PO-CH/NL4/724,

PART A

01.

CONFIDENTIAL

under cover and

Begins: 23/11/84
Ends: 28/11/84.

PO/CH/NL/724
Part A

Chancellor's (Lawson) Papers:

Treasury and Civil Service Committee

Enquiry Into The Autumn Statement.

CHANCELLOR OF THE EXCHEQUER
HONI SOIT QUI MAL Y PENSE

We will need to look further within [illegible] Government.

C/

I think this is really w/end reading. But you might like to glance at it quickly in advance of tomorrows TCSC hearing.

DLS

27/11

Thanks. We will now want to see the TCSC report before making our minds up on this point. But one [illegible] imperative, the PBS [illegible] as the PBS pension mediation.

CONFIDENTIAL

FROM: R PRATT
DATE: 23 NOVEMBER 1984

1. MR BATTISHILL

2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Mr Bailey
Mr Anson
Mr Cassell
Mr Evans
Mr Odling-Smee
Mr Lankester
Mr Scholar
Mr Gray
Mr Riley

I think you will find this gives you a fairly clear picture of what the middle part of the Autumn Statement would have looked like with 3 years public spending figures included. The mock-up also covers 3 years revenue figures and (revised) fiscal adjustments. The choice between a separate section or not for these is not crucial. AB 27/11

AUTUMN STATEMENT: 3 YEARS EXPENDITURE AND REVENUE FIGURES

You asked for an illustration of what the relevant sections of the Autumn Statement might look like if we had decided, this year, to give 3 years expenditure figures instead of just one.

2. Taking first public expenditure (part 2 of the Autumn Statement) we would need to extend the main public expenditure tables - table 2.1 and 2.2 - to include the two later years of the Survey. (Given that we do not publish National Industries' EFLs for three years' ahead even in the Public Expenditure White Paper, we have assumed that table 2.3 would continue to show EFLs for just one year but this would be an added awkwardness.) It would also be necessary to amend the part 2 text.

3. In the attached illustration, table 2.1 is extended by giving the revised plans for 1986-87 and 1987-88. It would, however, be possible to show, in addition the original White Paper figures for 1986-87 as a basis for comparison (there were, of course, no figures for 1987-88 in the White Paper). Extending table 2.2 (which gives the planning total in cash and cost terms, and as a percentage of GDP) would demonstrate that by 1987-88, the planning total will have been reduced, as a proportion of GDP, to a figure below that of 1979-80.

4. We have not been able to re-write the entire text of part 2, but by way of example, the attached illustration shows possible amendments to the introductory sections and states, in general terms, what additions would have to be made to the paragraphs on departmental programmes, nationalised industries and so on. Overall,

we would guess that the part 2 text would increase from 3 pages as at present to about 4.

5. Also attached are illustrative text and tables showing 3 years revenue forecasts. At present, the equivalent text and tables for the current and one forward year are included in part 1 of the Autumn Statement. It would be possible simply to amend the text and tables to cover 3 forward years, but this would contrast with the one year perspective of the rest of part 1. The alternatives are to include the 3 year projections at the end of part 2 (on public expenditure), or, as in the attached illustrative version, as a separate part 3. If the 3 year projections were not in part 1, it would, of course, be necessary to remove (or substantially abbreviate) the section in part 1 which at present deals with revenue and expenditure for the current and one forward year.

6. You will see also that in the attached illustration, it is assumed that we would feel obliged to give forecasts for GDP and also the GDP deflator for the full three years.

Richard Pratt

R PRATT

PART 2: Outline Public Expenditure Plans for 1985-86 to 1987-88

2.01 The Government has reviewed the public expenditure plans for 1985-86 and 1986-87 published in the Public Expenditure White Paper (Cmnd 9143) and considered its plans for 1987-88. Table 2.1 shows the public expenditure plans as now decided and for purposes of comparison the 1984-85 and 1985-86 plans. All figures are in cash.

The planning total

2.02 The outcome of the review is to set the public expenditure planning totals for 1985-86 and 1986-87 at £132.0 billion and 136.6 billion, slightly below the figures in the 1984 White Paper. In 1987-88 the plans allow for an increase in the planning total of 3½ per cent. Over the three years combined the increase from the level planned in Cmnd 9143 for 1984-85 is much the same as the expected increase in prices. So public expenditure is planned to be stable in real terms.

2.03 Table 2.2 shows the planning totals for 1979-80 to 1987-88 in cash and cost terms; and public expenditure expressed as a ratio to GDP. The plans imply the ratio falling progressively from 43½ per cent in 1981-82 to 39 per cent in 1987-88.

Changes in plans

Jul 1985-88?

2.04 Within the total for 1985-86 there are increases in social security, health, export credit and the UK's contributions to the European Communities. These are offset by reductions in other programmes including housing, employment services and the urban programme, together with an increase in estimated receipts from the special sales of assets. Full details of the plans will be given in the forthcoming Public Expenditure White Paper.

Programmes

1.05-21 [departmental paragraphs as before with additional sentence on later years where appropriate].

Nationalised Industries

2.26 [as before plus "Nationalised industries total requirements for external finance decline markedly between 1985-86 and 1987-88 as cost and efficiency improvements are made".]

Local authorities

2.27-2.2 [as before with additional sentence on provision for later years]

Special Sales of Assets

2.30 [as before with additional sentence on forecasts of receipts for later years]

Reserves

2.31 The plans include a Reserve of £3 billion for 1985-86, £¼ billion higher than that included in Cmnd 9143 for 1984-85. Larger Reserves are set aside for the later years - £4 billion in 1986-87 and £5 billion in 1987-88. The Reserves are intended to cover any spending not provided for elsewhere in the plans including policy changes, new initiatives and changes in demand led programmes.

Table 2.1 Public Expenditure Plans (1) (2) (3)

£ million

	1984-85	1985-86		1986-87	1987-88
	White Paper Cmnd 9143 with budget changes	White Paper Cmnd 9143	Revised Plans	Revised* Plans	Plans*
Departments (excluding nationalised industries' external finance)(4)					
Ministry of Defence	17 000	18 060	18 060	18 570	18 870
Foreign and Commonwealth Office	1 800	1 870	1 870	1 900	1 930
European Community	380	550	750	640	830
Intervention Board for Agricultural Produce	1 250	1 130	1 310	1 090	1 110
Agriculture	1 000	1 020	930	960	950
Forestry Commission	60	60	50	50	55
Departmet of Trade and Industry	1 350	1 290	1 360	1 390	1 100
Department of Energy	560	570	680	590	600
Department of Employment	3 130	3 250	3 180	3 210	3 240
Department of Transport	3 540	3 660	3 290	3 590	3 600
Export Credits Guarantee Department	160	30	190	110	-40
DOE-Housing	2 500	2 610	2 300	2 550	2 660
DOE-PSA	-90	-100	-90	-110	-130
DOE-Other	3 170	3 270	3 250	3 440	3 480
Home Office	4 360	4 540	4 590	4 780	4 870
Lord Chancellor's Department	500	550	540	570	610
Department of Education & Science	13 050	13 450	13 590	14 010	14 220
Office of Arts and Libraries	600	620	640	710	730
DHSS-Health & Personal Social Services	15 420	16 270	16 480	17 410	18 110
DHSS-Social Security	37 200	39 520	39 990	41 830	43 920
Civil Superannuation	1 050	1 130	1 070	1 180	1 290
Scotland	6 550	6 720	6 810	7 020	7 160
Wales	2 560	2 650	2 660	2 800	2 870
Northern Ireland	4 030	4 220	4 240	4 380	4 590
Other Departments	2 070	2 160	2 130	2 210	2 250
Nationalised Industries	1 830	1 140	1 320	180	-110
Local authority current expenditure not allocated to departments	660	400	600	0	0
Special Sales of Assets	-1 900	-2 000	-2 500	-2 250	-2 250
Reserve	2 750	3 750	3 000	4 000	5 000
PLANNING TOTAL (5)	126 300	132 100	132 000	136 600	141 500

(1) Some figures may be subject to detailed technical amendment before publication of the 1985 Public Expenditure White Paper.

(2) Departments figures are rounded to the nearest £10 million the planning total is rounded to £2 100 million.

(3) All columns include minor classification changes since Cmnd 9143. The revised plans columns and plans for 1987-88 also include transfers of provision for London Regional Transport from Department of Transport to Nationalised Industries. and for work related non advanced further education from Department of Education and Science to Department of Employment (see paragraph 2.12, 2.14 and 2.26)

(4) Provision in these programmes reflects an assumption that central government rates of pay and allowances in 1985-86 will increase on average by 3 per cent from the settlements dates.

(5) Excludes double counting of agricultural spending in Scotland and Wales which is also included in the Agriculture total.

* figures illustrative only

Table 2.2 Public Expenditure Planning Totals 1979-80 to 1987-88

£ billion

	Cash	Cost Terms (1,2) base year 1983-84	Public (3) expenditure as % of GDP
1979-80(4)	76.9	111.7	39½
1980-81(4)	92.7	113.5	42
1981-82(4)	104.7	116.5	43½
1982-83(4)	113.4	118.4	43
1983-84(4)	120.3	120.3	42½
1984-85(5)	126.3	120.5	42
1985-86(6)	132.0	120.6	41
1986-87(6)	136.6	120.1	39½
1987-88(6)	141.5	120.4	39

(1) Figures are rounded to the nearest £0.1 billion

(2) Cash figures adjusted for general inflation as measured by the GDP deflator at market prices. The GDP deflator is forecast to increase by some 4¾ per cent in 1984-85, 4½ per cent in 1985-86 as shown in paragraph [ ], 4 per cent in 1986-87 and 3¼ per cent in 1987-88.

(3) Planning Total plus net debt interest, refunded payments of VAT by local authorities and central government and an allowance for non-trading government capital consumption, expressed as a percentage of GDP at market prices.

(4) Outturn/estimated outturn.

(5) Plans in Financial Statement and Budget Report 1984-85, table 5.5, adjusted for subsequent classification changes. For estimated outturn, see paragraph 1.58.

(6) Plans

External Financing Limits

Table 2.3 External Financing Limits for the Nationalised Industries (1985–86)*

	£ million(1)
National Coal Board(2)	723
Electricity (England and Wales)	−1 128
North of Scotland Hydro-Electric Board	9
South of Scotland Electricity Board	191
British Gas Corporation	−352
British Steel Corporation	360
Post Office	−70
National Girobank	−3
British Airports Authority	−21
British Railways Board	918
British Waterways Board	45
National Bus Company	48
Scottish Transport Group	13
British National Oil Corporation(3)	−3
British Shipbuilders(4)	36
Civil Aviation Authority	27
Water (England and Wales)	203
London Regional Transport	323
Total	**1 319**

(1) Figures are shown rounded to the nearest £1 million.
(2) Provisional. To be reviewed at the end of the current industrial dispute.
(3) The figure for BNOC is not a limit. BNOC's trading results are likely to fluctuate from year to year given the uncertainties of oil trading.
(4) This single figure for British Shipbuilders includes an allowance for some receipts from the privatisation of warshipbuilding yards.

*Figures for future years beyond 1985-86 are not given. Nationalised industry financing figures are particularly uncertain. They are reviewed each year in the light of industries' performance and their corporate plans.

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PART 3: FISCAL PROJECTIONS TO 1987-88

1. Consideration of public expenditure alongside revenue is a key part of the process of fiscal planning. The public expenditure plans to 1987-88, which are outlined in section 2, have been drawn up to be consistent with the government's declared objectives for expenditure, taxation and public borrowing. [These objectives were most recently set out in the 1984 Medium Term Financial Strategy and the Green Paper on Public Expenditure and Taxation into the 1990s.] This section presents updated fiscal projections for the three year period covered by the expenditure plans.

Developments to the end of 1984-85

2. The PSBR in 1983-84 was £9.7 billion*, as forecast in March in the FSBR. The EC rebate in respect of 1983 was not received during 1983-84, and this increased central government borrowing on own account. On the other hand public corporations' borrowing turned out a little lower than expected.

3. In the first seven months of 1984-85, the PSBR is likely to have been slightly above the Budget forecast for the full year (£7¼ billion). It was expected that the PSBR would be more than usually front-ended loaded this year. Even so, it now seems likely that the year's total will be higher than at Budget time. Four major factors have contributed to this change:

(i) The coal strike may add, over the financial year as a whole, about £1½ billion to total borrowing.

(ii) Local authorities overspend on capital account in 1983-84 seems likely to be followed by further overspend in 1984-85.

(iii) Higher interest rates than expected at the time of the Budget have increased debt interest payments.

(iv) On the revenue side, extra receipts from North Sea oil do not fully offset these factors.

4. As a result, the PSBR for 1984-85 as a whole is now projected at £8½ billion, some £1¼ billion higher than the Budget forecast. There is, as always, a substantial margin of error surrounding this forecast (average errors in PSBR forecasts at this time of year exceed £2 billion).

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*New definition. On the old definition, (including bank deposits) it was £10.0 billion.

Assumptions

5. The assumptions underlying the projections are in line with those in the 1984 MTFS, updated to take into account the new public expenditure plans in part 2 and the economic forecast in part 1. As before, the PSBR is assumed to fall from 2 per cent of GDP in 1985-86 and 1986-87 to 1¾ per cent in 1987-88, equivalent in each year to about £7 billion. GDP is assumed to grow by 2-2¼ per cent after 1985-86, consistent with an averge of 2¼ per cent in the five years to 1988-89. Inflation, as measured by the GDP deflator, is assumed to fall from 4½ per cent in 1985-86 to 3¼ per cent in 1987-88. The effective exchange rate shows no major change from year to year.

Public expenditure

6. General government expenditure in national accounts terms is forecast to rise, in cash by 3½ per cent in 1985-86. For 1986-87 and 1987-88, the corresponding growth rates are 3 per cent and 3½ per cent respectively. Further details are given in part 2.

Table 3.1 General Government Expenditure

£ billion, cash

	1983-84	1984-85	1985-86	1986-87	1987-88
General Government expenditure (1)	120	128	132	136½	141½
National accounts adjustments (2)	4½	4½	5½	6	6
Interest payments	15	16	16½	17	17
Total expenditure in national account terms	139½	148½	154	159	164½

(1) Expenditure on programmes by central government and local authorities plus the Reserve less special sales of assets, after making allowance for expected outturn.

(2) Adjustmnets to line 1 to the definitions used in National Accounts Statistics.

Revenue

7. Revenue estimates depend on projections of incomes, spending and prices, as well as on policy decisions. Revenue is projected on conventional assumptions of revalorisation of the main direct tax allowances and thresholds, and of excise duties. Estimates of oil revenues assume that dollar North Sea oil prices do not change very much from present levels.

8. The revenue estimates are shown in table 3.2. On the above assumptions, general government receipts are projected to rise by about 29 per cent between 1983-84 and 1987-88, about 1 per cent less than the rise in money GDP.

Table 3.2 General Government Receipts

£ billion, cash

	1983-84	1984-85	1985-86	1986-87	1987-88
Taxes on income, expenditure and capital	97 ½	105 ½	113 ½	120 ½	127 ½
National Insurance and other contributions	21 ½	23	25	27	28 ½
Interest and other receipts	11 ½	10 ½	10 ½	11	11 ½
Accruals adjustments	½	1	½	½	½
Total receipts	129 ½	140	148 ½	158	167
of which North Sea tax revenues	9	12	12	10 ½	9 ½

Borrowing

9. Table 3.3 provides projections of Government receipts, expenditure and borrowing. The estimates of the fiscal adjustment are extremely uncertain. They depend on revenue and expenditure estimates all of which are subject to major uncertainties, in both directions. For the public sector as a whole, the flows on either side of the account approach £200 billion.

Table 3.3 Public Sector Borrowing*

£ billion

	1983-84	1984-85	1985-86	1986-87	1987-88
General Government expenditure	139 ½	148 ½	154	159	164 ½
General Government receipts	129 ½	140	148 ½	158	167
Fiscal adjustment from previous years	–	–	–	1 ½	6
Annual fiscal adjustment	–	–	1 ½	4 ½	3 ½
General Government borrowing requirement	10	9	7	7 ½	7 ½
Public sector borrowing requirement	9 ¾	8 ½	7	7	7
as percentage of GDP	3 ¼	2 ½	2	2	1 ¾
Money GDP at market prices	306	327	353	377	398

*Totals may not add due to rounding

10. These projections are based mechanically on the policy assumptions - and in particular the PSBR path - set out in the 1984 MTFS. The implied fiscal adjustment in 1985-86 is put at £1½ billion, marginally less than in the MTFS. The fiscal adjustments in the succeeding two years are put at about £4 billion and the cumulative fiscal adjustment up to 1987-88 is much the same as projected in the MTFS.

11. Particular care is needed in interpreting these projections. The figures should not be taken as a firm indication of possible changes in the 1985 Budget. As the 1984 MTFS noted, the appropriate path for the PSBR from year to year depends upon several factors, including the cyclical position of the economy and the composition of public sector receipts and expenditure. It will be reviewed at Budget time.

HOUSE OF COMMONS

MINUTES OF EVIDENCE

TAKEN BEFORE

THE TREASURY AND CIVIL SERVICE COMMITTEE

MONDAY 26 NOVEMBER 1984

SIR TERENCE BURNS, MR F CASSELL,
MR M C SCHOLAR, MR A M W BATTISHILL
and MR H P EVANS

Evidence heard in Public

Questions 166 - 307

MEMBERS' CORRECTIONS

Any Member of the Committee who wishes to correct the Questions addressed by him to a Witness is asked to send the correction to the Committee Clerk as soon as possible.

Members receiving these Minutes of Evidence are asked to ensure that the Minutes are confined to the object for which they are printed the special use of the Members of the Committee - and are not given wider circulation.

MONDAY 26 NOVEMBER 1984

Members present:

Mr Terence Higgins, in the Chair
Mr Anthony Beaumont-Dark
Mr Nicholas Budgen
Mr Mark Fisher
Mr Roger Freeman
Mr Ralph Howell
Mr Brian Sedgemore
Mr John Townend
Mr Richard Wainwright

SIR TERENCE BURNS, Chief Economic Adviser; MR F CASSELL, Deputy Secretary, Public Finance; MR M C SCHOLAR, Under Secretary, General Expenditure Policy Group; MR A M W BATTISHILL, Under Secretary, Central Unit, and MR H P EVANS, Under Secretary, Economic Assessment Group, H M Treasury, called in and examined.

Chairman

166. Sir Terence, may I welcome you once again to the Committee. We are very glad indeed to see you and your colleagues. If there are any opening statements you would like to make, we shall, of course, be very happy to hear them.

(Sir Terence Burns) I have no opening remarks to make, Mr Chairman.

167. Thank you very much indeed. As you know, we did take some evidence last week on specific issues arising in the context of the Chancellor's Autumn Statement, in particular with regard to aid, some aspects of agriculture and the EEC. We are, of course, looking forward to taking evidence from the Chancellor of the Exchequer this coming Wednesday. I wonder if I might begin the questioning on a very broad point which I think is giving Members

of the House some concern lately, with regard to the assessment of priorities for public expenditure which are now reflected in some considerable detail in the Autumn Statement, although, of course, the final detail emerges in the White Paper over a longer period of time. Could you tell us the mechanics of the way in which priorities are assessed between different government departments; what is the machinery by which this is done?

(Sir Terence Burns) I think that probably it is best if Mr Scholar takes this. He has been closely involved with the subject of public expenditure.

(Mr Scholar) The basic machinery is broadly the same this year as it has been for a number of years. The Public Expenditure Survey begins with an extended process in which officials prepare papers which describe the existing programmes and the services which those programmes are designed to perform, and which cost those programmes. Officials endeavour to provide in those papers material on which Ministers can base their judgements as to priorities as between different programmes. There then follows a process in which Ministers discuss, in various fora, these issues.

168. This is within a department?

(Mr Scholar) Both within departments and inter-departmentally. It is through those discussions that Ministers are able to exercise their judgements as to priorities between programmes, on the basis of the information which officials provide for them. That is broadly the system which has been in operation for a good number of years now.

169. You say that this happens within departments and between

departments, but at what stage is a comparison made between the need for expenditure in one department as against another? That is to say, is there any comparison between departments, and what is the mechanism by which that is carried out?

(Mr Scholar) That mechanism is carried out at the ministerial level, and the timing at which it takes place can vary from year to year, but normally one would expect it to begin relatively early on in the survey process.

170. If I could give a particular example (I take it purely as an example, without considering at all the merits of the case), let us consider, for example, the question which came up in the House the other day on the aid budget. At any stage is the case for spending more or less on the aid budget compared with, let us say, the case for spending more or less on the development of a particular military aircraft? If so, how is that done?

(Mr Scholar) Yes, there is a stage, during the survey, at which Ministers collectively can exercise, and do exercise, that kind of judgement. It can, as I was saying earlier, in some years come earlier on, or in some years it can come later on, but in my experience it is a stage which invariably does take place.

171. But usually at a later stage?

(Mr Scholar) Perhaps more often than not at a later stage in the survey, as the issues become sharpened.

172. Would there, for example, have been the kind of comparison I mentioned in the example just now?

(Mr Scholar) It is quite possible that during the ministerial discussions that kind of point would be made.

173. On what criteria?

(Mr Scholar) As the Committee knows, we have been putting a good deal of effort in recent years into improving the analysis that we provide of the outputs of public expenditure, the comparison between those outputs with the inputs of public expenditure and also the measures of performance in public spending. We hope that the material that is provided for Ministers gives them the basis for making that kind of judgement. Inevitably, as I have said to the Committee before, in some areas we are better at this than we are in others, but it is an area in which we are constantly seeking to improve our own performance.

174. The impression was given to the House the other day in debate that the amount which the Foreign Office had was in some sense fixed, and there were questions of how it was divided up within the Foreign Office budget, but no apparent comparison as to whether a case had been made for, say, the total of the Foreign Office budget being increased at the expense of some other department. However, you are saying that that is not the case; that there is an appraisal as to whether more should go on, say, defence (which obviously has a repercussion on foreign affairs)?

(Mr Scholar) You will appreciate that it is not for me to disclose the content of ministerial considerations on these matters, but I can say that there were a number of occasions which were set up for Ministers to decide whether they wished to pursue a higher programme in this case or a lower programme in that case and to make the kinds of judgements which are the judgements of conflicting priorities which underlie this whole exercise.

Chairman: Yes, we certainly would not want to go into the question of individual cases. As I say, I merely take it by way of making the question more specific. At the same time I think we ought to be clear that this Committee and the House do have an interest in whether priorities are being correctly assessed. At the moment certainly I think our perception of the way in which this is done is, to say the least, a little cloudy. No doubt this is something we can pursue with the Chancellor on Wednesday.

Mr Wainwright

175. You said just now that there were several fora in which Ministers discuss the relative priorities of one department's claims for expenditure as against another's. What are these different fora?

(Mr Scholar) When Ministers meet to discuss the Public Expenditure Survey they meet in various groups under various chairman, and, of course, one of those groups is the Cabinet.

Chairman: I think we can return to this probably on Wednesday. Let us move, then, to the question of the Industry Act forecast.

Mr Budgen

176. Sir Terence, I wonder if I might ask you about the Government's way of presenting its future proposals for inflation, because it seems to me that the Government is under increasing political pressure to reflate, and yet at the same time the Government is saying that it hopes to achieve sound money in the relatively near future. However, that is not so, is it?

(Sir Terence Burns) I am sorry, what is not so?

177. The last point. The Government has no serious intention of achieving sound money in the near future, has it?

(Sir Terence Burns) I think the Chancellor's expression this time last year, when we were discussing these matters, was that the ultimate objective was stable prices; that he intended to move in that direction, but reasonably gradually. That is beginning to make the inflation rate round about 5 per cent.

178. It is not likely that we shall see sound money on these present policies during this Parliament, is it?

(Sir Terence Burns) We have not presented any forecasts which suggest that there would be zero inflation over the life and time of the MTFS. I remember this being discussed at this time last year. In terms of the profiles that we presented this time last year, the point of zero inflation came somewhere between the end of the MTFS and the end of the Public Expenditure Green Paper period. There is no doubt, however, that the overall pressure upon inflation remains downwards; that inflation continues to do better in general than people are anticipating, and that the trend is in the right direction.

179. Sir Terence, there is strong pressure to prevent inflation rising above 5 per cent, is there not?

(Sir Terence Burns) There is desire, on the part of the Chancellor, to see inflation come down. It is not merely a desire to prevent inflation rising.

180. Sir Terence, you know perfectly well what I am putting to you. I am not talking about what the Government's desire is, I am talking about what they are actually intending to do and what they are prepared to enforce upon the economy and to take the political consequences of. The fact is, whatever they may desire, they are not prepared to screw inflation below 5 per cent and to take the political consequences of that screwing, are they?

(<u>Sir Terence Burns</u>) I do not agree. The intention <u>is</u> to bring down the inflation rate further. There is no suggestion of putting in place a set of policies aimed at stabilising the inflation rate at the current position. Our judgement is that the framework of policy that is in place and was outlined in the last MTFS <u>will</u> bring down the inflation rate over the lifetime of the MTFS period.

181. It will not do it over the next two years, will it?

(<u>Sir Terence Burns</u>) On what basis do you make that judgement?

182. Because if you take the view that the cause, as opposed to the immediate symptom, of inflation is an increase in the money supply, is it not right that even leaving aside the arguments about overfunding, the Government are printing money at about 10 per cent per annum? Is that not right?

(<u>Sir Terence Burns</u>) That depends upon the measure of monetary growth that you choose to examine. So far in this financial year, as in the last financial year and, if I recall, the financial year before that, the monetary targets have been met. Those targets were set on the basis that <u>we</u> judged to be appropriate to bring down inflation over the lifetime of the MTFS. As far as I can see, the outturn is in line with the framework that we have presented.

183. You are not answering the question I put to you, Sir Terence. The question I put to you was: will it be brought down below 5 per cent within the next two years?

(<u>Sir Terence Burns</u>) We have presented forecasts, Mr Budgen, which suggest that the inflation rate will be 4½ per cent by the end of 1985.

184. There are two main indicators, are there not: one, Sterling M3, and two, PSL2? Sterling M3 has been increasing at about 10 per cent, is that right?

(Sir Terence Burns) Yes.

185. That actually is rather favourable to you, because when the Chancellor was in a previous incarnation and went to make a speech at Zurich, he said that PSL2 was a better indicator, did he not, and that is increasing by 12½ per cent, is it not?

(Sir Terence Burns) Yes.

186. So on two indicators the money supply is increasing by something between 10 and 12½ per cent, is it not?

(Sir Terence Burns) Yes.

187. That means, does it not, that at some time in about 2 or 2½ years the rate of inflation is likely to be about 10 per cent less whatever real growth there may be, is not that so?

(Sir Terence Burns) Not necessarily.

188. Is not that the theory, at any rate, upon which the unfortunate British people elected the present Government?

(Sir Terence Burns) No, it is not.

189. Is it not?

(Sir Terence Burns) No, there is no suggestion of the kind of mechanical relationship that you are describing. We have set targets for two monetary aggregates: a broad aggregate (Sterling M3), and a narrow aggregate (M Nought). We designed ranges, and presented them in the MTFS, which we judged to be consistent with bringing down inflation. In making that judgement, we took account of recent developments of velocity and various structural changes that have been taking place in the financial markets, in particular examining what has been happening over the last three or four years.

My judgment is, was, and will remain that the monetary target that we have outlined will gradually bring down the growth of money GDP and on the basis that output growth is at the kind of trend rate which we have hypothesised, that should be sufficient to gradually bring down the inflation rate.

190. That would be if the Government was prepared to screw down the PSBR and also prepared if necessary to allow interest rates to go up, would it not? And the Government is not prepared to do either of those things, is it?

(Sir Terence Burns) Well, the PSBR for this year is going to be lower than it was last year - in fact, lower than it has been as a percentage of GDP for quite a lot of years. Interest rates went up rather sharply, if I recall, in the summer period. Since then that rise has been substantially reversed but nevertheless, we did go through that experience. I see no evidence that the Government is not prepared to take the actions that are necessary to live within the framework of the MTFS as it was outlined at the time of the Budget.

191. And the MTFS is extremely guarded in its forecast for inflation, is it not? It speaks of reducing inflation down to nought at some time after the end of this Parliament.

(Sir Terence Burns) No, it is rather more precise than that. It is true that it does not contain forecasts, but it does contain a number of assumptions about GDP and about inflation and the assumption in the MTFS if I recall was that inflation would be about 10 per cent. by the end of the MTFS period. I would also remind the Committee that this is a process that we have now been undertaking since March 1980. In terms of setting up the MTFS the inflation rate that that MT has delivered has been pretty well the inflation rate that was contained in those assumptions. It has involved a very steep decline in the inflation rate from 1980 to what we have today. Methodology remains essentially the same. The objectives are laid down and the broad assumptions around which it has been designed were set down in the MTFS and they involve a programme that will bring down the rate of inflation.

192. Sir Terence, just a final question: in the face of all these people who believe that the Government seriously intends to create nil inflation perhaps within 18 months, don't you think it would be better if the Government, for instance, just occasionally pointed to page 8 and chart 1.5 in the Autumn Statement and told them that the forecast there is for about 5 per cent. inflation and that by any standards other than those of the '70s, it is an appalling defeat and it is accepting a disgracefully high level of inflation, and perhaps that might silence some of those who deplore reflation?

(Sir Terence Burns) Inflation remains higher than the Government would like to see. It has put in place, however, a programme which it believes will bring down the rate of inflation. At no stage has it been suggested that the programme would bring down the rate of inflation to zero in the space of 18 months, therefore to suggest to me that because that has not been achieved the MTFS is failing on that score does not seem to me to be correct.

Mr Freeman

193. Good afternoon. My questions relate to the coal strike and to capital investment. If we can turn first of all to the effect of the coal strike on the forecast, on page 3 of the Autumn Statement in paragraph 102 it is stated that the formal assumption is made that the coal strike will be over by the end of this year. What happens if the coal strike goes on to mid-summer next year? What order of magnitude

of additional public expenditure are we talking about?

(Sir Terence Burns) I have not, I am afraid, got an estimate of what the consequences would be for public expenditure of the coal strike going on until next summer.

194. Has that work been done in the Treasury?

(Sir Terence Burns) At various stages we have looked at the rate of the cost of the coal strike, but as you can well imagine, that is rather a difficult calculation because the position continues to change in terms of the cost picture, and you have to make a lot of assumptions about the rate of recovery and the proceeds that are pursued after the end of the strike. I have no other information to give the Committee on the costs involved in different assumptions on the end of the strike.

195. Do you think it would be unreasonable to assume that if it went on for 6 months beyond this formal assumption, the additional cost could be of the order of a billion pounds, if it cost a billion and a half pounds approximately extra for nine months of the strike already?

(Sir Terence Burns) I would have thought, in round numbers, that does not sound a terrible lot.

196. Could I refer you to page 15 of the Autumn Statement, where it is said in paragraph 158 that the additional claims on expenditure in 1984-85 mean that the prospective outturn for the planning total at nearly £128 billion may exceed plans by about 1½ billion. Could you tell the Committee first of all where this 1½ billion is actually shown in table 2.1, which is on page 22? Under which heading is that shown? I am sure you do not have the figures to hand, but -----

(Mr Scholar) Table 2.1, Mr Freeman, does not give forecast outturn by programme. It simply gives the planned figures for 1984-85 so you will not find it distributed amongst the programmes there.

197. I am well aware of that. I am going to ask a question on that in a moment. My question was under which departmental heads shown in table 2.1 is the bulk of the 1½ billion extra in public expenditure?

(Mr Scholar) I think one would find it under the Nationalised Industries programme, and also in the Home Office programme. They would be the principal places, I would guess.

Chairman

198. Do you have a split, or not?

(Mr Scholar) As for this year?

199. Yes.

(Mr Scholar) For 1984-85 I have not an analysis of it.

Mr Freeman

200. Is there any reason why this Committee could not be provided with that in the future?

(Mr Scholar) I cannot imagine why we should not provide you with an analysis of that.

201. That being the case, do you think that you could indicate why we do not have a column in table 2.1 which includes an estimated outturn for 1984-85 because when the Committee tries to compare the revised plans in the fourth column, surely the correct comparisons between the revised plans for 1985-86 were/with the outturn for the 1984-85 and not with the original Command 9143 figures for 1984-85. Is there any reason why we cannot have estimated outturn figures by department ?

(Mr Scholar) I think the answer really is that the estimated outturn for 1984-85 is not carried out on this departmental basis.

202. I appreciate that, but you have just indicated to the Committee that you see no reason why we could not have an analysis of the 1½ billion excess over the original figures, the original estimated figures, for 1984-85. It should be possible to produce the column, if that is the case.

(Mr Scholar) I think we could do an additional piece of work, which I take it the Committee has now asked us to do, but we have not as a matter of form produced it in this table. We did not in the Autumn Statement last year, and we have not this year.

203. Do you think, when you come to prepare the Autumn Statement next year you could look at the advantage of including such a column? It may raise issues of policy as well as practicality, but I think it would be helpful.

(Mr Scholar) Yes.

204. Last question on coal: is the one per cent. increase in GNP growth in 1985-86 due to the end of the coal strike, which is essentially pushing growth originally forecast for this year into next year? How much of that growth is reflected in the increase in stocks? On page 18 you will see that the forecast increase in stocks next year is about a billion pounds. Is most of the increase therefore in the GDP coming from the ending of the coal strike? Can that be derived from the increase in physical stocks?

(Sir Terence Burns) No. The increase takes place because in change terms you are going from a position which is underneath what would have been the case. In other words, the 1984 position back to the level in 1985 that would have been the case anyway. We are not adding an extra amount into 1985 to undo some of the effects of 1984. In other words, we are not talking here about recovery of output to make up some of the lost ground of 1984. The extra 1 per cent. simply comes from moving from the position where the 1984 level has been depressed by 1 per cent. to the 1985 position, which of course is by assumption ex-strike.

205. I think my question was where will we find that extra 1 per cent. growth. Is it diffused in the economy, or is it reflected in the increase in coal stocks?

(Sir Terence Burns) It is derived because 1984 figures have been depressed, not because the 1985 figures are increased. Therefore the change is 1 per cent. higher, because the base is 1 per cent. lower. Therefore you look for the effects of the strike in the 1984 figures not in the 1985 figures.

206. But the practical effects of the coal strike in terms of national accounting have principally come from a run down of coal stocks, and a fall in production, so the answer to my question is yes, the extra 1 per cent. increase in the GNP next year is reflected by an increase in coal stocks.

(Mr Evans) It is the run down in coal stocks which is a considerable part of the fall in stocks in 1984, but in addition in 1984 the import figure is higher, because of the extra imports of oil which are replacing the coal.

207. Could you turn very briefly to capital expenditure ——

(Sir Terence Burns) I hope, Mr Chairman, that that is clear. We are not trying to evade this issue in any sense. I see some scepticism around the Committee about the answer we have just given.

Mr Beaumont-Dark

208. I do not think anybody would ever accuse you, Terence, of evading anything! But could you help the more simple of us: we have

got a draft order which should not be for discussion but will be for discussion on the coal industry - Limit on Deficit Grants Order 1984. Bearing in mind what you have told us about it, it is to increase the aggregate of grants made under that section from 1,200 million to a rather immodest 2,000 million. What does that mean except that the Government is going to, once again, if I may use a euphemism "shovel good money after bad"? Does that mean we are going to control the kind of money going into the coal industry if we are asked late at night to modestly put up by 800 million the grants that can be made to the coal industry? What would you say? I would like to see it the other way, wouldn't you?

(Sir Terence Burns) I do not think this is a question for me.

209. But surely it is. I am not asking you for a political answer - I am asking you for a factual answer.

(Sir Terence Burns) It sounded to me rather as if you were putting an issue of judgment to me!

210. No. Let me put it to you in a non--pejorative way - I thought I had; it is my nature! Can I ask you then what you would assume, if you were told that you were to be asked to increase the aggregate nature of grants from 1,200 million to 2,000 million? Can I ask you then, as an adviser to the Chancellor, what would you assume by that? That you were going to spend more money or less money?

(Sir Terence Burns) It sounds to me as if we were going to spend more money.

211. Right. Well, we really are at one, because I have assumed the same thing with my lack of your training, so if you are going to spend more money, would you assume that the Treasury might not - I don't say will - have to find some of that, because it cannot come out of

losses, can it? Is that fair? Where is it allowed for in the Autumn Statement figures?

(Mr Scholar) The Committee will be aware that there are winter supplementaries before the House at the moment, and there is a winter supplementary for the coal industry of over £600 million and I imagine that this Order, to which you have referred, about which I am not briefed in detail, will relate to the cost of the coal strike this year, as indeed the supplementary estimate relates, so it may be that the increase in the limit to which you have referred is an increase which arises out of the current year's spend in this area.

Mr Beaumont-Dark: So I should not worry about it.

Chairman

212. It is in the Autumn Statement?

(Mr Scholar) The total of the supplementary estimates which are before the House at the moment are taken full account of in the forecast out-turn of nearly £128 billion in Part I of the Autumn Statement.

(Mr Cassell) And that will also be included in the estimate of the public sector borrowing requirement for 1984-85.

Mr Beaumont-Dark

213. That has to come out of the increases to be put on the consumer via increased electricity, water and gas charges, I assume?

(Mr Cassell) I think we are talking about 1984-85.

(Sir Terence Burns) It has been taken up in increased borrowing. There is the cost of the coal dispute which amounts to a figure which is very much the same as the extent to which the PSBR is higher than was outlined at the time of the Budget.

Mr Freeman

214. My second question is on capital expenditure fixed investment. The Autumn Statement shows that in real terms fixed investment in 1985 will be about half the rate enjoyed in 1984, the figure coming down from 7½ per cent in 1984 to about 3 per cent in 1985. That is for the entire economy. On page 11, paragraph 1.43 that is broken down as between private sector and public sector investment and the Autumn Statement acknowledges that private sector investment is still rising, is forecast indeed to be higher next year, or at least experts believe it might be higher next year than this year. Therefore the implication is that the public sector fixed investment will fall very significantly next year.

Therefore how can one square the Chief Secretary's recent statement reported in the Financial Times on the 22nd November, when he said that the underlying gross capital spending figure has been broadly stable in real terms at around £22 billion for the past fiveyears? What is the equivalent figure for next year in terms of gross capital expenditure in the public sector?

(Mr Scholar) So far as the plans are concerned in the Autumn Statement there is no breakdown between current and capital. The Committee will have to wait until the publication of the Public Expenditure White Paper for that. In the Autumn Statement the plans shown contain nobreakdown between current and capital because the precise breakdown still has to be made and decisions have to be made in that regard. So the Committee will have to await publication of the Public Expenditure White Paper to get a full analysis of that breakdown.

215. I accept that. What is the answer to my question based upon the information we have now? It seems likely in the next fiscal year that public sector capital expenditure will show a fall in real terms from the year we are already in.

(Mr Scholar) There are some elements in the plans which certainly point in that direction. The privatisation of British Telecom for a start will cause a large reduction in the capital investment programme of the nationalised industries. Investment will grow in the private sector but it will show up as a sizable reduction in public sector capital expenditure.

(Mr Evans) If I may add something about the precise numbers in the Industry Act forecast? As Mr Freeman has said, the text on page 11 draws attention to a further quite large increase in private sector investment in 1985. The figure given here is of 7 per cent by volume. However, the forecast for total investment by both public sector and private sector is for the smaller increase of 3 per cent, and that difference is made up by a small increase, as the text says, in private housing investment and by a small fall, not a very large one, in the overall public sector work by volume terms.

Mr Howell

216. Could you explain the rather large error as far as the North Sea oil revenues are concerned? We were told about eight months ago that £9½ billion would be the figure and now we are told it is going to be £12 billion. That is an error of something like 25 per cent. It does not give us much confidence in one set of figures or the other.

(Sir Terence Burns) I am afraid there is inevitably a large degree of error surrounding the forecasts of revenue from the North Sea. It is in the nature of the calculation. The prices are fixed in dollars. It depends on the dollar/sterling exchange rate, and even the volume that would be produced is something which can frequently vary quite a lot from the forecast that we have made. On this occasion it is because the pound is lower against the dollar and because the volume of oil that has been produced has been higher than we expected.

217. Can we know by how much the increase in output has affected it?

(Sir Terence Burns) I think in broad terms, as far as I recall, it is about two-thirds down to the price in terms of sterling and about one-third to the higher volume.

218. Are your forecasts based on an unchanged US dollar/pound relationship?

(Sir Terence Burns) It assumes that neither dollar prices nor the dollar/pound exchange rate change very much from the current levels.

219. If I could turn to Table 2.1? I am sure you will agree that a very important factor in arriving at the forecasts is what is going to happen to unemployment. Would you agree that it is very misleading to see that these accounts are shown in such a way that expenditure by the Department of Employment is going down, which presumably is because there will be a lower anticipated take-up of YTS, which all comes into this, but at no stage is there any drawing together of thecosts of unemployment. Would you agree that is something which, as I for one have called for for some time and feel should be done, should be shown in these accounts as one particular item? Could I have your comments?

(Mr Scholar) On your first point indeed the downward movement in the figure for the Department of Employment does indeed arise in part from a revision downwards in the take-up of the Youth Training Scheme. That is one of the elements that has produced a reduction offset by a number of other increases. But we produced the Autumn Statement document, very rapidly after the decisions that had been taken which underlie the document, and it is very difficult to give all the detail one would ideally like to see. The Public Expenditure White Paper has, in the social security chapter, an analysis of payments made to different categories of benefit recipients, which I think contains some of the information which you are seeking.

220. Even in the Financial Statement it never appears as one item and I feel that it should, because here you have it in social security - I assume that the reason for the increase in expenditure

on social security of £470 million is very largely due to increased unemployment?

(Mr Scholar) It is partly due to that.

221. Yes, but we cannot see it. Could I make a specific request that expendituresoon unemployment be drawn together?

(Sir Terence Burns) I think this is a question which you may wish to put to the Chancellor on Wednesday.

Chairman

222. I was not quite clear why you thought that, Sir Terence. This is presumably a straight statement of fact is it not?

(Sir Terence Burns) The whole question of the presentation of information and how one puts these numbers together, what totals one wishes to do, the extent to which one wishes to change publication date of documents in order to be able to do more detailed calculations, seems to me to be an issue for the ministerial decision, Mr Chairman.

Mr Howell

223. There is one other point on the question of housing. Have you seen the report in The Guardian last week which indicated that due to joint tenancies and joint ownerships the expenditure could be as high as £190 million more than anticipated, and whereas the receipts were expected to reduce expenditure, loopholes have been found which might increase it. Do you know of that report?

(Mr Scholar) This is specifically housing benefit, not the housing programme but social security programme.

224. It is housing benefit?

(Mr Scholar) I am not aware myself of that report but of course the whole area ofhousing benefit is, as you well know, under review at the moment and the Secretary of State for Social Services is conducting a review of that as of a number of other areas.

225. Could we have some statement on that because it seems to me that this 310 reduction in expenditure might well be seriously upset.

(Mr Scholar) Over 310 reduction of expenditure relates to the Department of the Environment's housing programme and not to the DHSS programme.

226. So that would come in the DHSS?

(Mr Scholar) It would be taken into account in the DHSS figures.

Mr Wainwright

227. Sir Terence, I am asking about the estimated cost of interest payments on Government debt for 1985-86 because not only is there a quite considerable uprating of the expected interest payments for the current year, but in the Autumn Statement there is an even more substantial, in fact double, uprating of the estimated cost of interest payments for 1985-86. Why has this arisen for that particular year?

(Mr Evans) The answer in both years is essentially the same in that the upward revision to the estimates of debt interest shown in Table 1.7, compared with the corresponding table in the FSBR, reflects increased borrowing in 1984-85 and reflects a higher level of interest rates than was expected at the time of the March Budget.

228. So we can take this higher figure for 1985-86 as an indication that the Treasury estimate is that prevailing interest rates will remain higher in 1985-86 than they were, say, at the

beginning of this present year or at the time of the 1984 Budget?

(Mr Evans) No.

(Sir Terence Burns) No, you cannot assume that. All it tells is the comparison between what we are expecting now and what we were expecting at the time of the Budget.

229. That indeed was my question - at the time of the Budget. So interest payments have been uprated and you expect that to be a prevailing rate for 1985-86?

(Sir Terence Burns) You imply from that something about the level we were expecting compared with some particular date in the past.

230. Well, the Budget of this year.

(Sir Terence Burns) No, because it is a question of expectations now against the expectations then. As you know, we do not provide a profile of what we think will happen to interest rates in these forecasts because they are subject to issues of market sensitivity. So you cannot assume anything about whether we think the level will rise or fall. All this tellsus is the broad conclusions that we reach now about these levels compared with the conclusions we reached on the last occasion.

231. But don't the broad conclusions you have now tell us something? They must have a meaning, or are they just plucked out of the air?

(Sir Terence Burns) It is quite clear they could mean a variety of things. At the time of the Budget we thought there would be a steep decline; now there is a less steep decline. Or, at the time of the Budget we thought they were going to be flat and now we think they are going to rise. The whole thing is relative to what we anticipated.

232. I have no recollection whatsoever at that time of the 1984 Budget of the Chancellor saying that rates might well be in a period of steep decline.

(Sir Terence Burns) I am not suggesting this - I am not making any suggestion. I was giving an example of how it has had to mean a range of outcomes.

233. You are saying then this figure for 1985-86 tells us nothing of the Treasury's estimate of the likely prevailing rates during that year?

(Sir Terence Burns) Of course not, no; not that it tells us nothing. This figure is derived from a judgement of our level of interest rates and depends on the stock of outstanding debts in terms of the change from one year to another. One can get some idea of the scale of what is involved. I simply wanted to analyse that simply by comparing the interest payments in this document with the previous document. That in itself tells us nothing about the expected level of interest rates.

234. We shall want to pursue that with the Chancellor, Sir Terence. On this whole question of interest rates, why in any case should there be any question of their being so high in 1985-86, because is not the Treasury's whole theory that by screwing down the public sector borrowing requirement and getting it down to an estimated £7 billion, you are bringing down the price of money and the cost of borrowing?

(Sir Terence Burns) Yes, the strategy with regard to borrowing is to bring down the PSBR as a percentage of GDP, in order to take pressure off short-term interest rates. That stands. That remains the policy.

235. But how do you reconcile that with the estimate of Government interest payments for 1985-86?

(Sir Terence Burns) Simply that the extent to which we expect to see progress in that area is not as great as we expected at the time of the Budget. However, that is only part of it, and not necessarily a large part. Obviously the fact that the borrowing requirement for 1984-85 has turned out to be higher than, or we think it is going to be higher than, we expected, at 8½ as against 7.2, means, of course, that there will be high interest payments to be paid on that larger amount of outstanding debt. That will affect this year and it will carry forward into next year.

236. Yes, but surely the proportion of 1984-85 public debt (incidentally, much of which has been covered by overfunding earlier in the year), compared to the total of Government debt outstanding - the 1985 proportion - is small, is it not?

(Sir Terence Burns) The extra debt in 1984-85 is £1½ billion.

Chairman

237. But that, compared with the total of national debt, must surely be rather small?

(Sir Terence Burns) It is. Compared to the total outstanding, it is a relatively small figure, but it can still account for some of the change.

Mr Wainwright

238. But only a little?

(Mr Evans) Yes. The change in interest rates is probably a bit bigger as a reason for the change.

(Sir Terence Burns) The average level of interest rates in 1984-85 looks as if it is going to turn out to be higher than we expected in March. After all, we had the steep rise in July and, as I said earlier, this is substantially being undone, but it is likely to leave the average level higher than we anticipated.

239. But throughout my questioning I have been referring to 1985-86, and I really do not understand why a rise in 1984-85 is going to account for anything like the steep revision upwards which you have for 1985-86?

(Sir Terence Burns) As I say, part of it is the question of the debt, and part of it is a changed view of interest rates. Of course, partly (which also takes place at this time of the year) it is simply a change in the assessment of what this will deliver in the way of interest payments, because it is not a simple 2 + 2 calculation deriving the forecast of interest payments, and obviously there is a question of assessment as well. Even if you know exactly what the average level of interest rates are going to be and you know exactly what the outstanding debt is, it is still a matter of some judgement to guess what the total interest payments will be.

240. Has it got anything to do with the very sharp decline (very sharp indeed) in the savings ratio? Are there less savings from which to borrow?

(Sir Terence Burns) I am sorry, which sharp decline in the savings ratio are you referring to?

241. The British public's savings ratio, and the one which is shown in your Chart 1.7 on page 10. The pool of savings is shown as having been coming down fairly sharply ever since 1980-81, is it not?

(Sir Terence Burns) Yes, but it has not changed very much in 1984 relative to 1983, and we are not looking for a great change in 1985 either.

242. Why should that be so? Do you feel that people are now anxious to restore their savings, because they think inflation is on the up again?

(Sir Terence Burns) No, it is simply because we are not looking for the scale of decline of inflation into 1985 that we have seen in recent years, and also because 1985 is likely to be a year when real incomes rise at least at trend rate, and those are not typically the circumstances where you see a decline in the savings ratio.

Mr Wainwright: Thank you.

Mr Beaumont-Dark

243. I wonder if you could help me, because I am a bit lost amongst all this, frankly, so if we could just go through one or two things together it would be quite helpful. In your business

school days and, indeed, my own more humble ones, I was always told that if you feed the losers and soak it from the successful, that is a receipt for bankruptcy in private business. Would you think that is true, or would you tell people that, or not?

(Sir Terence Burns) I do recall making similar kinds of statements in the past, Mr Beaumont-Dark!

244. I am glad you said that, because I remember some time when you said something similar to that! I am not blaming you for this, but what worries some of us now in business, and on the peripheries of it as I now am, is that we have these nationalised industries and we are doing precisely what we always lectured people they should not do. We have got the coal industry where we are now being asked tonight to increase their modest contingency losses to about £2 billion. We have got the railways and we have got steel. All those things go along burbling and making huge losses. Then we have the others, the milchcows (which is a term I used to have used to me by lecturers), meaning those that were able to churn out the money. That turns out to be electricity, gas and water. I would have thought that what we are now doing is precisely what we would tell a businessman would be the very worst thing he could do. If you look at the figures, we are now entering a situation whereby attempts are being made to bolster up the chances of cutting direct taxes. I want to talk to you about the illusion of tax cuts. The illusion of tax cuts, in my view, is that I believe in indirect taxation, and indirect taxation to me means that it is avoidable. I smoke and drink - relatively modestly, but I smoke and drink. I do not have to. In other words, it is avoidable. You can buy an expensive suit or a cheap

suit, but you cannot choose whether you eat, you cannot choose whether you heat your home, you cannot really choose whether you have water in it. So you are a captive tax market. If you look at what we are now doing, if you take water, there the CBI (one of the great supporters of the Government, as I am myself) have now said today that a typical papermaking company, if they can get away with a 12 per cent increase, are going to be faced with a cost of £47,000. It is very likely that it is going to cost companies in the Midlands, where water is used in some of the steel processes, £50,000 or £60,000 (that is, if it is 12 per cent). That is because the EFLs that they have been set have now been reduced on water overnight, which, if it happened to any private company, would mean that they would go bankrupt. They have now been reduced from £443 million to being self-financing next year. What would you think if you were a businessman, if you had that trick played upon you?

(Sir Terence Burns) In general (if I may make one or two general statements, then Mr Scholar can speak about the particular subject of water), the decisions about the EFLs, decisions about prices and the rates of return to seek from industries are based upon views as to what kinds of return one should be getting from the capital that is employed there.

245. Can I say, I am very glad you said that, because that is precisely the point.

(Sir Terence Burns) I am doing quite well so far, Mr Chairman!

246. Why not the same rate of return, then, for the coal, the railways and the steel? Because you know you cannot get

away with it; that is why, is it not?

(Sir Terence Burns) I think that the position of the coal industry at the moment is a rather special one.

247. It has been for the last 50 years.

(Sir Terence Burns) As far as the other two industries are concerned, I think that you would agree that there has been progress made towards getting a more efficient industry. If you wish, Mr Scholar may wish to say something about the water industry.

(Mr Scholar) On the water industry, as I understand it, the industry is currently earning about 1 per cent real return on its assets. The new financial targets which are being set for the industry imply increasing those targets to about 1½ to 2 per cent, I think. That is in 1987-88. They would still be earning a real return on their assets, of under 2 per cent. I do not honestly think that one could describe that as their milking the consumer.

248. I still come back to the other question, then. We are setting ourselves, quite rightly, low inflationary targets. How can you say that a virtually nil inflation is possible, when industries' costs and the costs of people in the homes keep on being hammered? Or do you not think that a typical papermaking company having to pay £47,000 is at all inflationary? If industry cannot keep its prices down because of the burdens being placed upon it, how can you keep inflation down?

(Sir Terence Burns) Mr Beaumont-Dark, if you look at the forecast for retail prices that is on page 9 of the Autumn Statement, you will see that the forecast that we are making for nationalised industries is roughly the same as the overall rate of inflation. When you come to take account of (as you described it) the burdens upon industry, you have got to take account of a number of things: the abolition of the National Insurance Surcharge, etcetera. Company profitability is really doing rather well. If you are looking at the whole question of backing the winners or the losers, what you are seeing are some really quite rapid increases in profits, rather a healthy position in terms of liquidity and, as I say, nationalised industries' prices rising at about, or a little bit less than, the overall inflation rate.

249. No, you really cannot get away with that, because we have in these figures 3 per cent for wage increases for the Civil Service. So I hope you are not going to say that everybody in the country has got to have wage increases of around 3 per cent, while in the case of industries, on which we have some influence (we are always lecturing the CBI and we are always lecturing the unions upon what they must do about their prices), where we have a chance of leading, we lead the other way. I must tell you, I think that the EFL decision made to industry is basically an outrage. By "an outrage" I mean that we know that based upon what they have been told are their external financing limits, over the next three years the cost of water to industry, as well as to the domestic ratepayer, must be an increase of at least 50 per cent.

All good generals are meant to lead from the front, and to say that this is only going to be one or two per cent. on money is no good. Why must it be <u>this</u> critical year, when industry is trying to recover, that its costs have to be escalating while it is being lectured about keeping down its own prices?

(Sir Terence Burns) I thought we agreed earlier that it was right that the prices should be set in such a way that industry should earn the appropriate rate of return on the assets it is employing? To do otherwise is effectively to subsidise the users of those products.

250. But not overnight - not when industry is trying to recover from traumatic change, and if you take your own table 1.3 on retail prices, it says there that it excludes water.

(Sir Terence Burns) That is true.

251. And it excludes water, because that is the biggest increase out of any increase that industry has got to face?

(Sir Terence Burns) Let me assure the Committee, lest it feels that implies we have missed out water from these calculations altogether, that it actually happens to be in the housing role in this table and housing is also growing slightly less than the average.

Mr Beaumont-Dark: I know it is not your fault, so I will save my aggressive questions for the Chancellor!

Mr Wainwright

252. Mr Scholar, interjecting with Mr Beaumont-Dark just now, pointed out that the water industry was only yielding a return of 1 per cent. on its assets. Will he confirm that that 1 per cent. is not on the historical value of its assets, but is actually on the estimated replacement value of the whole of the water industry's assets, which were revalued specifically two or three years ago?

(<u>Mr Scholar</u>) I am afraid I cannot give confirmation on that.

Mr Wainwright: It does make all the difference.

Chairman

253. I think we ought to be clear about this. Sir Terence gave us a figure of going up from 1 to 2 per cent.

(<u>Mr Scholar</u>) It was my figure.

254. Well, we must know whether it is on historic cost or replacement cost.

(<u>Mr Scholar</u>) Yes.

255. Which?

(<u>Mr Scholar</u>) I imagine it is replacement cost.

256. If that is so, the figure on the historic cost would be vastly higher, would it not? Since much of the water authorities' equipment goes back 50 years.

(<u>Mr Scholar</u>) Yes.

257. The rate of return on historic cost may be perfectly reasonable. Whether that is the right basis or not is another matter, but we need to know which it is.

(<u>Mr Scholar</u>) I imagine it is being done on replacement cost but I can provide a note for the Committee on that, if that would help.

Chairman: I think we should certainly need a note.

Mr Beaumont-Dark

258. Could I make one final point on this: at the very time that we have suddenly pounced on the water industry, it is known that some mains and sewers are going to have to be replaced, so the actual effect upon the water rate itself is as excessive as it is now. If you take Birmingham, Sheffield, Manchester, Liverpool, they have had

their improvement grants and so forth cut, which is arguable, but understandable, but at the same time, when you have to do this great replacement programme, is it really sensible, is it good economics, to suddenly discover that this can be milked for all it is worth because people cannot do without water?

(Mr Scholar) I think part of the decision on water which is shown here in the Autumn Statement is a decision that investment in the water industry will rise quite sharply between 1984-5 and 1985-6. I think there is a 10 per cent. cash increase built into the figures, and that is part of the package which we have been discussing, and which I think has also involved an estimated 12 per cent. on average increase in water charges between the two years. This 12 per cent. figure, as I understand it, is rather a ——

259. Low figure?

(Mr Scholar) Well, it is a shot in the dark. Nobody quite knows what the figure will be.

Mr Beaumont-Dark: I will stake you £50 it will be 25 per cent.

Chairman: I do not think we can engage in side bets!

Mr Sedgemore

260. I am getting slightly puzzled, because you have this capacity to agree with Mr Budgen and Mr Beaumont-Dark, and Mr Budgen appears to be asking questions on the basis of one economic theory and Mr Beaumont-Dark on the basis of an entirely different one. Could you tell me as a matter of interest, in relation to Mr Beaumont-Darks questions, whether you believe that forcing public monopolies to raise prices is inflationary, or deflationary, or neutral?

(Sir Terence Burns) The statement I agreed with was that the Nationalised Industries as with other industries should earn the correct rate of return on their assets. If that involves a change such that the price level goes up then obviously in that year the inflation rate would be higher, unless the revenue that comes from that goes to offset that which may well happen. It depends what use you put to the revenue, but it would not produce a sustained increase in prices. It will be a simple one step change.

Mr Fisher

261. Sir Terence, earlier you answered a question of Mr Howell's, saying that the assumption behind the Autumn Statement was the exchange rate would remain approximately stable. Do you agree that if those assumptions prove to be wrong, then a great many of the figures in the Autumn Statement are threatened?

(Sir Terence Burns) Well, to the extent that the assumptions are wrong, a great number of the figures might have to be changed. That depends on how far they are wrong, and which particular assumptions we are dealing with. As I mentioned in my earlier reply, some aspects of the forecast of revenues and expenditure are inherently more volatile and uncertain than others.

262. Can you tell us if it is still the policy of the Government and of the Treasury not to have a policy on the exchange rate? That is what you told us last year.

(Sir Terence Burns) I am not sure I would phrase it in quite the way that you have done. Treasury has no target for the exchange rate. It takes it into account in assessing monetary conditions.

263. Even though the exchange rate is clearly very significant in the assumptions behind the Statement, you still stick to your view that you should not have a target for the exchange rate?

(Sir Terence Burns) Yes, although it is clear that variations in the exchange rate will affect, to differing degrees, a number of the calculations in the Autumn Statement, but that is simply a reflection of reality - target or not. I am sure the exchange rate would still on occasions be different to that which is forecast.

264. Pottery manufacturers in my constituency who are very dependent on exports to America are working for their purposes on an assumption that by next spring, the exchange rate will be somewhere between £1.30 and £1.40 against the dollar. What projections have you done?

(Sir Terence Burns) We have stated in the Autumn Statement that the assumption is that there will not be any significant change from the current levels. If your constituents are in that position and they are correct, they will be in a position to make a large amount of money!

265. Because you are so confident that your assumption is right, you have not made any projections at all about how you would re-assess the figures in the Autumn Statement, if the rate went up?

(Sir Terence Burns) I have no confidence in the sense that you are implying that other people have, about what will happen to the exchange rate. Experience suggests that the outturn can differ quite significantly from the assumptions that we make. Exchange rates are very volatile.

266. My question was not about your confidence. I am asking what provision in figures and statistics you have given to the Chancellor for the change in the Autumn Statement in the general projections, supposing it went up to, say, 1.30 or 1.40 or even 1.50? Have you not done any figures in providing the Chancellor with those sort of warnings?

(Sir Terence Burns) We are aware of the sensitivity of the calculations with respect to the exchange rate. In order to achieve a systematic set of calculations right across the board you have to specify rather precisely quite a lot of assumptions about whether one is speaking of a particular bilateral rate, or whether one is speaking about the effective rate; in turn what effects you think that would have upon world commodity prices, and in particular upon oil prices, the impact upon the inflation rate, etc. We have often put out documents which have shown various stylised simulations for changes in the exchange rate, showing the impact upon output and inflation. It is one of those things that we do as a regular course of action.

267. Have you told the Channellor or perhaps you could tell the Committee how much North Sea oil revenue would be reduced by if the exchange rate fell by, for instance, ten per cent.

(Sir Terence Burns) I think the rough orders of magnitude, for a one per cent. change to the sterling oil price, from whichever source it came, would be about 150 millions.

268. What effect is this going to have on the Government and the Chancellor's predictions on tax cuts next year? For instance, what change in the exchange rate, if the exchange rate rose, would affect the levels predicted in this year's budget? Would those tax cut predictions have to be abandoned?

(Sir Terence Burns) There is no doubt that if there was a very large change in the sterling/dollar exchange rate which did not have any compensated change in the dollar price of oil, the figures for the PSBR would be affected, and the projected fiscal adjustment would be affected.

269. Since one journalist has said, in commenting on the Autumn Statement, that the Chancellor seems to be working on the basis of a falling pound and North Sea oil tax cuts, if the exchange rate goes up, do you anticipate, or have you given the Chancellor any figures, what would happen with a rise in taxation?

(Sir Terence Burns) Well, I do not think that particular statement is anything more than a piece of journalistic licence, but there is no doubt that the projected PSBR would be affected by a change in the exchange rate, as I have mentioned, but I have to specify also, as I said earlier, very clearly that there are a lot of other assumptions at the same time in making a precise calculation, because a number of these things are very closely related. It depends whether it is sterling affected exchange rate that is changing. It depends whether it is dollar. Therefore, it depends what impact it is going to have upon dollar prices, and to what extent it will have an effect upon our own inflation rate and our own cost. I do not think there is any simple ready reckoner that I can give you to produce a do-it-yourself calculation about what will happen in a budget on the basis of particular sterling/dollar exchange rates.

270. But you do I take it recognise that there is a relationship between the exchange rate and the Government's future fiscal policy?

(Sir Terence Burns) Oh, indeed. I hope I have made that clear. I fully recognise the extent to which changes in the exchange rate can affect the calculations, the projections, of the revenues that will be earned, particularly on North Sea oil.

271. Would you not agree that what we are seeing in this Autumn Statement is that the Government taxation and fiscal policy next year is actually dependent on the exchange rate?

(Sir Terence Burns) No, not in the way you describe it. It is always the situation that at all times, if you have a resource the scale of North Sea oil, changes in the exchange rate are actually going to have a significant impact upon the revenues. Indeed, if I recall, in the last PSBR it was also suggested that the size of oil revenues is one of the factors taken into account in setting the PSBR - paragraph 2.17.

272. This is a rhetorical question, but would you not feel that all that is rather strange, going back to what you said earlier, that the Government does not have a target for the exchange rate given the importance of it obviously in the Government's future fiscal and taxation policy?

(Sir Terence Burns) But the weather has an important influence upon whether I get wet or not, but I do not have a target for the weather - for the very good reason that there is not a great deal I can do about it.

273. Can we turn to page 13 and paragraph 1.50. This is entitled "Unemployment", a short paragraph, and it is rather short on statistics. It only has one statistic in it, which is a monthly average increase put at 15,000 since the beginning of this year. What is the evidence for the assumptions behind this paragraph?

(Sir Terence Burns) I am sorry - which particular aspect of it?

274. Well, the projections of the Government on unemployment and the unemployment trend, which again is fairly important for public expenditure next year and for the whole future of industry. You make assumptions in that paragraph based on stable unemployment, slightly rising. What evidence have you given the Chancellor for him to come to those conclusions?

(Sir Terence Burns) That is a question first of all - we always go through this issue at that time of the year - the question of the status of the figures for unemployment.

275. We will agree they are working assumptions.

(Sir Terence Burns) I would like to get that on the record first - if you will record they are assumptions. As I have also said in the past it would be unusual if the assumptions we made varied a great deal, particularly for the year in question, from the expectations we have. It is based on a judgement about the impact of the growth rate we forecast, combined with a number of other judgements we have to make on productivity, etcetera, the impact that will have upon the level of unemployment, and in turn the impact of that unemployment.

276. If you will go back to paragraph 1.29 it is said there that earnings rises are well above price rises and the Chancellor in a speech to the Commons recently said exactly the same thing, that that will continue again next year. He went on to say that if we had the price/wage parity for two years it would create a million jobs, and for three years it would create $1\frac{1}{2}$ million jobs. He is assuming a price/wage parity is worth about half a million jobs a year. What are the wage equations used to generate those figures which the Chancellor put very confidentially to the conference.

(Sir Terence Burns) They not so much depend on wage equations as they are dependent on the judgements of the impact of wages on employment, and of course in turn upon output. They are based on an assessment of the various pieces of evidence that are around which suggest there is an elasticity of somewhere between a half and one in terms of the impact of changes of real wages on employment. Part of that is because it would be expected to change the level of output and partly because it would be expected to change the level of employment in relation to output. I may say the Chancellor did suggest at the time of his IMF speech that we were doing some work in this area and hoped to produce a piece of work, and we still have hopes to do that reasonably soon.

277. What figures have you given him that he comes to that conclusion of half a million jobs a year in the event of wage rise parity? Is that a hope of his or actually a prediction, or a detailed assessment of yours? Does it have a profile in different sectors of the economy and how do you arrive at those figures?

(Sir Terence Burns) First of all it is derived from an assessment of the evidence of studies made by other people of the impact of real wages upon employment. As I said earlier, the broad judgement that we came to, looking at the evidence, was that there was an elasticity of somewhere between a half and one. Take three quarters - that means 1 per cent change in real wages will affect the level of employment by three-quarters of one per cent. We have also done calculations using the Treasury model which produce similar kinds of results. We presented one set of calculations to NEDC a couple of years ago which showed the effects of changes in nominal wages on output and employment, and those changes in nominal wages had implications for changes in the real wages. We have been redoing those calculations and if you take the evidence as a whole it is consistent with that kind of figure. It would not impact immediately; you would not expect to see changes in real wages in the year affect the level of employment in year one to that extent. It would take three or four years to get the full impact of that through. But those are broad numbers that we have come up with from our work in this area.

278. Finally, with non-coal output rising, why also is there a rising trend of unemployment?

(Sir Terence Burns) I am sorry ....?

279. Output exclusive of coal is rising - it is in all the figures here in the Autumn Statement. How do you account for the fact that unemployment is also rising?

(Sir Terence Burns) Output has been rising at a rate over the last four years of somewhere round about $2\frac{3}{4}$ per cent per annum. Productivity in the whole economy has been growing at more or less the same rate. So the level of employment, taking four years together, has been broadly stable, but with the rising labour force and more recently the rising participation ratio that produced an increase in unemployment, it has produced an increase in unemployment.

280. A rising trend, as you predict, in part-time employment - is that how you see things going?

(Sir Terence Burns) There has been a rising trend in part-time employment for ten or fifteen years. It has been quite pronounced. My comments relate solely - what I have just been describing to you is what has happened over the last four years, this dramatic arithmetic. Broadly speaking the rate of growth of output has been matched by a rate of growth of productivity almost the same and over the four years together we see not a large change in employment.

Mr Townend

281. Would you agree that whatever the Government's hopes or aspirations or ethics, Departmental spending is still inexorably rising?

(Sir Terence Burns) The total level of public expenditure in cost terms has not changed a great deal in recent years.

282. Can we turn to the present year? We are told in the report that expenditure is £1½ billion over what was estimated and when Mr Freeman asked you some questions about this as to the headings it was mainly under, you replied "nationalised industries and Home Office".

(Mr Scholar) That was my reply, yes.

283. Could I refer you to page 21, paragraph 2.27 where you state: "In 1984-85 local authorities are budgeting to exceed Cmnd 9143 provision for current expenditure relevant for Rate Support Grant by around £1.2 billion".

(Mr Scholar) Mr Freeman's question was about the additional cost of the coal strike, the £1½ billion this year for the coal strike, and my reply about the nationalised industries programmes and so on was addressed to that question. If the question is not specific to the coal industry but is about the public expenditure out-turn as a whole, the local authority overspend this year has undoubtedly been an important factor.

284. Could we then turn to page 15 and paragraph 1.58 on expenditure: "The additional claims on expenditure in 1984-85 mean that the prospective outturn for the planning total, at nearly £128 billion, may exceed plans by about £1½ billion". You have just replied to me saying the whole of the £1½ billion in your reply was for the coal strike; but the total to the year is £1½ billion. So how do you accommodate other increases including local authorities?

(Mr Scholar) You will recall we began the year with a reserve of £2¾ billion. The outturn of nearly £128 billion represents an outturn of about £1½ billion over the planning total including that reserve. Now the £1.2 billion for local authority expenditure comes out of reserves.

285. But wouldn't one have expected the contingency reserve to be reserved for such unforeseen circumstances as the miners' strike?

(Mr Scholar) In other years we have had strikes - the rail strike in 1982 for example - but their impact on public expenditure was nowhere near as much as the impact of the coal strike.

286. So, leaving aside the coal strike, to what extent is expenditure running ahead of estimates this year?

(Mr Scholar) Leaving aside the coal strike entirely, expenditure is running broadly according to the original plan. If we look at the Red Book, which is produced at Budget time, the forecast there was that broadly the whole of the reserve would be spent and what we are now saying is, yes, the whole of the reserve will be spent but there is then this very large exceptional item of the coal strike which has taken us over the top.

287. So that is why expenditure is likely to increase by £1½ billion and the outturn is likely to increase by £1½ billion and PSBR will go up by £1.25 billion. The difference is basically the coal strike.

(Mr Scholar) You have to add into those calculations the difference in debt interest to arrive at the PSBR figure. To get from the planning total to PSBR you also have to take account of a number of adjustments including, most importantly, debt interest.

288. On the question of local authority spending, last year at this time you had to find an additional £600 million, and this year £1.2 billion; and yet in the Autumn Statement you are forecasting next year that local authority spending will be reduced by

3 per cent in real terms. Is that not rather optimistic in view of what has happened in recent years?

(Mr Scholar) Last year we added £600 million to provision for local authority current expenditure for realism. This year we have added considerably more than that, about £950 million, to local authority current expenditure, so we think the figure we have this year is more realistic a figure. This year what we did not have last year is, we have in place a number of mechanisms which the Government has designed to bring local authority current expenditure under better control; notably the ratecapping legislation is now in place and there will be eighteen rate capped authorities whose expenditure represents over 80 per cent of the overspend for this year, the overspend of £1.2 billion to which you referred. There is in addition a much more severe penalty regime for local authorities. Last year for the first 1 per cent overspend that they had they lost 2p in the pound of their grant. This year they are losing 7p in the pound for their first 1 per cent overspend, so there is a much more severe regime there in place.

289. Can you explain to me the accuracy of an article in the Financial Times today: "An extra £900 million has been allocated to local government spending planning totals next year as a result of the various direct and indirect costs of ratecapping". Is that statement accurate?

(Mr Scholar) No, I think it is not. I think the £900 million is to take account of the growth in local authority current expenditure which has arisen from a number of sources, notably their payment item on the manpower side. The ratecapping legislation we have will serve to bring the expenditure better under control.

290. While appreciating all the Government's efforts, is it not optimistic that in 1985-86 the Government is not looking to just keeping local government spending level in real terms but actually to reduce it by 3 per cent? Isn't that optimistic when we look at the record of the past years?

(Mr Scholar) All I can say is there have been criticisms that the figures have been unrealistic for a number of years and the Government's response to that has been to introduce measures to bring about the level of expenditure which they think right. As you will be aware, the present Government thinks its present level of local authority current expenditure is still far too high, and there are very large savings available to be made, especially in the manpower area, and these new mechanisms which are now in place should bring about those savings.

291. Let us hope the Government will be more successful than it has been in the past. Turning now to the estimates for 1985-86, is it not a fact that again Departmental spending has increased by something like £1.65 billion? We have only got at the planning totals by knocking off £750 million from the contingency reserve, £500 million additional special assets sales and £400 million additional council house sales. So again, in actual Departmental expenditure, despite the Government's efforts, it is grinding upwards and upwards. Is that not correct?

(Mr Scholar) There are reductions, as you see from Table 2.1, in a number of programmes: in the employment programme, the agriculture, transport, housing programmes. The housing programme reduction is not entirely an effect of the increased estimates of receipts from the sale of assets, it also represents some cut in capital expenditure. I would like to take up one point that you have made, Mr Townend. That is, that the reserve has been reduced by £750 million. That is something which naturally happens, and happens in every year, but as one gets nearer to the year in question so does one need a smaller reserve; the uncertainties are less great, and so there is a smaller need for a sizeable reserve. That is something we have seen take place over a number of years.

292. Would not it be helpful, as a presentation factor, if you showed or put in a line in these estimates, showing the total departmental spending? I think this practice was followed at one time.

(Mr Scholar) We could do that. I should make one further point about this table, which perhaps is not immediately apparent from it. That is, that local authority expenditure (which has risen, as you say, by over £1 billion) is here apportioned as between programmes, and, of course, it shows up in a lot of programmes. If you cut out local authority capital expenditure, you would see reductions in the number of programmes. For example, in the education programme you would see there had been a reduction in the central government provision for education.

293. But it is a fact that the reductions are much smaller than the increases, and the difference has been made up as I have already mentioned, has it not?

(Mr Scholar) It is entirely natural that one should draw on the reserve in the way that I described.

294. Is it not a fact that the amounts estimated to be available for tax cuts in the Budget are going completely to come out of the sale of assets? Would you not agree that tax cuts are basically recurring expenditure, whereas sale of assets is one-off expenditure? Although I am all in favour of selling assets, there must be a limit to how long you can go on doing it?

(Sir Terence Burns) I am sure that is correct, that there is a limit (although "limit" may be rather longer than some people sometimes imagine). We went over this at great length, if I recall, this time last year, when we made clear that the sale of assets was one of those factors that was taken into account in judging the appropriate level of the PSBR. This has been repeated on a number of occasions.

295. One would accept that. Would you also accept that my first statement is basically correct: that departmental spending taken in total is inextricably rising, despite the Government's efforts to limit increases?

(Sir Terence Burns) Looked at in cost terms, the figures which are produced by the totals for 1985-86, including the reserves, show a level of expenditure in cost terms much the same as the outturn for 1983-84. That is shown in Table 2.2. I do not describe that as "an inextricable increase".

(Mr Scholar) If I may add a point to that, if you look at it in cash terms, the public expenditure cash total has been within the public expenditure planning totals that were produced in the 1982 White Paper when we first went over to cash planning.

In each year there has been a halt to upward drift in cash terms.

296. But if you make all the adjustments that I have talked about and that we talked about last year, the share of public expenditure as a proportion of GDP has barely started to decline and is considerably more than it was in 1979-80. Do you accept that?

(Sir Terence Burns) It is certainly still, on these numbers, above the levels for 1979-80. However, there has been progress made in reducing public expenditure as a share of GDP, when we take into account the whole of the reserve as it has been spent.

Chairman: Thank you very much. I think there are just one or two particular points we would like to clear up, but obviously we want to adjourn fairly soon.

Mr Wainwright

297. Sir Terence, what do you estimate to have been the effect, during this current year so far, on the growth rate of M3, of the Government's recent overfunding of public debt?

(Sir Terence Burns) I think Mr Cassell is the man responsible for this area, and he may like to answer this.

(Mr Cassell) I think you do need to define the terms rather carefully here. The conventional usage now for funding is sales of public sector debt to the non-banking private sector. On that test, if you go back to the beginning of this target period for the monetary targets, we have underfunded the PSBR by about £1 billion. If you take into account a very uncertain seasonal adjustment for the PSBR, then we have probably overfunded it again by about £1 billion. Either way, however, I do not think that £1 billion is a very significant figure in itself; it needs to be seen in the perspective of a growth of bank lending to the private sector of about £10 billion (that is, ten times as great). There is no particular magic in a fully-funded PSBR; it has historically only come about by accident. There are long periods in the past when we have overfunded, on this present definition, but we did not call it "overfunding" in those days. As long as you are in a situation where the growth of credit to the private sector is growing at a pace faster than the monetary guidelines, then - subject, of course, to what is happening to the M Sterling accounts and these non-deposit liabilities - you are likely to find yourself in a situation where the Government <u>does</u> have to overfund if it is to keep broad money within the guidelines. That is what we have done over the past year.

298. Is it thought, then, that the valuable effect (by the Government's standards) of the effects of overfunding on the growth rate of M3 and so on, is worth the undoubted cost to public funds of overfunding?

(<u>Mr Cassell</u>) I am not sure I accept the premise that there is an undoubted cost to public funds. If you sell any debt that bears interest, as opposed, say, to issuing notes and coin which costs you nothing, there is a cost to public funds. But we are in the business of controlling money supply, and we have got to pay a certain price for it. We do not have an exchange rate target, as you have said, but we do have targets for money supply. I think it is rather important that we keep to those targets, and we do have to pay a price for it, yes.

299. You gave a definition originally of "overfunding", which I think you then departed from in your latest answer to me. I was not in any way comparing overfunding with simply printing money. I was using overfunding in the terms in which you defined it at the beginning of the exchange.

(Mr Cassell) You mean selling debt beyond the size of the PSBR?

300. Yes.

(Mr Cassell) But, as I say, if you take the first eight months of this financial year, in fact we have not sold more debt in size. We have had a very large PSBR through the first part of this financial year, for reasons, I think, that are well known, and we have sold slightly less debt than was necessary to fund that. As I said, however, the margin between the two in this particular period is not very great. We could have sold less debt, that is right, Mr Wainwright. We could have had a faster growth of broad money. On the whole, I think we feel rather more comfortable having kept the growth of broad money within the monetary guidelines.

301. And you do not have ambitions to, as it were, improve money supply performance from the Government's point of view vis a vis the guidelines; to have a slower rate of growth of M3 than in fact the top limit of the guideline range?

(Mr Cassell) Well, we want to be within the guidelines, but the guidelines have a bottom line as well as a top line. In fact, on broad money we have not been near that bottom line very often, but no, we want to be within the range. That is our target and that is what we are planning to do.

302. And you are not greatly worried as to whether you finish up at the bottom end of the range or at the top?

(Mr Cassell) We want to be within the range, and I mean - there is so much play and there is so much uncertainty in this that I think we would be very ill-served in all respects if we tried to narrow the range, as it were, by saying that there is yet another range, a snake within the tunnel if you like, and we want to be inside that snake. No, Sir, I would rest very happy if we are within the range that we have said.

Mr Fisher

303. Sir Terence, can you explain why debt interest, which this year is going to be a thousand million pounds, is outside the planning totals?

(Sir Terence Burns) This is a matter of custom and practice in the way that this approach has developed, and it is very much from the point of view of how it is best seen in controlling public expenditure, but Mr Scholar will add to this.

(Mr Scholar) I think we covered this ground to some degree with the Committee earlier this year, and our position is that the public expenditure planning total is a controlled total and it would not serve the interests of control to have a number in that total which is an extremely volatile number, and also is not controllable, in the sense in which departmental programmes in the main are controllable. That said, in the MTFS, debt interest is taken account of there because the measure of public expenditure which appears in the MTFS is of course in general the Government definition of public expenditure which includes debt interest.

304. I should have phrased my last remark more carefully. I should have said what is the implication of the fact that it is outside the total, and that it is going to be a thousand million pounds? Does that mean there is going to be increased borrowing or increased tax revenue or perhaps interest receipts? What is the implication going to be?

(Mr Cassell) We publish the interest receipts as well, which are also reflecting the same thing, but I think this goes back to the questions that were asked earlier on why it has come about; the implication however is that if there is an increase in the net interest burden after taking off the interest receipts then all that is taken into account in the arithmetic of the PSBR and the fiscal adjustments. If you have a big increase in net interest receipts, then your scope for tax cuts is that much smaller.

Mr Townend

305. I am sorry to come back on this, but as a simple accountant I cannot reconcile the figures. I have obviously made a mistake somewhere. You started off with a contingency reserve of 2.7 billion. You then add an increase of 1.5 billion, which leaves 1.25. You had an increase in interest charges taking the PBSR of half a billion, which left you with three quarters of a billion. You

had an increase in income of 1.5 billion which gives you 2.25 billion. The miners' strike is costing roughly 1.5 billion, which should leave you with PSBR going down by .75 and we have been told it is going up by 1¼. There is a 2 billion there I cannot account for. Will you help me?

(Mr Scholar) Perhaps if Mr Townend could repeat those figures ---

Chairman

306 . I wonder if perhaps he would like to let you have a note instead, and perhaps you might let us have the answer in time for the Chancellor's evidence on Wednesday.

(Sir Terence Burns) We would be happy to do that. I would be extremely surprised if our numbers did not add up.

Mr Budgen

307. Just a small point: we did a year ago have some discussion about the purposes for which the contingency reserve could be used, and you have now widened them, have you not? It used to be for contingencies only, that is, in the sense of changes in policy. It now can be used for estimating or assessing changes, can it not? There is a further element of elasticity in these figures?

(Sir Terence Burns) There is. It is higher, and the degree of uncertainty is that much higher as well.

Chairman: I think that may be a point we will wish to return to on Wednesday with the Chancellor. Thank you very much indeed.

1-55

FROM: R PRATT
DATE: 27 NOVEMBER 1984

MR SCHOLAR

cc PS/Chancellor
Sir Peter Middleton
Sir Terence Burns
Mr Battishill
Mr Evans
Mr Stibbard

TCSC ENQUIRY INTO THE AUTUMN STATEMENT

I attach a note which Terry Ward has written for the Committee on the Autumn Statement.

2. The TCSC are, as yet, in two minds about whether to publish this or not, with the odds perhaps slightly in favour of publication. The paper argues that, when taking account of asset sales, increased debt interest and variations in the rate of inflation, public expenditure, in cost terms, has been rising and, as a proportion of GDP, remaining constant rather than falling.

3. The Committee Clerk has asked for our comments particularly on the table at the end of Terry Ward's paper. Our comments will not be published but may be reflected in changes in the table before that is published.

4. I should be grateful if you would let me know whether you do wish to comment on the table and, if so, if I could have those comments by lunchtime on Thursday, 29 November.

Richard Pratt

R PRATT

TR 63

The Government's 1984 Autumn Statement

Note by Terry Ward

1. This year's Autumn Statement makes familiar reading. It reiterates the money supply and PSBR targets announced in the March Budget and confirms the Government's intention of keeping to the cash figure for total public expenditure published in the last White Paper. But it gives very few details of the changes necessary to achieve this total or even of what is happening to expenditure in the present financial year. It indicates that there ought to be scope for tax cuts in the Budget next Spring if things turn out as forecast (and even if they do not, it will prove difficult in practice not to make some reduction), but it contains no discussion of what form these might take or their longer-term implications. In general, it falls far short of being a preliminary or 'Green' Budget of the kind which the (preceding) Committee recommended some time ago.

Public Expenditure

2. Although the adjustments made to the public spending plans result in the planning total for 1985-86 being reduced by £100 million from the figure published in the last White Paper, in reality it is clear that in the most relevant sense public expenditure is likely to be significantly higher than intended at the beginning of the year. This is because, first, much of the reduction which has been required to offset increases in various programmes (in Social Security, in Health and in payments to the European Community, for example) has taken the form of additional receipts from the sale of financial assets and of land and buildings.

These additional receipts which count as negative expenditure under existing conventions, even though, as the Committee has argued, they are more properly regarded as a means of financing expenditure and the PSBR, amount to around £900 million. Secondly, the planning total on which attention is focussed excludes interest payments which irrespective of how far they are under Government control nevertheless represent an outlay and need to be financed. Since the plans drawn up at the beginning of the year, the forecast of debt interest payments has increased by £1000 million. If total expenditure is adjusted for these two items, then it is £1900 million (or 1½%) higher than it appears from the Autumn Statement.

3. Thirdly, the document makes no reference to the fact that the level of prices is now expected to be somewhat lower (about ½%) than envisaged at the time of the White Paper because inflation during 1983-84 turned out to be less rapid than was then estimated. Consequently the same amount of cash represents higher real expenditure in cost terms, while the finance available to meet such expenditure is slightly less on this account (a given set of tax rates generates a lower cash yield as inflation falls). In cost terms, therefore, total expenditure is now estimated to be some £700 million higher at 1985-86 prices than was projected earlier in the year. Putting these three items together produces a cost terms figure for the total which is £2600 million (almost 2%) higher than implied by the Autumn Statement (implied because no figure for total expenditure is given).

4. Once again the Government seems to be keeping to its public expenditure plans only by selling off assets, ignoring debt interest payments and neglecting what is happening to real expenditure - which is

surely the most relevant magnitude from all points of view - and the effect on this of valuations in the rate of inflation. Moreover this year it would appear that a significant part of the remaining 'cuts' which will be made take the form of increases in charges or prices which so far as the consumer is concerned may be difficult to distinguish from tax rises.

5. Table 1 sets out the changes in public expenditure since 1979-80, adjusting the figures shown in the Autumn Statement to be comparable over time and taking explicit account of debt interest payments as well as of the over-spending in 1984-85 (which for some reason is excluded from the time series displayed in Table 2.2). The effect of these adjustments is to push up the growth of public expenditure in cost terms significantly. Instead of the cost of total public expenditure in 1984-85 being only 9% above the level in 1979-80 as shown in the Autumn Statement (Table 2.2), after adjustment the growth over this period is increased to 14%, which represents an average rate of growth of almost 3% a year. Equally, instead of public expenditure gradually falling in relation to GDP over recent years as shown in the Autumn Statement, the figures after adjustment have remained a broadly constant proportion of GDP since 1981-82. To put the matter another way, the figures in Table 1 demonstrate that the means by which public expenditure growth has been kept down and the level reduced in relation to GDP is through selling off State assets, progressively abolishing the national insurance surcharge and changing the accounting treatment of certain benefits (without changing the cost to the Exchequer).

6. The last public expenditure White Paper forecast that the planning total would be about the same in 1984-85 as in 1983-84 in cost terms.

Now it appears that there is expected to be growth of around 1½%. When the increasing receipts from asset sales are allowed for and debt interest included, growth in cost terms in the present year is estimated at 3% - about the same rate of increase as over the past five years. Nevertheless real expenditure is still expected to decline in 1985-86, repeating the familiar pattern of expenditure plans under the present Government.

7. What remains unclear is precisely why and where public spending has risen above plans in the present financial year. The Autumn Statement seems to put the responsibility on the miners' strike. Yet this does not altogether square with the patchy details given elsewhere in the document. In particular, local authority current expenditure (at least that relevant for Rate Support Grant) is stated to be £1.2 billion higher than in the last White Paper (para. 2.2) and their capital expenditure seems also to be substantially in excess of cash limits (para. 2.29). It is hard to see how much of this can be the result of the miners' dispute. Clearly there is a need for considerably more information about over-spending than is given on the Autumn Statement before it is possible to make any satisfactory assessment of what has happened and of the implications for next year. So far as local authority expenditure is concerned, the significant fall in 1984-85 which was part of the White Paper plans does not seem to have occurred though this has not prevented the Government from building a large reduction (of 3% on current spending) into the present plan for 1985-86.

* Both for this year and 1983-84 since the Autumn Statement refers to considerable over-spending by lcoal authorities on their capital account in that year without quantifying this and without seemingly revising the figure for total expenditure.

8. An unforeseen event such as the miners' strike would seem to represent precisely the kind of occurrence which the contingency reserve is set aside to cover - in much the same way as it appears to have been used to finance the Falklands campaign in 1982. It is not clear, therefore, why it should necessitate an increase in the planning total for public spending. One problem might be that a large part of the contingency reserve included in the last White Paper plans seems to have been implicitly ear-marked for additional local authority expenditure, the total for which published in the plans was unrealistically low. As a result, what was left over to cover genuine contingencies may have been relatively small and insufficient to meet the increased costs arising from the miners' dispute (though just what those costs have been and where they have fallen remains to be discovered).

9. The lack of information about expenditure revisions extends to the plans for 1985-86. For example, reductions in external financing limits (EFLS) have been made with respect to a number of nationalised industries, including Electricity and Water (para. 2.26) while increases have been made with respect to Gas and Steel. But no details are given as to whether these changes will be associated with increased revenue (perhaps coming from higher prices) or reduced investment for the former group and vice versa for the latter group. Similarly in the case of Health, it is stated that 'some charges will be increased' (para. 2.22), without saying which and by how much, and that 'cost-improvement programmes .. should release substantial additional resources to enable health authorities further to develop services and improve patient care', without giving any indication of how much improvement is thought likely. That is especially relevant since the 1% increase in

expenditure above inflation planned for 1985-86 and would under normal circumstances be barely sufficient to maintain the present level of service.

The Economic Outlook:

10. The picture painted by the Autumn Statement is of an economy in which growth has been depressed by the miners' strike, but for which the outlook, providing the strike ends soon, is favourable. Growth of 3½% is forecast for 1985, inflation is projected to remain stable and the balance of payments is expected to improve. There are, however, a number of worrying features about present prospects, quite apart from the industrial dispute. In particular, though non-oil exports are likely to be much higher in 1984 than 1983, the trade performance of UK producers gives some cause for concern, especially since the contribution of oil to the balance of payments is expected to diminish steadily over the remainder of the decade. Both non-oil exports in total and exports of manufactures as the major proportion have shown no growth at all in volume terms during 1984, with the third quarter figures at about the same levels as in the first quarter, despite the growth of demand in export markets during that time. In contrast, import penetration has gone on rising steadily, with imports of manufactures 12½% higher in volume terms in the third quarter of 1984 than a year earlier.

11. At the same time, manufacturing production, as a reflection of this, seems to have picked up much less than in other countries as growth has occurred and though industrial investment is expected to rise sharply in the present year, the forecast is for a slowdown in 1985.

This would still leave investment in manufacturing well below its level in 1979 before the contraction in output took place.

12. Perhaps of greatest concern is the continued rise in unemployment, especially if there are doubts about the sustainability of growth at close to its present rate beyond next year. Though employment has risen, it has not had much effect on the unemployment figures, which may not be too surprising given that a large proportion of the jobs created have been for part-time women and given that the official figures for unemployment have become even less reliable than in the past, as a guide to the number of people out of work. It is apparent that as activity fell and jobs were reduced, large numbers of people simply disappeared from the labour force as officially measured because they were not eligible for unemployment benefit.

The Fiscal Adjustment:

13. Finally, although the Autumn Statement refers to a possible tax reduction of £1½ billion come next Spring, it is clear that there is considerable uncertainty about whether the Government will be able to deliver this while keeping to its PSBR target. Disregarding the miners' strike, much depends on the growth of tax revenue from the North Sea, which is extremely sensitive to what happens to the dollar-sterling exchange rate. The implicit assumption underlying the projections of North Sea revenue seems to be that the rate remains at its present level; which considerably boosts the figures. The present estimate of revenue is £2 billion higher for 1984-85 and £2½ billion higher for 1985-86 than projected in the March Budget. Much of this is due to the fall in sterling against the dollar, a fall which could easily be

reversed during the coming year, perhaps leaving little or no scope for tax cuts, though it would be useful to get some idea from the Treasury of just how sensitive the projections are to this kind of development.

14. On past record, however, the Chancellor will probably be able to find ways of delivering tax cuts whatever changes occur in the meantime without breaching the PSBR target. The possibilities for adjusting what appears as public sector borrowing without having any great effect on economic activity are almost endless. Nevertheless the Autumn Statement with its reiteration of the PSBR target and public spending plans and its promise of tax cuts of a certain amount does seem to commit the Chancellor to a particular course of action before the analysis underlying the formulation of a revised MTFS has really been carried out and certainly before it is open to outside assessment. It is at least debatable whether this represents the most satisfactory way of conducting economic policy.

Department of Applied Economics
University of Cambridge
14th November 1984

Table 1 Changes in Public Expenditure in Cost Terms

£million at 1983-84 prices

	1979-80	1983-84	1984-85	1985-86
1. Planning total in 1984 White Paper	112.3	120.3	120.3	120.7
2. Planning total in Autumn Statement	111.7	120.3	122.0	120.6
3. Planning total adjusted for national insurance surcharge, housing and sickness benefits*	111.7	122.0	123.9	122.4
4. excl. special sales of assets	113.2	123.2	125.7	124.7
5. Adjusted planning total excl. special asset sales plus net debt interest	118.2	130.2	133.3	132.5
6. Adjusted planning total excl. sales of asset and land and buildings plus net interest	118.8	132.1	136.0	(135.2)+
Indices, 1979-80 = 100				
1. Planning total in 1984 White Paper	100	107.1	107.1	107.5
2. Planning total in Autumn Statement	100	107.7	109.2	108.0
3. Adjusted planning total*	100	109.2	110.9	109.6
4. Adjusted planning total excl. asset sales	100	108.8	111.0	110.2
5. 4. plus net debt interest	100	110.2	112.8	112.1
6. 5. excl. net sales of land and buildings	100	111.2	114.5	(113.8)+
Public expenditure as % of GDP in Autumn Statement	39½	42¾	42	41
Adjusted public expenditure (line 6) as % of GDP	40	44	44	43½

* Adjusted for the reduction in the national insurance surcharge and changes in the treatment of housing and sickness benefits to put the figures for years from 1983-84 on a comparable basis to those for 1979-80.

\+ Assuming the same level of net sales of land and buildings as in 1984-85 since no details are given for this year in either the White Paper or the Autumn Statement.

2-6

FROM: K F MURPHY
DATE: 27 NOVEMBER 1984

1. MR BATTISHILL 27/11

2. CHANCELLOR OF THE EXCHEQUER

cc Sir Peter Middleton
Sir Terence Burns
Mr Bailey
Mr Monck
Mr Anson
Mr Cassell
Mr Scholar
Mr Evans
Mr Jameson
Mr Lankester
Mr Burgner
Mr Folger
Mr Gray
Mr Odling-Smee
Mr Williams

TCSC: OFFICIALS APPEARANCE ON THE AUTUMN STATEMENT

You may care to have a brief note on the main issues which arose at yesterday's hearing. In general, the hearing was cordial and there were relatively few difficulties.

2. There were a number of points which Committee Members said they would wish to pursue with you tomorrow:

(a) The procedures for Ministerial discussion of public expenditure priorities. Mr Higgins was keen to understand what fora, and on the basis of what evidence, Ministers balance the relative priorities of spending on, say, aid and defence.

(b) Mr Howell repeated his argument that the total public expenditure cost of unemployment should be clearly published. It was unsatisfactory that unemployment costs were carried under several different departmental heads.

(c) There was much discussion spearheaded by Mr Wainwright of the significance of the increased debt interest payments now expected in 1985-86 (this exchange was reported in today's FT - cutting attached). Officials pointed out that it was not possible to draw conclusions from this data about the Treasury's expectations for the absolute level of interest rates next year.

3. There were also three areas where the Committee asked the Treasury to produce a note:

(a) Mr Freeman asked for a note showing the breakdown between departmental and other heads of expenditure of the £1½ billion costs of the miners' strike. He also asserted that the Autumn Statement should contain estimates of current year outturn broken down into heads of expenditure; officials' agreed to consider this change for next year.

(b) There was considerable discussion, prompted by Mr Beaumont-Dark of the rate of return in the water industries. He criticised the imposition of the EFLs which would lead to higher utility prices and would therefore increase industry's costs. Officials were asked to provide a note which would discuss, inter alia, whether the new water industry EFL was based on rates of return calculated on a replacement or historic cost basis.

(c) Mr Townend asked for a note setting out the details of this year's public spending overrun, including spending out of the Contingency Reserve.

4. The discussion also covered a number of other areas:

(a) Mr Budgen alleged that the Government was unwilling to pursue policies which would reduce inflation below 5 per cent per annum during the life of this Parliament, and concluded that the money supply figures would produce a rise, not fall, in inflation. Officials pointed out the downward inflation path in the MTFS and refuted Mr Budgen's simple mathematical approach.

(b) Mr Freeman pursued the underlying reasons for the bounce-back in growth in 1985-86, while Mr Beaumont-Dark criticised the Government for asking Parliament to approve an increase in the coal industry deficit grant limit, which he alleged was indicative of increasing expenditure on the coal industry.

(c) Mr Freeman inquired about the breakdown of fixed investment between the private and public sector in the forecast. He was told that detailed information on the public sector would not be available until the PEWP but that the IAF was consistent with a small increase in private sector housing investment coupled with a small fall in overall public sector investment.

(d) Mr Fisher explored the effect of changes in expected exchange rates on the estimate of the fiscal adjustment provided in the Autumn Statement. He also enquired about the evidence for the assertion that real increases in wages have resulted in lower employment.

(e) Mr Townend pursued the reasons for the public expenditure overrun in 1984-85, and was sceptical that local authority current expenditure could be kept in check. He asserted that next year tax cuts were to be financed almost solely from sales of assets and that the underlying trend of public expenditure was upwards.

(f) Mr Wainwright pursued the question of overfunding, and was told that it was not clear that the Government was massively overfunding, and in any case there were benefits in terms of keeping monetary growth within target ranges.

K F Murphy

K F MURPHY
CU

EXTRACT FROM FINANCIAL TIMES DATED 27th NOVEMBER 1984, Pg. 9.

Treasury lifts interest rate estimate for 1986

By Max Wilkinson, Economics Correspondent

INTEREST RATES will be significantly higher up to the spring 1986 than was assumed at the time of the Budget, Treasury officials told MPs yesterday.

Mr Hugh Evans, the Treasury's chief forecaster, told the Treasury and Civil Services Committee that higher than expected interest rates underlied the Government's most recent estimate of the cost of servicing the national debt in 1985-86.

In the Autumn Statement earlier this month, the Treasury said that interest payments in 1985-86 were now expecetd to reach £16.5bn, which was £1bn more than it was expecting in March.

Mr Evans told the commitee that this rise resulted from the fact that borrowing was expected to be higher than the total forecast at the Budget as well as the forecast of higher interest rates.

Officials declined to give details and Sir Terence Burns, the Treasury's Chief Economic Advisor, pointed out that it was only possible to deduce that the Treasury had changed its expectation on interest rates, and not the level that it was predicting.

However, the answers appear to imply that the Treasury's more pessimistic view suggests that on average interest rates in the two years 1984 to 1986 would be about one to two percentage points higher than was hoped at the Budget.

Sir Terence assured the committee that the Government remained determined to continue with its strategy of reducing inflation.

Mr Evans also told the MPs that the volume of public spending on capital projects was predicted to fall very slightly next year.

However, Mr Michael Scholar, the under secretary in charge of the general expenditure policy group, said some decisions still had to be taken on the breakdown between capital and current spending and full details would not be available until the public expenditure White Paper was published next year.

FROM: T U BURGNER
27 November 1984

CHANCELLOR

cc: PS/CST
Sir Peter Middleton
Sir Terence Burns
Mr Monck
Mr Battishill
Mr Scholar
Mr Pirie
Mr Robson
Mr Grimstone
Mr Pratt

TCSC, 28 NOVEMBER:
SUPPLEMENTARY BRIEFING

I understand from Central Unit that the TCSC may ask about:

(i) The effect of tougher EFLs for gas, electricity and water for industries' costs.

(ii) The criteria for determining EFLs.

Some additional briefing is attached.

TB

T U BURGNER

Enc:

What will the increase in negative EFLs for gas and electricity and the smaller positive EFL for water do for industries' costs?

Prices are a matter for the industries to settle. Discussions will now take place within the industries on increases for 1985-86.

Supplementary points:

(i) Gas and electricity. Increases expected to be broadly in line with inflation. (No decisions yet taken on recovering costs of the coal strike including extra costs of maintaining electricity supplies).

Electricity prices to industry are generally in line with Continental competition, except for France with its high nuclear output. Recent outside evidence suggests UK gas prices are low by Continental standards.

Future of electricity load management scheme - this is a matter for the industry. The industry anticipate a scheme providing comparable benefits will continue in 1985-86.

(ii) Water. Expect the increases to be somewhat above the rate of inflation. How much will depend upon the efficiency savings the industry can achieve.

The increased charges will help to finance a much increased investment programme.

[If pressed: DOE has stated that increased charges are likely to be around 12%. But industrial charges will be less than domestic (possibly about 10-11%).]

By what criteria are nationalised industry EFLs decided?

EFLs are agreed by sponsor Ministers and the Treasury on an industry-by-industry basis. Several factors are taken into account, including the industry's medium-term financial target, the size of its investment programme, the scope for reducing costs and increasing efficiency, and the level of its prices.

[If pressed:

(i) The aggregate level of EFLs is influenced by macro-economic considerations and the overall public expenditure position.

(ii) For 1985-86 the liability of some industries to Corporation Tax has also been taken into account.]

FROM: MISS G NOBLE

DATE: 27 November 1984

MR SCHOLAR

cc Mr Battishill
Ms Seammen
Mr Hall

TCSC QUESTION ON HOUSING BENEFIT

I attach a short piece of briefing on the story in the Guardian last week about joint tenancies and housing benefit.

G Noble

G N NOBLE

JOINT TENANCIES, A NEW LOOPHOLE IN THE HOUSING BENEFIT SCHEME LEADING TO £190 MILLION OF ADDITIONAL EXPENDITURE?

Background

Last week's Guardian reported that a possible new loophole in the housing benefit scheme had been identified which could lead to expenditure of up to £190 million. If a working non-dependent is living in a household where the head of the house is claiming housing benefit, the non-dependent is assumed to be contributing £8.20 towards the households' housing costs and that amount is deducted from the housing benefit calculations. The Guardian claimed that an increasing number of such households were arranging joint tenancies. In such cases, the housing costs are divided between the tenants and a separate housing benefit calculation carried out for each. If the non-dependent has a low enough income the family may qualify for more housing benefit.

2. DHSS say that the estimate of £190 million is incorrect even on the assumptions used. A potential spend of £80 million would be more accurate on the assumptions used and actual exploitation of this loophole is likely to be far less because of the other implications of taking joint tenancies. Many landlords, including local authorities, will be reluctant to award joint tenancies because it extends the security of tenure to additional persons. DHSS are taking the problem seriously, however. They are still assessing the scale of the problem and the real potential for abuse, and considering what action, if any, needs to be taken to block the loophole. Any regulations will need to be carefully drafted, however, so they do not discriminate against legitimate shared tenancies.

Line to take

3. There are significant broader implications for both the tenant and landlord in switching to joint tenancies and the figures quoted in the Guardian look grossly overstated. However, I understand the Secretary of State for Social

Services is looking into the problem to assess the potential for abuse and is considering what action if any needs to be taken.

Footnote

4. An earlier loophole in the housing benefit scheme identified by the National Union of Miners - that strikers living with close relatives could claim they were paying rent and thereby claim board and lodgings payments - is being closed. The Secretary of State for Social Services announced that this loophole was to be closed on the day of the Autumn Statement (it was included in the DHSS Press Notice, though few commentators noticed it). Draft regulations have been submitted to SSAC and to the local authorities for consultation, and they will be laid in the house shortly.

WATER.

1. The Select Committee may raise the question of increases in water charges, following publicity about a letter of complaint from the CBI to Patrick Jenkin, the sponsor Minister. have not seen a copy of the letter, but according to press reports (attached) it makes the following points.

2. Industry is facing rises of up to 50 per cent in real terms over the next three years, to be debt free after that, and a reduction in capital investment. This will be a major blow to industry's costs.

3. None of these "facts" is correct.

(a) charges will rise somewhat above the rate of inflation but how much will depend on efficiency savings in the industry. 12 per cent (cash) rises will be the average in 1985-86 but industrial charges will rise less than the average - 10-11 per cent perhaps. In the following two years the increases shall be slightly less.

(b) investment is increasing, not decreasing, funded by the rising charges. About 10 per cent cash increase from 1984-85 to 1985-86, to enable more work to be done on eg underground mains and sewers, and on anti-pollution work. (£778m in 1984-85, £846m in 1985-86.) The CBI should welcome this extra infrastructure investment.

(c) Debt The EFL is declining (£284m in 1984-85, £203m in 1985-86) but the industry will be a long way from debt free in two years. Only one authority (Thames) will be close, as it has a negative EFL.

4. Other points

(i) Water has been too cheap. The industry has a very low profitability, and only earns 1 per cent (before interest) on its net current cost assets. The norm for nationalised industries is 5 per cent. The government has set targets of 1.4 per cent, 1.7 per cent and 1.9 per cent for the next three years, to move towards more economic pricing. (Assets are valued at their net current value to the business - estimated net replacement cost, about £30 billion.)

(ii) Not a sensible comparison to criticize increasing water 'rates' as inconsistent with rate-capping local authorities. Water services in England and Wales are provided by the water industry. Water charges are a charge for water, not a rate or a tax. Nothing to do with controlling the spending of profligate local authorities.

(iii) Domestic users are mainly at present charged on the basis of the rateable value of their houses, but industry is all metered - charged according to what they use. Government just launched a study of extending metering to all domestic users as well.

(iv) Effect on inflation, industrial costs etc should be small. Each 1 per cent charge in water charges raises RPI by only 0.01 per cent. Water is a small element of most industries' costs - some will feel the effect of these increases, but for most it should not be significant.

(v) It is not government policy to subsidize costs of utilities, as a way of subsidizing industry in general. Nationalised industries should be efficient and provide a good service but with minimum burden on the taxpayer. Until the water industry is earning 5 per cent on its net current cost assets, on a par with the private sector, there is in fact an implicit subsidy from the taxpayer - at present over £1 billion. (Assets £30 billion x (5% - 1% = 4%) = £1.2 billion.)

TCSC HEARING : BUDGET DISCIPLINE

The question and answer briefing set out below covers the main points of criticism on which the TCSC (particularly Mr Budgen) focussed when officials gave evidence on 19 November. My separate minute of today's date reports that the Foreign Affairs Council has so far failed to adopt the budgetary discipline conclusions because of disagreement as to whether any concession should be offered to the European Parliament. The Foreign Affairs Council will make a further effort to reach agreement tomorrow. The question and answer briefing suggests what you might say in the event that the Foreign Affairs Council fails to agree again. We will let you know before the TCSC hearing what the position is.

2. Annex A, the work of Miss Simpson, sets out the draft Conclusions of the Council on budgetary discipline in the form agreed at the 12 November ECOFIN Council and as presented to the House, together with an article by article commentary and a line to take on difficult points.

3. We suggest that you commend the budgetary discipline text to the TCSC not as an ideal outcome, which fully achieves the Government's negotiating targets, bu, as a vast improvement on the present position where there is n discipline at all. (The figures in Answer (c) below substantiate this). It has to be admitted that there <u>are</u> loopholes in the text - exceptions clauses etc. These can only be defended by reference to the need for some flexibility in controlling highly volatile agricultural spending. The essential points are that there will be a clear constraint on the agricultural price fixing decisions and that Finance Ministers will now have a substantial role to play.

BRIEFING TCSC, 28 NOVEMBER :

AUTUMN SURVEY : BUDGETARY DISCIPLINE

(a) <u>Budgetary Discipline not legally binding; subordinate to Treaty requirements (Art. 39) to maintain farmers' income</u>

The Government's objective was to get these rules incorporated into the Community's budgetary procedures and, once the text has been adopted, that will have been achieved; the Council will have bound itself to observe the rules in it governing both agricultural and non-agricultural expenditure.

2. As regards agriculture, Council will have committed itself to keep growth of expenditure below that of own resources base. That will be financial framework within which price fixing decisions are to be taken. The CAP objectives set out in Article 39 of the Treaty are in any case internally contradictory - references to both "fair standards of living" for agricultural producers and "reasonable prices for consumers". Nothing to say which of these two should have priority.

3. [If pressed on <u>legal nature</u> of the Conclusions]. Whether or not the text has legal force could in last resort only be decided by European Court. Hon Member greatly exaggerates significance of this point. Several apparently binding provisions of EC Treaty - eg freedom of services and removal of barriers to trade - have at best only been partially implemented. In contrast, both the 1980 agreement on UK refunds and the setting up of the EMS were agreed without any provision for them in the Treaty and on the basis of Council Conclusions and a Council Resolution respectively. What matters is that the Council is binding itself to observe this agreement.

(b) <u>HMG surrendered veto over own resources increase, in return for budgetary discipline which can be overturned by qualified majority</u>

4. UK did not "surrender veto". Fontainebleau agreement is a highly satisfactory deal; HMG agreed to propose to Parliament

increase in VAT ceiling to 1.4% in return for 66% abatements of our budgetary burden and the budgetary discipline rules governing agriculture. If no Fontainebleau agreement, no rebates, no abatements and no control of agricultural spending.

(c) But why qualified majority voting?

5. We wanted budgetary discipline incorporated in Community's budgetary procedure where qualified majority voting rule applies; hence qualified majority in this text.

6. So far as agricultural spending is concerned, Commission has bound itself to draw up its price fixing proposals in the light of the agricultural guideline. Provided it does so and sticks to its original proposals, Agriculture Council can only amend them by unanimity under Article 149 of Treaty. Moreover, if that seems likely to happen, the new rules require the Commission to summon a Joint Agriculture-ECOFIN Council to take final decisions.

(d) How can budgetary discipline be taken seriously when super-levy arrangements flouted by France, Italy etc?

7. Far too soon to conclude that super-levy will not be implemented. Commission has made it clear it will initiate action in European Court against recalcitrant Member States. Faint hearted/ to assume all is lost at first obstacle. Government has never pretended budget discipline easy or settled in a day. Hard decisions will be required on the CAP of which super-levy on milk only the first. The budgetary discipline text provides essential financial framework to ensure those decisions are taken.

(e) Agricultural Guideline far too generous. Will allow agricultural spending to grow in real terms.

8. Problem is that agricultural spending has risen far faster than own resources bases :-

	1984 on 1977	1984 on 1982	% inrease
(i) agricultural expenditure	168%	48%	
(ii) own resources base	75%	11%	

Now agreed that agricultural spending will rise less than own resource base. Our estimate is that this will give an increase of around 6% in 1986 on 1985 and lower increases thereafter - 4½-5%. That will be vast improvement compared with past. Zero growth simply unrealistic given large level of accumulated stocks.

(f) Foreign Affairs Council has not adopted budgetary discipline text. Government's negotiating triumph has vanished into thin air?

9. No. No disagreement in Foreign Affairs Council over substance of the text or the agricultural guideline. Sole point at issue is whether and how to associate the European Parliament with budgetary discipline - in a purely consultative role. Confident that this will be resolved speedily. No question of Government seeking House's approval of Inter-Governmental Agreement until text finally adopted.

Text

Whereas at its meetings on 19 and 20 March and 25 and 26 June 1984, the European Council reached agreement on a series of decisions and guidelines to ensure the relaunch of the Community and establish a solid basis for its further development during the present decade;

Whereas principles of budgetary and financial discipline are specifically laid down;

Whereas the European Council considered it essential that the rigorous rules which at present govern budgetary policy in each Member State shall also apply to the budget of the Communities, and stated that the level of expenditure will be fixed on the basis of available revenue, and that budgetary discipline will apply to all budgetary expenditure;

Whereas the European Council invited the Council of Ministers to adopt the measures necessary to guarantee the effective application of the principles as set out in its conclusions.

Commentary

Follows closely the Fontainebleau conclusions. Clearly therefore ties the budgetary discipline arrangements and the rest of the Fontainebleau package. No problems for the UK.

Text

Article 1

1. At the beginning of the budgetary procedure each year, the Council shall fix a reference framework, ie the maximum level of expenditure which it considers it must adopt to finance Community policies during the following financial year in accrodance with Articles 2 to 5 inclusive and Article 9.

2. In order to fix the reference framework, the Council shall act by qualified majority in accordance with Article 148(2), second indent of the EEC Treaty.

3. The relevant provisions of the financial guidelines concerning the Common Agricultural Policy, set out in the Annex to the Commission Communication of 6 March 1984, shall be implemented; these provisions are annexed to this conclusions.

Paragraph 2. The "qualified majority" is 45 votes (out of a total of 63) cast by at least 6 members. After enlargement will be 54/76.

Line to take Qualified majority voting is the normal rule for decisions which are part of the Community's budgetary procedure. (See separate note)

Paragraph 3 Firmly associates the Commission's proposals for control of agriculture spending with the Council's measures on budgetary discipline generally. The Commission has said it will make its agricultural proposals "in the light of" the guideline.

Commentary

Paragraph 1 empowers the Council (basically ECOFIN) to fix the reference framework. It now takes the form of a direct quotation from the Brussels/Fontainebleau conclusions. (Articles 2 to 5 and Article 9 refers to the agricultural guideline and the maximum rate provision respectively.) The major weakness of the Article is the timing. "At the beginning of the budgetary procedure" is an indeterminate time, and could turn out to be as late as June. We had originally marked a specific date that clearly preceded the agricultural price fixing, but were unable to achieve this.

Line to take. The guideline, rather than the reference framework, is the right control on agricultural expenditure. As the Commission have made it clear that they will compare the estimated budgetary consequences of their price-fixing proposals with the guideline, the Council will also be able to compare their compatibility. Commission has said it will provide necessary figures "early in the year" to enable Council to fix reference framework. This must be done before the Commission presents the Preliminary Draft Budget.

Articles 1 and 6.1 embody the reference framework in the Community's budgetary procedures.

Text

<u>Article 2</u>

The Council shall ensure that the net expenditure relating to agricultural markets calculated in accordance with Article 4, will increase by less than the rate of growth of the own resources base. This development shall be assessed on comparable bases from one year to the next.

Account shall be taken of exceptional circumstances, in particular in connection with enlargement.

<u>Line to take</u>: It is a fact of life that agricultural expenditure will be subject to unforeseen market developments. In addition, the Community will be going through an important structural adjustment over the next few years - namely enlargement. These are both legitimate, and sensible, reasons for providing for some flexibility within the guideline. We shall, of course, scrutinise most carefully all attempts to invoke this provision. No agreement to anything except enlargement as "exceptional". Qualified majority needed to agree on exceptional circumstances.

Commentary

This commits the Council to keep the rate of growth of agricultural expenditure below that of the own resources base. It does <u>not</u> now fully reflect the Fontainebleau conclusions, because with the changed method of calculating the guideline, the reference to "three-yearly" basis has been discarded.

<u>Line to take</u>: Nothing sinister about the removal of the reference to three years./ Simple cross-reference to Article 4. The intention of the article is still quite clear. The agreed method of calculation of the guideline also automatically provides a three-year comparison - years 1984, 1985 and X.

The reference to exceptional circumstances and enlargement comes direct from the Fontainebleau conclusions. the <u>Irish</u> have added an entry in the minutes claiming that account, under this heading, should also be taken of the costs of stock disposal. The <u>Council</u> has also pledged itself to take into account its and the European Councils' previous decisions, especially relating to less developed areas. The flexibility available within the Article is therefore uncomfortably large and there will clearly be scope for considerable argument about the adjustment of the guideline. Fortunately, neither of the Council minutes entires should become public knowledge.

Text

Article 3

The amounts to be taken into account for the application of Article 2 shall be:

(a) as regards expenditure:

that chargeable to Section III, Part B, Titles 1 and 2 (EAGGF Guarantees) of the Budget. The claculation of agricultural expenditure for the purpose of the guideline referred to in Article 2 shall be this expenditure, reduced by the sum of amounts corresponding to the marketing of ACP sugar, refunds in connection with food aid and the payments by producers in respect of the sugar and isoglucose levies as well as the revenue from any future internal agricultural charges;

(b) as regards the own resources base:

the potential revenue on the basis of which Titles 1 and 2 of the Revenue side of the Budget are determined. The calculation of the Community's own resources base for the purposes of the guideline referred to in Article 2 shall be the total VAT base upon which the VAT rate for the year in question is calculated, the amount of financial contributions (if any) included in the Budget of the year, together with the own resources, other than those derived from VAT, set out in Revenue Title 1, less the sugar and isoglucose levies as well as the revenue from any future internal agricultural charges.

When the potential revenue from VAT is changed following an alteration in the VAT ceiling, the guideline provided for in Article 2 shall thereafter be calculated as if the new maximum VAT rate had been applied in all the years relevant to the calculation of the guideline.

Commentary

The definitions of both the expenditure base and the own resources base for the guideline calculations. In both cases, they differ from those normally quoted by the exclusion of the sugar and isoglucose levies. The text corresponds to that of the Commission communication on budgetary discipline which was endorsed by all member states at Fontainebleau.

The final paragraph was inserted at the insistence of the UK , and is designed to ensure that increases in the own resources ceiling doe not permit a 'step' increase in the guideline. The effect will be to 'read back' the new VAT maximum rate into the figures for 1984 and 1985 so that the own resources factor will not be artifically inflated by a comparison between an own resources base calculated on 1% and one calculated on 1.4%

The UK has inserted a statement in the minutes accepting this definition of agricultural expenditure <u>only</u> for the purposes of this exercise, and rejecting any implications it may have for the budgetary treatment of FEOGA guarantee expenditure or other purposes.

<u>What difference does the "narrow definition" make?</u>
<u>Why did UK agree?</u>

(a) Will not make much difference (less than 10% of Budget) and omitted portion unlikely to grow faster than rest of FEOGA budget.

(b) This definition was proposed by Commission at Fontainebleau. UK accepted for use in this context only. Other member states wanted even narrower definition.

Text	Commentary
Article 4 The level of net expenditure relating to agricultural markets for a given financial year shall be calculated as follows: (a) the level of expenditure, as defined in Article 3(a), shall be the average of the actual outturn expenditure for 1984. and the best estimate of the outturn for 1985. (b) the own resources factor shall be established by dividing the forecast level of the own resources base for the financial year in question, as defined in Article 3(b), by the average own resources base for 1984 and 1985 (c) the level of expenditure for the financial year in question shall be determined by multiplying the amaounts obtained by the application of paragraphs (a) and (b), unless the Council acting by the majority defined in Article 1(2) decides otherwise; (d) the method of calculation shall be re-examined in accordance with the Fontainebleau conclusions under the heading "budgetary imbalances" on the basis of the report to be presented by the Commission, one year before the 1.4% VAT ceiling is reached.	The method of calculating the agricultural guideline, and core of the agreement. It has been changed from previous versions in 3 significant ways: (a) there is a fixed, rather than a moving reference period; (b) the reference period itself is 2, rather than three years; and (c) provision has been made for a review of the system. In addition, it has made special transitional arrangements for 1986 unnecessary. Line to take 1. The key matter in establishing the guideline was to eliminate "base drift" ie getting excess expenditure in any one year built into the system. This the present formula achieves. 2. The present formula, like the previous "original budgets", is based on one originally tabled by the UK. It is much more satisfactory than the previous one whould have been without "original" budgets, on which it became clear there was not going to be agreement. 3. Even with a 2 year base period, the formula gives a tight guideline. Total agricultural spending in 1986, on this basis, is expected to be some 6% more than in 1985, compared to increases averaging 16% between 1982 and 1985. Given the high level of stock disposals that will have to be financed, the 1986 figure will be a tight constraint. 4. The Fontainebleau conclusions always envisaged that there would be a review of the system. The Presidency on Monday accepted the Council Legal Services advice that this meant the mechanism continues to operate while expenditure remained within the 1.4% ceiling, which cannot be altered without our consent.

Text | Commentary

Article 5

In the event of failure to respect the qualitative guideline referred to in Article 2, the Council shall, during the following two financial years, ensure that, barring aberrant developments, agricultural expenditure is brought back within the limits imposed by this guideline. In so doing, the Council shall concentrate its activity primarily on the production sectors responsible for the failure to adhere to the guideline.

The clawback provisions, based on the Commission's proposals on the financial guideline. They are ambiguous, in that it is not clear whether they are intended to bring expenditure back to the original line, but starting from a higher base, or genuinely to claw back any excess expenditure. With the revised formula for calculating the guideline, the latter interpretation is the only one that makes any sense, as excess expenditure in any one year will not get built into the formula (after 1985). The formula, however, also have the advantage of making it more difficult to tinker with the guidelines, for example if excess expenditure on any one year leads to an effective very small increase (or even decrease) in expenditure the following year.

Line to take

This is an essential part of the package and one we fought hard to get included in the text. The guideline itself now provides for automatic avoidance of base drift. The effect of this Article will be that if, in any one year, expenditure does exceed the guideline, the Council will have to consider what measures are needed to offset any excess over the following 2 years. Clawback not automatic. Judgement will have to be made depending on cause of the expenditure overshoot. But strong presumption that clawback will be applied.

Text	Commentary
Article 6	
1. The council shall, when exercising its powers as legislative authority or branch of the budgetary authority, ensure that the reference framework is respected.	This article commits "the Council" ie individual spending Councils when taking decisions with financial implications, to respect the reference framework established by ECOFIN. It also permits the ECOFIN itself to amend the reference framework. This, although unwelcome, is in fact unavoidable. There are certain spending obligations of the Community for which provision will always have to be made and for which the reference framework will have to allow room.* The ECOFIN Council will not, of course, agree to expanding the reference framework without the most careful consideration of the reasons for which it is required. (See also Article 7).
2. At the request of a member of the Council or the Commission, the Council, acting by the majority laid down in Article 1(2), may amend the reference framework.	

* eg Supplementary Budget for agriculture.

Text

Articel 7

1. Except in the case of Decisions mentioned in paragraph 4, when the Council is on the point of adopting an act which appears likely to increase expenditure for a financial year beyond the reference framework applicable to that year, the adoption of that act shall, at the request of a member of the Council or the Commission, be suspended.

2. Within a period not exceeding one month, the Council, acting by the majority laid down in Article 1(2), shall determine whether the proposed act would, if adopted, lead to the reference framework being exceeded.

3. If the Council concludes that the proposed act would, if adopted, lead to the reference framework being exceeded, it shall reconsider the proposed act with a view to taking appropriate measures.

4. In the case of decisions affecting net expenditure relating to agricultural markets, the procedures laid down in paragraphs 5(c) and 6(b) of the Annex to the Commission's Communication of 6 March 1984 shall apply.

Commentary

This article provides for the ECOFIN Council (except under Article 7(4) to review spending proposals by other Councils which look likely to exceed the reference framework. It allows decisions on these projects to be delayed for a month, and provides for reconsideration if the financial consequences look unacceptable.

Articles (1) to (3) refer to non-agricultural spending. Article (4) refers to agricultural spending. The procedure to which it refers is one whereby if the Commission considers the Agriculture Council is likely to take decisions whose costs would breach Commission's original proposals. It will ask for the decision to be referred to a special Finance & Agriculture Council. It will also monitor expenditure throughout the year and ask for any potential overrun to be similarly referred. Although the original Commission proposals referred only to the price-fixing, the French, whose formulation this is, intend that in its present form it will apply to all agricultural spending.

The UK has secured an entry in the minutes which will enable an individual member state to trigger the review by formally asking the Commission to give its opinion on any potentially excessive exepnditure.

Text

Commentary

Article 8

When the Council is on the point of adopting an act which has considerable financial implications for several years, the Council shall, before taking the final decision, formulate an opinion on whether the financial implications of the proposed act are compatible with the principles and guidelines governing the Community's budgetary policy.

This has much the same effect as Article 7, except it relates to the decisions with longer term financial consequences rather than those relating to a single year.

Both this and Article 7 help fulfil a recommendation from the House of Lords Select Committee that Finance Ministers should generally be those involved in spending decisions.

There can be no automatic formula for applying this Article, as by definition no reference framework will have been fixed nor will the maximum rate be known. Important thing is that for the first time ECOFIN will have the opportunity to give its views on whether the rate of growth of expenditure is likely to be excessive in relation to the finance likely to be available under the reference framework and maximum rate in future years.

Text	Commentary
Article 9	
1. The Council shall comply with the maximum rate provided for in Article 203(9) of the EEC Treaty throughout the budgetary procedure. 2. In order to achieve this: - when establishing the Draft Budget, the Council shall keep the increase in expenditure other than that necessarily resulting from the Treaties or from acts adopted in accordance therewith to a level no higher than half the maximum rate provided for in Article 203(9); - at the second reading, the Council shall adopt a position such that the maximum rate is not exceeded. 3. Paragraphs 1 and 2 of this Article are without prejudice to the provisions of Article 203 of the EEC Treaty, particularly those of the last sub-paragraph of paragraph 9.	This does not add much to the procedures the Council is already supposed to respect in making its budgetary decisions. The existing provisions were, however, more often dishonoured than not, and Fontainebleau specifically called on the Council to adopt measures to ensure that the maximum rate provisions were respected. The proviso in paragraph 3 is to permit the Council to accept increases in the maximum rate itself, as is provided for in the Treaty. The Council Legal Services and the Commission had refused to accept a text that did not include this proviso. Line to take Council is binding itself to observe more scrupulously a provision of the Treaty that it has always been subject to, but has not always honoured. This fulfils the third leg of the Fontainebleau remit.

Text

Article 10

On the assumption that the 1986 budget will be prepared on the basis of own resources being increased in that year, these Conclusions shall first apply to the exercise of the Council's powers in 1985 concerning expenditure in the financial year 1986.

Commentary

This article will ensure that budgetary discipline and, especially, the agricultural guideline, should apply as from the beginning of 1986. It will therefore have to bite on the 1985 price fixing as that affects expenditure falling in 1986. It is an essentail article of budgetary discipline that is to be taken seriously as part of the Community's budgetary procedures. It is also consistent with budgetary discipline's position as part of the Fontainebleau package that it should come into operation at the same time as the rest of it. UK assistance played a large part in getting this starting date agreed.

CHANCELLOR'S EVIDENCE TO THE TCSC

The following questions have been suggested by the Committee's Clerks in their advice to the Committee:

- Does the Treasury provide advice to Ministers collectively on spending priorities and, if so, how are they determined?
- Are Ministerial bilaterals concerned mainly with spending at the margin of programmes, or is the approach more zero based?
- Could the Committee be provided with a departmental breakdown of forecast outturn for 1984?
- Is it not fair to say that public expenditure plans are really rising: firstly because, within the planning total, increases have been offset by increased asset sales and the abolition of National Insurance Surcharge; secondly, because interest payments (which are rising) are not included in the planning total; and thirdly because many of the plans in the Autumn Statement are based on clearly optimistic assumptions, such as the 3 per cent pay assumption and the assumed real cut in local authority spending?
- If it is true that revenue determines expenditure, why do we not have firm medium term plans for taxation as well as expenditure?
- Forecast oil revenues for 1985-86 have increased by £2½ billion. Since this more than accounts for the prospective £1½ billion fiscal adjustment, and yet, is, in effect, a windfall gain, would it not be irresponsible to use this money either for tax cuts or to increase spending?
- If it is true that asset sales are taken into account when deciding the level of the PSBR, can we expect a lower PSBR in 1985-86 than the £7 billion set out in the MTFS?
- The Government has criticised the US budget deficit but if the US policy were to change, there may be a consequential effect on the sterling dollar exchange rate and on oil revenues - which might in turn affect the scope for tax cuts. Does the Chancellor really want to a change in US fiscal policy?
- Why has the level of debt interest risen?
- What is the effect on the RPI of the increased charges that have been necessary in certain departmental programmes in order to achieve "savings"?
- Although MO and sterling M3 are within the target ranges, M1 and PSL2 are growing faster. Why does the Chancellor believe that M0 and £M3 are better indicators and is he not worried about the other indicators?

- The Chancellor said that if there were a 1 per cent reduction in real wages, there would be 200,000 jobs. How many of these would be for part-time women?
- What is the Chancellor doing to bring down real wages?
- The Autumn Statement shows a decline in the UK share of export markets. Does this not demonstrate declining cost competitiveness and if so, what is the Chancellor doing about it?
- What is the effect on industry's costs of the increase in the gas and electricity negative EFL and the reduction in the water industry EFL?
- How are nationalised industries EFLs decide - ie are different rates of return chosen for different industries.

TCSC: 1984-85 PLANNING TOTAL: DEPARTMENTAL ANALYSIS OF ESTIMATED OUTTURN

/The TCSC asked why Table 2.1 of the AS, which shows 1984-95 plans by departments, did not also show an analysis of estimated outturn7.

Line to Take

1. The speed with which the Autumn Statement is produced and the substantial uncertainty of the figures means that it would not be possible to produce an accurate breakdown.

2. The prospective outturn for the planning total of "nearly £128 billion" is itself subject to considerable uncertainty; a breakdown by department would have to be based on partial information and, at this early stage of the year, would be highly unreliable.

3. Estimated outturn expenditure by programme will, however, be shown in the Public Expenditure White Paper. But, even those estimates will necessarily be uncertain, and may need to be supplemente by a global unallocated allowance for longfall or shortfall, reflecting the latest information just before the White Paper is published.

If Pressed

1. I will consider whether it might be possible next year to give some indication of the departmental breakdown of the prospective outtu in the Autumn Statement.

What is Chancellor of the Exchequer doing to bring down real wages?

Real wages will more readily adjust if the labour market works better, with fewer impediments to free supply of labour and to matching of supply and demand. The government has acted in several areas to help bring this about. Cannot expect them to give overnight results when operation of UK labour market has been gummed up for so long.

2. Measures which will bear on real wages include:

(i) trade union legislation (in particular preovisions for strike ballots and provisions on closed shops effective from 1 November) helps restore better balance in industrial relations. Reduces monopoly power of unions and safeguards rights of union members.

(ii) cut in the burden of income tax on earnings and changes in social security system (abolition of earnings related supplement to unemployment benefit) have brought a bigger gap between what people can earn in work and what they can receive out of work. Incentives are improved and supply of labour is less distorted by taxes and benefits. [Replacement ration "reduced even including employee NICs]

(iii) 1946 Fair Wages Resolution abolished. Allows government contractors to create more jobs, free of special minimum wage restrictions

(iv) pay determination in the public services now set with much more regard to market factors, less to so-called "comparabilitv".

3. Other measures which will help to promote smoother labour market adjustment include:

(i) action to help geographical mobility (council house sales), end to conveyancing monopoly, encouragement for National Mobility Officers to help public sector tenants move)

(ii) training programmes to improve supply of skilled employees

(iii) action on occupational pensions to make it easier for people to move jobs.

Q. Forecast oil revenues for 1985-86 have increased by £2½ billion. Since this more than accounts for the prospective £1½ billion fiscal adjustment, and yet is, in effect, a windfall gain, would it not be irresponsible to use this money either for tax cuts or increased spending.

Q. If it is true that asset sales are taken into account when deciding the level of the PSBR, can we expect a lower PSBR in 1985-86 than the £7 billion set out in the MTFS.

A. The size of the fiscal adjustment and of the PSBR for 1985-86 will be announced at Budget time next year, and will take account of all relevant factors, including those mentioned here.

Q. The Government has criticised the US budget deficit, but if US policy were to change, there may be a consequential effect on the sterling/dollar exchange rate and on oil revenues - which might, in turn, affect the scope for tax cuts. Does the Chancellor really want a change in US fiscal policy?

A. Any change in US policy would have a large number of consequences. It is not sensible to pick out only one consequence and judge the desirability of the policy change solely by that criterion.

The Government's view on the US deficit is that it is unsustainable in the longer term and therefore will have to change. The sooner the change takes place, the better.

The Government would, of course, accept any effects on the prospective fiscal adjustment of the kind described, but there will be other effects of a reduction in the US deficit - such as that on the dollar oil price, and is by no means clear that the net effect on oil revenues would be negative. The Government will have to consider all the relevant factors, when making a judgement on the PSBR and fiscal adjustment at next year's Budget.

Q. What is the effect on the RPI of the increased charges that have been necessary in certain departmental progrmames in order to achieve savings?

A. I presume you are referring to the effect of increased charges by nationalised industries. These are a matter for the industries themselves and final decisions have not been made. No accurate estimate of the RPI can be made.

Q. Although MO and £M3 are within target ranges, M1 and £M3 are growing faster. Why does the Chancellor believe that MO and £M3 are better indicators and, is he not worried about the other indicators?

A. M1 is clearly distorted by interest bearing sight deposits and there is no reason to be concerned by its growth.

PSL2 can be considered as a cross check to £M3, and the Government have looked carefully at the reasons for its growth.

In fact the growth in PSL2 is largely due to the growth in Building Society liabilities, and it is not surprising that these are growing rapidly at this stage in the development of Building Societies.

Q. The Chancellor has said that if there were a 1 per cent reduction in real wages, 200,000 jobs would be created. How many of these would be for part-time women?

A. There is no reason to suppose that the mix between full-time and part-time jobs that might be expected would be very different from the actual mix that occurred over the last decade or so.

Q. Does the Treasury provide advice to Minsiters collectively on spending priorities and how is that advice determined?

A. The Treasury has a natural focal role in planning, monitoring and controlling both total public spending and the individual programmes. It is the job of Treasury officials to advise the Chief Secretary and me on both aspects. Their advice on individual programmes reflects detailed assessments of the pressure for additional provision and the scope for savings, based on their regular discussions with officials in other Departments. It is for the Chief Secretary and for me to decide, on the basis of that advice, what proposals we put, and what responses we make, to individual spending Ministers and to the Cabinet.

Q. Are Ministerial bilateral discussions concerned with spending at the margin or are they more concerned with a zero-based approach to departmental spending?

A. Procedures for analysing spending on individual programmes follow no single set pattern. And nor should they. No one approach or technique has all the answers. Inevitably considerable attention is given to proposals for changes at a margin - whether a proposed new initiative, the ending of a particular function or revised estimates of the cost of executing present policies. But that does not preclude more fundamental reviews of total spending in particular areas. And the Government's record since 1979 shows that major shifts in priorities between different expenditure programmes have been achieved.

COMMITTEE OFFICE
HOUSE OF COMMONS
LONDON SW1A OAA
01-219 3285 (Direct Line)
01-219 3000 (Switchboard)

TREASURY AND CIVIL SERVICE COMMITTEE

27th November 1984

Dear Terry

This is to confirm that the Committee would like the Treasury to examine the figures in the Table annexed to Mr Terry Ward's paper, a copy of which was sent to you earlier today. If you think any of his calculations are wrong, I would be obliged for early warning - since this might enable us to put a better version on the table at tomorrow's meeting of the Committee. You may find by then that there are some changes in the later parts of the text. This exercise, incidentally, should be deemed to subsume that referred to by Mr Townend towards the end of his questioning yesterday.

In hand

On the question of additional expenditure in 1984/85 attributable to the coal strike, the Committee would like to know how much of the projected total increase is directly attributable to that cause and how much of the additional provision required has been met out of the contingency reserve.

Revised draft tomorrow morning from GE.

Yours,

Donald

A.M.W. Battishill Esq.,
H M Treasury
Parliament Street
London SW1P 3AG

D.W. Limon

24/110

FROM: A M W BATTISHILL
DATE: 27 November 1984

CHANCELLOR OF THE EXCHEQUER

cc Sir P Middleton
Sir T Burns
Mr Bailey
Mr Scholar
Mr H P Evans

cc Mr Ridley
Mr Culpin

TCSC BRIEFING

This minute covers briefing for your appearance tomorrow before the Treasury Committee.

2. Immediately below at Flag A are some notes for the brief opening statement you wish to make. Those on the economy have been prepared by Sir T Burns and those on public spending by Mr Scholar. PE will provide a short piece on BT tomorrow.

3. There then follow briefs on a number of issues mentioned at your meeting this morning or which came up with officials yesterday. They are at Flag B:

(a) debt interest: the revisions since the Budget;

(b) public investment;

(c) the planning total figures: NIS, VAT and corporation tax;

(d) local authority current expenditure;

(e) housing receipts;

(f) housing benefit - the Guardian story about joint tenancies;

(g) the water industry.

4. Also attached at Flag C are some notes on EC budget discipline (with the text of the inter-governmental agreement) just in case Mr Budgen returns to the charge.

5. Lastly, at Flag D, is a list of the questions we understand the Committee may wish to put to you tomorrow. Many of them cover very familiar ground on which you are unlikely to want any extra briefing. But we have asked for a line to take on those marked with an asterisk - though I am afraid it will not be possible to cover all these until the morning. Those that are available are at Flag E.

6. I understand you already have a copy of the transcript of officials' evidence; and GE will be letting Mr Peretz have direct drafts of the notes we undertook to provide at yesterday's hearing. Mr Peretz also has a copy of a note for the Committee written by Mr Terry Ward on which we have been asked to check the figures.

AMB

A M W BATTISHILL

As last year the Autumn Statement brings together a number of announcements which fall to be made at this time of year. In particular it allows the public spending plans for the year ahead to be set in the context of a fresh economic forecast.

It is not an occasion for a general restatement or updating of economic strategy which is primarily for the Budget. But I would emphasise that the overall objectives and strategy remain unchanged. The objectives are to continue to bring down inflation and create the conditions that will enable progress to be made in bringing down unemployment. The ultimate ambition is stable prices although as I emphasised last year we do not assume at the moment that this will be achieved by the end of the present MTFS period.

But we continue to make better progress on inflation than most commentators have expected and I expect this downward pressure to continue over the next year. Although we are not expecting much of a change in the inflation rate over the 12 months, if achieved, it will mean a significant period when inflation has been below 5 per cent. Because expectations are now adjusting to this lower rate it should provide the basis for the further downward movement of inflation that policy is designed to achieve.

The framework of policy remains as set out in the MTFS with target ranges for both Sterling M3 and M0 and an illustrative path for the PSBR. So far this year both monetary aggregates are within the target range and although the PSBR is now expected to be above the level planned it will still represent the lowest proportion of GDP for more than 10 years.

Many commentators continue to refer to the years since 1981 as a period of weak recovery. But a closer examination of the figures shows that the pace of recovery of output has been far from weak. If we are correct about the rate of growth in 1985 then the growth of output over the four years cumulatively will have been almost 12 per cent. This is very respectable by past standards. It more than matches the growth of output during the recovery period 1975-79. On the basis of annual data the highest four year growth figure since the war was for 1962-66 when 15 per cent growth was registered. The only four year period since 1966 which has seen growth clearly faster than 12 per cent was the years 1969-73.

Unfortunately growth during this recovery period has still not been fast enough to bring down unemployment. During the recovery period unemployment has tended to turn out higher than we assumed or expected. It is important to recognise the reasons why unemployment has turned out higher than expected.

The first reason for this is that on average the growth of output has been matched by equivalent growth in productivity. Productivity growth has been faster than we expected, particularly after the disapointing performance in the 1970s. But of course that low productivity growth of the 1970's was a major reason for the rapid growth of unemployment in recent years. It meant inadequate profitability, substantial overmanning and a cost structure that was not sustainable. In retrospect it may seem inevitable that the overmanning had to come to an end. But we have been surprised by the extent and the speed of that adjustment. Even so the level of employment in 1985 is likely to be on a par with the level of employment in 1981.

The second reason for the continued rise of unemployment is that the labour force has grown by more than expected. This has particularly been the case for women in part-time employment. This is a trend that we have seen for many years but it has continued at a rapid pace during the period of recovery.

I have argued on a number of occasions that the level of unemployment would have been improved if real wages had grown at a less rapid pace. Over the years of recovery real wages have grown by an amount similar to the overall growth of output. If real wages had grown less rapidly the level of output would have been higher. And the ratio of employment to output would have been higher reflecting a changing mix of products and a different labour, capital mix. I hope to publish some further analysis of this important topic in the not too distant future and I hope that the committee will support the general conclusions that I have just outlined.

The Committee has, no doubt, studied the revised expenditure plans for 1985-86 outlined in the Autumn Statement. The results of this year's Survey, summarised in just five pages of the statement, represent the outcome of the usual detailed review of all programmes. Since 1979 the Government has brought about a substantial re-ordering of priorities within public expenditure programmes. This year's review has, as usual, led to decisions to increase provision in some areas, and some hard decisions to reduce it elsewhere.

As indicated in the Statement, we now expect that, because of the exceptional factor of the coal strike, public spending in 1984-85 will be some £1½ billion above the planned level. This has led us, in the review of the 1985-86 position, to pay particular regard to the realism of the plans and to the adequacy of the Reserve provision.

We cannot of course be sure what will be needed to cover unforeseen developments. But we have taken a number of steps to ensure the realism of the 1985-86 figures. On local authority expenditure, we have increased provision by nearly £1 billion, matched by much tougher penalties for overspending and the introduction of rate-capping. This means that the plans for local authority current spending are both realistic and achievable. The calculation of our EC contributions is now more securely based following the Fontainebleau settlement, compared with the stylised and inevitably somewhat unrealistic figures in earlier plans. And, even after the normal annual process of reducing the Reserve for the year ahead as the plans are firmed up, we have provided for a figure of £3 billion, £¼ billion more than the provision for 1984-85 in the last White Paper.

All these adjustments, up and down, have once again been carried out within an unchanged public expenditure planning total. Ever since the introduction of cash planning, we have held the aggregate plans within the cash totals set in earlier White Papers. That we have done again, with a planning total for 1985-86 of £132 billion. In real terms this is the same level as that planned for 1984-85, [and below the expected outturn] implying a further reduction in the ratio of public expenditure to GDP. The latest plans therefore underline yet again the Government's determination to keep a firm grip on public spending.

ANALYSIS OF REVISIONS TO DEBT INTEREST FORECASTS

The general government debt interest forecasts published in the Autumn Statement were £16 billion for 1984-85 and £16½ billion for 1985-86, respectively some £½ billion and £1 billion higher than the forecasts in the 1984 Budget. Officials were closely questioned on the reasons for the revised forecasts when they appeared before the TCSC on Monday 26 November. Mr Wainwright had previously raised the subject with the Chancellor in the House - see attached extract from Hansard, col 782. The TCSC Chairman indicated that the Committee will return to this subject when they see the Chancellor on Wednesday 28 November.

2. Table 1 shows the short and long term interest rate assumptions used in the 1984 Budget and 1984 Autumn Statement.

Table 1: Interest rate assumptions (annual averages)

	1984-85	1985-86
Long term rates		
1984 Budget	9.3	8.7
1984 Autumn Statement	10.8	10.3
1985 White Paper	10.8	10.0
Latest (26 November)	10.3	..
Short term rates		
1984 Budget	8.7	7.8
1984 Autumn Statement	10.3	9.8
1985 White Paper	10.3	9.0
Latest (26 November)	9.8	..

3. Table 2 shows the corresponding revisions to general government debt interest forecasts, and also breaks down the revision into the amounts due to higher interest rates, higher borrowing and estimating changes.

Table 2: General government debt interest revisions (£million)

	1984-85	1985-86
Total change	500	1000
of which due to:-		
Interest rates	250	650
Increased borrowing	50	100
Assessment changes	200	250

4. Based on these figures (which should not be quoted) the suggested line to take on the revisions is:

> "Over half the revision is due to a profile of interest rates somewhat higher than expected at the time of the Budget. A little is due to higher borrowing and the remainder is due to the normal reassessment process that occurs in the light of later outurns."

5. If pressed to divulge actual interest rates being assumed, line to take:

> "Not the practice to divulge interest rate forecasts as they are market sensitive. But as I said in the House on 15 November [column 782], I now see the prospect of interest rates falling from their present levels."

6. If pressed on poor record of debt interest forecasts over the past, the suggested line to take is below. [Note: the average error on corresponding forecasts over the last ten years is about 10 per cent. This year's change - £1billion on £15½billion - represents 6½ per cent.]

> "As outside forecasters will appreciate, debt interest is by its nature difficult to forecast and obviously very sensitive to interest rates, which in turn are not easy to predict. [This year's revisions

are not high by historical standards, but officials are constantly reviewing modelling procedures to see if any improvements can be made."

7. Max Wilkinson (FT, 27 November) suggests that the latest forecasts imply that on average interest rates in the two years 1984 and 1986 would be about one to two percentage points higher than was hoped at the Budget. There seems no reason to deny that these figures are of the right order, without confirming precise numbers.

PSF Division

27 November 1984

HANSARD Tuesday, 15th November 1984
(cols. 782-3)

Public Debt

2. **Mr. Wainwright** asked the Chancellor of the Exchequer to what extent the trend of public debt interest is higher than his forecast of March.

The Chancellor of the Exchequer (Mr. Nigel Lawson): "The Autumn Statement 1984" gives estimated figures for debt interest in 1984-85 and 1985-86 which are respectively about £½ billion and £1 billion above previous estimates.

Mr. Wainwright: As the Chancellor of the Exchequer has referred not only to the autumn uprating of the current debt estimate, but to the estimate for 1985-86, which is stretching a long way ahead, how does he explain his recent statement that the prospect is of further interest rate cuts? Will the right hon. Gentleman say something about interest rates to reassure British industry?

Mr. Lawson: I can deal with the hon. Gentleman's puzzlement quite simply. The increase in the estimates to which I referred is an increase over what was envisaged at the the time of the last Budget. When I say that I now see a prospect of interest rates falling, I am talking about falling from their present levels. I am glad to say that that prospect remains as a result of this Government's policies.

Sir William Clark: Does not my right hon. Friend agree that as the national debt increases year by year because of overspending, interest charges will obviously increase as far as revenue is concerned? As the interest payments on the national debt are now more than £45 million per day, would not it be folly to increase our public expenditure now?

Mr. Lawson: My hon. Friend is quite right. It would be folly to increase public expenditure now and that is why the Government have no intention of doing so. It is a quite remarkable fact that, despite the miners' strike and the events in the United States, where interest rates have risen sharply, the level of interest rates in Britain is no higher than it was at the time of the last general election, and is set to go lower.

TCSC enquiry into the Autumn Statement

Public investment

1. Public expenditure plans for 1985-86: some decisions yet to be taken on breakdown between capital and current spending. Full details in next White Paper.

2. Important to understand definitions. Capital spending by the public sector, including investment by nationalised industries, defence spending on equipment such as ships, tanks, aircraft, but excluding sales of council houses and other assets, amounts to over £20 billion. (For details see attached table from February 1984 EPR, taken from Cmnd 9143, table 1.13).

3. Capital spending in real terms (ie cash deflated by GDP deflator) roughly constant in recent years, up to and including 1984-85. [Warning: figures not yet finalised for 1985-86, but fall in real terms likely.]

4. For purposes of Industry Act Forecast, assumptions made about likely split of expenditure plans into capital and current. Table 1.10 in Autumn Statement shows rise of 3 per cent in fixed investment for whole economy in 1985: paragraph 1.42 shows private sector investment rising faster, and implication is that public investment will show a small fall. Note that definition of public investment included in total investment in table 1.10 is on national accounts basis, much narrower than 1984 White Paper table 1.13 (ie table attached).

5. [Not published; for use if pressed] Industry Act Forecast includes a figure of a fall of 3 per cent in public investment - in national accounts terms - in 1985. (This excludes the effects of changes in council house sales; and is not affected by the privatisation of BT.) This is accounted for by a fall in local authority investment, following the likely spending this year: see paragraph 1.43 of AS.

Table 3 Public sector capital spending

£ million cash

	1978-79 outturn	1979-80 outturn	1980-81 outturn	1981-82 outturn	1982-83 outturn	1983-84 estimated outturn	1984-85 plans
Goods and services							
General government and some public corporations							
Expenditure on dwellings	2,101	2,395	2,302	1,943	2,204	2,212	2,227
New construction other than dwellings	2,556	3,165	3,766	3,912	4,340	4,302	4,524
Purchases (net) of vehicles, plant and machinery	629	736	877	902	1,056	1,140	1,132
Defence expenditure*							
Construction	46	205	283	271	395	456	528
Equipment	1,779	2,211	2,905	3,445	3,800	4,554	5,200
Nationalised industries and other public corporations†							
Expenditure on dwellings		2	3	2	3	5	3
New construction other than dwellings	4,734	1,929	2,352	2,489	2,694	2,930	2,838
Purchases (net) of vehicles, plant and machinery		3,564	3,962	4,388	4,240	4,743	4,647
Total goods and services	11,845	14,207	16,450	17,352	18,732	20,342	21,099
Cost terms (base year 1982-83)	19,250	19,760	19,275	18,504	18,732	19,373	19,137
Capital grants to private sector							
General government and some public corporations	1,552	1,619	1,936	2,019	2,638	2,988	2,749
Nationalised industries and other public corporations†	9	12	12	14	14	24	25
Total capital grants to private sector	1,561	1,631	1,948	2,033	2,652	3,012	2,774
Total goods and services plus capital grants to the private sector	13,406	15,838	18,398	19,385	21,384	23,354	23,873
Cost terms (base year 1982-83)	21,787	22,029	21,558	20,672	21,384	22,242	21,654
Net lending							
General government and some public corporations							
Net lending to private sector §	244	658	920	1,356	1,103	89	983
Net lending and investment abroad	267	−319	−521	−270	−97	47	192

*NATO definition of defence capital expenditure.
†Several points on the nationalised industries figures need to be noted:— (a) they are not included in the planning total, (b) they include the planned capital spending in 1984 85 of British Telecom and British Airways but no figures are available for Enterprise Oil, (c) British Telecom changed the accounting treatment of certain fixed assets in 1983 84 (d) the 1978-79 figure includes net expenditure on land and existing buildings.
§Includes cash expenditure on company securities.

PLANNING TOTAL.

Q.1 Why did you reduce the planning total in the FSBR to take account of the abolition of NIS? (We said at the time that if we had not done so departments would have had extra cash to spend on other things.)

A.1 NIS was no longer a liability on programmes, so programme totals and the planning total were reduced accordingly. NIS has not, of course, been added back to individual programmes.

Q.2 So why now add NIS back into the total, to bring it up from £131.6 billion to £132.0 billion?

A.2 We have not done so. The new planning total of £132.0 billion - which is somewhat below the Cmnd 9143 figure, and further below the Cmnd 8789 figure of £132.2 billion - is higher than the FSBR figure of £131.6 billion (corrected for classification changes to £131.7 billion) by less than the NIS adjustment of around £450 million. We have stuck to the White Paper cash total; and, although it is true that we are not now deducting NIS from that figure, neither are we adding to it, either for 1985-86 or subsequent years, to take account of the Corporation and Value Added Tax changes in the Budget which together increased the pressures on public expenditure programmes by over £200 million in 1985-86. [Note: the "over £200 million" consists of around £190 million for VAT and about £40 million for Corporation Tax.]

LOCAL AUTHORITY CURRENT: REALISM

1. Addition of £950 million to provision (compared with addition of only £600 million at this time last year) requires average 3 per cent <u>cut</u> on local authorities' budgets (in cost terms). Government is directly tackling problems of high spenders through rate capping etc - exercising direct control over £3 billion+ of local authority expenditure through rate capping; and the 18 rate-capped authorities account for over 80 per cent of overspending in 1984-85.

2. The targets set for authorities in the provisional settlement reflect their past spending. Most authorities spending below GRE are allowed increases over 1984-85 adjusted budgets of $4\frac{1}{2}$ per cent. Other authorities have been given much more realistic targets than last year (the largest cut sought last year was 6 per cent over budget; this year it is $1\frac{1}{2}$ per cent).

3. The Government has backed this up with a much more severe penalty regime. Last year an authority only lost 2p in the £ in grant for the first one per cent overspend and 4p for the second percentage point. Inevitably a large number of authorities decided to overspend by 2 percentage points. This year the first percentage point in overspend will cost 7p in lost grant, the second 8p.

4. The Government is backing this up with a virtual cash standstill on adjusted Aggregate Exchequer Grant (has to be adjusted to take account of reduced LA responsibilities eg LRT, some non-advanced further education). Again, this will increase the pressure on authorities to spend in line with provision.

5. Although the pay assumption does not formally apply to local authorities, pay, which accounts for $\frac{2}{3}$ of local authorities' net current expenditure, is crucial in determining the level of services local authorities can provide for their provision.

Manpower is also important. Local authorities have only cut manpower by 4 per cent or so since June 1979 - and the downward trend was temporarily reversed last year. All this despite eg school rolls declining (and education accounts for about half LA current).

HOUSING RECEIPTS

Q. On what basis have council house sales been assumed to increase (by £430 million) in 1985-86?

A. 1. The assumption made about housing capital receipts in Cmnd 9143 for the two later years of the Survey was inevitably somewhat broadbrush. Only in September this year could a detailed forecast of receipts in 1985-86 from council house sales be made once information about applications had been received from local authorities.

2. Three factors have tended to increase the receipts forecast. First the Housing and Building Control Act 1984 will have full effect for the first time. This reduces from three to two years the length of time needed to qualify for "right to buy" discounts and increases the maximum discount. Second, on the basis of recent experience the proportion of sales financed by private sector mortgages is expected to be rather higher than previously assumed.

3. Third, prices rose quite sharply in 1983-84 and the early part of 1984-85. But there is always a margin of uncertainty in the figures. In the recent past receipts have tended to be under rather than over forecast.

4. Nevertheless, numbers of sales are in fact assumed to fall slightly compared to 1984-85. What we are assuming is that receipts from sales will increase in 1985-86 both compared to 1984-85 and to our previous forecast. These depend on the proportion of sales financed privately, the average discounted price and the number of homes sold.

1-16

FROM: R PRATT
DATE: 28 NOVEMBER 1984

MR PERETZ

cc Mr Burgner
Mr Wilson

TCSC THIS AFTERNOON: BA

I spoke to Mr Wilson about the item into today's Guardian about BA. A copy of the item is attached.

2. Also attached is a note on the background and a line to take which reflects my discussion with Mr Wilson this morning.

Richard Pratt

R PRATT

BA PRIVATISATION: GUARDIAN STORY ON 28 NOVEMBER

Background

BA and the Department of Energy are negotiating inter alia about a capital reconstruction of BA in advance of privatisation. The Guardian leak is almost certainly from BA and is a negotiating ploy to suggest a compromise - but one which is favourable to them.

Line to take

There are naturally extensive discussions between the Government and BA in advance of privatisation. It would be premature to comment on these now. An announcement will be made in due course.

THE GUARDIAN

Taxpayers and BA profits aid flotation

By Michael Smith, Industrial Editor

A package of taxpayers' money and British Airways' trading profits, together worth between £350 million and £400 million, has been pieced together to reconstruct the state airline before next year's privatisation.

Final agreement on the reconstruction, which is essential

City Notebook, page 23; Parliament, page 27

to the February flotation, is imminent and could be announced within the next week.

The agreement follows months of negotiations in Whitehall, the City, and at Heathrow and removes one of the last main hurdles to the £1 billion privatisation of the airline.

The reconstruction plan breaks new ground in using taxpayers' funds and a company's profits to reshape BA's debt-ridden balance sheet. Using the airline's profits to help to rebuild the balance sheet may also help to divert some criticism from the Government over the use of taxpayers' money to fatten up public enterprise for sale into private hands. British Airways and the taxpayer, through the Treasury, will make broadly similar contributions to the reconstruction.

BA intends to divert part of this year's profits and some of next year's into the balance sheet to offset a portion of the airline's huge loan debts. The total contribution, spread over two separate trading years, is likely to emerge at between £150 million and £200 million.

At the same time, the Treasury is expected to donate a similar sum of around £200 million from the anticipated £1 billion proceeds of the flotation to offset a further portion of the debts.

This is substantially less than was deemed necessary three years ago when privatisation of BA, then saddled with £1 billion of debts, was first mooted. At that stage it was expected that the Treasury would have to absorb up to £800 million of BA's mountain of debts to permit the airline to be sold into private hands.

British Airways has been making its own contribution to the reconstruction by paying off close on £200 million of it bank loans during the past eight months.

BA, the world's most profitable airline, is expected to reveal next Monday that total borrowings have been reduced from more than £900 million in March to around £700 million.

The injection of £400 million into the company will provide the airline with one of the strongest balance sheets in commercial aviation and ensure that flotation is made easier.

5/1c

22

RESTRICTED

FROM: DAVID PERETZ

DATE: 28 November 1984

cc Sir T Burns
Mr Battishill
Mr Scholar
Mr Culpin
Mr Pratt
Mr Ridley

SIR P MIDDLETON

TCSC HEARING THIS AFTERNOON

The Chancellor has made some small changes to the proposed opening statement for this afternoon, and I attach a clean version.

2. As you know the Chancellor is still looking for a "nugget" of news he could let drop sometime during the hearing, not necessarily in the opening statement. We are still waiting for a few words for the opening statement about BT. Could Mr Battishill check, for example, whether we could not after all say something about the number of applications for BT shares that have been recieved?

3. Although this afternoon's briefing meeting has been postponed till 3.30 pm, suggestions for nuggets of "news" would be appreciated by 2.30 pm.

DLP

D L C PERETZ

MO'M
This can go off now.
DLP

C

I gather this shd go to the TCSC quickly.

It is probably right that paras 4 & 5 shd be cleared with Mr Walters, though it will be difficult in the time.

Shall I go ahead as suggested?

DLP

OK. No need to clear with Mr Walters m..

CONFIDENTIAL

FROM: M L WILLIAMS
DATE: 28 NOVEMBER 1984

CHANCELLOR

cc Chief Secretary
Sir P Middleton
Mr Bailey
Mr Monck
Mr Anson
Mr Cassell
Mr Scholar
Mr Watson
Mr Gilmore
Mr Jameson
Mr Burgner
Mr Fitchew
Mr H Evans
Mr Battishill
Miss Peirson
Mr Stibbard
Mr Robson

TCSC: 1984-85 OUTTURN

The Clerk to the TCSC has, following officials' appearance on Monday, asked for a note giving more details of the prospective outturn for the planning total in 1984-85. The Clerk's letter (see attached, second paragraph) seems to misunderstand somewhat the nature of the Reserve and the extent of potential claims.

2. I attach a draft note for the TCSC. In the time available it has not been thoroughly cleared, but I am forwarding it now as additional briefing for your own appearance. If other recipients have further comments they can be incorporated before sending the note to the TCSC.

arrived at 6.45!

3. The figure of £1½ billion for the cost of the strike was strictly attached to the PSBR impact of the strike, but it was also implied that the expenditure cost of the strike and the prospective overrun on the planning total in 1984-85 rounded to the same figure, which is used in the attached note. At the time of the Statement, a more precise estimate of the expenditure cost would have been a little below £1½ billion, but more recent information has taken it close to that figure (PE will shortly be letting you have more details when reporting their quarterly monitoring meetings with the nationalised industries).

4. Before sending the note to the TCSC you might wish to show it to Mr Walker. He would expect to be consulted before any details

of the strike costs were given to Parliament. I accordingly attach a draft private secretary letter.

MLW

M L WILLIAMS

1.5

PUBLIC EXPENDITURE IN 1984-85: PROSPECTIVE PLANNING TOTAL OUTTURN

(Note by HM Treasury)

The Committee have asked for a note on the prospective outturn for total public expenditure this year, the cost of the coal strike, and the claims upon the public expenditure Reserve. The Autumn Statement indicated (paragraph 1.58) that the prospective outturn on the planning total was nearly £128 billion, an excess of about £1½ billion over plans (shown in Table 2.1), and a figure which is broadly equivalent to the public expenditure cost of the coal strike continuing to Chritmas. Since the Reserve was set at £2 3/4 billion, the implied aggregate potential ~~overrun~~ excess on programmes is about £4¼ billion.

Firm Claims

2. The aggregate potential claim on the Reserve comprises a large number of items. Those already charged to the Reserve include increases in cash limited and demand-led programmes shown in Supplementary Estimates which have been presented to Parliament. The additional provision implied by Summer and Winter Supplementary Estimates is consistent with the estimated outturn for the planning total given in the Autumn Statement.

3. The main items in this category are summarised below:

		£billion
1.	Carry forward of capital underspends in 1983-84 under the end year flexibility schemes	0.3
2.	Health service: pay of groups covered by review bodies, and of ancilliaries; dentists and pharmacists expenses; FPS	0.4
3.	Social Security (including National Insurance Fund)	0.3
4.	Housing benefit (England)	0.3

5.	Export credit support	0.2
6.	Regional and selective assistance	0.1
7.	Other, net	0.2
	Total	1.8

The Coal Strike

4. As indicated by the Chancellor in his Autumn Statement, the public expenditure cost in 1984-85 of the coal strike continuing to Christmas, would be of the order of £1½ billion. This sum is a claim on the Reserve.

5. It should be emphasised that the projections of strike costs are subject to considerable uncertainty and it is only possible to give broad brush estimates. The impact on individual nationalised industries is affected by trading between them. After taking this into account, the aggregate impact on overall nationalised industry external financing is likely to account for about £1¼ billion of the total cost. The programme mainly affected, to a total of some £1 billion, is the Department of Energy's. Other industries affected fall elsewhere on the Trade, Industry, Energy and Employment programme and on the Transport and Scotland programmes. Aside from the impact on nationalised industry external finance, about £¼ billion will fall on other programmes, mainly Law and Order, in respect of the additional policing costs of the dispute, and also Social Security.

Other Potential Claims

6. The balance of the potential claims totals about £1 billion; this figure represents a net claim after taking into account some important offsets. The assessment of potential claims necessarily involves making forecasting judgments, on the basis of past experience and monitoring information as well as to reflect current developments, of the shortfall or longfall on particular categories of expenditure. Any detailed breakdown of this figure at this stage of the year would therefore be unreliable. It is, however, possible to indicate the main areas of divergence from plans:

1) Local authorities in GB are budgeting to overspend (current expenditure) plans by around £1.2 billion.

2) Local authorities' capital expenditure is also likely to exceed plans, although the authorities are in general heeding the Secretary of State's requests to exercise

restraint and to maximise receipts.

3) There is a potential claim arising from an increase in our estimated net contribution to the EC.

4) Experience of recent years suggests that some departments will underspend their cash limits. In each of the last two years, such underspending has totalled £0.6 billion, although this margin will not necessarily be repeated.

5) It is also likely that receipts from the programme of asset sales in 1984-85, and other miscellanous receipts that offset public expenditure, will exceed plans, ~~somewhat~~.

7. An up-to-date estimate of the prospective outturn on the planning total will be published in the Public Expenditure White Paper early in the New Year. Greater detail will also be given the prospective outturn by programme, together with latest estimated external financing requirements for the nationalised industries. It will still probably be necessary, however, to include a unallocated estimate for additional shortfall or longfall, in line with the latest assessment at the time.

1.5

28/11/84.

PUBLIC EXPENDITURE IN 1984-85: PROSPECTIVE PLANNING TOTAL OUTTURN

(Note by HM Treasury)

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The Coal Strike

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Other Potential Claims

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restraint and to maximise receipts.

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4) Experience of recent years suggests that some departments will underspend their cash limits. In each of the last two years, such underspending has totalled £0.6 billion, although this margin will not necessarily be repeated.

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Draft letter from
PS/Chancellor to PS/S of S for Energy
cc to
Mr Turnbull, No 10

TCSC: COST OF THE MINERS' STRIKE

The Treasury and Civil Service Committee have asked for a note about the additional expenditure in 1984-85 attributable to the coal strike and the extent to which it is being met from the Reserve. The public expenditure cost of the strike in 1984-85 was indicated in the Autumn Statement to be about £1½ billion.

2. I attach a draft note which, since it inevitably has to focus on the cost of the coal strike, Your Secretary of State ~~Mr Walker~~ might like to see. The Chancellor is aware of the difficulties in providing a detailed breakdown of the cost, particularly of the impact on different nationalised industries. The references in the attached note ~~instead~~ are therefore broad brush ~~and~~. I should be grateful for confirmation that Your S of S ~~Mr Walker~~ is content. We are, I fear, required to let the TCSC have this note this week.

3. I am copying this letter to Andrew Turnbull in No 10.

COMMITTEE OFFICE
HOUSE OF COMMONS
LONDON SW1A OAA
01-219 3285 (Direct Line)
01-219 3000 (Switchboard)

TREASURY AND CIVIL SERVICE COMMITTEE

27th November 1984

Dear Terry

This is to confirm that the Committee would like the Treasury to examine the figures in the Table annexed to Mr Terry Ward's paper, a copy of which was sent to you earlier today. If you think any of his calculations are wrong, I would be obliged for early warning - since this might enable us to put a better version on the table at tomorrow's meeting of the Committee. You may find by then that there are some changes in the later parts of the text. This exercise, incidentally, should be deemed to subsume that referred to by Mr Townend towards the end of his questioning yesterday.

On the question of additional expenditure in 1984/85 attributable to the coal strike, the Committee would like to know how much of the projected total increase is directly attributable to that cause and how much of the additional provision required has been met out of the contingency reserve.

Yrs.

Donald

D.W. Limon

A.M.W. Battishill Esq.,
H M Treasury
Parliament Street
London SW1P 3AG

TO

24/11/0