND	OTHER RECEIPTS	GEN GOVT RECEIPTS	PCMOB	PSBR
1973-74	29.3	2.9	-0.3	31.9	31.9	24.9	0.0	1.4	2.0	28.3	0.7	4.3
1978-79	65.7	7.4	1.7	74.8	74.8	58.2	0.6	2.8	4.1	65.7	-0.4	9.2
1986-87	143.8	17.5	7.6	168.9	164.4	142.3	4.8	6.0	6.5	159.7	-1.3	3.4
1987-88	150.9	17.7	8.4	177.0	171.9	156.9	4.7	6.1	6.2	173.8	-1.5	-3.5
1988-89	157.7	18.3	10.2	186.1	179.1	174.1	3.2	6.6	6.9	190.9	-2.1	-13.9
1989-90	172.0	17.1	10.1	199.2	194.2	187.9	2.9	7.0	8.5	206.3	-1.7	-13.8
1990-91	187.9	15.3	10.5	213.7	208.7	199.1	2.6	6.8	8.5	217.0	-1.7	-10.0
1991-92	203.8	14.7	9.5	228.0	223.0	211.0	2.8	6.4	8.6	228.8	-0.2	-6.0
1992-93	219.1	13.7	9.7	242.5	237.5	222.8	2.7	5.8	9.0	240.3	-0.2	-3.0
1993-94	231.6	12.9	10.1	254.6	249.6	232.9	2.2	5.2	9.3	249.6	0.0	0.0
1994-95	240.9	12.0	10.6	263.5	258.5	242.3	1.9	4.6	9.7	258.5	0.0	0.0
1995-96	249.8	11.1	10.9	271.8	266.8	250.8	1.7	4.3	10.0	266.8	0.0	0.0
1996-97	257.9	9.9	11.3	279.1	274.1	258.4	1.6	3.8	10.3	274.1	0.0	0.0
1997-98	265.3	8.9	11.5	285.7	280.7	264.8	1.7	3.6	10.6	280.7	0.0	0.0
1998-99	272.7	8.0	11.8	292.5	287.5	271.4	1.6	3.6	10.9	287.5	0.0	0.0
1999-00	280.1	7.4	12.1	299.6	294.6	278.3	1.6	3.6	11.1	294.6	0.0	0.0
2000-01	287.5	7.0	12.4	306.9	301.9	285.2	1.6	3.7	11.4	301.9	0.0	0.0

PER CENT OF GDP

	PLANNING TOTAL EXCL PP	DEBT INT PAYMENTS	OTHER ADJ	GGE EXCL PP	GGOVT EXP	NNSEA TAX & CONTR	N SEA TAXES	INTEREST DIVIDEND	OTHER RECEIPTS	GEN GOVT RECEIPTS	PCMOB	PSBR
1973-74	39.0	3.9	-0.4	42.5	42.5	33.2	0.0	1.9	2.7	37.7	0.9	5.7
1978-79	38.0	4.3	1.0	43.2	43.2	33.6	0.3	1.6	2.4	38.0	-0.2	5.3
1986-87	37.3	4.5	2.0	43.8	42.6	36.9	1.2	1.6	1.7	41.4	-0.3	0.9
1987-88	35.5	4.2	2.0	41.6	40.4	36.9	1.1	1.4	1.5	40.8	-0.4	-0.8
1988-89	33.4	3.9	2.2	39.4	37.9	36.9	0.7	1.4	1.5	40.4	-0.4	-2.9
1989-90	33.8	3.4	2.0	39.1	38.1	36.9	0.6	1.4	1.7	40.5	-0.3	-2.7
1990-91	34.8	2.8	1.9	39.6	38.7	36.9	0.5	1.3	1.6	40.2	-0.3	-1.9
1991-92	35.7	2.6	1.7	39.9	39.0	36.9	0.5	1.1	1.5	40.0	-0.0	-1.1
1992-93	36.3	2.3	1.6	40.2	39.4	37.0	0.4	1.0	1.5	39.9	-0.0	-0.5
1993-94	36.7	2.0	1.6	40.4	39.6	37.0	0.3	0.8	1.5	39.6	0.0	0.0
1994-95	36.7	1.8	1.6	40.2	39.4	37.0	0.3	0.7	1.5	39.4	0.0	0.0
1995-96	36.8	1.6	1.6	40.0	39.3	37.0	0.3	0.6	1.5	39.3	0.0	0.0
1996-97	36.9	1.4	1.6	39.9	39.2	37.0	0.2	0.5	1.5	39.2	0.0	0.0
1997-98	37.0	1.2	1.6	39.9	39.2	37.0	0.2	0.5	1.5	39.2	0.0	0.0
1998-99	37.1	1.1	1.6	39.8	39.1	37.0	0.2	0.5	1.5	39.1	0.0	0.0
1999-00	37.2	1.0	1.6	39.8	39.1	37.0	0.2	0.5	1.5	39.1	0.0	0.0
2000-01	37.3	0.9	1.6	39.8	39.1	37.0	0.2	0.5	1.5	39.1	0.0	0.0

TAX BURDEN, DEBT RATIO AND EXPENDITURE IN COST TERMS

	GDP (Bn)	NNSGDP GDP(Bn)	TAX BURDEN	NNSTAX BURDEN	GDP DEFLATOR	DEBT	DEBT/GDP	PT EXCL PP AT 1987-88 PRICES ACTUAL	FLAT TAX BURDEN
1973-74	75.1	75.1	33.2	33.2	6.8	N/A	N/A		
1978-79	173.1	169.9	34.0	34.3	10.8	95.3	55.1		
1986-87	385.9	377.9	38.1	37.7	3.4	171.1	44.3		
1987-88	425.6	416.4	38.0	37.7	5.0	171.3	40.2	150.9	150.9
1988-89	472.4	465.9	37.5	37.4	7.2	157.1	33.3	147.1	147.1
1989-90	509.4	502.3	37.4	37.4	5.4	143.7	28.2	152.2	152.2
1990-91	539.4	532.3	37.4	37.4	3.9	133.9	24.8	160.0	160.0
1991-92	571.4	564.2	37.4	37.4	3.0	127.2	22.3	168.6	168.6
1992-93	602.8	595.6	37.4	37.4	2.6	125.7	20.9	176.6	176.6
1993-94	630.2	622.7	37.3	37.4	2.0	125.4	19.9	183.0	183.0
1994-95	655.6	647.8	37.2	37.4	1.5	124.5	19.0	187.5	187.5
1995-96	678.8	670.7	37.2	37.4	1.0	123.9	18.3	192.6	192.6
1996-97	699.2	690.8	37.2	37.4	0.5	121.2	17.3	197.8	197.8
1997-98	716.7	708.1	37.2	37.4	0.0	120.3	16.8	203.5	203.5
1998-99	734.6	725.8	37.2	37.4	0.0	119.3	16.2	209.2	209.2
1999-00	753.0	744.0	37.2	37.4	0.0	118.3	15.7	214.8	214.8
2000-01	771.8	762.6	37.2	37.4	0.0	117.3	15.2	220.5	220.5

Annex: Comparison with December results

(i) Up to 1991-92

1. The conclusion of the December exercise was that, on the assumption of a zero PSDR after 1989-90 and with 3¼ per cent a year growth in real spending on programmes, the non-oil tax burden would fall by 1¾ per cent of GDP between 1988-89 and 1991-92. On a similar assumption about spending on programmes, the present exercise shows a smaller decline of 1¼ per cent in the tax burden though with a PSDR still 1 per cent of GDP in 1991-92. A detailed comparison is given in the attached table.

(ii) after 1991-92

2. In December we calculated that for a flat tax burden to be maintained after 1991-92 real spending on programmes must grow about in line with GDP. On the PSDR path now being assumed, real spending on programmes could continue to grow faster than GDP up to 1993-94, when budget balance is reached, without raising the tax burden. Thereafter, as in the December exercise, a flat tax burden would require an approximately flat ratio of spending on programmes to GDP.

Comparisons of December projections and those in Case A

	Percentages of GDP		
	Levels		Changes
	1988-89	1991-92	1988-89 to 1991-92
December exercise			
Total GGE	38.4	38.0	- 0.4
Total receipts	40.1	38.0	- 2.1
PCMOB	- 0.4	0.0	0.4
PSBR	- 2.1	0.0	2.1
Spending on programmes*	33.9	34.6	0.7
Tax burden**	37.2	35.4	- 1.8
Case A			
Total GGE	37.9	37.8	- 0.1
Total receipts	40.4	38.8	- 1.6
PCMOB	- 0.4	0.0	0.4
PSBR	- 2.9	- 1.1	1.8
Spending on programmes*	33.4	34.4	1.0
Tax Burden**	37.4	36.1	- 1.3

* Planning total excluding privatisation proceeds.
** Non-oil taxes as per cent of non-oil GDP.

SECRET

1. Another way of putting X is to point out continuing need to contain growth of total spending.
2. Perhaps we could have real growth of GGE (ex pp) (a) 1984/5 to 1988/9 & (b) 1984/5 to 1989/90 in cash.

FROM: J. ANSON
9th May, 1989.
Ext. 4370

CHIEF SECRETARY

c.c. Chancellor
Sir P. Middleton
Sir T. Burns
Dame A. Mueller
Mr. Hardcastle
Mr. Monck
Mr. Phillips
Mr. Scholar
Mr. Edwards
Mrs. Lomax
Mr. Riley
Mr. Spackman
Mrs. R. Butler
Mr. S. J. Davies
Mr. MacAuslan
Mr. Mowl
Mr. Potter
Mr. Richardson
Mr. Gieve
Mr. D. Savage
Miss Walker
Mr. Call

Ch/ This shows just how tough maintaining a declining GGE/GDP path will be – even in the medium term and even if we abstract from the unfortunate statistical blip caused by the community charge. DJS

ANSON
→ CST
9/5

PROSPECTS FOR THE SURVEY

In preparation for your forthcoming talk with the Prime Minister, Mr. MacAuslan has been pulling together the results of your talks with individual expenditure divisions. The outcome is summarised in his minute of 8th May (flag A).

Long-term projections of tax burden

2. As background to this, Mr. Savage has also updated the long-term fiscal projections which you last saw in January. His note at flag B summarises the results. For continuity with the projections you have seen earlier, this is still written in terms of GGE and the old definition of "spending on programmes". This familiar presentation is more helpful in giving one a feel for the difficulty of the decisions which may be involved, but for the

purpose of the next Autumn Statement the key figures are those for GGE. Also for convenience, I use below the term "GGE ratio" as shorthand for the ratio of GGE (excluding privatisation proceeds) to GDP.

3. The note illustrates the prospects by examining three alternative scenarios (none of which, of course, is meant to represent a policy prescription). The first of these (case A) shows the result of holding to the Autumn Statement cash totals and continuing thereafter the same real growth in spending on programmes (3¼ per cent as in the Autumn Statement). This produces a reduction in the non-oil tax burden so long as the PSDR declines; but a gradual increase in the tax burden, and in the GGE ratio, from 1993-94 onwards. The non-oil tax burden bottoms out at 35.4, which is still higher than in 1978-79.

4. The second scenario (case B) therefore examines what action would be needed on expenditure in order to get the non-oil tax burden back to its 1978-79 level. To achieve that by 1996-97, starting from the Autumn Statement cash figures for the first two years, requires a slower real growth of programmes (2¼ per cent) thereafter. What might seem not too ambitious a target for the tax burden therefore requires very rigorous action indeed on expenditure by the standards of past Surveys.

5. The third scenario (case C) simply computes the expenditure profile consistent with a level non-oil tax burden from 1988-89 onwards. This would leave headroom, compared with the Autumn Statement, of roughly £3½ billion next year and £7 billion the year after. In the later years, however, the long-term growth of programmes would still need to moderate to around 2½ per cent. This scenario is purely an illustrative case and in no sense a satisfactory policy outcome, since it would not reduce the non-oil tax burden at all, and the GGE ratio would rise at once. But it does show how little room for relaxation there is if there is to be any significant reduction in the tax burden at all.

Survey background

6. One further technical point needs to be mentioned at this stage. For the reasons explained in Annex C to Mr. MacAuslan's note, the introduction of the Community Charge will produce a step change in the figures for GDP, causing the GGE ratio to be nearly ¾ of a percentage point higher in 1990-91 and later years than it would otherwise have been. Clearly we could not also offset an increase of that size in the Survey, and it will therefore need to be explained in the Autumn Statement as a technical adjustment. This will further complicate what will anyway be a difficult presentation. But except where it is specifically mentioned, the discussion below leaves it out of account and concentrates on the underlying trend.

7. Given the policy to maintain a declining GGE ratio in the medium term, one approach to this Survey would be to ask what headroom would be available before the GGE ratio would be held simply at its 1988-89 level. As the 1988-89 ratio has now probably slipped down to 39¼, this comes out at rather over £2 billion next year and £4 billion the year after. In order to maintain a continuing decline in the GGE ratio, the increases conceded in the Survey therefore need to be significantly less than those amounts, plus whatever can be released from the Reserve.

8. The shortfall in 1988-89 was quite exceptional and unlikely to be repeated (see Mr. Richardson's first report of 5th May on the prospects for the current year). To some extent this unexpectedly successful outcome reflected the rapid growth of the economy in the past two years. The GGE ratio currently envisaged for 1989-90 is 2½ percentage points lower than was envisaged in the 1987 Autumn Statement. It would not therefore be surprising if the ratio were to flatten out in the next year or two as the economy slows down; and even some slight increase could still imply a creditable performance by comparison with previous plans. It may prove necessary in the Autumn Statement to recognise that the 1988-89 ratio was aberrantly below trend and therefore that the ratio may not show a continuous decline in every year. But in that case it will be all the more important to demonstrate an adequate decline over the medium-term.

Possible Survey outcomes

9. Against that background, Mr. MacAuslan's analysis suggests that a realistic outcome of the Survey might be increases in GGE of £5½ billion, £6½ billion and £9¼ billion. The individual components are, of course, at this stage not precise. But the totals are disturbing. These figures would produce a run of figures for the GGE ratio as follows:

GGE (excluding privatisation proceeds) as percentages of GDP

	1987-88	1988-89	1989-90	1990-91	1991-92	1992-93
FSBR	41½	39½	39¼	39	38¾	38
New figures:						
(a) underlying trend	41½	39¼	39¼	40	39¾	39½
(b) after "community charge effect" (para 6 above)	41½	39¼	39½	40¾	40½	40¼

10. We shall need to look more carefully at all the components of this when we have scrutinised the bids. For example, Mr. MacAuslan has assumed drawing down the Reserve by £3½ billion in each year, which is what we would have done under the old planning total regime. As he says, it would be possible to draw down the Reserve by rather more than that, consistently with the submission on the new planning total which we gave you last month. On the other hand, the local authority figures, outside the new planning total, could turn out worse.

Yes

11. Even so, an outcome of the order which Mr. MacAuslan describes is much too close to Case C (in paragraph 5 above) for comfort. And the GGE ratios, even after explaining away the technical point about the community charge and presenting the 1988-89 figure as aberrantly low, would still be much less good than those in the FSBR.

12. In the Survey itself, and in the local authority discussions in the Summer, we shall therefore need to do what we can to improve on the possible outcomes which Mr. MacAuslan has brought together in his note. In particular, having already got below the 40 per cent barrier, you will not want to show the ratio exceeding that figure again (apart from the technical adjustment); and even if the ratio in the first Survey year turns out higher than in 1988-89, you will want to show some subsequent decline through the three years of the Survey.

13. At your meeting with the Prime Minister next week you will want to bring out how limited the room for manoeuvre will be. She is already aware that departments will feel encouraged by the large PSDR to submit bigger bids although this would ignore the need for fiscal caution if inflation is not to be rekindled. Mr. MacAuslan will be letting you have a short draft minute to send to her later this week, taking account of any immediate reactions which you may have to these papers - which you may in any case want to discuss with us.

J. ANSON

gep.md/may/jacst8

SECRET

FROM: J MACAUSLAN (GEP1)
DATE: 9 MAY 1989
x 4780

Note above

1 MR ANSON A 9/5

2 CHIEF SECRETARY

copies attached for:

Chancellor
Sir Peter Middleton
Mr Anson

cc: Mr Monck
Mr Phillips
Mr Edwards
Mrs Lomax
Mr Sedgwick
Mrs Butler
Mr Mowl
Mr Potter
Mr Richardson
Miss Walker

MACAUSLAN → CST 9/5

1989 PUBLIC EXPENDITURE SURVEY

You and the Chancellor are to meet the Prime Minister on 17 May to discuss the prospects for the Survey. This note offers, as background, an assessment of the prospects in the light of the meetings you have held with divisions.

2. Annex A shows a guess at the possible additions in the 1989 Survey, based on divisions' assessments and the outcome of the meetings we have had with you. This is obviously very speculative, especially since the bids are not yet in.

3. Annex B shows, for comparison, the figures emerging from the 1988 Survey.

Bids

4. The bids in the 1989 Survey may be on a similar scale to those submitted last year. The figures in Annex A summarise the extent to which divisions think bids may need to be conceded.

5. Of the £7 billion total for 1990-91, about £1 billion reflect commitments already made. This category includes

- £400 million for the change to the pensioners' earnings rule,

- £200 million for poorer pensioners,

- £100 million for community charge benefits,

- £115 million for student loans.

6. Another £3 billion or so reflects bids which, if made, would be extremely difficult to resist. This includes:

- about £400 million for the effects on social security of revised economic assumptions (principally higher inflation) and estimating changes;

?

- about £400 million for electricity exit EFLs (very speculative);

- about £200 million each for the roads review and for coal restructuring;

- around £¾-1 billion for health (to cover the effects of the 1989 Review Body awards, the costs of the NHS review, service development, extra capital investment and possibly community care).

7. The other main items for 1990-91 in Annex A include

- £1 billion for RSG and NNDR,

- some £½ billion or more for housing and other environmental bids,

- about £½ billion for territorial formula consequences,

- about £¼ billion each for other transport investment, prisons and courts etc, and education bids.

8. Finally, we may need to provide for substantial increases for self-financed local authority expenditure, outside the new planning total, but within GGE.

Assessment

9. Four main points emerged from your recent round of meetings:

(a) the main additions for 1990-91 seem likely to be on health, social security, and grants to local authorities (about £1 billion each).

(b) significant infrastructure bids are building up within the Survey period, especially on transport. The health increases also build up quickly. These increases are likely to continue to escalate beyond the Survey period, causing difficulties in later Surveys. To a large extent they reflect decisions already taken (at least in principle).

(c) substantial increases may again be necessary for other public services (law and order, education, environment); and, even if the 3 year deal with MOD holds for the first 2 years of the Survey (as assumed in Annex A), a hefty bid for 1992-93 is probable.

(d) we cannot realistically expect reductions on anything like the same scale as last year - in particular, on unemployment, housing receipts, or the nationalised industries.

10. The final point is worth stressing. In your strategy meeting with Groups, we identified possible savings from freezing Child Benefit, from land sales and cost improvement for health, and from the Employment and (just possibly) DTI programmes. The savings we identified total less than £1 billion in 1990-91. It is only to be expected that much of the policy fat has been squeezed out after ten years of rigorous scrutiny. In the last Survey, of course you got savings of over £6 billion a year. That, in large part, reflected the benefits of faster economic growth for which we have now taken full credit.

11. We have some room to accommodate higher spending on key programmes. The Reserve has been set at £3½/7/10½ billion in each of the last 2 Surveys. If we set it at the same level this year, we could drawdown £3½ billion each year. The introduction of the new planning total may affect the judgement on the size of the Reserve. Drawdown could be a little bigger.

12. Outside the new planning total, but within GGE, there is no reason to expect any help from debt interest or other national accounts adjustments; but (if we are to publish realistic figures for GGE) we may need to allow £2 billion or more for higher "self-financed" local authority expenditure than implied by the 1988 Survey. (None of this takes any account of some possible classification changes in the pipeline; we will submit separately on those).

13. All this points to a net addition to GGE excluding privatisation proceeds in 1990-91 of perhaps over £5 billion. This would be well in excess of the net additions made in recent Surveys. It would also add around 1 percentage point to the GGE ratios.

14. Annex C explains the effect that the replacement of rates by the community charge will have on measured money GDP. The 1990-91 GGE ratio (39 per cent in the last White Paper) will be pushed up to about 39¾ per cent. There is a real prospect that an extra £5 billion would take the ratio to about 40¾ per cent.

15. By the time of the Autumn Statement we may have revised the money GDP figures, at least for the earlier years; but for the moment the MTFS figures remain our best estimate. On that basis there is a clear risk that the ratios for each of the 3 new Survey years will be above 40 per cent. There is also a risk that we will not be able to present them as lower than the ratios for either 1988-89 or 1989-90, even without the community charge effect. It will be all the more essential to maintain the medium term decline.

16. These figures imply an average real growth rate of GGE excluding privatisation proceeds from 1989-90 to 1992-93 of about 2¾ per cent. This compares with 1¾ per cent projected in the Autumn Statement for 1988-89 to 1991-92. The increase reflects among other things the partial unwinding of the real terms squeeze on departments' spending that has been occurring in recent years. We may in fact not have fully taken on board in this assessment the extent to which departments' fears of higher inflation will add to pressures for increases, which may also escalate in the later years more than suggested here.

17. Carys Evans' note of 3 May asked for a short minute for you to send to the Prime Minister. I attach at Annex D a rough outline of the sorts of points that the note to the Prime Minister might cover. We are still working on it; but if in the meantime you have any reactions, we would be grateful for them. We will put a full draft to you shortly, along with some briefing.

JM

J MACAUSLAN

gep1.ip/jm/surv add

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ANNEX A

POSSIBLE 1989 SURVEY ADDITIONS

(£ billion)	1990-91	1991-92	1992-93
MOD	0.1	0.1	¾
FCO/ODA/MAFF/DTI/DE	-	-	-
DTp	½	¾	1¼
DOE	½	¾	¾
HO/Legal	½	½	½
DES	½	½	½
DH	1	1½	2
DSS	1	1	1
DEn	¾	¼	¼
Other	1¼	1¼	1½
European Communities	¼	¼	¼
Aggregate Exchequer Finance	1	1¼	1¼
Change to programmes in new planning total	7	7¾	10¼ *
Local authority outside new planning total	2	2¼	2½ *
Drawdown of Reserve	-3½	-3½	-3½
Change to GGE	5½	6½	9¼
GGE ex priv proc	215½	227¼	237¾
GGE as % of GDP	**40**	**39¾**	**39½**
Adjusted for effect of Community charge	40¾	40½	40¼

* Equals change to programmes in old planning total; equivalent to "net change to programmes" in Annex B.

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ANNEX B

OUTCOME OF 1988 SURVEY

(£ billion)	1989-90	1990-91	1991-92	1992-93*
Gross bids				
- submitted	12	16	21	
- agreed	10	13½	18½	
Offsetting savings				
- unemployment	-1½	-1¾	-1¾	
- housing etc receipts	-2	-1½	-1½	
- IBAP	-½	-½	-¼	
- Nat inds	-½	-¾	-1	
- Other	-1½	-1¾	-2½	
	-6¼	-6½	-7¼	
Net Change to programmes	+3½	+6¾	+11¼	
Drawdown of Reserve	-3½	-3½	-3½	
Change to planning total	**0**	**+3¼**	**+7¾**	
Change to GGE	+½	+3	+6	
GGE ex priv proc	199	210	221	229
% of GDP	**39¼**	**39**	**38¾**	**38**
Adjusted for effect of community charge	39½	39¾	39½	38¾

* FSBR projections

ANNEX C

GGE/GDP RATIOS AND THE COMMUNITY CHARGE

This annex sets out the impact of the community charge on the GGE/GDP ratios.

2. Domestic rates are classified as an expenditure tax and therefore add to money GDP at market prices. The community charge will not be so treated and GDP will therefore be lower than otherwise. There will be a small effect this year (1989-90) with the introduction of the charge in Scotland. The full effect will be felt in 1990-91 when it is introduced in England and Wales.

3. In the run up to the Budget, it was assessed that the introduction of the community charge would cause the ratio to be nearly ¾ of a percentage point higher in 1990-91 than it would otherwise have been. Applying this to the FSBR ratio for 1990-91 would put the figure at 39¾ (excluding privatisation proceeds), ½ a percentage point higher than our latest estimate for 1988-89.

4. A similar increase will affect 1991-92 and later years. But it will not affect the earlier years. There will therefore be a step increase in 1990-91.

ANNEX D

DRAFT MINUTE FOR PM: POINTS TO MAKE

1. Past achievement: sharp, sustained reduction in GGE ratio through overall restraint helped by successful economic policies. Increases in key programmes required rigorous scrutiny of priorities.

2. From now on, the going is bound to be tougher:

- less policy fat after 10 years;
- already taken full credit for economic success (and immediate economic outlook less helpful).

Reflected in outcome of 1988 Survey, which implied very little further decline in GGE ratio.

3. Important not to let up. Budget surplus offers less room for manoeuvre than commonly supposed. Need for caution in reducing PSDR, until inflation brought down. Important to maintain medium term downward trend in GGE ratio (especially if temporary blip up). And further decisive reduction in GGE ratio, relative to present plans, needed to get back to 1978-79 tax burden.

X

4. Against this background, prospects for coming Survey are sobering:-

- lots of substantial claims (and commitments), eg health, roads, social security;
- local authorities: special problem given first year of community charge in England and Wales. But not solved by throwing money at it; would just enable local authorities to spend more;
- scope for offsetting reductions up to £5 billion less than last year (eg less help from LA receipts).

5. Conclusion: inescapable need for difficult choices this year. First challenge: E(LF). Local authorities settlement will have major impact on rest of Survey.

cst.ps/6jm11.5/mins

SECRET

FROM: CHIEF SECRETARY
DATE: 12 May 1989

cc Chancellor
Sir Peter Middleton
Mr Anson Sir Terence Burns
Mr Monck Mr H Phillips
Mrs Lomax Mr Riley
Mr MacAuslan Mr Sedgwick Mrs S Walker

CST
→ P.M
12/5

PRIME MINISTER

1989 SURVEY

We are to discuss next week the prospects for the 1989 public expenditure Survey.

2. Public expenditure restraint has been a key instrument of our economic strategy over the past ten years. We have held the growth of public spending below that of money GDP, in order to eliminate the borrowing requirement and to make room for reductions in the tax burden. Since 1982-83, the ratio of government spending to GDP has fallen by 7 percentage points, bringing it, for the first time in 20 years, to under 40 per cent.

3. But our success in controlling expenditure has been used primarily to tighten the fiscal stance. The tax burden has fallen only slightly since the 1981-82 peak, and is still well above the 1978-79 level. If we are to get below that level we must continue to keep a firm grip on expenditure.

4. We have been helped in the last year or two by very strong economic growth. That pushed up money GDP; it also meant savings on expenditure from lower unemployment, more housing sales, better performance by the nationalised industries, and lower debt interest. We took credit in the expenditure plans announced after the 1988 Survey for the progress thus made. We were able to increase provision for key programmes, and find sufficient savings to maintain a modest decline in the ratio of government spending to GDP.

5. The outlook for the 1989 Survey must at this stage remain uncertain - as regards both the extent of spending pressures and the path of the economy. But we have no reason at present to expect anything other than the slowdown in the growth of money GDP projected in the Budget; and some of the developments which worked in our favour in the last Survey will not do so this time.

SECRET

6. As for spending, I have reviewed the prospects for each department carefully. It is clear that after 10 years of searching scrutiny it will be far more difficult to find offsetting policy savings than in the past. It is therefore essential to achieve any savings that are available, and to restrict increases in all but the highest priority areas.

7. There will be strong upward pressure on many spending programmes. The bids will reflect the commitments we have already made (adding about £1 billion to expenditure in 1990-91) and other proposals are already in view which are unavoidable and amount to another £2½ billion or so.

8. Any increase in investment in housing, rail, or prisons, and any extra for education and science or an expansion of the health service would have to come on top of that. Departments will also be very conscious of the prospects for inflation, particularly those whose programmes have been squeezed because inflation has turned out higher than when last year's plans were set.

9. There will also be great pressure this year for higher grant to local authorities so as to keep down the levels of the community charge in the year of its introduction. However, there is a real danger here that any extra grant would simply pass through into higher spending and not be used to hold down community charges. Some councils will undoubtedly set a high community charge in order to embarrass the Government. There is clear evidence of that in Scotland, where councils have increased the community charge further than was required, even to finance the excessive levels of spending they budgeted for.

10. It will be important for colleagues to understand that the budget surplus is not a cornucopia. The prospect is that a good deal of it will automatically disappear as economic growth moderates. Spending it incautiously would risk fuelling inflation, and as I indicated in paragraph 3 above, it needs to be dedicated to reducing the tax burden if we are ever to bring it back to the level we inherited ten years ago - which we regarded as too high at the time.

11. Since savings this year will not be available on the scale of last year, neither can we afford increases on last year's scale without damage to our general policy. The first decision - and politically one of the most difficult - will be the settlement for local authorities in E(LF). The outcome of that will inevitably have a major impact on the rest of the Survey. I conclude that, as ever, difficult choices will be inescapable.

John M.

JOHN MAJOR

GRAY TO EVANS NOTE OF MTG 17 MAY

PMP

~~PMP~~

BF No 10 mtg 25/5 folder

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

17 May 1989

Dear Carys,

PUBLIC EXPENDITURE

The Prime Minister had a discussion this afternoon with the Chancellor and the Chief Secretary about the prospects for the 1989 Public Expenditure Survey. Sir Robin Butler and Richard Wilson (Cabinet Office) were also present.

I should be grateful if you and copy recipients would ensure that no further copies of this letter are taken.

privatisation proceeds

The Chancellor said that the public expenditure negotiations this year were likely to be more difficult than ever. To some extent the Treasury would be the victim of the success in controlling public spending in the recent past; general government spending excluding expenditure had risen by only 1 per cent in real terms in total over the last five years.

The Chief Secretary agreed with this assessment. He thought that there would be a number of difficulties this year that had not been experienced, at any rate not to the same extent, in the past. First, after ten years of the present government, politically feasibile policy savings were very hard to find. The main possibilities he had identified were employment measures, additional land sales and a continuing freeze on child benefit; but these would not yield major savings. Second, the estimating savings that had materialised in 1988, for example on unemployment benefit, would not recur this year; neither would increased estimates of housing receipts. Third, there were already substantial unavoidable commitments to additional expenditure before the Survey had begun. Absolutely firm commitments were £1b., and there were further unavoidable measures of £2½b. Taken together this meant that the funds traditionally available for relocation from the Reserve of some £3½b. were already spoken for; this was before any consideration was given to the strong pressures for extra spending that would arise in other programmes, notably health.

Continuing, the Chief Secretary said that there would be major pressures for additional Revenue Support Grant in the negotiations on the local authority settlement. These would be particularly strong given that 1990-91 would be the first year for the community charge in England and Wales. On the basis of the Scottish experience this year, however, high levels of grant would not necessarily serve to reduce the levels of community charge adopted by local authorities. It would be particularly important to structure the discussions in E(LF) on the right basis, and to avoid focussing only on spending Ministers' assessment of "need". It would be essential to look in parallel at the consequences for levels of grant. The Chancellor added that, as in the past, all the service Ministers represented on E(LF) were likely to speak with one voice in pressing for higher grant; it would be important to try to reach an agreed approach with the Secretary of State for the Environment, and the attitude to be taken towards his bids on his central government programmes could be a relevant consideration in this context. The Chief Secretary said that a further aspect of in this year's E(LF) discussions would be the changed rules of the game; not only the introduction of the community charge but also the new planning total. The new regime did, however, provide an opportunity to get away from some of the old concepts, for example in relation to grant percentage.

The Prime Minister said that she recognised the difficulties likely to be encountered in the public spending round, and the importance of maintaining tight control over public spending. In order to constrain the discussions on the local authority settlement she saw attraction in using last year's GREs as the starting point for the assessment of need. As the public spending round proceeded it would be necessary to consider which programmes provided the greatest vulnerability for the Government; she thought that health was likely to be the most sensitive area. She also felt that, in the round up to the next election, there would be increased pressure to raise the basic retirement pension; this meant it was particularly important to emphasise the benefits pensioners would receive from the ending of the earnings rule, together with the carefully targeted packages already agreed for assistance to older pensioners on income support.

I am copying this letter to Duncan Sparkes (HM Treasury) and to Trevor Woolley and Richard Wilson (Cabinet Office).

Yours,
Paul

Paul Gray

Miss Carys Evans
HM Treasury.

RUNNING COSTS
15/6

Luce/drafts/CST.PES.89

CONFIDENTIAL

FROM: T R H LUCE - MPRC
DATE: 15 JUNE 1989
ROOM: 54/1
EXT: 4544

CHIEF SECRETARY

cc PS/Chancellor
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir Peter Middleton
Mr Anson
Dame Anne Mueller
PEX + 1
Mr Edwards
Mr Kelly
Mr Binns
Mr Davis
Mr Mertens

1989 SURVEY: RUNNING COSTS

1. We do not yet have all the running costs bids and bidding material; and have so far received only about half the running costs management plans. Our first assessment of bidding pressures and likely outcomes is therefore tentative, and it would be misleading at this stage to provide an analysis department by department. What follows is the best general analysis we can make at present.

Main features of bids

2. For 1990-91, the Survey baseline is £14.8 billion. The bids we have so far received and identified total some £770 million, but we expect general bids of at least £50 million, and we may also get late bids on accommodation and relocation. Were we to concede all bids, the 1990 PEWP would probably have to show an increase in Civil Service costs between 1989-90 and 1990-91 of 10% or more (nearly 6 per cent in real terms if the 4 per cent forecast of general inflation is still current at the end of the Survey).

3. The main bidding pressure is on pay. Generally speaking, departments are seeking to substitute higher allowances for pay increases than were agreed in the last Survey, and are also bidding to restore costs of the 1988 and 1989 pay agreements (particularly for NUCPS and CPSA) which they claim to have under-forecast. There are also bids for accommodation cost rises (including VAT on rents and utilities). These are at present confused mainly because the PSA was late in notifying departments of increased charges for next year and departments are also having to guess the costs of those accommodation services which will be "untied" from PSA. (It is unlikely that these accommodation issues will be resolved before August). In addition, there are a fair number of bids for service expansion, and some for relocation.

4. On present information, the departments of significant size whose bids imply particularly high levels of increase into 1990-91 are Home Office (12%), the Lord Chancellor's Department (18%), Health (18%), Social Security (14%), and Customs (15%). The Defence bid is expected to be a little below the average; and the Employment bid <u>appears</u> more favourable than in reality it is because Mr Fowler hopes to retain and redeploy the running costs provision for the Skills Training Agency after its privatisation.

5. For the later years, bids imply increases in overall costs of the order of 3 per cent each year above the present forecasts of general inflation.

6. Of the 30 departments which received three-year settlements in the last Survey nearly all are bidding to re-open for one reason or another.

7. The manpower implications of the bids are still uncertain, but the Social Security rundown should mean that the projections in the 1989 PEWP should broadly stand around 585,000.

Possible outcome

8. Running costs bids are usually harder to reduce than programme expenditure bids. In the last Survey, for example, some three-quarters of the running costs bids were conceded. We cannot yet offer an informed target for the overall running costs outcome this year, but suspect it will be realistic to aim at a rather similar level of reduction. The result might then be a Civil Service cost increase into next year of between 8½ and 9½ per cent, appearing to represent a 4½-5½ per cent real terms increase assuming that the present forecast of general inflation remains unaltered at 4 per cent. This would represent a worse outcome than in recent Surveys, where the year-on-year real terms growth implied - on Survey inflation forecasts - has been of the order of 1%-2%.*

9. In previous Surveys we have set ourselves two main objectives. The first has been to contain the running costs' share of total public expenditure, so that what some see as the "Civil Service overhead" is not seen to rise. (This objective has been used as an internal target. It has not been made public.) The second is to contain the cash increase into the first Survey year so that real costs do not appear to be rising excessively. (This objective has been implied, though not explicitly stated, in PEWPs). In the last two Surveys we have achieved both objectives.

10. For the present Survey we cannot yet formulate - or decide whether it would be sensible to formulate - an objective related to a running costs "share" in total public expenditure. This is because the move to the new planning total has interrupted the

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*Viewed in retrospect, the running costs record has been better than these prospective presentations imply. If the overall running costs outturns for 1987-88 and 1988-89 is measured against actual (rather than forecast) inflation in those years, they show little or no real growth - a real increase of 0.4% in 1987-88, and a marginal decrease (-0.1%) in 1988-89.

trend analysis on which this approach largely depends. It may be possible to formulate an objective of this kind as the Survey progresses (e.g. for the July Cabinet, or in October), if one is desired.

11. For the July Cabinet, however, we shall certainly need to formulate an objective related to the rise in cash costs, and the implied real terms rise, if we are to have an agreed and suitably tight framework for handling running costs in the bilaterals.

Tactics

12. We shall make a fuller report, with specific recommendations for the July Cabinet, when we have more complete information, but there are two areas where it is already clear that we should concentrate our attack.

13. The first is on pay. In present circumstances it is hard to argue that the assumptions about levels of future pay increases which most departments wish to make are unrealistic. For 1990-91, they are generally around 8 per cent or a little more, though there are two or three which go closer to 10 per cent. Present trends in the economy as a whole, and the conclusion over the last 18 months of new pay agreements for most Civil Service groups which imply a degree of linkage between Civil Service pay increases and those elsewhere, it would be unrealistic to impose significantly lower assumptions for the majority of departments. But we shall want to (a) probe very carefully those departments whose forecasts are significantly higher than the average, and (b) ensure that the later year pay assumptions show a declining trend (even though this approach in the last Survey underlies some of the pay bids for 1990-91 in this one).

14. However, the other element in pay bids - i.e. to recoup departments' under-forecasting of the full-year effects in 1990-91 and later years of the 1988 and 1989 pay agreements is another

matter. In the last Survey departments were encouraged to make their own assumptions about future pay increases and we did not depress them. The main departments were also kept closely in touch with the pay negotiations, to which none of them offeredsignificant objection. All departments knew that the financing risks of these pay negotiations lay with them. We therefore intend to identify those elements in the pay bids attributable to under provision for past pay settlements, with the intention of rejecting those elements in the bids.

15. The second soft area in bids may be the level of efficiency gain which some departments are projecting in their management plans. We shall provide a fuller assessment as soon as we can but on present information we would expect both tax departments, for example, to have difficulty in justifying their plans against the 1½% minimum annual target.

16. Nor have we so far been able to identify any significant and favourable effects on efficiency projections from Ministers' Next Steps.

17. We shall aim, therefore, to identify departments which could be targeted for improvement. This might help to yield some reductions in their bids, and would follow up the Prime Minister's suggestion at her recent value-for-money seminar.

Handling

18. We shall make a fuller assessment within the next two weeks. You would then be able to consider the best handling of running costs in the July Cabinet, and we can formulate guidance to groups on the preparation of agenda letters.

19. You may also wish to consider, at about the turn of June/ July, sending the Prime Minister a minute summarising the running costs position so that you can take account of her reactions before settling the approach to Cabinet. This would parallel the

discussions the Chancellor and yourself have already had with her on the general handling of the Survey, and enable you to pick up the various running costs points raised in the seminar. If you see merit in this, we will provide you with a draft when we make our fuller assessment.

20. In the meantime, if you are content, we will advise Groups to prepare the ground for special pressure on the two elements I have mentioned - "the catching up" component of pay bids, and the level of efficiency gains where these seem low.

NFIH

pp **T R H LUCE**

MACAUSLAN
→ CH/EX
15/6

gep1.ip/jm/6.6

COPY NO: 1 OF: 23

FROM: J MACAUSLAN (GEP1)
DATE: 15 JUNE 1989
Extn: 4780

1 MRS LOMAX RL 15/6
2 CHIEF SECRETARY pp PW 15/6
3 CHANCELLOR

cc: Sir P Middleton
Mr Anson
Sir T Burns
Mr Monck
Mr H Phillips
Mr Riley
Mr Sedgwick
Mr Luce
Mrs Butler
Mr Gieve
Mr Hansford
Mr Mowl
Mr Potter
Mr Richardson
Miss Walker
Mr Call
Mr Tyrie
Mrs Chaplin

SURVEY PROSPECTS 1989

This is our preliminary assessment of the prospects for the 1989 Survey. It is based on discussions we have had with divisions. Our first scorecard is at Annex A. Annex B comments briefly on the bids for each department. The rest of this note outlines the bids, divisions' forecasts of the outcome, and the main uncertainties.

2. My separate note of 12 June (not copied to all) covered sheets prepared by divisions giving an assessment for each department. Those sheets show the main bids and options, and describe the forecast outcome. Mr Luce is submitting a separate assessment of the running costs position.

Total bids

3. The bids are higher than we expected in May. The main ones are:

486
71

	1990-91	1991-92	1992-93
Departmental (exc nat ind)		(£ billion)	
Transport	0.6	1.0	1.4
Housing	1.1	1.3	1.3
Law and order	0.7	1.0	1.2
Education	1.4	1.7	1.9
Health	1.8	2.5	3.4
Social Security	1.2	1.5	3.5
Other	1.8	1.8	3.4
RSG & NNDR (England)	0.8	1.1	1.1
Territories	1.7	2.2	2.6
Nationalised Industries	1.6	1.0	1.0
TOTAL	**12.7**	**15.1**	**20.8**

4. The bids are not yet all in. The nationalised industry bids are very provisional. Departments have noted a number of areas where their bids are not yet complete. And the demand led bids (social security etc) reflect the March assumptions on inflation, unemployment, etc. Decisions will be needed in early July as to whether the assumptions need changing.

5. The scorecard shows the departmental components of the new planning total. It omits local authority spending financed from the community charge. Any overspending there - and we expect some - will be an addition to GGE but not to the planning total. Changes to debt interest payments are also accounted for at that point.

6. The scorecard is not therefore a complete tally of the possible additions to GGE.

Kinds of bids

7. We have broken the bids down into 3 main categories:

(£ billion)

Virtually irresistible (Table 1)	4	4¼	6¾
Main battlegrounds (Table 2)	6	7	10¼
Other	2½	3¾	3¾

8. Of the <u>virtually irresistible</u> bids, some are firm commitments (eg student loans, poorer pensioners); others are more or less demand led (eg social security upratings); still others reflect the costs of policies already agreed (eg the extension of VAT to fuel and power etc). Two points:

- while some of these bids may be scaled down, and departments may be forced to absorb parts of the remaining cost, the great bulk will almost certainly have to be conceded;

- and we have kept this list to a minimal hard core. In practice much of the nationalised industry and running cost bids will also be irresistible; and some of the health bids, including those for the NHS review, will be very hard to attack.

9. Table 2 highlights the main <u>battlegrounds</u> (ie the areas where we will have to seek substantial reductions if the forecast outcome is to be achieved). These total some £5¼ billion in 1990-91, or about £6 billion with territorial consequences added in. Well over half represents capital. A fair chunk of the capital will be construction. Departments argue that much of this is required to keep up with rising prices.

tough

[illegible]

10. The <u>remaining bids</u> ("other" in paragraph 7 above) cover virtually all the bids made by FCO, MAFF, DTI, DE, legal departments, OAL, the Chancellor's departments, and territorial departments (apart from formula consequences). They also cover substantial residues from the main departments (eg some £½ billion

from DH, and some £350 million from DES). They include most of the running cost bids (some £¾ billion in 1990-91). There is no implication that these bids are soft; only that they are miscellaneous and, mostly, individually small.

11. To some extent the bids reflect Departments' expectations of higher inflation than allowed for in the baseline. (By no means all such bids are explicitly attributed to inflation. I spotted some £1,500 million of bids in 1990-91 that were). The baseline for 1992-93 was rolled forward from 1991-92 with 2½ per cent added on. So Departments' 1992-93 bids are high, reflecting their own expectations of higher inflation then.

12. Something similar may be occurring to some extent in 1990-91 and 1991-92. For this Survey there were no previous plans for grants to local authorities or credit approvals. So the baseline was formed by rolling forward 1989-90 grants by 2½ per cent each year. Again departments may be bidding in part to provide more realistically for inflation on those grants, and/or to restore the levels of expenditure by local authorities in the previous plans.

Implications of bids for GGE

13. Table 3 suggests that the bids might imply the following additions to GGE:

+£11 billion +£12 billion +£19 billion

14. I have used the FSBR figures for debt interest, and rather conservative numbers for the possible additions to local authority self-financed expenditure. I have (for simplicity) ignored additions to other national accounts adjustments (though we already know of some changes there that will add to GGE). In other words, the additions are almost certainly understated.

15. Table 4 shows the resulting ratio of GGE excluding privatisation proceeds to the money GDP figures in the FSBR:

41% 40¾% 41%

The forecasters will produce new estimates of money GDP shortly. The classification of the community charge will reduce money GDP at market prices. That will raise the GGE ratio in each of the Survey years by some ¾ percentage point. The figures quoted above exclude this effect since I assume we will seek to focus attention on the underlying trends.

Forecast outcome

16. Divisions think the bids might be reduced by some £4½/6/8½ billion. That would mean additions to programmes within the new planning total of £8/9/12¼ billion (compared with our May guess of £7/7¾/10¼ billion). Achieving such an outcome would require a determined attack on the key areas: DE, DTp, housing, and DES; and trimming bids in other areas. In particular, it assumes:

(a) a defence budget below 4 per cent of GDP in 1991-92 and 1992-93.

Why should there?

(b) little if any increase in aid as a percentage of GNP, and restricting the Polish fund to the minimum.

(c) no relaxation in the rules for RSA, and cuts in other DTI support for innovation, aerospace, and English Estates.

(d) further big cuts in ET/YTS beyond those made last year.

[illegible]

(e) restricting annual volume increases in road building to under 10 per cent, rather than the over 35 per cent sought.

(f) halving the proposed substantive additions to housing.

(g) minimal additions to police manpower, conceding 2 new prisons not 4, and trimming the bid for prison refurbishment by ¼.

(h) restricting the education increases to the agreed bids and only about $^1/_3$ the of the rest.

(i) halving the bids for hospitals' capital, and reducing those for hospitals' activity levels even further (the forecast outcome on this - see Table 2 - looks very ambitious; but it incorporates further cost improvements, so is more generous in gross terms).

(j) freezing child benefit again (for 1990-91), cutting back the disability package, and no premia for pensioners (beyond what is already agreed).

LS Mayhew for and 80s

(k) on the nationalised industries the forecast outcome is no more than a guess; it excludes megaprojects.

17. Capital bids of £2¾ billion in 1990-91 are shown in Table 2 (excluding the nationalised industries, for which a breakdown of the forecast outcome cannot sensibly be made at this stage). This forecast implies reducing these to £1¼ million.

<u>Comparison with 1988 Survey</u>

18. Table 5 compares this forecast outcome with what happened last year. Four main points emerge:

(a) substantial <u>extra</u> bids were entered last year between June and November (some £2¾/3½/4½ billion).

(b) divisions are forecasting somewhat more success in cutting bids and achieving options than we actually had last year (£4½/6/8½ billion, compared £3½/4¼/5 billion last year).

(c) the outcome of the 1988 Survey was much better in the first year than we foresaw in June; but this was because large savings came in on unemployment, asset sales, IBAP, and the trading position of nationalised industries.

(d) the assessment last June of how far the bids might be cut back was not far wrong in the event.

In that light, divisions' forecast of the outcome this year looks ambitious.

Bids to come

19. We can already identify some possible further bids (Table 6), totalling about £1 billion a year. Not all of these will need be conceded, and some of the biggest (lead, community care, the rail megaprojects) might be deferred till the 1990 Survey. But there will also be extra bids we have not yet identified.

20. On top of that, economic assumptions may change. Each 100,000 unemployed cost some £¼ billion. Each extra 1 per cent on the interest rate assumptions (currently 10 per cent for 1990-91) would add some £100 million. Each extra 1 per cent on the price level automatically costs about £500 million on social security. The current assumption for the September 1989 rpi is 6¼ per cent.

21. But there would be other bids too if the inflation assumption rose. MOD, DH and DES have already threatened such bids. Table 6 shows the possible scale. In the event, we might compensate programmes, overall, for only about half the increase in the price level. That might mean no compensation at all for most departments, nationalised industries, or local authorities; for education, only on student awards; only 50 per cent for defence; 75 per cent for health; but virtually full compensation for social security. Thus in total each 1 per cent on the price level might add at least £1 billion to GGE.

[illegible] ?!

22. On the other hand, each 1 per cent on the price level also increases money GDP (unless real GDP is revised down, as it was in the FSBR). The net effect might be to reduce the GGE ratio by some 0.2 percentage points.

23. There are, as ever, large uncertainties. The main areas where surprises would be no surprise are: unemployment, IBAP, the nationalised industries, payments to the EC and, outside the planning total but within GGE, housing receipts. Variances of £½ billion on each would be quite possible. The unemployment assumption could be revised down, saving £¼-½ billion. The rest look at the moment no more likely to go down than up; indeed housing receipts this year look likely to move in an unhelpful direction.

24. Finally, there are the other components of GGE. The debt interest figures might be revised. We are already aware of pressures totalling some £½ billion a year on other national accounts adjustments. And it is not yet clear what allowance we should make for additions to local authority self-financed expenditure.

Implications for GGE and ratios

25. Divisions' forecasts of the outcome, along with the conservative assumptions in paragraph 14 above, imply additions to GGE of (£ billion):

+6¼	+6¼	+10¼

(see Table 3).

26. But making allowance for the possibility of overshooting divisions' forecasts (say £1 billion), for possible changes to economic assumptions (say £2½ billion), and for additions to the other components of GGE (say £½ billion) could mean additions to GGE of more like £10 billion in the first year rising to £14 billion in the last.

27. Table 4 shows ratios of GGE (excluding privatisation proceeds) to money GDP. The FSBR projected (%):

1987-88	1988-89	1989-90	1990-91	1991-92	1992-93
41½	39½	39¼	39	38¾	[38]

The GGE figures implied by paragraph 25 above, using the FSBR assumptions for money GDP, give ratios of

			40	39¾	39½

or, after money GDP is adjusted for the introduction of the community charge,

			40¾	40½	40¼

28. On the FSBR deflators, GGE excluding privatisation proceeds would grow in real terms by 3 per cent a year on average between 1989-90 and 1992-93.

A tougher package?

29. In short, the forecast outcome is ambitious; there are real risks that it will not be achieved. And it may not be good enough anyway. So we discussed with some divisions the scope for a tougher approach:

(a) Roads: a smaller increases for 1990-91, and perhaps in the later 2 years as well.

(b) Housing: no net increases except the technical HRA bid.

(c) Home Office: prison refurbishment bid could be cut further, 2 remaining new prisons dropped, and other bids trimmed.

(d) Education: cut science in real terms, defer remaining capital.

(e) DSS: freeze child benefit for all 3 years, restrict UB to 6 months, no additions for poorer families.

30. Such a package might reduce the cash additions to GGE by something like £½ billion in 1990-91, and up to £1½ billion in 1992-93, reducing the ratio in 1992-93 by ¼ percentage point.

31. Further health savings could fall into a yet more difficult category. At that point, other options - which we have not discussed with divisions - could come into play. These could include rejecting the MOD bid for 1992-93, further savings from DE and DTI, reducing Scottish overprovision, and a yet tougher approach to ODA, legal departments, and the nationalised industries.

JM

J MACAUSLAN

gep1.ip/tables/resist

SECRET

TABLE 1

1989 SURVEY: VIRTUALLY IRRESISTIBLE

Committed			
Student loans/awards	150	230	250
Poorer pensioners	200	200	200
Pensioners earnings	375	400	400
Other	325	370	300
	1050	**1200**	**1150**
Demand led/estimating			
Police pay	200	300	420
Students loans/awards	100	100	100
Health review bodies	150	175	175
Social Security uprating	250	300	350
Other	0	-125	1500
	700	**750**	**2500**
Costs of agreed policies			
Extension of VAT	230	280	300
Restructuring	250	200	200
HRA (offset within GGE)	450	450	450
Other	100	130	130
	1000	**1100**	**1100**
RSG and NNDR (GB)	1000	1050	1050
TOTAL HARD TO RESIST			
(incl estimated territorial consequences)	**4,000**	**4,500**	**6,750**

gep1.ip/tables/battle

TABLE 2

1989 SURVEY: MAIN BATTLEGROUNDS

		Bid/Option			Forecast Outcome		
		90-91	**91-92**	**92-93**	**90-91**	**91-92**	**92-93**
MOD:	Final year	-	-	1250	-	-	700
ODA:	Aid budget	125	200	300	85	100	150
DE:	ET/YTS option	-210	-350	-350	-130	-170	-210
DTp:	National roads	550	850	1200	300	450	530
DOE housing:	Housing Corporation	250	475	750	120	230	370
	Homelessness	150	100	10	85	65	10
	LA renovation	150	175	115	75	90	60
DOE OES:	Local capital	200	300	330	100	130	130
Home Office:	Prison capital	175	225	200	135	170	125
DES:	School etc capital	500	670	825	125	125	135
	HE capital	160	150	150	65	50	50
	Science	100	150	150	50	50	50
DH:	HCHS activity/unit cost	280	450	700	85	150	170
	HCHS capital	320	400	500	150	150	200
	NHS review	500	680	700	300	425	475
DSS:	Disability	10	50	600	50	60	70
	Poorer families/ pensioner premia	250	250	250	70	70	70
	CB freeze	-210	-210	-210	-210	-210	-210
	UB 6 months	0	-75	-100	0	0	0
SO:	Block adjustment	-255	-265	-270	0	0	0
Nationalised industries		1,600	1,000	1,000	1,400	900	1,000
TOTAL BIDS SHOWN †		**5,300**	**6,150**	**9,000**	**3,200**	**3,215**	**4,300**
TOTAL CAPITAL BIDS SHOWN *		**3,200**	**4,200**	**5,200**	**[1,200**	**1,500**	**1,700]**
TOTAL TREASURY OPTIONS SHOWN		**-675**	**-900**	**-930**	**-340**	**-380**	**-420**

† Excludes territorial consequences; including them bids come to roughly £6/7/10¼ billion.

* Total capital <u>bids</u> includes rough allowance for nationalised industries; forecast <u>outcome</u> on capital does <u>not</u> (because not available). Bids and outcome are not comparable.

SECRET

TABLE 3

IMPLICATIONS FOR GGE

(ex priv proc)

(£ billion)

	1989-90	1990-91	1991-92	1992-93
Baseline	199	210	221	229
1.(a) Bids		+12¾	+15	+20¾
(b) Bids to come [1]		+1¼	+1¼	+1½
(c) Drawdown of Reserve [2]		-4	-5	-4½
(d) Local authority self financed		+1	+1	+1
Implication of bids		+10¾	+12¼	18¾
New GGE	199	220¾	233¼	247½
2.(a) Forecast outcome on bids		+8	+9	+12¼
(b) - (d) as above [3]		-2	-2¾	-2
Implication of forecast outcome		+6¼	+6¼	+10¼
New GGE	199	216¼	227	238¾

Notes

1 Covering bids where departments have put down markers, including lead in water, police manpower, community care, some NNDR costs etc. Excludes any changes to inflation and other economic assumptions.

2 Assumes Reserves of £3/6/9 billion.

3 See paragraph 14: minimal changes only made to FSBR figures; further additions likely.

gep1.ip/tables/gge ratios

TABLE 4

G G E (excluding privatisation proceeds)

R A T I O S (% of GDP)

1. **Plans and actuals**

	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91	1992-93	1992-93
1987 PEWP	44¾	44½	44	42¾	42¼			
1988 PEWP	44½	44	42½	42	41¾	41¼		
FSBR	44½	43¾	41½	39½	39¼	39	38¾	38

Averages

1985-86 to 1987-88	1986-87 to 1988-89	1987-88 to 1989-90
43¼	41½	40

	1990-91	1992-93	1992-93
2. **Implications of bid**	41	40¾	41
(after Community Charge effect)	(41¾)	(41½)	(41¾)
3. **Implication of forecast outcome**[1]	40	39¾	39½
(after Community Charge effect)	(40¾)	(40½)	(40¼)

REAL GROWTH RATES (%)

	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91	1992-93	1992-93
1. FSBR	-0.2	1.6	-0.2	-2	1.7	1.4	2.1	0.9
2. Bid						6.5	2.5	3.6
3. Forecast outcome						4.3	1.9	2.7

Notes

1. Ratio based on minimal changes to FSBR figures (see paragraph 14). Some upward pressures ignored!

SECRET

TABLE 5

1 9 8 8 S U R V E Y

(£ billion)

June assessment

Bids	+9	+12	+16
Reductions in bids/Treasury options	-3	-4½	-5
Unemployment	-	-	-
Receipts	-¼		
IBAP	-¼	-¼	-¼
Programme outcome	+5½	+7¼	+10¾

November

Bids	11¾	15½	20½
Reductions in bids/ Treasury options	-3½	-4¼	-5
Outcome on bids	8¼	11¼	15½
Other savings	-4¾	-4½	-4¼
of which			
Unemployment	-1½	-1¾	-1¾
Receipts	-2	-1½	-1½
IBAP	-½	-½	-¼
Nat ind improved trading	-½	-¾	-1
Programme outcome	+3½	+6¾	+11¼

SECRET

TABLE 6

1989 SURVEY: BIDS TO COME

Identified and costed threats

			(£ million)
Lead in water	250	350	350
Police manpower	15	40	70
Inner London education grant	100	80	65
Community care	50	50	50
Other identified threats	700	600	1000
Total identified and costed (£bn)	1	1	1½

Effect of 1% on inflation on bids

MOD	210	210	210
ODA	16	16	16
DES	40	40	40
DH	210	220	230
DSS	450	450	450
EC	20	20	20
AEF	200	200	200
Formula consequentials	80	80	80
Debt interest	200	300	300
Local authority self-financed	50	50	50
TOTAL	1,500	1,600	1,600

Effect of 100,000 fewer unemployed

Social security	-250	-250	-250

Effect of 1% on interest rate assumptions

ECGD, housing, LAPR/MIRAS	100	100	100

SECRET

SUMMARY SCORECARD

Date of last update: 12/06/89

(£million)

	1990-91 BASELINE	1990-91 DEPT POSITION	1990-91 FORECAST OUTCOME	1990-91 HMT POSITION	1991-92 BASELINE	1991-92 DEPT POSITION	1991-92 FORECAST OUTCOME	1991-92 HMT POSITION	1992-93 BASELINE	1992-93 DEPT POSITION	1992-93 FORECAST OUTCOME	1992-93 HMT POSITION
Ministry of Defence	21,187.0	148.0	75.0	25.0	22,101.0	143.0	60.0	0.0	22,653.0	1,257.0	700.0	0.0
FCO - Diplomatic, Information, Culture	841.0	86.6	19.8	-11.1	884.0	47.2	30.3	-11.1	906.0	43.8	24.9	-11.1
FCO - Overseas Development Administration	1,627.0	123.4	68.0	25.0	1,692.0	192.2	90.1	28.4	1,734.0	290.7	124.6	-15.9
Intervention Board for Agricultural Produce	1,342.0	6.5	5.0	-44.6	1,518.0	-51.9	-55.0	-94.9	1,556.0	-31.8	-35.0	-145.1
Ministry of Agriculture, Fisheries and Food	578.0	84.0	50.0	-36.0	590.0	128.0	60.0	-67.0	605.0	164.0	70.0	-85.0
Forestry Commission	77.0	4.5	4.2	-5.0	80.0	8.0	4.8	-5.0	82.0	8.2	5.6	-5.0
Trade and Industry	1,300.0	17.0	-54.6	-179.4	1,155.0	51.9	-55.1	-192.3	1,185.0	-25.2	-168.3	-303.3
Export Credits Guarantee Department	122.0	20.5	20.5	14.7	61.0	-26.1	-26.1	-31.0	63.0	-109.5	-109.5	-102.2
Energy	312.0	80.6	75.9	-6.1	275.0	54.8	52.6	-8.9	283.0	52.4	49.7	-24.9
Department of Employment	3,887.0	139.1	-106.0	-300.6	3,894.0	165.9	-162.4	-484.1	3,991.0	250.4	-195.5	-537.7
Department of Transport	2,645.0	624.5	350.0	5.0	2,724.0	1,042.0	561.0	1.0	2,792.0	1,404.2	643.0	-2.0
DOE - Housing	5,737.0	1,093.7	634.7	200.6	6,157.0	1,282.0	714.0	146.2	6,311.0	1,346.7	719.7	62.3
DOE - Other Environmental Services	1,194.0	503.4	273.9	-30.1	1,226.0	560.4	272.3	-46.7	1,256.0	399.4	103.7	-208.3
DOE - Property Services Agency	-138.0	192.0	123.8	-64.5	-186.0	224.8	125.6	-114.8	-191.0	181.1	64.6	-166.2
DOE - Local Government	19,365.0	780.0	685.0	622.0	19,849.0	1,130.0	789.0	722.0	20,345.0	1,148.0	807.0	739.0
Home Office (inc. Charity Commission)	4,504.0	574.5	462.8	-43.2	4,581.0	812.6	659.2	-30.5	4,695.0	938.1	742.2	-96.9
Legal departments	1,188.0	130.9	107.6	-3.0	1,261.0	197.8	166.5	-4.0	1,292.0	301.2	261.4	-5.0
Department of Education and Science	5,824.0	1,367.6	644.0	11.2	5,932.0	1,682.1	748.3	3.9	6,080.0	1,917.4	782.2	2.0
Office of Arts and Libraries	456.0	46.6	13.0	0.0	486.0	47.9	2.5	0.0	498.0	84.4	25.0	0.0
Department of Health and OPCS	20,987.0	1,799.7	1,093.0	-198.7	21,941.0	2,490.1	1,454.9	-274.6	22,489.0	3,410.8	2,000.9	-687.9
Department of Social Security	55,126.0	1,179.0	806.0	470.0	58,300.0	1,458.0	995.0	593.0	59,757.0	3,478.0	2,493.0	2,065.0
Scotland: negotiable	9,179.0	55.9	11.4	-301.6	9,491.0	88.0	30.0	-313.0	9,728.0	128.0	43.0	-329.0
Scotland: formula		672.8	392.2	8.7		897.5	509.8	-8.1		1,085.4	589.1	-92.6
Scotland: RSG/business rates		210.0	161.0	60.0		207.0	173.0	27.0		188.0	167.0	-12.0
Wales: negotiable	4,133.0	42.2	40.4	-3.6	4,247.0	38.1	30.4	-7.9	4,353.0	46.3	5.9	-23.0
Wales: formula		280.8	155.3	14.7		375.5	198.2	9.1		459.6	231.1	-25.7
Wales: RSG/NNDR		84.0	72.0	34.0		97.0	81.0	37.0		98.0	84.0	38.0
Northern Ireland: negotiable	5,655.0	110.7	107.0	107.0	5,866.0	161.4	138.0	138.0	6,013.0	228.5	140.3	140.3
Northern Ireland: formula		270.0	188.0	0.5		337.0	225.0	-5.4		394.0	250.0	-29.2
Chancellor's Departments	4,322.0	205.5	173.5	95.7	4,530.0	233.9	196.6	72.0	4,644.0	352.7	294.7	79.8
Cabinet Office, Privy Council Office, etc	337.0	13.7	11.0	-1.1	352.0	11.5	10.0	-0.8	361.0	11.0	10.3	0.0
European Communities	1,950.0	35.0	35.0	35.0	1,580.0	-35.0	-35.0	-35.0	1,620.0	230.0	230.0	230.0
Nationalised Industries	-396.0	1,625.0	1,400.0		979.0	985.0	900.0		1,002.0	970.0	1,000.0	
Adjustment												
TOTAL ADDITIONS TO PROGRAMMES	173,341.0	12,657.6	8,148.4	500.5	181,566.0	15,107.6	9,004.5	42.4	186,103.0	20,800.9	12,234.7	448.3

Annex A

ANNEX B

1989 SURVEY: DEPARTMENTAL BIDS

MOD	- will make substantive bid for years 1-2 if inflation assumptions rise.
ODA	- rising GNP ratio is real aim.
DTI	- bids look tactical, intended to head off cut below baseline.
DE	- ditto.
ECGD	- savings reflect interest rate assumptions (currently 10% for 3 month rate in 1990-91).
DTp	- going for over 35% volume increase in national roads from this year to next: bid of £½/¾/1¼ billion.
DOE - Housing	- totals include £½ billion technical bid for HRA subsidy, netting out within GGE; and £¼ billion rising to £¾ billion for Housing Corporation.
DOE OES	- £200 million for credit approvals and £160 million for Docklands transport in 1990-91. Bid is 42 per cent of baseline. Lead in water bid yet to come.
DOE-LG	- some risk of reopening in October, especially if inflation higher.
Home Office	- 4 new prisons; prison maintenance; and police earnings; police manpower bid yet to come.
DES	- huge bids: £150 million agreed student loans bids. £150 million for pay and inflation, and over £650 million for capital.
Health	- of £1¾ billion bid in 1990-91 nearly £400 million for pay and inflation, over £500 million for NHS review, nearly £200 million for higher costs, £150 million for miscellaneous support. Leaves £300 million for patient care and £200 million for extra capital. Community care bid yet to come; will also increase bid if inflation assumption rises.
Social Security	- In 1990-91 £800 million for agreed bids, £200 million for higher inflation. Main discretionary bids are £250 million for poorer families and pensioners (plus £600 million for disabled in 1992-92). Each 1% extra inflation will add £500 million; 100,000 off unemployment saves £250 million.
EC	- Very volatile estimates.

COPY NO: 1 OF: 18

I have drawn this to CST.

FROM: MRS R LOMAX (GEP)
DATE: 15 June 1989
x4499

Re para 21, yes PSE

1. CHIEF SECRETARY pp PW 15/6
2. CHANCELLOR

cc Sir P Middleton
Mr Anson
Sir T Burns
Mr Monck
Mr Phillips
Mr Luce (MPRC)
Mr Riley (MP)
Mr Sedgwick (EA)
Mr Gieve (IDT)
Mr MacAuslan (GEP)
Miss Walker (GEP)
Mrs Chaplin
Mr Tyrie
Mr Call

we must plan

Ch
Will be difficult — and no doubt will have to raise planning total — but there is an element here of GE staking out cautious position so they are not forced to have 'failed' by too much during Survey negotiations
AA

LOMAX → CH/EX 1989 SURVEY PROSPECTS 15/6

1989 SURVEY PROSPECTS

Mr MacAuslan's minute summarises GEP's initial assessment of the Survey prospects, based on Groups' reactions to the bidding letters. The clear implication is that it will be difficult to achieve a Survey outcome consistent with the Government's policy, defined in the FSBR as "maintaining a downward trend over the medium term" in the GGE ratio. How difficult will depend on the revised forecasts for money GDP and inflation, which will not be available for another week. But the prospect looks appreciably worse than it did on 9 May, when Mr Anson put forward our summary of what Groups were expecting, together with the latest long term projections of the tax burden.

2. The immediate question is what, if anything, can be done in the run up to the July Cabinet to improve the chances of an acceptable outcome. This note suggests a possible way forward, reflecting our preliminary discussions with Groups, and with the Chief Secretary.

Strategy

3. The broad aim should be to achieve an outcome that can credibly be presented as consistent with maintaining a downward trend in the GGE ratio. When the revised forecasts are available, we will do more work on what that might mean in practice. Until then, there is little to add to the approach outlined in Mr Anson's minute of 9 May.

4. A "blip" in the GGE ratio should be manageable, provided it can be seen to be no more than that. In his evidence to the TCSC last Autumn, the Chief Secretary stressed that the GGE objective applied "over a run of years". We can argue that the 1988-89 outcome was aberrantly low, and we can separate out the 3/4% addition to the ratio caused by the classification of the Community Charge. However, to maintain credibility, we would need to show some decline in the ratio through the Survey period and end up at a point which, in some sense, is lower than the starting point. For this purpose the starting point might be defined as 40% (excluding the Community Charge effect), a barrier which you may not wish to breach anyhow, and one which happens to correspond to the average outcome over the three years up to and including 1989-90.

5. We will also need to look carefully at the scale of the cash additions to GGE, certainly in 1990-91. The present provisional estimates are in Table 3 of Mr MacAuslan's submission. Extra GGE in the first year of around £10 billion (the implication of the bids), or even over £6 billion (on divisions' fairly bullish estimates of the forecast outcome), could be very difficult to present convincingly, both in political and market terms.

(hear hear)

The nature of the problem

6. The background is a virtual standstill in real GGE since 1984-85, at a time when real GDP has grown by nearly 20% and the budget has swung into massive surplus. Table 1 (attached) shows how the plans for 1990-91 have suffered a progressive real terms

squeeze since they were first set in the 1987 Survey, as the inflationary outlook has deteriorated. Reflecting these pressures, total programme spending was substantially increased in cash terms last year, though the additions were unevenly distributed and offset by major non-discretionary savings from higher receipts, lower unemployment, lower debt interest etc. This year there is very little prospect of repeating those savings; less headroom to reduce the GGE ratio from an artificially low 1988-89 base; and even more intense pressures for higher spending.

7. While the scale of the bids was rather larger than we were expecting, our discussions with Groups do not support the idea that the problem is primarily one of excessive "soft" bids. Mr MacAuslan's minute suggests that, with one or two notable exceptions, the bids are not out of all proportion to those tabled, or indeed conceded, during the course of the last Survey, when we were saved mainly by higher receipts and lower unemployment (Mr MacAuslan's Tables 5 and 6). Many respond to higher inflation or policy initiatives to which the Government is already publicly committed. The bids in the two later years also reflect the artificiality of the baseline. The discretionary margin is not all that large, and some of the decisions required to eliminate it may be politically unattractive to Ministers collectively, as well as to individuals.

Possible responses

8. This is no more than a reminder of the problems we will face in producing an acceptable outcome. We have considered how best to set the stage for what is bound to be a very difficult Survey, by recent standards - taking as read the tough noises which always emanate from the Treasury at this time of year. Possibilities for special action include:-

- asking some Ministers to reconsider their bids, either privately (through personal contact or correspondence) or semi-publicly (by means of a formal letter, perhaps copied to colleagues, including the Prime Minister);

- getting the Prime Minister to utter a stern collective warning ahead of the July Cabinet;

- aggressive press briefing. We normally encourage the idea that the Treasury is preparing to fight a tough battle, and the papers guess the scale of the bids. Estimates are now running up to, but not above, £10 billion: would it be in our interests to talk this total up?

NO

- trying to deflate public expectations about extra spending on the infrastructure, in particular eg through a Ministerial speech, EPR article, press briefing.

9. There are dangers in overreacting. High profile action, which risks leaking, inevitably raises the stakes for Treasury Ministers. It could backfire. It will certainly set a precedent for future years. The possible effects on markets, in current circumstances, are for others to judge. It would be only prudent to act on the assumption that we shall almost certainly need to add substantially to the cash totals for public expenditure this Autumn. How much is highly uncertain at this stage, but the total of bids is very likely to rise further over the summer, unless the inflationary outlook improves. We should not adopt tactics that will unduly limit our freedom to make the best of what may still seem a bad outcome for the Treasury, come November.

10. Against this background, we would want to rule out:

i. briefing the press on the scale of the bids. The numbers are too uncertain at this stage for us to be confident that we could pitch it right, and it would make it more difficult later to discourage blow by blow reporting of the bilaterals.

ii. issuing a formal request to some (or all) colleagues, to reconsider their bids. This would probably achieve very little, and it could make subsequent negotiation more difficult, as astute colleagues sought to claim credit for any modest trimming back of their original bids.

iii. asking the Prime Minister to intervene ahead of the July Cabinet.

11. Nevertheless, without resorting to extreme measures, we think we should try to change the climate ahead of the July Cabinet, both by sending replies, on a personal basis, to selected colleagues, and by using the Chief Secretary's forthcoming speech to the Adam Smith Institute to put down some markers for the Survey. You will also want to keep the Prime Minister closely in touch with developments on this front. Finally, it is not too soon to start working up a line for the press, though we shall need to review this once the forecast is available and we have done more work on the strategy.

Ministerial colleagues

12. The obvious candidates for immediate replies are those Ministers whose bids were both large (in absolute terms and in relation to their programmes), and lacking any sense of priorities. The frontrunners in this category (shown in Table 2 below) are Mr Baker and Mr Channon.

i. HE and PE strongly favour an early reply to **Mr Channon**, spanning the whole transport field (ie railways, including mega-projects, as well as roads) telling him to sort out his priorities. This letter would usefully map out the ground ahead of the Chief Secretary's meeting with him on mega-projects towards the end of this month. It would stress the difficulty of the Survey prospect, and say that there can be no prospect of undertaking such a large package of infrastructure renewal all in one go. The aim would be to encourage Mr Channon to scale back the bids for rail (which are still very provisional), and if possible to keep mega-projects out of this Survey.

ii. The pay off from writing to **Mr Baker** is less obvious. There is very little realistic prospect of inducing him to set out his priorities at this early stage. However, if any of the bidding letters deserves a sharp response, it is his. The Chief Secretary might point out that Mr Baker is, in effect, asking for education to be given top priority in this Survey, while flatly refusing to make any choices himself. He must expect a very difficult time.

13. In addition, a letter has already gone to Mr Fowler, resisting his request for a statement on YTS before the Recess, and taking the opportunity to put down a marker about the need for further savings in the Survey on both ET and YTS.

14. The other candidates for immediate responses are **Mr Ridley, Mr Hurd** and **Mr Patten.**

i. On the face of it there is a case for writing to Mr Ridley too: but high as his bids are, they almost certainly represent a significant scaling down of his departments' proposals. However, it may be worth picking up his hint that an alternative approach to homelessness could mean a reduced bid.

ii. On balance, we would recommend against writing to Mr Hurd. While he did very well out of the last Survey, and has put in substantial bids again this year, the main items (police manpower/pay and prison refurbishment) are politically well-found. HE think an early letter would achieve nothing.

iii. Mr Patten is another marginal case: while his bids are, arguably, excessive, and not well supported at the detailed level, the sums at stake are not that large.

Chief Secretary's Speech (27 June)

15. The Chief Secretary's speech to the Adam Smith Institute will provide an on the record opportunity to deflate public expectations about the Survey in general, and spending on the infrastructure in particular. Mr MacAuslan's minute highlights the scale of the capital bids and notes that divisions are assuming that these can be drastically scaled back. This will be particularly difficult given the expectations that have been built up in recent months, especially in the transport field: and the pressures are increasing all the time, (eg the NEDC discussion on infrastructure in July.)

16. This will clearly be a major issue for the Survey. As you know, the forecasters are working up a dossier on construction, the first instalment of which you have already seen. The next stage (which will be available for the July Cabinet) will analyse the implications of the bids, in the light of the revised forecast. This effort needs to be complemented by taking a robust line in public. The message for the Chief Secretary's speech, could be very simple. The Government's plans already allow for a large increase in capital spending. It will take time for this to come through. [The recent rises in construction output prices and earnings are already disturbing.] Infrastructure is no exception to the general rule that spending must be at a pace which the economy can afford: this is not the time for a capital spending spree.

Not the [illegible] ([illegible] & [illegible])

July Cabinet

17. We will need to consider what remit we want from the July Cabinet in the light of the revised forecast. In general we should not shrink from playing on anxieties about the wider economic situation: this is not the year to dwell on the prospect of further tax cuts. Rather, the message should be that there is no room for anything that looks like a spending bonanza, until inflation is well under control, and sterling is a lot steadier. The consequence could only be a sharp further rise in interest

rates - the simple point being that if the Government is not prepared to restrain its spending, the squeeze on private spending must be that much greater.

18. Both to make this line credible, and to put Ministers on the defensive in the bilaterals, we should get any upward revisions to the inflation assumptions on the table at the July Cabinet. It would be most unfortunate if we were faced with the need to put up the inflation assumptions at the last minute for the second year running : memories of last year still rankle, and may be one reason for the scale of this year's bids. However, we will want to keep the likely downward revision to the unemployment assumption up our sleeve, if we can.

Next Steps

19. If you agree with this approach, the next step might be for the Chief Secretary to minute the Prime Minister, updating his earlier assessment of Survey prospects, on the following lines:

- the initial bids are higher than we expected and there will be more to come;

- a lot of colleagues have indicated that they will re-open if, as we must expect, the inflation assumptions are moved up;

- the bids are more difficult to resist than one might suppose and there seems very little prospect of savings on anything like the exceptional scale achieved last year;

- the Chief Secretary therefore proposes to write, on a personal basis, to a few selected colleagues, to urge them to re-examine their priorities;

- more generally, without resorting to extreme measures, we will be aiming to change the climate among colleagues and in the press, ahead of the July Cabinet.

20. It would be for Divisions to draft replies to Mr Channon, Mr Baker and Mr Ridley. You might also want to ask IDT to work up a line for the press for use over the next few weeks. GEP is already working on a passage for the Chief Secretary's speech to the Adam Smith Institute.

21. You will no doubt wish to discuss.

RL

RACHEL LOMAX

TABLE 1 :OUTCOME OF 1988 SURVEY : 1990-91

1. Changes between AS 1987 and AS 1988

	1990-91
Money GDP (%) (level)	7.5
GDP deflator (%) (level)	4.7
Real GGE %	-3.1
of which (main real gains)	
Transport	17.3
Home Office & legal	13.2
NHS(E)	2.8
DES (CG)	1.6
ODA	0.4
GGE ratio	
AS 1987	41¼
AS 1988	39

2. Changes between AS 1988 and 1989 FSBR

Money GDP (%)	(levels)	-
GDP deflator (%)	(levels)	1.9
GGE ratio		
FSBR 1989		39

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TABLE 2

MAIN BIDS AS A PERCENTAGE OF BASELINE

(%)	1990-91	1991-92	1992-93
DOE-OES	42	46	32
DTp	24	38	50
DES	23	28	32
HO	13	18	20
DH	9	11	15

REAL GROWTH IMPLIED BY MAIN BIDS

(% real growth over previous year)

DOE-OES	39	2	-10
DTp	30	12	9
DES	22	3	3
HO	15	3	2
DH	9	4	3

[Using FSBR deflators]

cst.ps/8pw19.6/mins

CONFIDENTIAL

CHIEF SECRETARY TO THE TREASURY

FROM: P T WANLESS
DATE: 19 June 1989

MR LUCE

cc: PS/Chancellor
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir Peter Middleton
Mr Anson
Dame Anne Mueller
PEX + 1
Mr Edwards
Mr Kelly
Mr Binns
Mr Davis
Mr Mertens

PMP
Pls attach to original minute as may shortly be needed on folder

1989 SURVEY: RUNNING COSTS

The Chief Secretary was most grateful for your submission of 15 June.

2 The Chief Secretary agrees with your conclusions that we should:

- resist the "catching up" component of pay bids; and
- press for a greater level of efficiency gains where these seem low.

3 The Chief Secretary does see some merit in minuting the Prime Minister about the overall running costs position towards the end of this month.

PW.

PETER WANLESS
Assistant Private Secretary

Duncan

pmp

Ch.

Cntthm wR 13/7

We need to fix a date for July public expenditure cabinet. Options are 6, 13 or 20 July; last year was 14 July.

Forecasters would be v. uncomfortable with 6 July: v. tight timetable between forecast on 23 June and sending draft Cabinet paper to PM a week later. But not impossible.

CST/GEP would, equally, find 20 July pretty inconvenient: it would leave them barely 10 days to get all the agenda letters out. But again, not impossible.

This leaves 13 July as the officials' favourite. But it's the day you and PM leave for the Summit and you will have a fair amount on your plate preparing for that. Nevertheless, Paul Gray thinks PM would be happy with 13 July if you are.

→

GEP will be putting up a formal submission shortly but would like an informal idea of your views in advance.

DIS

cst.ps/8ce23.6/mins

UNCLASSIFIED

BF CST

FROM: MISS C EVANS
DATE: 23 June 1989

MR A C S ALLAN -2

cc: Mr Anson
Mrs Lomax
Mr MacAuslan
Mrs Thorpe
Miss Walker

PUBLIC EXPENDITURE CABINET

I mentioned to Paul Gray that the Chief Secretary's minute of today to the Prime Minister is on its way. He suggested that the Prime Minister will probably want to have a meeting with the Chancellor and the Chief Secretary early in the week beginning 3 July to discuss the Survey position and the handling of the public expenditure Cabinet. He thought she would find it helpful to have for next weekend's box a note of our views on the Cabinet remit in the light of the summer forecast. I have mentioned to Mrs Lomax.

CE

MISS C EVANS
Private Secretary

cst.ps/4jm23.6/drfts

SECRET

cc CX, Sir P Middleton, Sir T Burns
Mr Anson, Mr Monck, Mr Phillips
Mr Edwards, Mrs Lomax, Mr Luce
Mr MacAuslan, Mr Riley, Mr Sedgwick
Mr Gieve, Mr Potter, Miss Walker
Mr Tyrie, Mrs Chaplin

000307

FROM: CHIEF SECRETARY
DATE: 23 June 1989

PRIME MINISTER

1989 SURVEY

My minute of 12 May warned that we would face strong upward pressure on many spending programmes in the coming Survey. Colleagues have now sent me their bids for the three Survey years.

2. The bids are even higher than I had expected, totalling £13 billion in 1990-91, and £15 billion and £21 billion respectively in the two later years. A number of these bids represent very large percentage increases on the departmental baselines - for instance, nearly 25 per cent for DES in 1990-91, and even more for DTp. In addition to this several colleagues noted that there were further bids to come, and a number warned that they would need to reconsider their bids if the inflation assumptions were increased.

3. I have been through the bidding letters very carefully.

4. As we foresaw, there are a hard core of bids, amounting now to around £4 billion, which are virtually irresistible. These include the cost of policies to which we are already publicly committed, on student loans, for example, and on the pensioners earnings rule. They also include the effect of higher inflation on social security upratings; and the extra AEF for English local authorities, which E(LF) has just agreed, along with comparable increases for Scotland and Wales.

FOR SURVEY M+G ON THURS.

CST TO PM 23 JUN

SECRET

5. There are other bids where some additional spending is probably inevitable, though the sums sought by colleagues will need to be pruned. For example, Kenneth Clarke's bid of £1¾ billion in 1990-91 for the health service includes some £½ billion for the costs of implementing the NHS Review.

6. A particular group of bids is for extra capital investment in housing, education, prisons, roads, rail, and health; these already total over £3¼ billion in 1990-91; further bids are yet to come on rail, particularly for the later years. Individual bids may be well supported: for example Paul Channon's bid for greatly expanded road investment follows E(A)'s decision, and his recent White Paper. Taken together, however, they amount to a wholly unrealistic expansion of public sector investment. Quite apart from its cost, this would put a severe strain on the capacity of the supplying industries, with adverse effects on both prices and imports.

7. The overall bids are almost a third higher than they were at this stage last year. Further bids of about £3-4 billion a year emerged during the course of last year's Survey and something similar is likely to happen again. Last year, the eventual outcome was transformed by savings of nearly £5 billion a year which emerged on unemployment benefit, housing receipts, the nationalised industries and agricultural market support. These savings reflected the success of our policies, but have now already been built into the plans for the present Survey years. We cannot therefore expect a similar last-minute reprieve this time.

8. We clearly cannot contemplate increasing expenditure to anything like the extent sought by colleagues. It would be quite irresponsible in the present economic situation. It would put off indefinitely our hopes of reducing the present tax burden as a proportion of national income, still less of getting back to the level we inherited ten years ago.

9. I am also concerned about public expectations of the prospective scale of extra spending on the infrastructure. I shall be seeking to inject a greater sense of realism into this debate in a speech I shall be making to the Adam Smith Institute on 27 June.

10. This is bound to be a very tough Survey even by recent standards. I shall be writing straight away, on a personal basis, to a few selected colleagues including Paul Channon and Kenneth Baker, urging them to re-examine their priorities. I have also warned Norman Fowler that I shall once again need to seek very substantial cuts in the employment programme. But the bulk of the bilateral discussion will have to wait until after the Cabinet on 12 July. I hope colleagues will agree then that the present economic climate requires severe pruning of their initial bids if we are to retain the credibility of our medium term economic and fiscal aims.

John M.

JOHN MAJOR

SECRET

10 DOWNING STREET

LONDON SW1A 2AA

ppp.

From the Private Secretary 26 June 1989

✓ 26/6

Dear Carys,

1989 PUBLIC EXPENDITURE SURVEY

The Prime Minister was grateful for the Chief Secretary's minute of 23 June, and has noted the latest position on Ministers' bids.

She would be grateful if the Chief Secretary could let her have a further note later this week setting out specific proposals on the remit that Cabinet might be invited to endorse. She would like to discuss this with the Chancellor and the Chief Secretary early next week.

I am copying this letter to Alex Allan (HM Treasury).

Yours,
Paul

(PAUL GRAY)

Miss Carys Evans,
Chief Secretary's Office.

SECRET

GRAY TO EVANS 26 JUN

FROM: J S HIBBERD (EA1)
DATE: 27 JUNE 1989

CHANCELLOR OF THE EXCHEQUER

cc : Chief Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Dame A Mueller
Mr H Phillips
Mr Scholar
Mr Monck
Mr C W Kelly (Pay)
Mrs Lomax
Mr Luce
Mr Mountfield
Miss Peirson
Mr Peretz
Mr Riley
Mr Sedgwick
Mrs R Butler (GEP)
Mr Gieve (IDT)
Mr MacAuslan (GEP)
Mr McIntyre (ST1)
Mr Mowl (PSF)
Mr Owen (EA1)
Mrs Chaplin
Mr Tyrie

HIBBERD TO CX 27JUN

ECONOMIC ASSUMPTIONS FOR PUBLIC EXPENDITURE

This submission seeks your approval for a revised set of Economic Assumptions to be sent to Departments in the light of the June forecast. We are due to discuss them with you at a meeting on Thursday.

2. The purpose of issuing revised assumptions to departments is to give them the best available basis for planning and control. You will at the same time want to consider which assumptions will best assist a successful outcome for the forthcoming discussions with departments. (Some of the figures for 1989 will, following past precedent, appear also in the table attached to your Cabinet paper; a draft of which Mr Riley will send to you tomorrow.)

3. Economic assumptions will be reassessed in October. The assumptions decided then for unemployment, earnings and inflation for the current and next financial years will be published in the Autumn Statement. No assumptions are published at this time of year, and interest rate assumptions are not published at any time. Unless the forecast published in the Autumn Statement is radically different from the current June forecast there is a strong possibility that we shall need, before the end of the Survey, to revise substantially the

assumptions issued in March at least for 1989 and quite probably for 1990 (the years covered by the Autumn Statement forecast). The expenditure figures in the Autumn Statement will need to be consistent with the economic outlook in the forecast.

4. Past experience has underlined the difficulty of revising assumptions at the last minute, especially for the GDP deflator which is important for many programmes like health, defence and overseas aid, and tends to condition the kind of settlements which are reached on running costs. Changes of the order implied by the June forecast would clearly be very difficult to manage at the end of the Survey. There is again a case this year, therefore, for now giving departments figures which are realistic for the current year, and which, for the coming year, minimise the risk that further changes will be needed in the published Autumn Statement. Nonetheless, they should not be so much higher (lower for unemployment) that they would risk being revised downwards (upwards for unemployment) in the autumn.

5. The June forecast depicts significantly higher inflation throughout the Survey period than was presented in the MTFS. This produces something of a conflict for the economic assumptions exercise. The well-established convention is that, once the MTFS is published, subsequent revisions to economic assumptions through the rest of the year are restricted to the current and next financial year. For subsequent years (in this case 1991-92 onwards) the practice has been to revert to the MTFS path. This practice can produce sharp discontinuities in the assumptions.

6. However, it can also be argued that for public expenditure planning purposes it is important to establish the most realistic assumptions possible at this stage of the Survey. In particular the pressure on DSS to agree to policy reductions, which largely take effect in later years, will be reduced if they do not have to put in sizeable estimating bids. For these reasons, ST Division favour higher inflation assumptions for later years than presented in the MTFS, giving greater (but not total) weight to the June forecast.

7. Against that it has to be said that the June forecast itself is particularly uncertain. That is inevitable when we are either at or forecasting a significant turning point in the economy. Moreover, to circulate higher inflation assumptions than contained in the MTFS for

the later years as well may be construed by departments as reflecting a change in macro-economic policy, with a major relaxation of counter inflationary objectives. And we do not normally consider it desirable to change our medium term view of the economy more than once a year, and certainly not on the basis of three months new data since the last MTFS.

8. These issues clearly need to be considered at your meeting on Thursday. For the purposes of what follows I have adhered to previous practice and proposed assumptions which revert to MTFS paths from 1991-92. But I also present alternative assumptions which reflect ST Division's views.

Unemployment

9. We did not revise the assumptions for narrow GB unemployment in March, but persevered with the figure first published in the Autumn Statement of 1.9 million for 1989-90 and beyond. We maintained this figure despite the fact that unemployment had been falling sharply in the preceding months, and was at the time perceived likely to fall further to give an average for 1989-90 of 1.78 million - noticeably lower than 1.9 million. The main reasons for sticking with the figure of 1.9 million in the March assumptions were that it would provide a more realistic basis for the Survey, and avoid difficult upward revisions if our forecasts subsequently proved incorrect.

10. In fact, GB unemployment has continued to fall at an underlying rate of about 40,000 a month throughout this year, to 1.73 million by May. (The fall in May was only about 20,000; but this is regarded as due to special factors after the exceptionally large fall of 60,00 in April.) The June forecast projects a further, but much slower, decline to 1.68 million by the end of this year, and a very slow rise subsequently. For 1989-90 the outturn is forecast to be 1.7 million and 1.75 million for subsequent years. In choosing the assumption we do not normally take account of forecast changes in unemployment beyond the next month or so.

11. At this stage it is desirable for public expenditure negotiations to choose an unemployment assumption which is as high as is feasible, but still plausible. Against this background, and in the light of the forecast, it would seem reasonable to extrapolate

something very close to the last actual figure of 1.73 million throughout the period. I propose 1.75 million. It assumes no further fall in unemployment from now on, but is defensible as a stylised assumption. We could even go for 1.8 million, if you wished, though it would risk causing undue suspicion on the part of departments most concerned, DSS and DEmp.

Unemployment - GB millions

	1989-90	1990-91	1991-92	1992-93
FSBR/MTFS figures	1.78	1.86	1.90	1.91
March (and PEWP) assumptions	1.9	1.9	1.9	1.9
June forecast	1.70	1.75	1.73	1.72
Proposed assumption	**1.75**	**1.75**	**1.75**	**1.75**

Average earnings

12. The average earnings figure published last November in the Autumn Statement showed a 7½ per cent increase in 1989-90, after an estimated increase of 8¾ per cent in 1988-89. Unpublished assumptions for 1990-91 and 1991-92 had earnings growth falling to 6 and 5 per cent respectively. The assumptions were revised up in March after the Budget (the tax calculations and press briefing of which were done on the previous assumptions). The March assumptions were revised line with the MTFS figures. This is illustrated below.

Recent average earnings assumptions

	1988-89	1989-90	1990-91	1991-92	1992-93
1989 PEWP assumptions*	8¾	7	6	5	
FSBR/MTFS	8.9	9.0	7.8	6.2	5.5
Revised March assumption		**9.0**	**7¾**	**6¼**	**5**

* Only 1988-89 and 1989-90 figures were published in Autumn Statement.

13. The Department of Employment's estimate of underlying whole economy average earnings growth has risen from 8½ per cent in April 1988 to 9¼ per cent in April 1989. The immediate prospect is for a further rise in the next few months. It seems almost certain that the figure for May will be 9½ per cent. The forecast is that earnings growth will not slow down until the end of 1989 and beyond. The profile of earnings growth in the June forecast is higher than in the FSBR/MTFS projections.

14. It is widely expected that earnings growth will continue to rise from its current rate, and we will almost certainly have to publish a figure at, or close to, 9½ per cent for 1989-90 in the Autumn Statement. I propose that we use that figure now. For 1990-91, I suggest we use something below our forecast but above our previous assumption. That should allow us to revert to the MTFS path for earnings in 1991-92 without too implausible a discontinuity. The proposed path for earnings will then be consistent with our proposed GDP deflator and RPI assumptions for the same years (see below)

Average earnings assumptions
(percent changes on year earlier)

	1988-89	1989-90	1990-91	1991-92	1992-93
1989 PEWP	8¾	7	6	5	
MTFS/FSBR figures	8.9	9.0	7.8	6.2	5.5
March assumption		9.0	7¾	6¼	5
June forecast		9.5	8.5	7.8	7.7
Proposed assumption		9½	8	6¼ -6½	5
Alternative assumption		9½	8	7	6

Retail prices

15. RPI assumptions are needed for September 1989, 1990 and 1991, to determine the size of the Social Security upratings in the following financial years. The September 1989 figure for inflation implied by the June forecast is 7.3 per cent and for September 1990 is 6 per cent. These figures are considerably higher than the assumptions of 6¼ per cent and 3¾ per cent respectively, which were consistent with the FSBR/MTFS outlook. The latter incorporated a smoothly declining interest rate profile. The June forecast, by contrast, has short-term interest rates being sustained at current levels until mid-1990 and declining only slowly subsequently. Underlying or core inflation is also generally higher in the June forecast than in the FSBR/MTFS outlook.

16. I propose an assumption of 7¼ per cent for September 1989. By the time we next have to publish a forecast in the Autumn Statement, that figure will be recorded. The assumption for September 1990 will then need to be reassessed in the light of what we are likely to publish in the Autumn Statement for forecast RPI inflation for the fourth quarter of 1990. But unless there are significantly lower

prospects for interest rates in 1990 and beyond than we currently foresee, it seems best that we move now to a higher figure for September 1990, say 5 per cent, before reverting to our previous assumption for September 1991. The table below summarises recent assumptions and forecasts, and our latest proposed assumptions.

RPI, per cent changes a year earlier

	September 1989	September 1990	September 1991
Published PEWP assumption	5½	4	
Unpublished FSBR/MTFS figures	6.3	3.7	2.6
March assumptions	6¼	4	2½
June forecast	7.3	6.0	4.7
Proposed assumptions	**7¼** 7?	**5**	**2½** 3
Alternative assumption	7¼	6	4
	7½	5½	3½

17. The **RPI excluding housing** (**the Rossi index**) is used for uprating about a third of the social security programme. In the June forecast, it is expected to rise by about 5 per cent in the year to September 1989 and 4 per cent in the years to September 1990 and September 1991 respectively. These are consistent with both the PEWP Rossi assumptions (published in DSS's Chapter of the 1989 PEWP) and the March assumptions. There is no need, therefore, to change these.

Rossi index assumptions

(per cent changes on year earlier)

	September 1989	September 1990	September 1991	
1989 PEWP	5	4		
FSBR/MTFS	4.7	3.5	2.6	
March assumption	5.0	4	2½	
June forecast	5.0	4.0	4.0	
Proposed assumption	**5.0**	**4.0**	**2½**	3.0
Alternative assumption	5.0	4.0	3½	

GDP deflator

18. The March assumption for GDP deflator inflation was the same as the path published in the FSBR/MTFS. To avoid confusion at that time we made no allowance for the impact of the community charge in Scotland in April 1989 and in England and Wales from April 1990. But, given the way the abolition of domestic rates is to be handled in the national accounts, the rise in the consumers' expenditure deflator in 1989-90 and 1990-91 will be reduced below what it would otherwise have been when the community charge is introduced.

19. The impact of this on the overall GDP deflator will be to reduce it by 0.2 per cent in 1989-90 and by 1.9 per cent in 1990-91 below what it would otherwise have been. Most officials in departments are as yet unaware of this, though there has been discussion by an inter-departmental CSO committee. The occasion of these revised assumptions and the forthcoming public expenditure negotiations will be the first time they are formally introduced to it. The treatment of the community charge will start affecting the published national accounts, though only in a small way at first, when the CSO publish the 1989Q2 national accounts in September.

20. Adjusting for this purely statistical feature of the data (ie adding back the "community charge effect"), it is clear that the forecast for GDP deflator inflation has been revised up quite considerably in the June forecast compared to the FSBR/MTFS projections. It is proposed that we reflect this fully in revised assumptions for 1989-90, but only partly for 1990-91. We then propose to go back to the MTFS path for later years.

GDP deflator

(per cent changes on year earlier)

	1988-89	1989-90	1990-91	1991-92	1992-93
1989 PEWP	6¼	5	3½	3	
FSBR/MTFS	7¼	5½	4	3	2½
June forecast	7¼	7.0	3.3	4.6	4.2
June forecast (adjusted for community charge)	7¼	7.2	5.2	4.6	4.2
		7?	5	4	3
Proposed assumptions		7¼	5	3	2½
Alternative assumption		7¼	5	4½	3½

Interest rates

21. The FSBR/MTFS projected a one-point decline in short-term interest rates in July 1989 and in January 1990, and a gradual decline thereafter. The March interest rate assumptions broadly followed the FSBR/MTFS path. The June forecast, however, incorporated an assumption of a fixed UK short-term interest rate of 14 per cent from 1989Q3 to 1990Q2. Thereafter short-rates are assumed to fall ½ point in 1991Q3 and by a similar margin every two quarters until stabilising at 11½ per cent in 1992Q3.

22. The June forecast thus clearly marks a significant departure from the FSBR/MTFS path for interest rates. Nonetheless, in keeping with the overall approach to assumptions adopted here we revert to the MTFS path for short-term interest rates by 1991-92. We do the same for long rates, with LIBOR rates unchanged from the March assumptions. Though the interest rate assumption are not published, they are circulated to a large number of departments including ECGD, DoE, No 10, and the Scottish and Welsh Offices, mainly for calculating housing subsidies. Nothing suggests that long rates (except in 1990-91) or dollar-LIBOR rates need to change much.

	1989-90	1990-91	1991-92	1992-93
3-month inter bank				
1989 PEWP	11	9½	9	
March assumption	12	10	8½	7
June forecast	13.9	13.5	12.5	11.7
Proposed assumption	**13¾**	**11½**	**8½**	**7**
20-year gilt rate				
1989 PEWP	9½	9½	9½	
March assumption	8½	8	7½	7¼
June forecast	9.9	9.7	9.3	9.0
Proposed assumption	**9¾**	**9½**	**7½**	**7¼**
6 month dollar LIBOR				
1989 PEWP	10	9	9	
March assumption	10	9	9	9
June forecast	9.1	8.7	8.5	8.5
Proposed assumption	**9**	**9**	**9**	**9**
	9	9	8	8

23. We have also been asked for the first time to produce an additional assumption on interest rates for ECGD purposes (ECGD already receive our other interest rate assumptions.) This is an assumption for world long rates, specifically for 5-year bond rates for sterling, dollar, yen, mark and the French franc. The rationale for this is explained more fully in **Annex A** along with proposed assumptions. GEP division support ECGD's request. If you are content with this, they will become a regular feature of the assumptions in the future.

OK

Effects on expenditure

24. **Annex B** summarises all the assumptions proposed here. **Annex C** sets out a ready reckoner indicating the approximate effect on forecast expenditure of the proposed changes to economic assumptions compared to the equivalent March FSBR/MTFS assumptions

	1989-90	**1990-91**	**1991-92**	**1991-93**
Effect of:				
Unemployment	- 380	- 398	- 413	- 428
RPI	+ 15	+ 305	+ 610	+ 610
GDP deflator	+ 90	+ 143	+ 143	+ 143
Interest rates	+ 150	+ 275	+ 95	+ 54
Total	- 125	+ 325	+ 435	+ 379

Decisions

25. Are you content for us to proceed as proposed.

JH

J S HIBBERD

ANNEX A: INTEREST RATE ASSUMPTIONS FOR THE SDR CURRENCIES

We have been asked to provide a set of assumptions on short and medium term interest rates for the SDR currencies. These are to be used by ECGD in the calculations for their interest make up account (Class V, vote 6). The precise assumptions required are for interbank rates and for 5-year government bond yields. The five SDR currencies are the US dollar, Yen, Deutschemark, French franc and pound sterling.

The table below presents the June forecast projections of the relevant numbers, along with recent values of the rates in question, and our proposed assumptions. With the exception of the UK, we do not forecast yields on government bonds. The assumptions on these are based upon the short rate projections, coupled with analysis of recent behaviour of the respective yield curves. Assumptions for UK and US short rates are identical to the main economic assumptions.

June forecast

	Latest (21.6.89)	1989-90	1990-91	1991-92	1992-93
Short rates					
US	9.35	9.1	8.7	8.5	8.5
J	5.375	5.5	5.1	4.5	4.5
G	6.80-6.95	7.6	7.4	6.9	6.4
F	8.875	9.6	9.4	8.9	8.5
UK	14.19	13.9	13.5	12.5	11.6
Long rates 5-year Gilt rate, UK only					
UK (5 yr)	11.56	11.1	11.0	10.7	10.4

Suggested Assumptions for world interest rates

	Latest	1989-90	1990-91	1991-92	1992-93
Short rates					
US		9	8¾	8½	8½
J		5½	5	4½	4½
G		7½	7½	7	6½
F		9½	9½	9	8½
Long rates (5 yr)					
US	8.38(10 yr)	8½	8½	8½	8½
J	5.52(9 yr)	5¾	5½	5	5
G	6.67(9 yr)	7	7	6½	6½
F	8.64(5 yr)	9	9	8½	8½

ANNEX B

ASSUMPTIONS ON UNEMPLOYMENT, EARNINGS INFLATION AND INTEREST RATES

Unemployment GB narrow (millions)	1988-89	1989-90	1990-91	1991-92	1992-93
Published PEWP assumption	2.1	1.9			
Unpublished FSBR/MTFS projections	2.06	1.78	1.86	1.90	1.91
Unpublished March assumptions		1.9	1.9	1.9	1.9
Unpublished June forecast	2.08	1.70	1.75	1.73	1.72
Proposed Assumptions		**1.75**	**1.75**	**1.75**	**1.75**

Average earnings (percent changes)	1988-89	1989-90	1990-91	1991-92	1992-93
Published PEWP/GAD assumption	8¾	7½			
Unpublished PEWP/GAD assumption			6	5	
Unpublished FSBR/MTFS projections	8.9	9.0	7.8	6.2	5.5
Unpublished March assumptions		9	7¾	6¼	5
Unpublished June forecast	8.5	9.5	8.5	7.8	7.7
Proposed Assumptions		**9½**	**8**	**6¼**	**5**

RPI (per cent changes)	Year to September 1989	Year to September 1990	Year to September 1991
Published PEWP assumption	5½	4	
Unpublished FSBR/MTFS forecast	6.3	3.7	2.2
Unpublished March assumption	6¼	4	2½
Unpublished June forecast	7.3	6.0	4.7
Proposed Assumptions	**7¼**	**5**	**2½**

RPI excluding housing - Rossi index (per cent changes)			
Published PEWP assumption	5	4	
Unpublished FSBR/MTFS forecast	4.7	3.5	2.6
Unpublished March assumption	5	4	2½
Unpublished June forecast	5.0	4.0	4.0
Proposed Assumption	**5.0**	**4.0**	**2½**

GDP deflator (per cent changes)	1988-89	1989-90	1990-91	1991-92	1992-93
Published PEWP assumption	6¼	5	3½	3	
Published FSBR/MTFS forecast (March assumption)	7¼	5½	4	3	2½
Unpublished June forecast (corrected for community charge)	7.3	7.3	5.2	4.6	4.2
Proposed assumptions		**7¼**	**5**	**3**	**2½**

ANNEX B (continued)

ASSUMPTIONS ON INTEREST RATES

3-month sterling interbank rate	1989-90	1990-91	1991-92	1992-93
Unpublished PEWP assumption	11	9½	9	
Unpublished FSBR/MTFS figures	12.0	10.25	8.6	7.1
Unpublished March assumption	12	10	8½	7
Unpublished June forecast	13.9	13.5	12.5	11.6
Proposed Assumptions	**13¾**	**11½**	**8½**	**7**

20-year gilt rate	1989-90	1990-91	1991-92	1992-93
Unpublished PEWP assumption	9½	9½	9½	
Unpublished FSBR/MTFS figures	8.8	8.3	7.6	7.3
Unpublished March assumption	8½	8	7½	7¼
Unpublished June forecast	9.9	9.7	9.3	9.0
Proposed Assumptions	**9¾**	**9½**	**7½**	**7¼**

6-month Dollar LIBOR	1989-90	1990-91	1991-92	1992-93
Unpublished PEWP assumption	10	9	9	
Unpublished FSBR/MTFS figures	10.1	9.8	9.3	9.2
Unpublished March assumption	10	9	9	9
Unpublished June forecast	9.1	8.7	8.5	8.5
Proposed Assumptions	**9**	**9**	**9**	**9**

ANNEX C: EFFECT OF CHANGES IN ASSUMPTIONS ON THE PUBLIC EXPENDITURE PLANNING TOTAL

£ million

		1989-90	1990-91	1991-92	1992-93
(a)	**100,000 rise in unemployment**				
	DSS	255	265	275	285
	N. Ireland	[5]	[5]	[5]	[5]
(b)	**One point rise in 3-month sterling interbank interest rates for 1989-90**				
	ECGD (short rates)	50	-	-	-
	[Housing subsidies (pool rate*)England from 1990-91 onwards.	53	31	15	7
	DTI credit to shipbuilders (short rates)	9	-	-	-
	LAPR/MIRAS	25	-	-	-
(c)	**One point rise in 20 year gilts for 1989-90**				
	Housing (UK)	3	10	8	8
(d)	**One point rise in 6-month dollar LIBOR for 1989-90**				
	ECGD	5	-	-	-
(e)	**One per cent higher earnings 1989-90**				
	DSS	-10	-10	-10	-10
	[N Ireland]	[-2]	[-2]	[-2]	[-2]
(f)	**One per cent higher September 1989 RPI**				
	DSS (relevant to April 1990 uprating)	-	280	280	280
	N Ireland	-	[8]	[8]	[8]
	Civil Superannuation	15	15	15	15
	ODA Superannuation	2	2	2	2

* Housing subsidy pool rate responds with a lag to changes in short and long rates

(g)	**One per cent higher September 1989 ROSSI**				
	DSS	-	140	140	140
	N Ireland	-	[4]	[4]	[4]
(h)	**GDP deflator 1% higher in 1989-90**				
	Housing benefits (GB)	50	50	50	50
	(N Ireland)	2	2	2	2

ANNEX D

DEPARTMENTS RECEIVING ECONOMIC ASSUMPTION

Unemployment	DHSS, DEmp, Northern Ireland Office, (NIO), GAD
RPI including and excluding housing costs	DHSS, ECGD, NIO, GAD
GDP deflator	DHSS, GAD
Average earnings	DHSS, GAD
Interest Rates	DTI, ECGD, DOE, NIO, Scottish Office, Welsh Office. (The last four receive these to compute housing subsidies.)

* Superannuation uprating assumptions go to departments paying public service pensions. Though described as superannuation uprating assumptions, the departments are well aware that they are actually the September to September all items increase.

cst.rj/docs/28.6.7

SECRET AND PERSONAL

SCORECARD
Copy no 1 of 9

FROM: A G TYRIE
DATE: 28 June 1989
cc: Chief Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mrs Lomax
Mrs Chaplin

CHANCELLOR

* For this afternoon's meeting.

THE JULY CABINET

Even more than usual, colleagues need a sharp shock to change their attitudes.

2. They could perhaps be told that:

- An increase in spending on this scale would make it very unlikely that the economy could be put in apple pie order for the next election.

- The bids seem to have been drawn up in isolation from the economic climate and, particularly, without any appreciation of market conditions.

- The fiscal surplus cannot be counted upon. A large part of it is inflationary and a downturn in business confidence and activity could soon see it withering away. Combined with these bids that would leave the Government with no room for tax cuts in the run up to an election.

3. All this points to going for option A, as the toughest of the three formulae. Option B, "as close as possible to the existing plans", sounds pretty imprecise and invites further questioning. Option C sounds like a change of policy on public expenditure.

4. Of course, taking a tough line makes it even more important that something pretty close to the existing ratios can be delivered. As I have said before, I do think there is scope for a substantial reduction in these bids:

- Kenneth Baker's bids can be radically trimmed. GEP's forecast outcome already implies trimming them by more than half, but there may be scope for even more.

- The transport bids, although worthy, can legitimately be pushed to the back end of the Survey period. It is unlikely that such large sums could in practice be spent in the new year one, anyway.

- I have already minuted in some detail on why there is scope for a substantial slashing of Norman Fowler's budget.

- It may be that by the Autumn the political climate has changed just sufficiently to trim a little from the health bids. Admittedly that would be very tricky.

- MOD might be foolish enough to try and reopen their three year deal. Should they do so I think we should not just fend them off: we should look for cuts. With amity and peace breaking out everywhere the international relations scene cannot possibly warrant increases.

- Last, and certainly not least, departments need to be told that further bids, over the summer, cannot possibly be considered. In particular, they will have to take an inflationary hit. There will be much wailing and gnashing of teeth about this, with the new GDP deflator for 1991 substantially higher than scored in the FSBR, and higher still than scored in the Autumn Statement. But, as they have in the past, departments will just have to absorb this. The ratios, and indeed the whole round, would be in deep trouble if inflation were to be accommodated.

RJ.

pp A G TYRIE

tables

CONFIDENTIAL

FROM: J S HIBBERD (EA1)
DATE: 29 JUNE 1989
EXT : 4590

CHIEF SECRETARY

cc : Chancellor
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Mrs Lomax
Mr Riley
Mr Sedgwick

HIBBERD TO CST 29/6

ECONOMIC ASSUMPTION: GDP DEFLATOR

You asked for some recent history of revisions to the economic assumptions for the GDP deflator. This is set out in the Table below.

GDP DEFLATOR ASSUMPTIONS

	1987-88	1988-89	1989-90	1990-91	1991-92	1991-93
PEWP 1988	4¼	4½	3½	3	-	-
March 1988	-	4½	4	3½	3	-
July	-	5½	4½	3½	3	-
October	-	6¼	5	3½	3	-
PEWP 1989	-	6¼	5	3½	3	-
March 1989	-	-	5½	4	3	2½

2. The assumptions we circulated in March 1988 were consistent with the MTFS path set out in the 1988 FSBR. For 1989-90, the first year of the then Survey period, the MTFS path was ½ per cent higher than the previous PEWP.

3. In July 1988 we revised up the figure for 1988-89 (by 1 per cent) and 1989-90 (by ½ per cent) before reverting to the MTFS path.

4. In October 1988 we revised 1988-89 (again up by 1 per cent) and 1989-90 (up ½ per cent), but still reverted to the MTFS path for 1990-91 and beyond.

JH

J S HIBBERD

CONFIDENTIAL

mp.pc/Riley/226

Covering SECRET

FROM: C J RILEY (MP)
DATE: 29 June 1989
Extn: 4439

CHANCELLOR

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Phillips
Mr Monck
Mr Scholar
Miss Peirson
Mrs Lomax
Mr Luce
Mr Peretz
Mr Sedgwick
Mr S Davies
Mr MacAuslan
Mr Mowl
Mr Gieve
Mr Pickford
Miss Simpson
Miss Walker
Mrs Chaplin
Mr Tyrie

Ch
Not time for you to look at in any detail before this afternoon's meeting. But chance to comment on tone & structure. I think it needs a bit more on public expenditure this year, which comes in right at the end (though hints earlier)
AA

RILEY TO CH/EX 29 JUN

PAPER FOR JULY CABINET

I attach a draft of your paper for the Public Expenditure Cabinet on 12 July. You may wish to discuss the general thrust of the paper, if not the detailed drafting, at your meeting on the Survey. — if you or anyone else has had time to glance at it first.

2. Normal practice suggests sending the paper to the Prime Minister on Friday, 7 July, so that it can be circulated to Cabinet on Monday, 10 July. But with the Cabinet advanced to Wednesday, you may wish to consider whether the timetable for circulating the paper should be advanced also. NO

Could do – is it necessary? I suppose Ld otherwise give only v short time for depts to brief, but doesn't Hayden or someone give PFOs an indication @ end of previous week?

3. The draft includes a table, in the same format as last year, giving our latest view on the likely development of the economy in 1989. The figures are taken from the June forecast; we will have to ensure that they square with the economic assumptions to be used in the Survey, which are discussed in Jim Hibberd's note of 27 June.

Covering SECRET

4. Finally, you will wish to consider how far to go in describing the prospect for the public finances. Last year there was no discussion of this in the paper, but the case for underlining the fragility of the PSDR is a strong one in present circumstances.

a bit O.T.T.

CJR

C J RILEY

mp.pc/Riley/223
ov SJ Davies.

SECRET

CABINET

ECONOMIC PROSPECTS

See redraft of this page

Memorandum by the Chancellor of the Exchequer

During the 1980s we have experienced a period of sustained economic growth, at a rate faster than our major European competitors. Unemployment continues to fall, profitability is high, and rising private investment - now at record levels - augurs well for the future. This performance has been the result of prudent macro-economic policies combined with supply side reforms.

not in 80's

2. But over the last two years inflationary pressure has re-emerged and the economy has grown at a rate which cannot be sustained. Some slowdown is required. There are clear signs that this is happening following the tightening of monetary policy since last summer. Yet demand and inflationary pressures remain uncomfortably strong. Inflation is higher than forecast at Budget time, and the current account deficit has also been larger. Domestic demand and non-oil output are both more buoyant than expected. Many sectors of the economy, most notably the construction industry, are experiencing considerable pressures on capacity.

Needs more balance - policy working well in some areas (housing especially) slower in others.

3. It is essential that these pressures are contained and that inflation is ~~seen to be~~ placed firmly on a definite downward path. This means continuing to pursue tight monetary and fiscal policies. It has been necessary to tighten monetary policy since the Budget, and [the financial markets remain fragile.] At a time when we are seeking a slower growth of private sector demand any suggestion of a relaxation of fiscal policy, with the public sector adding to existing pressures on the economy, would be very damaging. In these circumstances, the fact that we are running a budget surplus does not suggest that we can afford to be any more relaxed than in the past about the forthcoming public expenditure round.

?

SECRET

mp.pc/Riley/223

SECRET

4. It is especially important in current circumstances, with substantial pressures on capacity, to sustain the momentum of supply side reforms. Reducing the share of public expenditure in the economy to contain, and if possible bring down, the tax burden are essential components. The tax burden still remains above the level we inherited a decade ago, and only with continued restraint in public expenditure is there any real prospect of progress on this.

certainly the tone is wrong. But do we want this anyway?

WORLD ECONOMY

5. The world economy grew much more rapidly than expected in 1988, and in every country within the G7, forecasts of the growth of GNP and domestic demand were ~~comfortably~~ exceeded. GNP growth in the G7 ~~Group of 7 countries (G7)~~ as a whole reached ~~was~~ 4½ per cent and world trade in manufactures grew by 10½ per cent.

6. The indications are that the world economy has remained ~~very~~ buoyant in the first half of this year. Growth in Japan and Germany appears to be particularly ~~very~~ strong, though there are clear signs of growth slowing in the US in response to tighter monetary policy.

7. The strong growth of the past two years is in large part the result of a worldwide ~~major~~ investment boom, ~~All over the world investment has surged~~ in response to the more stable economic environment of the 1980s with lower ~~low~~ inflation, ~~improved profitability,~~ and less intervention by governments.

has risen in all the major industrial countries

8. This dynamism in the world economy has, however, brought with it increasing inflationary pressures. ~~the risk of higher inflation~~. Capacity utilisation is at historically high levels, and ~~as a result~~ inflation ~~has edged up~~. In response all the major countries ~~monetary authorities~~ have raised interest rates. ~~In some countries, such as the US, the tightening of monetary policy has already been partially reversed. In others there may be some further tightening if inflation continues to edge up.~~

since the spring of last year

9. Provided that countries continue to take the necessary action to restrain inflation the prospect is for further satisfactory growth in the world economy, though at a somewhat lower rate than in 1988.

While ~~there are signs that~~ in the US interest rates may have peaked, in Europe interest rates were raised further in the last week in June, and a further increase is also likely in Japan.

SECRET

THE BRITISH ECONOMY

~~domestic demand~~

domestic

10. There are now clear signs that growth of GDP and ~~consumer~~ demand have begun to moderate in response to recent rises in interest rates. GDP growth ~~But although growth in the most recent quarters has been at a lower rate than in the first half of 1988, non-oil GDP was still over 4 per cent higher than a year earlier in the first quarter of 1989.~~ I expect growth of total GDP in 1989 as a whole as now forecast to be 2¼ per cent, just a little below the budget forecast. But this is entirely due to lower North Sea production following recent accidents, and non-oil GDP growth looks like being ½ per cent above forecast, for 1989, at X per cent.

11. The growth of personal sector spending has slowed down sharply. Retail sales have risen only slowly so far this year, and indicators of consumer confidence indicate that ~~lower~~ growth will continue is so slow. Reduced mortgage lending and a pretty depressed housing market ~~much slower increase in house prices~~ suggest that consumers will be more cautious from now on and will gradually increase net saving from the very low recent levels. Even with continued strong growth of private investment the growth of total domestic demand is likely to be much lower in 1989, at 3 per cent, than the 6½ per cent recorded last year. Nevertheless ~~domestic demand growth~~ in the circumstances this is still too rapid, and needs to come down further if inflation and the current account deficit are to fall significantly. This ~~may~~ will require policy to remain tight for some time yet.

(understated surely)

12. There ~~is~~ was evidence of widespread pressure on capacity in manufacturing industry in the second half of last year. These pressures have eased a little in 1989, and should ease further as output grows more slowly and new capacity comes on stream as a result of the investment boom. The construction industry, however, has shown more worrying symptoms of capacity constraints, with ~~reported~~ serious shortages of labour and evidence that prices are rising much faster than in the rest of the economy - well into double figures. The latest DTI and CBI surveys, together with evidence from the industry itself, suggests continuing growth of construction demand; capacity constraints ~~and strong upward pressure on prices~~ are likely to persist for some while yet in this sector.

wise?

13. Underlying inflation has been a little ? higher so far in 1989 than envisaged at Budget time, having risen throughout the recent period of very strong growth. The RPI excluding mortgage interest payments - the nearest equivalent to the measures of consumer prices used in nearly all other major countries - was 6 per cent higher than a year ago in May. Including mortgage interest payments, RPI inflation in May was 8.3 per cent. And pay is continuing to grow more rapidly than is desirable, especially in the public sector. I now expect total RPI inflation to be 6¼ per cent in the fourth quarter of this year, above the forecast of 5½ per cent published at that time of the Budget. By this time, however, other less distorted measures of inflation - such as producer prices and the RPI less mortgage interest payments - should have clearly stabilised and begun to fall.

[~~SEE~~ RILEY 30 JUNE re new sentences on investment prices]

14. There was a ~~substantial~~ recorded current account deficit of £15 billion in 1988 ~~in the recorded balance of payments accounts that~~ has persisted so far this year, and a substantial deficit though in the light of the enormous balancing items in the accounts the times deficit may well be overstated. It should be possible gradually to reduce this deficit, and in the meantime to finance it, provided we maintain a ~~very strict~~ policy stance that ~~effectively~~ sensibly restrains the growth of domestic demand.

15. The public finances remain strong, though there are some signs that the PSDR in 1989-90 may prove ~~a bit~~ slightly smaller than I budgeted for in March. Our policies to boost personal pensions have been more successful than anyone foresaw~~, for example,~~ and the consequential rebates of national insurance contributions will reduce government revenues, though in the longer term there will be substantial savings on SERPS spending ~~not only this year but for several years to come.~~ And ~~As I have already made clear,~~ the favourable cyclical influences which have boosted the surplus over the past two years will tend to unwind ~~in the medium term~~ as the economy slows down. The fiscal projections in the MTFS showed minimal scope for discretionary tax reductions given present public expenditure plans, even with the budget reverting gradually to balance. It would clearly be a very damaging reversal of policy if we had to raise taxes to maintain an adequately tight fiscal stance.

~~corporation tax tail-off~~

CONCLUSION

16. The policies which we have ~~been~~ pursued in the 1980s have greatly strengthened the British economy. But there are clear risks in the present situation. We must not weaken in the fight against inflation. At a time when we are seeking to reduce the growth of private sector demand it is vital not to ~~allow imprudent increases in public expenditure. And we must not jeopardise the progress we have made on the supply side by exacerbating pressure on interest rates or putting off still further the prospect of a lower tax burden.~~

add to our difficulties by expanding the public sector's claims on resources.

17. It is essential, therefore, that we follow the recommendations in the Chief Secretary's paper.

SECRET

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

30/6

ACSA — Gray 30/6

CST.
Sir P. Middleton
Sir T. Burns
Mr Phillips
Mr Monck
Mr Luce
Mr Riley
Mr Sedgwick
Mr Mowl
Mr MacAuslan
Mr Gieve
Miss Walker
Mrs Chaplin
Mr Tyrie
Mr Anson
Mrs Lomax

Paul Gray Esq
Private Secretary to
Prime Minister
10 Downing Street
LONDON
SW1

Dear Paul,

PUBLIC EXPENDITURE CABINET: LINE TO TAKE

Your letter of 26 June to Carys Evans asked for a proposal on the remit that Cabinet might be invited to endorse. The Chancellor and Chief Secretary have discussed this, and they suggest the following:

> "The Cabinet reaffirmed the policy that public expenditure should continue to take a declining share of national income, holding as close as possible to the ratios set out in the last Public Expenditure White Paper."

This is in line with the 1987 remit (see earlier correspondence attached). The 1988 remit referrred to keeping as close as possible to the existing planning totals, and this would not be appropriate this year given that we are moving to the new definition of the planning total.

I am copying this letter Carys Evans.

Yours
Alex

A C S ALLAN

31/c
DC

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

11 July 1988

Paul Gray Esq
10 Downing Street
LONDON SW1

cc PS/Chief Secr
Sir P Middlet
Mr Anson
Mr Monck
Mr Phillips
Mr Odling-Sme
Mr Gieve
Mr MacAuslan
Mr Richardson
Mr Turnbull

Dear Paul,

PUBLIC EXPENDITURE CABINET: LINE TO TAKE

The Chancellor and the Chief Secretary have been considering what might be said after the Public Expenditure Cabinet. They suggest the following: -

> "The Cabinet had its usual July discussion of public expenditure today. It agreed that public spending should be held as close as possible to the existing planning totals so that the share of public spending in national income should continue to decline steadily over the 3 Survey years. With this objective, the Chief Secretary will hold bilateral discussions in the Autumn. In the light of these, the Government will take decisions on individual programmes and the planning totals, and these will be announced, as usual, in the Autumn Statement in November.

The Chancellor would be grateful to know if the Prime Minister is content with this.

... I also attach some question and answer briefing for use after the Cabinet.

I am copying this letter to Bernard Ingham, and to Richard Wilson (Cabinet Office).

Yours

Moira

MOIRA WALLACE
Private Secretary

171

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

22 July 1987

David Norgrove Esq
10 Downing Street
LONDON
SW1

Dear David

PUBLIC EXPENDITURE CABINET: LINE TO TAKE

The Chancellor and the Chief Secretary have been giving some thought to what might be said after the Public Expenditure Cabinet. They suggest the following:-

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

The Chancellor would be grateful to know if the Prime Minister is content.

I am copying this letter to Bernard Ingham.

Yours
Alex

A C S ALLAN
Principal Private Secretary

SECRET AND PERSONAL : SCORECARD

COPY NO 1 OF 11

FROM: J GIEVE (IDT)
DATE: 30 June 1989
x4420

GIEVE TO CST 30/6

CHANCELLOR

CHIEF SECRETARY

cc Sir P Middleton
Sir T Burns
Mr Phillips
MrMonck
Mrs Lomax
Mr MacAuslan
Mrs Chaplin
Mr Tyrie

Ch/ Three minutes here in reaction to the tone of Thursday's meeting. Special advisers seem particularly alarmed at sentiments expressed by CST.
DIS

CABINET REMIT

I have been giving some further thought to the likely reaction in the media and the City to the remit which was agreed at yesterday's meeting namely:

> "Cabinet reaffirmed the policy that public expenditure should continue to take a declining share of national income, holding as close as possible to the ratios in the Public Expenditure White Paper."

2. While this maintains the existing "downward trend" formula, many commentators will go over the words very carefully and they will pick up the differences from last year, in particular:

(a) the absence of any commitment to hold to or to stay as close as possible to the existing cash plans;

(b) we are aiming only to get as close as possible to the PEWP ratios and by implication could well exceed them;

(c) with GDP growing faster in the current year than forecast at the time of the Budget, the formula is consistent with large cash increases and a rise in the ratio in 1990-91 at least.

3. While we can point to the change in planning totals as the reason for (a); we will not be able to deny (b) or (c) although we can refuse to confirm or put any figures on the increase in money GDP.

4. If we use this remit, therefore, it seems likely that both the press and the City forecasters will publish quite large estimates of the likely cash increases and will forecast a kink in the downward trend in 1990-91.

5. This reaction would be useful in preparing the ground for the eventual announcement but may not be helpful for the bilaterals if, as I suspect, few of your colleagues have any idea of the likely size of the cash additions.

6. The alternative approach would be to adopt a form of words a little closer to that used last year on the following lines:

> "Cabinet agreed to maintain the downward trend in the ratio of public spending to national output and to hold as close as possible to existing plans."

This would be received as "business as usual" by the commentators and might provide a more helpful basis for the bilaterals. The disadvantage is that it would do nothing to prepare for the Autumn Statement - especially since the same "as close as possible" formula was used last year when we stuck to the planning total for year 1.

7. The choice, therefore, lies between having a quiet July and August but needing to work hard in the Autumn to prepare people for the eventual outcome, and risking a general expectation in July that unusually large cash additions will be made to programmes. It may be sensible to review the formula in the light of the market position nearer the time.

I know John MacAuslan feels that the loss of "downward trend" in the formulation we have chosen is regrettable.

JSG. Gieve

JOHN GIEVE

gep1.ip/jm/chx

SECRET AND PERSONAL

SCORECARD
COPY NO 1 OF 14

FROM: J MACAUSLAN (GEP1)
DATE: 30 June 1989
x 4780

CHANCELLOR OF THE EXCHEQUER 1

cc: Chief Secretary
Mr Anson
Mr Monck
Mr H Phillips
Mrs Lomax
Mr Gieve (IDT)
Miss Walker
Mrs Chaplin
Mr Tyrie

1989 SURVEY PROSPECTS: MEETING WITH PRIME MINISTER

I attach some tables as background briefing for your meeting with the Prime Minister on Tuesday 4 July.

2. You may also want to take with you Rachel Lomax's submission of 28 June, her and my submissions of 15 June, and the Chief Secretary's minutes to the Prime Minister of 12 May and 23 June.

3. The tables below are as follows:

Table 1: total bids and forecast outcome (both incorporating the likely effects of the new economic assumptions agreed yesterday).

Table 2: bids and likely outcome: implications for GGE/GDP ratios and real growth (ditto).

Table 3: GGE/GDP ratio and tax burden: historical series.

Table 4: departmental bids as a percentage of baseline, and implied real growth.

Table 5: virtually irresistible bids (including effects of new economic assumptions).

Table 6: main capital bids.

Table 7: bids yet to come (those foreshadowed in Ministerial letters, plus the effects of new economic assumptions). This table sets out bids not included in the figures of paragraph 2 of the Chief Secretary's minute to the Prime Minister of 23 June, but referred to in general terms in the last sentence of that paragraph. In Tables 1-2 above, the figures for bids include the effects of the new economic assumptions and the megarail bids, but none of the rest; the figures for the forecast outcome make some allowance for the likely outcome on all these bids. The bids will not all actually be made; some can be resisted, and other deferred.

Table 8: economic assumptions agreed on 29 June.

4. On Monday I will give you further briefing on the implications of the bids for the construction industry.

5. We are also planning to produce a draft speaking note for the Prime Minister to use at the 12 July Cabinet. We will submit this on Monday in case it is useful background for the meeting. You may well not want to show this to the Prime Minister on Tuesday; the revised version could go over to No 10 late next week or early the week after.

JM

J MACAUSLAN

SECRET

TABLE 1

IMPLICATIONS FOR GGE

(ex priv proc)

(£ billion)

	1989-90	1990-91	1991-92	1992-93
Baseline	199	210	221	229
1.(a) Bids (including effects of new economic assumptions)		+13¼	+16½	+23
(b) Drawdown of Reserve, GGE adjustment, etc		-1¾	-2¼	-4
Implication of bids for GGE		+11½	+14¼	19
New GGE	199	221½	235	247½
2.(a) Forecast outcome on bids		+9¼	+10¾	+14½
(b) as above		-1¾	-2¼	-4
Implication of forecast outcome		+7½	8½	+10½
New GGE	199	217½	229¼	239¼

TABLE 2

G G E (excluding privatisation proceeds)

R A T I O S (% of GDP)

1. **Plans and actuals**

	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91	1992-93	1992-93
1987 PEWP	44¾	44½	44	42¾	42¼			
1988 PEWP	44½	44	42½	42	41¾	41¼		
FSBR	44½	43¾	41½	39½	39¼	39	38¾	38

Averages

1985-86 to 1987-88
43¼

1986-87 to 1988-89
41½

1987-88 to 1989-90
40

		1989-90	1990-91	1992-93	1992-93
2.	**Implications of bid**	38½	39¾	39¾	39½
	(after Community Charge effect)		(40½)	(40½)	(40¼)
3.	**Implication of forecast outcome**[1]	38½	39	38¾	38¼
	(after Community Charge effect)		(39¾)	(39½)	(39¼)

REAL GROWTH RATES (%)

		1985-86	1986-87	1987-88	1988-89	1989-90	1990-91	1992-93	1992-93
1.	FSBR	-0.2	1.6	-0.2	-2	1.7	1.4	2.1	0.9
2.	Bid						5.8	2.5	2.3
3.	Forecast outcome						3.8	1.9	1.3

gep1.ip/tables/exp trends

TABLE 3

TRENDS IN EXPENDITURE, TAX AND BORROWING

(% of GDP)

	GGE ex priv proc	Tax burden (non-oil)*	PSBR
1978-79	43¼	34½	5¼
1979-80	43½	35	4¾
1980-81	46	36¼	5¼
1981-82	46½	38¾	3¼
1982-83	46¾	38¼	3¼
1983-84	45¾	37¾	3¼
1984-85	46¼	37¾	3
1985-86	44½	37¼	1½
1986-87	43¾	37¾	1
1987-88	41½	37¾	-¾
1988-89	39½	37½	-3
1989-90	39¼	37½	-2¾
1990-91	39	36¾	-1¾
1991-92	38¾	36	-1
1992-93	38	35¼	-½

(Source: FSBR)

* Non-oil taxes and NICs as % of non-oil GDP

CONFIDENTIAL

TABLE 4

MAIN BIDS AS A PERCENTAGE OF BASELINE

(%)	1990-91	1991-92	1992-93
DOE-OES	42	46	32
DTp	24	38	50
DES	23	28	32
HO	13	18	20
DH	9	11	15

REAL GROWTH IMPLIED BY MAIN BIDS

(% real growth over previous year)

	1990-91	1991-92	1992-93
DOE-OES	38	2	-10
DTp	29	11	8
DES	20	2	3
HO	14	2	3
DH	8	4	3

[Using 29 June deflators]

SECRET

TABLE 5

1989 SURVEY: VIRTUALLY IRRESISTIBLE

Committed			
Student loans/awards	150	230	250
Poorer pensioners	200	200	200
Pensioners earnings	375	400	400
Other	325	370	300
	1050	**1200**	**1150**
Demand led/estimating			
Police pay	215	310	415
Students loans/awards	85	110	105
Health review bodies	170	175	175
Social Security uprating	550	950	1325
Other	250	50	1750
	1250	**1600**	**3750**
Costs of agreed policies			
Extension of VAT	150	215	230
Restructuring	275	250	250
HRA (offset within GGE)	450	450	450
	900	**900**	**950**
RSG and NNDR (GB)	800	900	1000
TOTAL HARD TO RESIST	**4,000**	**4,600**	**6,850**
(incl estimated territorial consequences: £bn)	**4¼**	**4¾**	**7**

SECRET

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Table 6

1989 SURVEY: MAIN CAPITAL BIDS

(£ million)

		1990-91	1991-92	1992-93
DTp	National roads	550	850	1200
	Local transport	50	140	140
DOE	Housing Corporation	250	475	750
	Local housing	410	400	280
	Local environmental	215	310	350
	Other	140	160	90
Home Office	Prisons	175	225	200
	Local capital	70	90	110
Legal	Court building etc	35	30	30
DES	Higher education etc	250	225	250
	Schools etc	400	575	705
DH	HCHS capital	325	400	500
	NHS review capital	200	230	195
	Local capital	30	40	50
Other		200	200	100
Territorial consequences (estimated)		600	800	900
Nationalised industries		810	670	700
GRAND TOTAL		**4,700**	**5,850**	**6,500**
of which:				
Construction (estimated) (£bn)		**2¼**	**3**	**3½**

30 June 1989

gepl.ip/tables/comingbids

CONFIDENTIAL

Table 7

BIDS FORESHADOWED

	Reason	Maximum Likely Bid		
MOD/DH/DES	Increase in GDP deflators	800	1000	1200
FCO	UN peace/boat people	20	10	
ODA	ATP/Climate/Africa	20	30	35
	Economic assumptions	3	5	6
MAFF	Miscellaneous	10	10	10
DTI	Miscellaneous	20	20	20
	NEC	40	40	40
ECGD	Economic assumptions	75	20	45
DE	TECs superannuation/VAT	5	10	15
DTp	Maintenance/Eurocontrol/Heathrow	60	10	10
DOE	Miscellaneous	10	10	10
	PSA cost of change	30	40	50
	Economic assumptions	150	130	150
HO	Police manpower	13	40	68
	Other	5	5	5
OAL	Heritage/Palumbo/other	25	25	25
DH	Community care	50	100	100
	Welfare milk	15	16	16
	Other	50	50	50
DSS	Water/social fund/running costs	12	12	12
	Economic assumptions	300	650	950
WO	Housing/health	30	40	45
NI	H&W/Water	60	33	34
	Economic assumptions	3	11	18
Nat inds	Mega/Hidden/NNDR	250	900	1250
Chancellor's	Economic assumptions etc	45	60	80
Other	NNDR premium	100	100	100
TOTAL		**2,250**	**3,400**	**4,400**

In addition extra bids are possible for lead in water (£¼ billion a year), and for some other items totalling £150-250 million.

gep1.ip/tables/ec a

CONFIDENTIAL

TABLE 8

ECONOMIC ASSUMPTIONS: 30 JUNE 1989

	1989-90	1990-91	1991-92	1992-93
Umeployment (000)				
March	1900	1900	1900	1900
July	1750	1750	1750	1750
GDP deflator (%)				
FSBR	5½	4	3	2½
July	7	5	3½	3
[Cumulative Change	+1½	+2½	+3	+3½]
RPI				
(%; September)				
March	6¼	4	2½	
July	7½	5	3	
ROSSI				
(%; September)				
March	5	4	2½	
July	5	4	3	
3 month interest rates (%)				
March	12	10	8½	7
July	13¾	11½	9	8

FROM: C J RILEY (MP)
DATE: 30 June 1989
Extn: 4439

CHANCELLOR

Use Riley 2 paras.

cc Chief Secretary
Sir P Middleton
Mr Anson
Sir T Burns
Mr Sedgwick
Mrs Lomax
Mr Gieve
Mr MacAuslan
Mrs Chaplin
Mr Tyrie

PAPER FOR JULY CABINET

I have looked again at the draft I sent you on 29 June in the light of the points made at your meeting yesterday on the Survey. I think the main points which you wished to stress are included in the draft (although of course you may wish to change the way they are presented) or will feature in the Chief Secretary's paper. However, one point which the Chief Secretary raised - that the higher growth in the GDP deflator which we now forecast owes a good deal to buoyancy of investment prices - is not included in the draft of your paper. This could be handled by expanding (and splitting) paragraph 13 as shown below.

"13. Underlying inflation has been slightly higher so far in 1989 than envisaged at Budget time, having risen throughout the recent period of very strong growth. The RPI excluding mortgage interest payments - the nearest equivalent to the measures of consumer prices used in nearly all other major countries - was 6 per cent higher than a year ago in May. Including mortgage interest payments, RPI inflation in May was 8.3 per cent. And pay is continuing to grow more rapidly than is desirable, especially in the public sector.

and next page

13a. I now expect total RPI inflation to be 6¼ per cent in the fourth quarter of this year, above the forecast of 5½ per cent published at that time of the Budget. By this time, however, other less distorted measures of inflation - such as producer prices and the RPI less mortgage interest payments - should also have clearly stabilised and begun to fall. Growth of the GDP deflator may nevertheless be about 7% in 1989-90 as a whole, compared with 5½% in the Budget forecast, ~~with~~ reflecting ~~especially~~ in particular strong pressures on prices in the investment sector where demand is particularly buoyant."

C J RILEY