S6(A-D)

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR

At your regular bilateral tomorrow the Chancellor wants to discuss two issues:

(i) The PES negotiations.

(ii) The Mansion House speech.

PES Negotiations

First, a further update. I understand that the Employment programme has now also been settled. It also appears that the earlier FCO agreement, which had become unstitched, has been put back in place.

That leaves just three programmes - arts, education and defence. After the first bilateral on arts, although a settlement is not certain, Treasury are optimistic. Slow progress is now also being made on Education: and Treasury believe Mr. MacGregor will settle without going to Star Chamber. Defence has become bogged down - though again I understand Mr. King is unlikely to go to Star Chamber.

Second, now that Star Chamber seems unlikely to meet, the likely scale of additions to the planning total are clearer. You will want to ask the Chancellor the following.

(i) What is the likely addition to the planning total figure for 1991-92 of £192.3 billion?

(ii) Although the forecasts are not yet completed, what is the likely projection for General Government Expenditure (GGE) in 1991-92? What will be the real and nominal growth in GGE over this year?

(iii) What is the expected GGE/GDP ratio for 1991-92; and what will be the path in the ratio over the three years 1989-90 to 1991-92?

Third, you may want to discuss some of the difficult policy judgments which have been made in reaching the tough overall PES settlement. In particular, you will wish to be aware of three points on the social security programme (see Mr. Newton's minute at Flag A and the Chief Secretary's minute at Flag B).

(a) As indicated earlier, child benefit is to be increased for only the first child by £1. This will be presented as £1 for every family; but the cost is less, of course, than the cost of a full uprating for all child benefit (equal to an extra 75p on all child benefit).

(b)(i) A complex package on Statutory Sick Pay (SSP) and National Insurance Contributions is planned. At present, employers initially pay their Statutory Sick Pay (SSP) obligations for their employees; they are then reimbursed at 100 per cent by DSS. In future, that rate of reimbursement will be reduced to 80 per cent. This adds to employers' costs but reduces public expenditure. This will be offset, however, by a reduction in the rate of NIC employers contributions.

(ii) This package itself is said to be neutral on employers costs and the PSDR. While public spending is lower, the surplus on the National Insurance Fund will be reduced. But, taking into account other complex effects on tax revenues, and minor adjustments, including under-indexation of NIC thresholds, a small net gain to the PSDR is projected (around £140m).

(iii But it does have a redistributive effect: the losers are those in labour intensive industries with a high record of illness, that is mainly heavy manufacturing, coal mining etc. Small service business should be better off.

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(c) As part of the overall deal, however, Mr. Newton has agreed an uprating at above the Rossi index level for people in residential care and nursing homes. Also an extra £1 on the Pension Premium for those on income support is proposed. Both are measures to target extra help on the most needy.

You may wish to discuss with the Chancellor the public reaction to these proposals: it is worth noting that the SSP changes will require a short bill in the forthcoming session. Paragraph 2 of the Chief Secretary's minute makes the main point: faced with huge non discretionary bids, the Chief Secretary sought and achieved large cuts in discretionary elements within the Social Security programme.

Mansion House speech

The Chancellor will outline in ideas on what might be included in his Mansion House speech. I understand he is considering floating ideas for reform of the RPI.

You will recall earlier discussions about reconstruction of the RPI. Among the changes mooted were the following:

(i) A new treatment for housing costs that would exclude the present use of mortgage interest rates.

(ii) Exclusion of the community charge.

(iii) (More modestly) revising treatment of rebates on community charge so that higher rebates feed into a lower RPI. as was the case pre 1986

(iv) Getting rid of the "corporatist" membership of the RPI Advisory Committee and replacing it with a team of experts, perhaps headed by Bill Robinson.

(v) The PAC recently criticised the collection of data for the RPI. This too needs to be examined.

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You may wish to probe how far the Chancellor intends to go at this stage. Is it sensible to float revising the RPI in advance of the expected fall in the rate, rather than later? Arguably the economy has suffered from the headline figure being above the underlying rate over the last year to 18 months: it might be appropriate to get the symmetrical benefits over the next year as the headline rate falls below the underlying rate when interest rates are reduced. The Government would then take steps to reform the RPI.

But you will want to probe the lags: can the idea be floated soon but with no reforms till, say, mid-late 1991?

BHP

BARRY H. POTTER
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