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cc NO

Treasury Chambers, Parliament Street, SW1P 3AG

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Dear Andrew

I attach a draft approved by the Chief Secretary of the Paper he is to put to Cabinet on 9 February on the balance between capital and current expenditure. Subject to any comments the Prime Minister may have, he proposes to circulate this to Cabinet on Thursday.

Yours sincerely

JSL Gieve

JOHN GIEVE
Private Secretary

DRAFT CABINET PAPER

CAPITAL AND CURRENT EXPENDITURE

Paper by the Chief Secretary to the Treasury

Background

On 10 November 1983 I was invited by the Cabinet "to give thought to how more satisfactory information on the split between capital and current expenditure could be made available, and to circulate proposals at an early stage of the 1984 survey". It was subsequently agreed on 12 January that Cabinet should have a paper "about the trend over time in the distribution of public expenditure between current and capital expenditure" for its early February discussion of the economic situation and prospect.

2. It has been alleged that public sector capital spending has declined, so producing an imbalance between capital and current expenditure.

3. This paper considers in turn;

(i) the presentation of the facts on public sector capital spending.

(ii) the case for any particular level of public sector capital spending or relative proportions of capital and current expenditure.

Presentation

4. Successive Public Expenditure White Papers have shown a decline in the proportion of capital within the public expenditure planning total. A detailed table 1.9 on this same basis will again be included in next week's 1984 White Paper. It is shown at annex A. The aggregate figures show:

£ billion

	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84 Estimated outturn	1984-85 Plans
Cash	9.1	10.2	11.1	10.8	10.0	10.4	10.0
1982-83 cost terms	14.9	14.2	13.0	11.6	10.0	9.9	9.4

5. Over the period 1978-79 to 1984-85 this aggregate suggests a fall of nearly 40% in cost terms.

6. The public expenditure planning total, of which these figures are a part, is an aggregate of individual control totals. But it does not measure the economic and social significance of public sector activity, and is a poor guide to public sector spending on capital goods and the construction industries. The Chancellor told the House on 24 November that it was hoped to improve the clarity of the presentation of this aspect in the forthcoming White Paper.

7. The better indicator for this purpose is gross spending by the whole of the public sector on new capital goods.

8. The planning total figures understate this in three ways:

a. figures of capital formation are shown net of asset sales; this does not measure new work.

b. by international convention, virtually all defence expenditure is classified as current not capital. This obscures the real nature of much defence spending, and its impact on the equipment and construction industries.

c. external financing limits rather than capital expenditure are scored for the nationalised industries and some other public corporations.

9. Colleagues will now have seen that the new White Paper will also include a new table 1.13 on a more comprehensive basis. The full table is shown in annex B; annex C shows the adjustments and details the reasons for them.

10. The summary statistics on the new basis show:

£ billion

	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84 Estimated outturn	1984-8 Plans
Public capital spending on goods and services							
Cash	11.8	14.2	16.5	17.3	18.7	20.3	21.1
1982-83 cost terms	19.3	19.8	19.3	18.5	18.7	19.4	19.1
Public capital spending on goods and services plus capital grants to private sector:							
Cash	13.4	15.8	18.4	19.4	21.4	23.4	23.9
1982-83 cost terms	21.8	22.0	21.6	20.7	21.4	22.2	21.7

11. The contrast with the planning total presentation is striking. Whether looking at spending on goods and services alone, or including capital grants to the private sector, the picture is of virtually no change in cost terms over the 1978-79 to 1984-85 period. In presenting the White Paper we shall be able to demonstrate that much of the criticism of the trend of the capital spending figures has been misplace

Position in Later Years

12. Figures on the new basus after 1984-85 will not be given in the White Paper because of data problems. Particular difficulties relate to the "capital" proportion of defence spending and the treatment of the planned privatisation of British Telecom, British Airways and

Enterprise Oil. The programme of privatisation will undoubtedly mean that "nationalised industry investment" - and hence public sector investment - will be treated as falling significantly from 1984-85 onwards. (Indeed, privatisation has already had some effect in the earlier years; investment by companies already privatised was some £300 million in 1978-79). This is a deliberate act of policy and one we can readily present. But colleagues may like to note that if we assume that:

(i) the capital proportion of total defence spending remains as is planned for 1984-85 (one-third);

(ii) the three privatised corporations continue to invest at the same rate in cost terms as in 1984-85

then the cost terms figures for public sector capital spending on goods and services on the new presentation show:

£ billion 1982-83 cost terms

	1984-85	1985-86	1986-87
Excluding BT, BA and EO after 1984-85	19.1	17.0	16.6
Adding back assumed investment by BT, BA, and EO	19.1	19.0	18.6

13. On a broadly comparable basis this suggests little change in 1985-86 and a small fall in 1986-87.

What Level of Capital Spending?

14. The new presentation shows that the level of public sector capital spending has been broadly maintained. We cannot expect that to silence our critics; they will continue to argue that we should spend more still. This plea is always seductive and strikes a chord with our supporters. Certainly no-one can deny that certain types of capital project should be a high priority for any Government. However I am sure that we should continue to examine projects one by one and that it would be a great mistake to start looking for a correct - or even a minimum - level of capital expenditure in aggregate.

15. In reaching a balanced assessment of this question we must bear in mind first that some types of current expenditure can be as important as capital.

For example, industrial training is as much an investment as bricks and mortar. Most R&D is current, but designed to improve long term productive capacity. Much current expenditure provides valuable orders and work for private industry, such as NHS purchases of drugs. More work for the private sector can in turn lead on to increases in productive capacity and demands on the capital goods industries.

15a. That is not to say all current expenditure should be viewed equally favourably. To the extent that we fail to hold back areas such as local authority current spending the capital/current balance is bound to be affected. Similarly, the growth of large current programmes like social security holds down the capital proportion within total public spending.

16. Second, there are areas in which we would wish to see investment by the public sector held back because it is more properly a matter for the private sector. Some investment, such as defence, can effectively be carried out only by the public sector. But elsewhere, as in housing, we have as a matter of policy cut back public sector investment to encourage a shift towards private sector provision. Similarly, transferring nationalised industries to the private sector is intended to free their investment from Government constraints and to ensure that fully commercial considerations will apply to future investment decisions. We need to look, therefore, at investment in the economy as a whole; and aggregate private sector investment is much greater than that in the public sector. Precise comparisons on the new presentation are difficult. But on a broadly equivalent basis, after deducting private sector purchases of Council houses, private sector investment in 1982-83 was some £29 billion compared with public sector capital spending on goods and services of £18.7 billion. (The conventional national accounts presentation gives figures of £31 billion and £12 billion respectively).

17. Third, appropriate levels of public sector investment are affected both by demographic factors and the rate of economic growth. There are examples of the "need" for capital spending falling; such as the impact of the birth rate on the need for educational buildings, the shift of emphasis in the health service from expansion of facilities to more efficient use of the existing capital stock, and the effect of lower economic growth in recent years on demand for energy and other infrastructure projects.

18. Fourth, capital investment is not an end in itself, but a means to an end. In some policy areas, consideration must be given to whether the end is best served by capital or current spending. For example, is the aim of better education best served by improved teacher training or new school buildings? Is the aim of maintaining a desired standard of infrastructure best served by maintenance of the existing capital stock or by new capital works? In the public as in the private sector, it is essential to consider the costs of investment proposals and compare them with expected returns; and in relevant cases to compare the returns with what could be achieved by non capital spending.

19. In the nationalised industries the test should nearly always be whether the project will earn a commercial return. In the public services, where it is often not possible to put a market value on the output, the costs have to be set against an evaluation of the benefits of maintaining or improving the service to meet demonstrated need. The 1960s and 1970s produced many projects where the costs, timescales or commercial risks were seriously underestimated and the actual returns achieved were inadequate. In general, the nationalised industries' returns on capital since the early 1970s have been very poor; particular examples include the Isle of Grain, BSC modernisation and rail electrification. Similarly, Concorde is by no means the only example of uneconomic investment by central and local government.

20. The starting point for assessing future capital spending plans must be through project appraisals in accordance with the normal guidelines. Consideration of the correct level turns on the return which particular projects can be expected to achieve. The initiative for altering the balance within programme totals between capital and current expenditure must rest with spending Ministers and their departments. Under the present arrangements for controlling public expenditure it is not possible for Treasury Ministers to alter the overall balance significantly, nor is it likely that satisfactory alternative arrangements could be devised which would enable them to do so.

Conclusions

21. The new table of public capital spending to be included in this year's White Paper will demonstrate that this type of expenditure has been broadly constant in cost terms over recent years.

22. There is no way of determining in aggregate what are the right proportions of current and capital expenditure within a given total of public spending. The case for capital expenditure can only be considered . project by project

23. At the end of the day the balance bwtween current and capital spending must depend primarily on colleagues' judgement of the priorities within their own programmes. But it will be evident that the scope for accommodating cost-effective projects within the planning totals we have agreed will depend on our ability to withstand pressure for increased current expenditure.

ANNEX A

TOTAL PUBLIC EXPENDITURE BY ECONOMIC CATEGORY

Table 1.9 — £ million cash

	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87
Current expenditure									
Wages and salaries	20,948	24,840	30,841	34,245	36,290	38,423	39,097	40,620	41,840
Other current expenditure on goods and services	11,501	14,012	16,652	19,357	22,361	24,633	26,034	27,510	28,700
Subsidies	4,004	4,939	6,102	6,027	6,060	6,128	5,423	5,060	4,700
Current grants to the private sector	18,542	22,115	27,053	32,846	37,316	40,286	42,395	44,880	47,100
Current grants abroad	1,618	1,819	1,306	1,289	1,784	1,812	1,779	2,050	2,140
Local authority current expenditure not allocated to programmes							735	510	350
Total	56,614	67,725	81,955	93,764	103,811	111,281	115,463	120,620	124,830
Capital expenditure									
Gross domestic fixed capital formation	5,244	6,019	6,238	5,166	5,445	5,927	5,308	6,140	6,430
Increase in value of stocks	57	-14	84	7	318	381	447	270	270
capital grants	1,810	1,869	2,204	2,338	2,954	3,300	3,032	3,100	3,130
Net lending to private sector	240	658	921	1,356	732	-62	980	500	410
Net lending to nationalised industries and some other public corporations	1,075	2,464	2,770	1,943	1,593	901	892	150	-370
Net lending and investment abroad	267	-319	-521	-270	-97	47	192	150	140
Cash expenditure on company securities (net)	4		-1		371	151	3		
Market and overseas borrowing by nationalised industries and some other public corporations	442	-481	-623	294	-1,281	-239	-819	-590	-910
Total	9,138	10,196	11,073	10,833	10,035	10,407	10,036	9,730	9,100
Adjustments									
Special sales of assets		-999	-356	79	-488	-1,200	-1,900	-2,000	-2,000
Reserve						250	2,750	3,750	4,750
General allowance for shortfall						-400			
Planning total	65,752	76,922	92,672	104,676	113,358	120,338	126,349	132,100	136,680

ANNEX D

Table 1.13

£ million

PUBLIC SECTOR CAPITAL SPENDING	1978-79 outturn	1979-80 outturn	1980-81 outturn	1981-82 outturn	1982-83 outturn	1983-84 estimated outturn	1984-85 plans
ods and services							
General government and List III public corporations (1)							
Expenditure on dwellings	2104	2395	2302	1943	2204	2199	2290
New constructions other than dwellings	2556	3165	3766	3912	4259	4395	4571
Purchases (net) of vehicles, plant and machinery	[illegible]	734	877	902	1104	1133	1155
Defence expenditure (2)							
Construction	46	205	283	271	395	456	578
Equipment	1779	2211	2905	3445	3800	4554	5200
Nationalised industries and other list I and II public corporations (1)(3)(4)(7)							
Expenditure on dwellings	0	2	3	2	3	5	8
New construction other than dwellings	4704	1766	2175	2284	2691	2907	2895
Purchases (net) of vehicles, plant and machinery	0	3720	4134	4550	4253 (8)	4743	4639
Total, goods and services	11815	14200	16445	17309	18709	20392	21281
Cost terms (Base year 1982-83)	19201	19750	19270	18458	18709	19421	19302
Capital grants to private sector							
General government and List III public corporations (1)	1462	1566	1890	1974	2581	2921	2601
Nationalised industries and other list I and II public corporations (1)(3)(4)	9	12	12	14	14	24	25
Total, capital grants to private sector	1471	1578	1902	1988	2595	2945	2626
Total, goods and services plus capital grants to the private sector (5)	13286	15778	18347	19297	21304	23337	23907
Cost terms (Base year 1982-83)	21592	21945	21498	20578	21304	22226	21684
Net lending							
General government and List III public corporations (1)							
Net lending to private sector (6)	244	658	920	1356	1094	87	995
Net lending and investment abroad	267	-319	-521	-270	-97	47	203

(1) See definition of list I, II and III public corporations in part V of Volume 2 (PEWP)
(2) NATO definition of defence capital expenditure. Table 14.4 reconciles this definition with that used elsewhere in this White Paper
(3) Not included in the planning total
(4) The 1978-79 figure includes net expenditure on land and existing buildings by nationalised industries
(5) See Table 4.2 for reconciliation of this total with non-current expenditure in Table 1.8
(6) Includes cash expenditure on company securities
(7) "Nationalised industries" includes British Telecom's and British Airway's 1984-85 planned capital spending. No figures are available for Enterprise Oil
(8) British Telecom's accounts treatment of certain fixed assets changed in 1981-82

ANNEX C

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Source.

million

TABLE 4.4

		1978-79 outturn	1979-80 outturn	1980-81 outturn	1981-82 outturn	1982-83 outturn	1983-84 estimated outturn	1984-85 plans
	Capital expenditure in Table 1.8	9138	10196	11073	10833	10035	10407	10036
	ADJUSTMENTS							
	Goods and services							
deduct	Purchases (net) of land and existing buildings	-143	-402	-821	-1720	-2334	-1899	-2837
deduct	Changes in levels of stock and work in progress	57	-14	84	7	318	381	447
	Defence expenditure							
add	Capital expenditure under the NATO definition	1825	2416	3188	3716	4195	5010	5728
deduct	Capital expenditure included in public expenditure	101	125	114	129	159	180	239
	Nationalised industries and other List I and II public corporations expenditure (1)							
add	Capital expenditure (2)	4743	5506	6328	6892	6951	7702	7570
deduct	Capital grants to nationalised industries and some other public corporations	341	294	304	355	372	363	325
deduct	Net lending to nationalised industries and some other public corporations	1075	2464	2770	1943	1593	901	892
deduct	Market and overseas borrowing	442	-481	-623	293	-1281	-239	-819
	Net lending							
deduct	-to private sector (3)	244	658	920	1356	1103	89	983
deduct	-and investment abroad	267	-319	-521	-270	-97	47	192
	Public sector capital spending in Table 1.13	13322	15793	18362	19348	21348	23296	23912

(1) See defenition of List I, II and III public corporations in Part 5 of Volume 2
(2) Several points on the nationalised industries figures need to be noted:- (a) they are not included in the planning total, (b) they include the planned capital spending in 1984-85 of British Telecom and British Airways but no figures are available for Enterprise Oil, (c) British Telecom changed the accounting treatment of certain fixed assets in 1983-84, (d) the 1978-79 figure includes net expenditure on land and existing buildings
(3) Includes cash expenditure on company securities

ANNEX C CONTINUED

The table sets out the adjustment in moving from the old to the new presentation of capital expenditure. These are:

a. figures of gross domestic fixed capital formation are shown in the national accounts net of assets sales. But in measuring new work placed with industry it is not appropriate to deduct (or add) sums which merely transfer the ownership of assets between the public and private sectors. Hence, the adjustment excludes the purchase and sale of land and existing buildings. Council house sales is by far the largest component, which has risen from under £500 million in 1978-79 to over £2000 million a year now.

b. by international convention, virtually all defence expenditure is classified as current not capital. The adjustment includes the NATO definition of defence capital expenditure rather than the conventional definition. The NATO definition of capital covers equipment (excluding ammunition) and construction, but excludes spares and repair and maintenance. It gives a broad indication of expenditure of a capital nature rather than operating costs, although the method of compilation is necessarily approximate.

c. external financing limits rather than capital expenditure are scored within the planning total for nationalised industries and some other public corporations. The adjustment substitutes their aggregate capital expenditure, which is currently around £7 billion a year and has shown little change in real terms since 1978-79.

d. the adjustment omits net lending from the total.