PRIME MINISTER

PUBLIC EXPENDITURE

We are meeting tomorrow morning to discuss the Chancellor's latest depressing minute on the public expenditure figures.

It may help the discussion if I identify the reasons for the increases in some of the figures compared with earlier plans.

For 1980-81, the volume total is now expected to be £79.4 billion compared with £77.8 billion - an increase of £1.6 billion. The reasons for this increase are as follows:

£ billion	
0.6	Increase in spending on demand determined programmes which are not - and by definition cannot - be subject to cash limits. The principal overspends are on social security due to the faster rise in unemployment than had been forecast, and increases above forecast on the short-time working compensation scheme and on payments by the Government to the redundancy fund. There have also been minor increases - compared with the earlier forecast - on housing subsidies (because of high interest rates) and on agricultural support.
0.2	Local authority overspending.
0.3	Defence spending (this is the equivalent in 1980 survey prices - i.e. November 1979 prices - of the estimated £465 million excess on the original MOD cash limit).
0.2	Lower sales of assets.

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£ billion

0.9 Loss of shortfall. Last year's White Paper included a shortfall provision of £1.15 billion at 1980 survey prices; the Treasury are now expecting shortfall to be only £0.25 billion. This is a major revision and arises because there will - by definition - be no shortfall at all on local authority and defence spending and because spending on other programmes now seems likely to come much closer to the original cash limits than had been predicted. This may be because Departments have been under greater pressure as a result of earlier "cuts" and because they have learnt how to cope with the cash limit system better - in earlier years, there was a tendency for greater under-shooting of the cash limits because Departments were less able to judge their rate of spend so as to keep it just within the cash limit.

Sub-total 2.2		Note. Increased spending on nationalised industries was taken out of the Contingency Reserve and therefore does not feature in this table.
- 0.6	EEC refund	
Total 1.6		

For 1981-82, the latest figure is £79.1 billion compared with £76.8 billion in the White Paper - an increase of £2.3 billion (and this is after including the EEC refund of about £700 million).

When the Chancellor came to colleagues last July, he proposed that the planning totals for 1981-82 should be the same as in the White Paper less the EEC refund. By the autumn it was clear that, in order to achieve this, spending cuts of £2.7 billion would be required - largely because of increased spending on the nationalised industries (£1.1 billion) and because of revised economic prospects affecting social security spending, etc. (£700 million). The Chancellor decided that it was politically impossible to seek reductions amounting to the full £2.7 billion, and instead proposed a total reduction of £1.75 billion. In the

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event, Cabinet only agreed cuts of £0.7 billion - to a considerable extent, this was because they were unwilling to accept his proposals on defence and social security.

After taking into account the EEC refund, this left the planning total - as of November - about £1.3 billion above the figure in the White Paper. Since then there has been a further deterioration of £1 billion. The main reasons are as follows:

£ billion	
0.4	Higher spending on short-time working compensation scheme and on the redundancy fund.
0.2	Higher spending on unemployment benefit (the Treasury are now assuming a net average of 2.5 million unemployed in 1981-82 as opposed to 2.3 million in the Actuary's report).
0.1	Extra funding over what had earlier been set aside for BL.

I have not worked out the precise reasons for the excesses of £2 billion and £1 billion in 1982-83 and 1983-84; but they are probably on similar lines to those for 1981-82.

Based on the above, it seems to me that the reasons for the excesses are basically twofold. First, there have been substantial forecasting errors - partly related to the recession (but very few outside forecasters were expecting unemployment to rise as rapidly as it has, and in any case the Treasury are always under pressure to assume optimistic forecasts for public spending purposes), and partly relating to shortfall. The latter was clearly misjudged, although the loss of shortfall would have been very much less without the local authority and defence overspend. Second, there was the failure in November to take the necessary spending decisions.

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I do not believe that the cash limit system as such can be blamed for the excess in 1980/81. Every cash limited programme, apart from defence, has stayed within its cash limit - and on defence, we have agonised at length.

The overspend by local authorities is a reflection of the inadequate control which central Government has on local authority borrowing. The Treasury and DOE have just set up a working group to see if control can be improved.

As regards the demand determined programmes, there is nothing that can be done to reduce spending on unemployment benefit - given the higher unemployment forecasts - without reducing the rate of benefit further. But the Chief Secretary has asked for a review of the Short Time Working Compensation Scheme and the Redundancy Fund with a view to seeing if the costs of these programmes can be reduced.

Paragraph 4 of the Chancellor's minute also includes figures in cost terms and cash terms. The figures in cost terms are the same as those in volume terms, but take into account also the change in pay and prices in the public sector relative to pay and prices in the economy as a whole. The figures in cost terms are higher than the volume figures basically because public sector pay has gone up faster than private sector pay over the last year.

The increases in cash terms from year to year look very large indeed, but they are not so extraordinary when account is taken of recent inflation and the increase in public service pay. The moral here surely is that we should have taken earlier steps to rein back public service pay - though this was perhaps easier said than done.

As regards the planning of expenditure, I know that you have been keen to see the demise of volume planning and its replacement by cash planning. This idea was looked at by an inter-departmental group last summer and rejected. The Treasury have been looking at it again, and at least at official level they still think it would be undesirable and unworkable. The main objections are:-

(i) There would be an enormous amount of argument about the inflation assumptions. It is difficult enough to reach agreement on inflation assumptions for one year in advance; it would be that much harder looking two or three years ahead. They argue that it is difficult enough to get collective agreement on the volume figures; for the Chancellor to put forward proposals in cash terms would simply add to the argument;

(ii) Cash allocations would not make a lot of sense to departments for later years until they had first worked them back into volume figures. This again would require agreement on inflation assumptions - including arguments as to how inflation would affect particular programmes (e.g. defence).

I believe the Chancellor has not fully made up his mind against moving entirely to cash planning: he believes that, if cash figures were used, the planning figures would look so frightening that colleagues might more easily acquiesce when he asks for reductions.

My own view is that - as long as inflation continues to run at more than just a few percentage points - volume planning will continue to be necessary. I understand that the only other country which plans expenditure in cash terms is Germany, but even they adjust their figures upwards for pay and social security payments. And their public expenditure people have told the Treasury that, if their inflation exceeded 5%, the system would soon collapse.

Nonetheless, the Treasury are looking at ways of improving the planning system. In particular, they are likely to propose that - from now on - the planning figures should be set in the prices prevailing during the year in which the PESC review is being conducted. Thus, the 1981 review would be in the same price terms as the 1981/82 cash limits; and not, as they would be under the existing system, at November 1980 prices.

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The idea here is that the figures will have a greater reality; for when Ministers consider possible increases and reductions, they will be able to relate them directly to the cash limit figures for 1981/82. This proposal will be put to the Chancellor in the next few weeks.

The other change that has already been made is that the PESC review and White Paper will only look three years ahead, rather than four. It has been suggested that we do not need to look more than one year ahead; but spending departments do need to have an idea of the resources they will have for more than one year given the lead time on many kinds of expenditure; and of course we do review the figures each year.

I hope this does not all sound unduly defensive of the Treasury. But I do believe they are no less concerned than you at the overspending. Certainly, they would admit that there is scope for further improving their systems of monitoring, control and planning; and they are alive to the failure to forecast the full extent of the recession (though again, there has been a tendency for Ministers to assume a more optimistic path for output and unemployment than forecasters were predicting). But we do not want criticisms of the system as it is to divert attention from the need to make it work and from the basically political issue of getting Ministers to agree to restrain their spending. The latter includes the crucial issue of improving the efficiency of the nationalised industries and reducing their drain on the Exchequer.

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T. P. Lankester

26 January 1981