

*Let the Minister
see the paper*

cc No 8

COPY No 1 of 7 copies

①

Prime Minister

SECRET

The argument in paras 4-7 of the paper is put persuasively. There

Qa 06414

To: PRIME MINISTER

From: JOHN SPARROW

7 July 1983 *are one or two*

good ideas in the second part of the

Public Expenditure

paper. Suggest we work out for them in the Chief Secretary's

1. On 21 July Cabinet will be having its first discussion on this paper, year's Public Expenditure Review. This provides an important opportunity paper, for setting public expenditure in the context of the Government's strategy but for the next five years and even beyond. I attach a paper which the CPRS has prepared on the subject.

take no other action. Agree?

2. I have two reasons for sending you this paper. First, I have been struck by the way the annual PES round has become more an instrument of short term cash control and less an instrument for planning and resource allocation over the longer term. This is unfortunate. The beginning of a new Parliament may be the best time to persuade Ministers to do something about it and look ahead. Secondly, the absence of a strategic framework has meant that the Government may have inadvertently lost the room for manoeuvre it needs if it is to secure a proper balance between its various objectives.

MUS 8/7

3. One objective of Government policy - and one which I personally regard as important - is the reduction of taxation. Yet, as the analysis in the first part of our paper shows, the extent of commitments and expectations for public expenditure programmes over the years ahead leaves very little scope for meeting that objective even on the most optimistic assumptions about economic growth. The Cabinet needs to be able to determine collectively the balance to be struck between the tax objectives and those other objectives which rely on public expenditure for their achievement. Political judgement may well favour aiming for a less exciting tax reduction target in order to achieve other policy targets. But the important thing is that there should be sufficient room for manoeuvre to allow a free and informed choice to be made.

SECRET

4. The second part of our paper canvasses a number of practical suggestions which, if implemented with sufficient vigour by Ministers, might help the Government over time to break out of the current strait-jacket. But the essential first thing to establish with Ministers is the need for a framework to be developed in which decisions about taxation and borrowing can guide (and not be dictated by) public expenditure over the longer term - a framework which does have the possibility of giving the Government a solid record of achievement to present to the electorate in five years time, whilst eliminating the need for sudden short term changes of course in response to the exigencies of the day. The present system imposes (often unseen) policy changes without evaluating them, and seems unable to avoid sacrificing capital spending whilst preserving current spending. In short, cash control can be the enemy, and not the handservant, of proper financial control.

5. A paper such as we have written may not be suitable for wider circulation since it could open up discussion on second order problems to the detriment of attention to the central issue. But I do not know what papers Ministers will have in front of them on 21 July, and we have not seen anything from the Treasury. I hope, however, that our paper may help you to achieve the desired results.

6. I am sending a copy of this minute and its attachment only to Sir Robert Armstrong.

RB.

Att

SECRET

cc Sir L Tibbs
(ICD)

COPY NO 1

TAX AND PUBLIC EXPENDITURE IN THE LONGER TERM

Note by the Central Policy Review Staff

1. This note addresses two questions:
 - i. Are present policies for the public provision of goods, services and transfers consistent with the long-term commitment to lower taxation and borrowing and the desire to restrain the encroachment of the public sector on the life of the community as a whole?
 - ii. If not, how might tax and public expenditure objectives be reconciled?

Conflicting Objectives

2. Among the important objectives, set out in the Manifesto and elsewhere, which will require the public funding or supply of goods, services and transfers are:

- strengthening the rule of law;
- defending Britain's freedom;
- improving the quality of life in our cities and countryside;
- protecting the weak;
- encouraging free enterprise (through, for example, help for the new technologies and an improved road network).

3. The current public expenditure plans (described in the White Paper published in February 1983) imply that these objectives are consistent with no increase in public spending in real terms over the three years to 1985-6. Looking further ahead the objectives have not been translated into firm long-term

SECRET

SECRET

public expenditure commitments. The only specific Manifesto commitment concerns the price protection of retirement pensions and other linked long-term benefits. However, the public expenditure plans and the absence of Manifesto commitments almost certainly give a misleadingly optimistic picture of the prospects for holding down public spending.

4. There are several reasons why the current expenditure plans are misleading. First, with cash planning the PES system has become more an instrument of short-term control and less an instrument for resource allocation and planning over the longer term. This carries the risk that later years will produce unpleasant surprises. Some of these are already emerging. Second and closely related, the White Paper shows sharp changes in the expenditure trends for the programmes that have been growing most rapidly. The question is whether this is realistic. Defence, for example, is projected as growing by only one per cent in cost terms in 1985-6, after growing at an average of four per cent per annum over the previous six years. The health and personal social services programme is projected as falling in cost terms in every year after 1982-3 although it rose by 17 per cent over the previous five years. Finally, the planned flat profile of spending owes much to one-off savings. There are limits to how far future savings can be achieved by ending subsidies to "lame-duck" industries and by relying on demographic trends to reduce expenditure on education.

5. We have analysed the public expenditure plans for 1985-6 in terms of Government-encouraged expectations about future trends in spending. For programmes responsible for about half of all public expenditure (eg defence, health, pensions and law and order) Government statements have created a strong expectation that expenditure will rise in cost terms throughout this Parliament. For programmes accounting for another quarter of public spending (eg employment, education, roads and the welfare safety net) Government statements have implied that expenditure will continue to be maintained at about the level planned for 1985-6. (Within this group are some categories of spending that should show a decline if unemployment decreases significantly). There is an expectation (sometimes expressed as a hope) that expenditure will fall in cost terms in programmes responsible for less than one tenth of public expenditure (eg nationalised industries and

SECRET

SECRET

housing). Over the remaining programmes, which account for less than one-fifth of public expenditure, Government statements have probably created no strong expectations about long-term future trends. But for most of these programmes the Government's stance has encouraged the belief that expenditure is more likely to be maintained than to be significantly reduced.

6. Thus, even with a minimum of Manifesto commitments, there are Government-engendered expectations that spending will be maintained or increased in cost terms across programmes accounting for three-quarters of total public expenditure. It is unclear how far the Government's specific programme objectives really warrant such expectations. In some cases the expectations may be based on a confusion in the public mind between the level of spending and the standard or quality of service.

7. Whether these pressures on public spending can be reconciled with the Government's objectives on taxation and borrowing will depend on the future rate of economic growth and on how far Ministers want to go with reducing tax and borrowing by 1988. Even with economic growth at the top end of the likely range meeting present spending expectations and achieving a modest reduction in taxation and borrowing will require firm control of public expenditure and of any new commitments. Weaker economic performance or a more ambitious tax objective (eg returning the tax burden as a proportion of GDP to a level below that inherited in 1979) would necessitate extraordinarily large public expenditure cuts across a very narrow range of programmes. The obvious alternative would be to review the implied assumption that for most public sector programmes stable or rising public spending is essential for the achievement of the Government's objectives. A further approach would be to consider revising the Government's objectives for some programmes.

Reconciling Tax and Public Expenditure Objectives

8. Ministers face a basic choice:

- to allow progress towards the tax and borrowing objectives to be determined by public expenditure totals that largely emerge as the sums of individual programme decisions;

SECRET

SECRET

- or, first, set targeted levels of tax and borrowing and then use these as the framework within which competing claims for public expenditure would be assessed, and priorities determined.

The first option has been the approach adopted for much of the post-war period. It carries the strong risk that any tax (and borrowing) objective will be completely over-ridden. The second option is more logical for a Government that gives great weight to the importance of tax rates and the size of the market sector in determining incentives, freedom of choice and economic growth. But it carries the risk that important programme objectives will be forfeited.

9. If Ministers decide to hold down total public spending what approaches are open to them consistent with minimising damage to individual programme objectives? A fundamental requirement is to break the public and departmental illusions that improved quantity and quality of services must mean higher public expenditure and that achievement of government objectives can be met principally by means of public expenditure. Four strategies could help to challenge these assumptions:

- management efficiencies;
- better targeting;
- shifting responsibility to the private sector;
- changing bureaucratic attitudes to public expenditure.

None of these approaches is new. All have been used to obtain greater control over public expenditure in recent years. However, in our judgment all can and need to be taken further. Even together they may not yield sufficient savings in sufficient time. This leaves a fifth strategy: to revise programme objectives in the light of what can be afforded.

i. Management efficiencies

10. The Financial Management Initiative and Rayner Scrutinies will continue to improve value-for-money and to contribute efficiency savings. Three areas where there is scope for further initiatives are:

SECRET

SECRET

a. Contracting out. The advances over the last three years have relied on a "bottom-up" approach - ie on departments bringing forward their own suggestions - with no clear view of the total scope for savings. Emulating the US Federal Government, an exercise should now be carried out to identify the total number of staff employed on all commercial type activities within Central Government that could potentially be put out to contract. The onus should then be on departments to contract out such services unless it can be shown that internal arrangements can provide the required standard of service more cheaply. Consideration should be given to extending this approach to local government and to health authorities, backed up if necessary by use of financial penalties or legislation.

b. Competition among suppliers. Significant savings could be made in several areas by opening public procurement, both civilian and defence, to wider competition from the private sector, including foreign companies. Private competition could not only help public spending objectives but would assist the suppliers themselves to become internationally competitive. Again a cross-departmental review would be more effective in identifying opportunities than relying on departmental initiatives.

c. Using results, not inputs, to measure performance The public and many departments still equate public sector performance with expenditure and inputs, not with actual achievements. Educational standards are equated with teacher-pupil ratios, not with levels of numeracy. Health standards are equated with NHS expenditure. Defence capability is equated with defence expenditure. Developing measures of output in the public sector is difficult but it is essential if resource allocation and efficiency are to be improved. Promising initiatives, such as the Assessment of Performance Unit in DES and the Treasury exercise relating output measures to PESC, appear to have lost their way.

SECRET

SECRET

ii. Better targeting

11. The prime cause of the increase in public expenditure since World War II has been the use of the Government budget to redistribute income and welfare. Yet no department regularly reviews who benefits from its redistributive policies with a view to seeing whether benefits, subsidies or services could be more closely targeted on those who need them most. There is a case for requiring all departments sponsoring redistributive policies to provide a biennial report on:

a. who currently benefits, whether individuals or companies, in terms of income bands or other relevant characteristics;

and b. the scope for reducing or ending expenditure on those least in need.

Proposals for improving the targeting of programmes would need to be framed with an eye to the effect on the poverty and unemployment traps. The more they can be co-ordinated with the tax changes they are designed to produce the greater their political acceptability.

12. Interpreted broadly, better targeting is also relevant to other areas of public expenditure such as defence and nationalised industries.

iii. Shifting responsibility to the Private Sector

13. The Government is already committed to transferring activities back to the private sector and choice to the individual via privatization, user charges and contributions and the development of partnerships. This reduces public expenditure. To the extent that the financing needs of the industries privatized are also reduced it helps ease pressure on interest rates.

14. In judging how quickly the privatization of nationalized industry activities can be brought about, the Government should consider whether viability needs to precede privatization, or whether privatization should come first, in the

SECRET

SECRET

expectation that private sector management will secure viability more quickly and more cheaply. The answer will not be the same for all industries. It is also necessary to examine the established operational structure of nationalized industries, since the organization of corporations under state ownership may well not correspond with the market's view of actually or potentially viable businesses. Further, there seems to be no reason to retain a large minority shareholding in some at least of the denationalized industries.

15. The scope for user charges has been studied fairly intensively in some areas, notably health. There is perhaps a case for a cross-sector review to see where opportunities have been neglected. Possible starting points could include local authority planning and refuse functions; agricultural research, development and advisory services; and industrial training.

iv. Change departmental attitudes to public expenditure

16. Tight cash limits have encouraged competition for funds between new policy proposals and existing programmes. But do departments give equal rewards to those who develop new ways of spending money and to those who identify redundant, inefficient or over-generous programmes? Changing attitudes takes time and cannot come wholly from within but the following might contribute to the development of a more critical approach to public expenditure:

a. Increase the emphasis on evaluating the effectiveness of existing programmes and on reviewing departmental procedures for appraising new policy proposals eg by getting the Exchequer and Audit Department to give greater priority to these areas or by transferring more departmental resources into internal audit functions. Procedures for appraising new programmes, particularly those involving current expenditure, remain unsystematic and unstandardized in many departments. Procedures for evaluating on-going programmes are even more primitive.

b. Require all departments to publish regular statistics on productivity growth both within their administrative functions and, where applicable, in their expenditure programmes.

SECRET

SECRET

c. Introduce a system of incentives under which outstanding contributions to the saving of public expenditure received due recognition eg awards, merit pay or promotion.

v. Revising judgement as to what can be afforded

17. Every year Cabinet rejects worthwhile new claims on public resources on the general grounds that the Government cannot afford to do everything asked of it. But too rarely is an attempt made to go systematically back and review existing programmes and promises to see if there are some that should be cut back on the grounds that they can no longer be afforded. If the tax objective is seen as over-riding and the strategies already outlined do not produce sufficient savings, it will be necessary to consider the future implications of previous promises and commitments.

Conclusion

18. You may wish to consider commissioning further work on some of the strategies outlined in paragraphs 10 to 17.

SECRET