

Ref. A084/1902

PRIME MINISTER

Economic Outlook and Public Expenditure

(C(84) 16-18)

BACKGROUND

On 5 July the Cabinet will have their customary initial 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 three papers on the agenda:

- (a) C(84) 17: the Chancellor of the Exchequer's memorandum on economic prospects.
- (b) C(84) 18: the Chief Secretary, Treasury's memorandum on public expenditure in 1984 and Civil Service manpower.
- (c) C(84) 16: a further memorandum by the Chief Secretary, Treasury on contracting out in the public services.

Economic Prospects

2. C(84) 17 shows few changes from the forecasts produced at the time of the Budget in March and published in the Financial Statement and Budget Report (FSBR). The main differences relate to international developments: the six major OECD countries other than the United Kingdom are forecast to grow at 5 per cent in 1984 (FSBR 4 per cent); and world trade is forecast to increase by 6 per cent (FSBR 5 per cent). Associated with this is an increase in forecast United Kingdom exports of goods and services of 6½ per cent (FSBR 5 per cent). This offsets a rather lower forecast increase in domestic demand: consumers' expenditure is now forecast to grow at 2½ per cent (FSBR 3 per cent) and fixed investment by 6 per cent (FSBR 6½ per cent). The forecast increase in total output remains constant at 3 per cent. The main anxiety, as at the time of the Budget, centres on the United States deficit and the risk that this creates of higher interest rates. Domestically, the Chancellor of the Exchequer suggests

that the main cause for concern is continued excessive wage settlements, which are preventing unemployment from falling despite increases in output and low inflation.

3. The Chancellor does not suggest that the economic outlook poses a threat to the Government's published plans and financial strategy. But he stresses the fragility of sentiment in the financial markets and the need for continued firm control of public expenditure.

Public Expenditure Survey

4. The baseline figures for the current survey are as follows:

	<u>£ million</u>		
	<u>1985-86</u>	<u>1986-87</u>	<u>1987-88</u>
Programmes in Cmnd 9143	130,330	133,930	
Sales of assets (net)	- 2,000	- 2,000	
Reserve	3,750	4,750	
Planning total in Cmnd 9143	<u>132,080</u>	<u>136,680</u>	
Agreed changes (a)	- 361	- 388	
1984 Survey baseline	<u>131,719</u>	<u>136,292</u>	<u>139,005</u>

(a) Mainly reduction in National Insurance Surcharge

5. There are large bids, net of reduced requirements, in each year.

Departmental programmes	2,644	2,950	5,615
Nationalised industries	892	1,330	1,315
Local authority current expenditure	<u>1,500</u>	<u>1,500</u>	<u>1,500</u>
Total	<u>5,036</u>	<u>5,780</u>	<u>8,430</u>

6. The Chief Secretary, Treasury proposes that the aim of the survey should be to maintain the baseline figures for 1985-86 and 1986-87. For 1987-88, the baseline for which was constructed by increasing programmes, with the main exception of expenditure in the Falkland Islands, by 2½ per cent, he proposes that the figure should be £140.4 billion: this figure results from using an uplift

factor of 3 per cent rather than the 2½ per cent just mentioned. The figures include reserves of £3 billion in 1985-86, £4 billion in 1986-87, and £5 billion in 1987-88.

7. The Chief Secretary does not, as he did last year, give any indication of which bids he thinks are likely to have to be accepted. But it is clear that an overspend of the order of £1 billion a year, compared with the provision in Cmnd 9143, on local authority current expenditure is virtually unavoidable; the figures for our net contribution to the Community budget, though subject to forecasting errors, cannot be changed by policy decisions; and much of the increase in social security and other demand-determined expenditure is likely to prove unavoidable. A small part of the prospective increase can be absorbed by the reserve (rolling the figures forward from the 1983 survey in effect produces savings of £0.75 billion in each of 1985-86 and 1986-87). But it is clear that in order to bring the figures back to baseline while absorbing those increases which are unavoidable difficult decisions will be needed.

Civil Service Manpower

8. The Government's published objective is to reduce Civil Service numbers to 593,000 by 1 April 1988. Although bids from Departments suggest that this target should be hit, they are asking for numbers slightly higher than the published figures for intermediate years. Even for 1988 there are bids on the contingency margin of 7,500 which suggest that the target may not be hit. The Chief Secretary proposes that the contingency margin should be increased to 10,000 and that the aim should be to produce a significant reduction in the figure of 593,000.

Running Costs

9. Departmental running costs (pay, provision for superannuation, and general administrative expenses) amount to some £16 billion a year, less £2 billion of receipts; the figures include the armed forces. Every year since 1979-80 running costs have increased by more than the general rate of inflation, despite pay settlements below the rate of inflation and reductions in Civil Service numbers.

I understand that the Treasury have been considering trying to tackle the problem by setting explicit targets for running costs, but have rejected this solution because it is technically difficult to reconcile it with the other (fairly numerous) control systems applied to Departments and could be hard to square with expenditure provisions based on pay factors set deliberately low in order to protect the Government's position in pay negotiations with the Civil Service trade unions. However, the Chief Secretary does suggest that Departments should at least produce forward estimates of running costs to provide a basis for discussion when the 1985-86 Supply Estimates are settled this winter.

Contracting Out

10. C(84) 16 is essentially a progress report, with some fairly generalised proposals designed to keep up the pressure on Departments and other public sector bodies. As the memorandum suggests, the Secretary of State for the Environment is due to report to the Ministerial Sub-Committee on Economic Affairs (E(A)) on 25 July on contracting out in local government.

MAIN ISSUES

11. The main issues before the Cabinet arise on C(84) 18:

- (i) Do the Cabinet agree with the planning totals proposed by the Chief Secretary, Treasury as the aim for this year's public expenditure survey?
- (ii) Do the Cabinet agree with the Chief Secretary's proposals on Civil Service manpower and running costs?

Although less extensive discussion should be required, you will also wish the Cabinet to consider the progress report on contracting out in C(84) 16.

The Public Expenditure Survey

12. It seems unlikely that many members of the Cabinet will suggest that the Government should abandon the planning figures published in Cmnd 9143. The main points likely to be raised in discussion are probably those discussed in paragraphs 13-15 below.

Pay

13. There are two points on pay that may be raised. First, some members of the Cabinet may take up the remarks in paragraph 10 of C(84) 17 and suggest that the Government should be doing more to try to influence outside pay settlements. Secondly, it may be suggested that, in particular, recent experience with the pay review bodies and the teachers' pay negotiations show that the Government is basing its expenditure plans on unrealistic assumptions about likely public service pay settlements and that the public services will not in the end continue to accept pay settlements lower than the economy. There is no need to resolve such points tomorrow, should they be raised: it is usual to consider whether there should be an explicit public expenditure pay factor, and if so what it should be, in September. But to the extent that the points are valid they imply that it would be prudent, at this stage of planning, to maintain a fully adequate reserve.

The Reserve

14. The Chief Secretary proposes a reserve of £3 billion in 1985-86, £4 billion in 1986-87, and £5 billion in 1987-88: £0.25 billion more than the reserves for the corresponding years of last year's survey. These figures may seem large by comparison with past years; but they now cover all expenditure overruns, and not only those resulting from policy decisions by central Government. Moreover, experience this year - for which the reserve is already fully committed - does not suggest that it would be wise to use lower figures. Indeed, if other things were equal, there would be a good case for increasing the Chief Secretary's proposals. But the figures for local authority current expenditure likely to result from this year's survey should be more realistic than in past years; and this should reduce the extent of likely calls on the reserve.

Figure for 1987-88

15. The survey baseline for 1987-88 was produced by increasing the figures for 1986-87, with a few exceptions, by 2½ per cent.

The Chief Secretary proposes a planning figure which is slightly higher. This is produced by using 3 per cent as the uplift factor. Two points may be raised:

- (a) The Chief Secretary's proposed relaxation applies to the total, not to individual programmes: the baseline figures for individual programmes would continue to use the factor of 2½ per cent. It may be suggested that this is inconsistent. If so, the Chief Secretary can be expected to reply that the aim of his proposal is to give more room, within an acceptable planning total, for dealing with unavoidable bids and reordering priorities, not to shift the starting point for all departmental bids upwards.
- (b) The projection of the public sector borrowing requirement in Table 2.4 of the FSBR showed a public expenditure planning total in 1987-88 of £141½ billion - say, a 3½ per cent uplift. Some Ministers may ask why the current proposal is lower. The reply will be that Treasury Ministers do not consider it prudent, in the light of all the uncertainties, to recommend a higher planning total than £140.4 billion. No doubt they will point out that it is always easier to increase public expenditure than to reduce it. They are also likely to make the point that the figure for 1986-87 (the last year of the 1983 survey) was essentially based on an uplift of 3½ per cent: it would not be easy to square using the same factor this year with falling inflation forecasts and the policy of not allowing public expenditure to rise in real terms.

Civil Service Numbers

16. The Chief Secretary's concern about manpower numbers is understandable, as is his belief that Government should be able to do better than achieve the agreed targets to 1988. It is however very difficult to assess the scale of the problem without knowing the up-to-date assessments of the need for staff in the Ministry of Defence and the Property Services Agency in the survey period. These Departments should be pressed for early

clarification of their needs, so that the Cabinet can return to the issue later in the public expenditure round. Some Ministers are likely to emphasise that, while they fully accept the desirability of reducing manpower as far below the target figures as possible (whether through greater efficiency or greater contracting out or hiving off) it would be very disruptive of departmental planning to seek to set new public control numbers so soon after last autumn's announced decision.

Running Costs

17. Running costs represent about 12 per cent of Government Departments' expenditure, and are directly under departmental control. At present we have a backward-looking annual scrutiny of running costs. The Chief Secretary proposes that this should be replaced by a forward-looking scrutiny. I believe that it would be a pity to lose the retrospective examinations of real running costs which we now have and which are based on fact not estimation. But the two concepts are not alternatives; they should be mutually supportive.

18. Ministers are unlikely to oppose a forward look at running costs, but two points may be raised:

- (a) It may be suggested that in view of the substantial real increases in departmental running costs that have taken place in recent years, both in total and in costs per head, something more stringent is required. The Chief Secretary may well accept that there is force in this point; but he is likely to argue that there are genuine difficulties in trying to impose yet more control systems on Departments, especially when the Government is trying to give the departmental managers more freedom and responsibility through the Financial Management Initiative. The Cabinet may well feel that a more stringent system should be examined as a longer-term aim, but should not be imposed on Departments at this stage.
- (b) Contrariwise, some members of the Cabinet may be concerned that the "forward-looking scrutiny" may be operated unrealistically. They are likely to be particularly concerned

that they may be asked to produce figures based on an optimistic pay factor and then be held to them even if a pay settlement above the factor is agreed. They will fear that a forward look will slip over into a control number. Departments can operate with two control numbers - cash limits and manpower ceilings - but the introduction of further sub-controls would diminish flexibility and devalue the doctrine of the cash limit. I understand that the Chief Secretary is well seized of these points and will be briefed to offer reassurances.

Contracting Out

19. Again, there is unlikely to be much disagreement with the proposals in C(84) 16. You will probably wish to underline the political importance of continuing to make progress, and to back the requests to the Secretary of State for the Environment and the Secretary of State for Social Services to come forward in good time with reports on local government and the National Health Service respectively.

HANDLING

20. You will wish to invite the Chancellor of the Exchequer to open the discussion by describing the current 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

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

- (i) Do the Cabinet agree that the aim of the 1984 public expenditure survey should be to arrive at planning totals of £131.7 billion, £136.3 billion and £140.4 billion for the three years 1985-86 to 1987-88?
- (ii) Do the Cabinet agree with the Chief Secretary's proposals on manpower: in particular, that the contingency margin for 1 April 1988 should be increased

to 10,000, and that the aim should be to reduce Civil Service numbers by that date below 593,000?

- (iii) Do the Cabinet agree that there should be a forward-looking scrutiny of running costs?
- (iv) Do the Cabinet endorse what is said about contracting out in C(84) 16?

On the basis of (i)-(iii) above, you will wish to invite the Chief Secretary, Treasury to hold bilateral discussions with spending Ministers and to bring forward further proposals to the Cabinet in the autumn.

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Approved by
ROBERT ARMSTRONG
and signed in his absence.

P.S It will be necessary to agree a form of words for the Press and your questions. Bernard and Treasury have been in touch and agreed the line in the attached minute

AT

4/7

4 July 1984