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Original Fiscal Economic Policy: Public Expenditure Pt 23. Copied to Econ Pol Strategy Pt 24 & Civil Service Long Term Policy Pt 13.

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PRIME MINISTER

Economic Outlook and Public Expenditure
(C(83) 23-26)

BACKGROUND

On 21 July the Cabinet will, as is customary at this time of year, have its first collective discussion of the current Public Expenditure Survey against the background of an assessment by the Chancellor of the Exchequer of the prospects for the economy. There are four papers on the agenda:

(i) C(83) 26: the Chancellor of the Exchequer's memorandum on economic prospects.

(ii) C(83) 23: the Chief Secretary's main memorandum on public expenditure, both in 1984-85 and the two succeeding years, and in the longer term.

(iii) C(83) 24: a memorandum by the Chief Secretary on Civil Service numbers.

(iv) C(83) 25: a memorandum by the Chief Secretary on contracting out and privatisation.

2. Because of the gap imposed by the General Election the usual detailed PESC Report is not yet available. But that should not hamper the Cabinet's discussion: the aim at this stage is to lay down broad guidelines and not to discuss individual programmes in detail.

Economic Prospects

3. C(83) 26 surveys the economic scene in broad terms. It sees some encouraging developments on prices and on unemployment, but draws attention to the risks, particularly on the overseas front because of the high budget deficit in the United States. On the domestic side, it recalls the recent disturbing trends in the money supply, public expenditure and borrowing which lay behind the measures announced on 7 July. It implies that the modest fiscal adjustment of £½ billion in 1984-85 foreshadowed in this year's

Financial Statement and Budget Report is at risk. The highest level of public expenditure that can be afforded is that published in this year's Public Expenditure White Paper (Cmnd 8789). Even then there will be a risk that taxes may still have to be put up next year.

Public Expenditure: Current Survey

4. C(83) 23 has two main sets of proposals: one set for the current survey period and one for the longer term. The main figures relevant to the survey period are as follows.

	£ billion		
	1984-85	1985-86	1986-87
Cmnd 8789			
Programmes	125.3	130.4	
Planning reserve	3.0	3.0	
Net sales of assets	-1.5	-0.5	
Other adjustments	-0.4	-0.7	
Planning total	126.4	132.3	
Survey baseline for 1986-87			137.5
Change on previous year	5.8%	4.7%	4.0%
1983 Survey			
Agreed changes*	0.7	1.1	
Departmental bids	5.4	5.8	7.0
Prospective addition to planning total/baseline	6.1	6.9	7.0

*Mainly due to changed economic assumptions.

5. The Chief Secretary proposes that his objective in the bilateral discussions with spending Ministers which customarily lead up to final decisions by the Cabinet in the autumn should be to hold to the published planning totals for 1984-85 and 1985-86 and to keep the total at approximately the same real level in 1986-87: I understand that this implies a planning total in 1986-87 of £140.3 billion.

6. The Chief Secretary proposes to maintain the planning reserve (also [redacted] referred to as the "contingency reserve" -

see paragraph 11 below) at £3 billion rather than, as in recent surveys, to draw it down in order to meet agreed additional bids. He also indicates that unavoidable bids in 1984-85 are likely to total £2½ billion. I understand that this is made up as follows.

	£ billion
Agreed changes	0.7
Local authority current expenditure	0.5
Social security	0.2
Defence	
Price increases	0.1
1983 AFPRB award	0.1
NHS: 1983 DDRB award and family practitioner service	0.2
Agricultural price support	0.4
Other	0.3
	2.5

It follows that to get back to the planning figure for 1984-85, not only must the whole of the remaining bids be rejected, but also a net £2½ billion of savings must be found. At its meeting on 14 July the Ministerial Sub-Committee on Economic Affairs (E(A)) agreed to aim for savings of about £1 billion on the external financing requirements of the nationalised industries (ie that the industries' bids for an additional £½ billion of external finance should be rejected and that, in addition, reductions below the baseline of £½ billion should be secured). But even if that should prove realistically attainable, it will leave £1½ billion to come from Departmental programmes. The Chief Secretary considers that similar reductions are required in the remaining years of the survey.

Public Expenditure: Longer Term

7. The Chief Secretary also draws attention to the threat to the Government's tax objectives in the longer term presented by high levels of public expenditure. A combination of 2½ per cent a year economic growth and holding public expenditure constant in real terms to 1988-89 - ie extending the Chief Secretary's proposals for the survey period to the end of the maximum life of the present Parliament - would still leave the ratio of taxation to gross

domestic product above the level of 1978-79. The Chief Secretary proposes that the Cabinet should endorse a target of holding total public expenditure constant in real terms up to 1988-89. He would then circulate in September a set of programme figures constructed on the basis of this target for discussion by the Cabinet. The programme figures, as amended in the light of that discussion, would then inform the remaining stages of the survey. The beginning of a new Parliament is clearly a good time for establishing a trend for public expenditure beyond the short term.

Civil Service Numbers

8. C(83) 24 refers back to the Cabinet discussion of last December (CC(82) 53rd Conclusions, Minute 8), when it was agreed to identify and quantify the scope for reducing Civil Service manpower between 1984 and 1988. It reports that there is already a fair prospect of reducing the size of the Civil Service to 605,000 by 1 April 1988 (although this depends critically on the hiving-off of the Royal Ordnance Factories), and proposes that one of the aims in the bilateral discussions of public expenditure between now and the autumn should be to identify further savings, with the aim of at least getting below 600,000.

Contracting Out and Privatisation

9. C(83) 25 is essentially a progress report coupled with a general request to members of the Cabinet to keep up the pressure to reduce the size of the public sector. It proposals a further report in a year's time.

MAIN ISSUES

10. The main issues before the Cabinet arise on C(83) 23. They are:

(i) Does the Cabinet endorse the Chief Secretary's proposed aims for the current Public Expenditure Survey?

(ii) Does the Cabinet agree with the Chief Secretary's proposals for handling longer-term prospects?

Although they should require less extensive discussion, you will also wish the Cabinet to consider:

(iii) Are the Chief Secretary's proposals on Civil Service numbers, and contracting out and privatisation, acceptable?

The Public Expenditure Survey

11. It seems unlikely that many members of the Cabinet will argue that the Government should now abandon the aim of holding to the published planning figures for 1984-85 and 1985-86, or should plan for large real increases in expenditure in 1986-87. The main points likely to be raised in discussion are probably the following:

Economic Prospects. Some members of the Cabinet may express surprise that the improved prospects for output and inflation should not have more favourable effects on the prospects for public expenditure. In isolation, they are obviously beneficial But they need to be weighed against other, less favourable factors such as less buoyant revenue, to which the Chancellor draws attention in C(83) 26. And experience this year shows the vulnerability of economic forecasts and the importance of caution in managing public expenditure.

Pay. It may be argued that if the Government sets, and can adhere to, a low public service pay factor for 1984-85, the prospects for public expenditure will be easier. That will be a matter for discussion and decision in September. But although the pay factor may influence the level of public service settlements, it does not determine them. In any case this should not be allowed to distract discussions from the immediate question before the Cabinet, which is the overall objective of the survey.

Contingency Reserve. It is likely to be argued that a contingency reserve of £3 billion is excessive. Cmnd 8789 said that the reserve of £2.5 billion in 1981-82 and £2.4 billion in 1982-83 were "unnecessarily large"; and although this year's reserve of £1.5 billion is tight, there are no signs yet that it is likely to be overspent. The argument is partly a matter of terminology. Strictly speaking, the contingency reserve for a financial year current or immediately in prospect is a control device. Only increases

in expenditure which are within the control of Ministers are charged against it: overruns on demand-determined programmes or overspending by local authorities, for example, are not so charged. The Chief Secretary is effectively arguing for a £3 billion reserve in a broader sense: a safety margin against all forms of excess expenditure. Not only are there the inevitable uncertainties about demand-determined expenditure. There are also items - such as our contribution to the European Community and local authority current expenditure - for which the figures eventually published are likely to represent what the Government wants to happen rather than a central estimate of what will happen. Again, the scheme of end-year flexibility which the Cabinet approved on 7 July will tend to increase expenditure in 1984-85 and later years. All these are arguments for a substantial "contingency reserve" in the broader sense mentioned above.

Sales of Assets. It may be suggested that sales of assets should be increased. But the published plans already take credit for significant sales. More sales, even if they could be achieved, would not affect the long-term balance between expenditure, revenue and borrowing. Even the Chancellor's announcement on 7 July that the Government was planning an extra £500 million of disposals in the current financial year attracted unfavourable comment in the media.

Years after 1984-85. The Chief Secretary says that reductions of "at least the same order" will be required in 1985-86 and 1986-87 as in 1984-85. But that is not immediately apparent from the figures. Agreed changes in 1985-86 total only £1.1 billion; and the Treasury have not indicated at official level that they regard any significant part of the Departmental bids of £5.8 billion in 1985-86 and £7.0 billion in 1986-87 as unavoidable. Moreover, E(A) agreed to seek about £1 billion savings from the nationalised industries in each year. It may therefore be argued that it is unnecessary to do more in respect of Departmental programmes than to require the withdrawal of additional bids. It will be for the Chief Secretary to defend his proposals in detail. But if there is dispute it

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will probably be best to concentrate on the need to agree on measures which give reasonable assurance that the overall totals approved by the Cabinet can be delivered.

Public Expenditure in the Longer Term

12. In discussion of the longer term you will wish to avoid at this stage any major dispute on specific issues of substance (for example, over the scope for real growth in defence expenditure or the future of the Health Service). At this stage the Cabinet are being asked merely to agree in principle to work towards an overall expenditure target for 1988-89. There will be opportunities in the autumn to discuss the Chief Secretary's projections and to confront the difficult issues about priorities which may arise.

13. There may be pressure for "alternative assumptions" to be used. Some Ministers may argue that the assumptions suggested by the Chief Secretary are pessimistic and that more optimistic assumptions should be taken. The Chief Secretary is likely to point out that, judging by the experience of recent years, economic growth of 2½ per cent a year would be an above-average performance; and that, even on that basis, he does not envisage getting the relevant tax burden down to the level of 1978-79. There might indeed be a case for inviting the Chief Secretary to explore alternative scenarios (though the number of them would obviously need to be strictly limited) biased towards less favourable economic assumptions, and with more ambitious targets for reducing taxation.

Civil Service Numbers

14. It is unlikely that there will be any substantial disagreement with the proposals in C(83) 24. The Chief Secretary is merely asking for "rather larger reductions than those so far on offer" with the aim of bringing the total some way below 600,000. He will be pursuing these matters in his bilaterals.

15. Pressure on numbers focuses Departments on improving management (and the scrutinies show there is still scope for reduction). A figure of around 600,000 comes out of the survey of Departments. Over four years that would be an average of 1.2 per cent per annum. That is perhaps a realistic figure, given the reductions that will already have been achieved. But it is

relatively modest - particularly given that it includes the hiving-off of the Royal Ordnance Factories, which accounts for part of the reduced numbers. If we are not going to set a lower target, we shall need to keep up and even step up the other pressures for improving efficiency and productivity in the Civil Service.

Contracting Out and Privatisation

16. Again, there is unlikely to be much disagreement with the proposals in C(83) 25. The Chief Secretary is seeking only the Cabinet's endorsement for maintaining the effort. You will probably wish to underline the political importance of continuing to make progress.

17. Reductions in Civil Service numbers are likely to require some measures of "hiving-off". A Community Directive (on "Acquired Rights") appears to impose constraints on staff savings during certain types of "hiving-off". It may be suggested that these constraints may be a serious obstacle to reducing staff numbers at an acceptable cost. You will not wish to pursue this point in detail: the Chief Secretary is already considering the scope and effect of the Directive.

HANDLING

18. You will wish to invite the Chancellor of the Exchequer to open the discussion by describing the economic background and prospects and the Chief Secretary, Treasury, to follow this up with a more detailed account of his proposals on public expenditure. All members of the Cabinet will wish to contribute to the subsequent discussion.

CONCLUSIONS

19. You will wish the Cabinet to reach conclusions on the following.

(i) Does the Cabinet endorse the Chief Secretary's proposals for the current Public Expenditure Survey on:

(a) the public expenditure totals and therefore the savings to be found;

(b) taking the survey forward by the customary process of bilateral meetings and a report to the Cabinet in the autumn?

(ii) Does the Cabinet endorse the Chief Secretary's proposals:

(a) on the longer-term aims for public expenditure;

(b) for a discussion of this in September which would, among other things, set a framework for the proposed bilaterals?

(iii) Does the Cabinet endorse the proposals in paragraph 9 of C(83) 24 on Civil Service numbers?

(iv) Does the Cabinet endorse the proposals in paragraph 10 of C(83) 25 on contracting out and privatisation?

20. If so, the Cabinet will need to authorise the Chief Secretary to proceed with his discussions of public expenditure and manpower accordingly.

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20 July 1983