

Prime Minister to see

Ref: A0 4307

PRIME MINISTER

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N.P.G. Mitchell
Duty Clerk 20/2/811981 Public Expenditure Survey

(C(81) 10)

BACKGROUND

(FLAGA')

The Chancellor of the Exchequer proposes in C(81) 10 that in the 1981 Public Expenditure Survey the discussion should be in terms of cash rather than of survey prices for the focal year, 1982-83. You have seen this paper in draft.

2. The case for change is set out in paragraphs 1-5. The main deficiency of the present system is that, while the Chancellor has projections in estimated cash terms of the revenue side of the account, he - and spending Ministers - do not know until far too late in the day the cash consequences of decisions on expenditure taken on a volume basis. There is then only limited scope to make further changes to expenditure programmes and, if net borrowing is to be contained, the whole burden falls on tax changes. Moreover, the present process of revaluation allows for each programme to be revalued by a multiplicity of particular factors, rather than general inflation factors, so that no account is taken of shifts in relative costs. Decisions are further confused because the prices in which expenditure is discussed are neither those ruling at the time of the discussions nor those likely to rule when the money is spent.

3. The main features of the Chancellor of the Exchequer's proposals are:-

(i) Discussion of the focal year, 1982-83, should be in terms of estimated cash values rather than of 1981 survey prices (ie those ruling in Autumn 1980).

(ii) The inflation assumptions, covering public service pay and prices, to arrive at 1982-83 cash figures should be decided collectively by the Cabinet in March 1981, twelve months before the beginning of the year to which they relate on the basis of his proposals for the guidelines for the 1981 Survey (under the existing system they would not have to be decided before November 1981 (for the Rate Support Grant) or early 1982.

(iii) For 1981-82 all increases on cash limits, whether volume or pay or price increases, should be charged to the Contingency Reserve (Paragraphs 13-15).

(iv) It should be left open, for further discussion in March if necessary, whether the later years of the survey period should also be in cash terms.

(v) He should announce these changes 'in conjunction with the publication of the Public Expenditure White Paper' on 10 March; this language is in response to your wish that he should not refer in the paper to an announcement in his Budget Speech.

4. The proposed system has been discussed this week at interdepartmental official meetings at both Finance Officer and Permanent Secretary level in order to acquaint them with what is proposed. There was general understanding of the problems arising from the present system and of the case, in principle, for greater attention to cash planning. At the same time there was considerable concern over the mechanics of the particular scheme being put forward, and fear that the speed of its implementation might create more problems than it would solve. Much was made of the fact that an interdepartmental report last July on the survey system concluded that there were major objections to moving towards cash planning. (This report was not discussed by Ministers collectively because its conclusions were not accepted by Treasury Ministers.)

5. Your colleagues are likely to be more relaxed about the new system than those who will have to operate it in detail. But some of the concerns expressed could carry through into the Cabinet discussion, and you may find it helpful to have the gist of the criticisms made. Briefly, the system will involve great uncertainty for Departments, who have to be concerned with volume (how many soldiers etc) as well as price. The uncertainty arises principally because under the proposed system (a) the Cabinet will have to choose at the beginning of the PESC operation (March 1981) twelve months ahead of the beginning of the year in question, the assumptions for inflation between 1981-82 and 1982-83, and (b) these assumptions will be generalised and not tailored to the particular programmes. Over the last

five years or so the Government's forecast of inflation, a year before the start of the forecast year, has on average been wrong by 3 or 4 percentage points. If future assumptions are as badly out, it is argued, either there will be a further and substantial volume squeeze on departmental programmes, throwing in doubt major policy aims, or (if the error is the other way) there will be scope for large unintended increases on the volume of expenditure, or there will have to be a series of revisions to inflation assumptions which will undermine the new system.

6. The worry over a severe volume squeeze from the inflation factors is reinforced by the Chancellor's proposal, in his paragraph 10, that in future any squeeze or underspending in the current cash limit year should normally be carried forward into later years. Departments argue that, while this is fully justified when long-term improvements in efficiency have been identified, it will build up trouble when savings in the cash limit year have been achieved only through short term expedients, such as the temporary deferment of essential investment.

7. There is particular worry over the assumption to be made for public sector pay - if this is separately distinguished from the assumption on prices. The assumption chosen will inevitably be known to all those seeing the detailed operational guidelines and involved in survey work and so, even though it will not be published, it will undoubtedly become publicly known. If it is initially pitched too high, it will then be difficult subsequently to wind expectations down. If it is initially pitched too low, there is a risk of a long period of mounting campaigns by unions and a greater disposition towards industrial action.

8. These doubts could lead to either, or both, of the following lines of argument in Cabinet.

9. First, it might be suggested that the introduction of the new system should not be rushed but evolved. This might be done either by starting the survey exercise and the summer discussions on the basis of 1981 survey prices and then deciding the inflation assumptions and converting to a cash base in the autumn; or by making a start now by converting to estimated

1981-82 out-turn prices and making a further cash adjustment in the autumn. Either way would carry the advantage of reducing the period over which inflation assumptions would have to be made, although making the change while the survey discussions were still under way and it was possible to make major changes in programmes. The very plain disadvantage, as the Chancellor of the Exchequer will no doubt point out, is that it would be highly confusing to change the whole basis of the figures half way through what is already a complicated exercise.

10. Secondly, some Ministers may point out that the essence of the proposed system is to shift the burden of uncertainty arising from inflation off the Chancellor's shoulders and on to those of spending Ministers. Spending Ministers, who have a continuing concern with the volume of their programmes, will be particularly vulnerable to the inflation assumptions chosen. In these circumstances they could well argue that they should be given a much stronger collective role in macro-economic forecasting and decision making and, in particular, that they should be entitled to much fuller discussion with the Chancellor of his revenue expectations. They could further argue that, given the strains which the new system will impose, it should be accompanied by other changes in the arrangements - for example, greater flexibility between years, changes in contract procedures, less central constraints on pay and conditions of service.

11. The Chancellor of the Exchequer is likely to argue that, while he accepts that the new system will throw up some very real problems, these do not amount to a case for general deferment of its introduction. Rather they point to the need for care in working out and conducting the new arrangements as they are developed, and also possibly to parallel developments which the proposed move would encourage. There will be greater pressure on those responsible for volume planning, but there is no escaping from the simple fact that decisions on volume are not immune from decisions on the cash which can be afforded. The Chancellor would no doubt wish to consider further with you any proposals that there should be more collective discussion of economic forecasting and of revenue and taxation projections.

12. Some of the concern expressed will be mitigated if the Chancellor can agree to set the inflation assumptions in November rather than in March. If the objections are strenuous, you may wish to see whether the Chancellor would settle for this: I understand that it would be workable.

13. In view of the difficulties likely to be seen in moving to a cash basis for 1982-83 the Chancellor may well not press at this stage for extending the cash base to the later years of the survey, when the problems of making inflation assumptions would of course be all the greater.

HANDLING

14. After the Chancellor of the Exchequer has introduced his paper you will wish to hear the views of each of the Ministers responsible for expenditure programmes and large pay votes, and particularly of the Secretaries of State for Defence, the Environment, Education and Science, and Social Services and the Lord President. If the Cabinet appear ready to accept the general thrust of the Chancellor's approach, but are strongly resistant to commitment to the details, you might point out to them that the specific and detailed ground rules for the 1981 Survey, including the inflation assumptions, will be put to them by the Chancellor of the Exchequer for collective discussion after the Budget; and that these ground rules will have been discussed interdepartmentally at official level first.

15. If Cabinet agree in principle to the introduction of the new scheme, subject to a further look at the details later in March, you will wish to consider whether the Chancellor should refer to the decision in his Budget Speech and, if so, in what terms. He will, in any event, want to avoid commitment to details but how he expresses the general intention will turn very much on the degree of support which Cabinet are willing to give him at this stage. At the very least he should be able to refer to the formulation in the Public Expenditure White Paper which, at present, reads:-

'In future the Government intend to give more weight to prospective cash costs and expenditure planning, particularly for the focal year of the Survey, that is the year immediately ahead'.

But he will no doubt want to be more forthcoming than that.

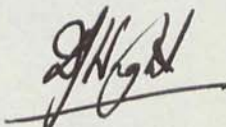
16. You will also wish to decide whether further work should be done with a view to putting the later years of the 1981 Survey on to a cash basis. The probability is that Cabinet will want to see how things work out for 1982-83 before taking this further step, and that this will be acceptable to the Chancellor.

CONCLUSIONS

17. In the light of the discussion, and with reference to paragraph 16 of C(81) 10, you will wish to record conclusions on:-

- (i) Whether there is agreement on the broad changes proposed for the 1981 Survey.
- (ii) The proposals in paragraphs 13-15 of C(81) 10 on the management of the 1981-82 Contingency Reserve.
- (iii) Whether the Chancellor can announce the changes in his Budget Speech and, if so, broadly in what terms.
- (iv) Noting that the Chancellor will put detailed proposals to Cabinet in mid-March and directing him on whether these should consider the possibility of putting 1983-84 on a cash basis too.

If necessary it would be possible to have a further discussion of the general principles before the Budget at the meeting on Thursday, 5 March.



ROBERT ARMSTRONG

*(approved by Sir R. Armstrong
and signed on his behalf)*

20 February 1981