

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR

At the bilateral on Monday 16 July, the Chancellor wishes to discuss the public expenditure stance for this year's PES Round and the line to take at next week's Cabinet discussion. The Chancellor would like the Chief Secretary to accompany him.

Secondly the Chancellor wants to have a few words (without the Chief Secretary present) about the reshuffle of junior ministers.

Treasury Minutes

At FLAG A is a minute from the Chancellor setting out the economic background to this year's PES negotiations. The analysis is familiar. Para 20 brings out the key point on public finances - the expected deterioration next year. The less buoyant tax revenues expected pose an unpalatable prospective choice between a return to public borrowing, or an increase in taxation. Keeping public spending plans down in the PES round is essential in the circumstances.

At FLAG B is the draft minute from the Chief Secretary setting out the proposed stance for this year's PES Round. There are three main elements to the strategy:

- a. hold as close as possible to the planning totals set out in the 1990 White Paper;
- b. aim to keep the ratio of public spending (excluding privatisation proceeds) i.e. GGE to GDP on a downward trend; and
- c. given the AEF settlement for local authorities already agreed, to constrain as tightly as possible any additions to other programmes.

It is worth drawing attention to two subsidiary aims in the

minute:

- the need for major reductions in the bids on behalf of nationalised industries;

- the need for major reductions in the bids on running costs.

The minute also envisages that, if necessary, the Star Chamber would meet to consider any unresolved bids on programmes.

Assessment

The Cabinet must of course endorse the strategy. Success in planning for (and then achieving) a reduction in the GGE to GDP ratio is of paramount importance. This has been the yardstick by which the Government's policy objective of keeping public spending under control has been judged. Failure to meet this would be very damaging politically, as well as economically in terms of reaction in financial markets.

It is customary for there to be a press announcement after the Cabinet. The presentation is particularly important this year. It will be sensible to acknowledge that the negotiations will be difficult; to emphasise the toughness of the objective which the Government has set itself: and to stress the Government's determination to continue the progress made in reducing the GGE to GDP ratio.

The Overall Position

The paper does not provide background information on how difficult the overall public spending situation is - the papers at Flag C give detailed figures. You may wish to probe both the overall position and the Chief Secretary's "hit list" in terms of individual programmes.

The basic facts are that, in total, bids of £17 billion have been submitted for 1991/92. If agreed, this would represent an unacceptable five per cent real increase in public spending plans.

The bids must be cut back substantially. The focus will be on next year. £3 billion is automatically available to meet bids in 1991/92 - because it is transferred from the reserve to programme expenditure. Some cash addition to the published plan will also be needed. The Chief Secretary indicated to you earlier he might have great difficulty in keeping this addition down to around £5 billion.

On the face of it, some £8 billion (i.e. the £3 billion transferred to programme expenditure, plus £5 billion in new money) to meet bids of £17 billion may look reasonable. In practice, it would be a very difficult (and quite probably impossible) because:

i. over £3 billion has already been committed to extra AEF support for local authorities (taking account of extra money for Scotland and Wales);

ii. other public spending programmes with costs linked to interest rates or the RPI will cost an extra £2 billion next year;

iii. extra money for the Health Service - particularly on wages - is bound to add around £1.5 billion.

So in practice the Chief Secretary might have to confine all other bids within a total envelope of only some £1 to £2 billion. You might like to ask the Chief Secretary:

a) what minimum cash addition to PES plans for 1991-92 he expects;

b) what room that gives to meet the GGE/GDP target.

Detailed Programmes

There have been some developments on individual programmes since your last discussions with the Chief Secretary a month ago. The

main points you might like to explore include the following:

i. Health: now that it is accepted that the Health reforms will go ahead, how much extra money will the Treasury have to concede to ensure smooth introduction?

ii. Defence: what scope will there be for achieving some cuts in defence expenditure next year? *None*

iii. Transport: East West Cross Rail is not resolved and Mr Parkinson is still pressing strongly: will it be possible to accommodate this expenditure within the present total, e.g. by cutting back the roads programme?

iv. Prisons: is it possible to slow down or postpone the prison building programme further?

v. Child Benefit: the Chief Secretary indicated earlier that a further freeze would probably be necessary.

vi. Housing and Local Environmental Services: you saw earlier correspondence proposing cut backs on the urban programme. Both Mr Patten and Mr Ridley (surprisingly) have sought to defend the programme. Will the Chief Secretary be able to cut back resources here and on the Housing Corporation?

vii. Local Authority Capital: local authorities have overspent massively on capital spending as well as on current spending over the last two years. Is there scope for cutting back across the board - while, through better targeting, ensuring that the school building programme is not severely damaged?

viii. Employment: Mr Howard's bids were surprisingly large and the Chief Secretary has tried to cut them back.

Conclusion

Cabinet ~~must~~ endorse the strategy. At Flag D is a speaking note from Treasury ~~which~~ you might like to draw on at the Cabinet discussion.

The proposals are wholly sensible. The difficulty of the target should not be underestimated. You might like to probe whether the Chancellor or Chief Secretary think any further action from you is desirable to raise their chances of achieving that difficult goal.

BHP

BARRY H POTTER

12 July 1990

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