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John Redwood
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10 DOWNING STREET

From the Private Secretary

23 January 1985

Dear Rachel.

PUBLIC EXPENDITURE SURVEY

The Prime Minister held a meeting yesterday to discuss the outcome of the 1984 PES and to consider the prospects for the 1985 Survey. Present were the Chancellor of the Exchequer, Home Secretary and Chief Secretary. Also present were Sir Robert Armstrong, Sir Peter Middleton, Mr. Bailey, Mr. Gregson, Mr. Scholar, Mr. Redwood and Mr. Willetts.

Opening the discussion, the Chief Secretary said one of the main lessons to emerge from the 1984 Survey was that the Government's objective of holding public expenditure constant in real terms was a very ambitious one which could only be achieved with difficulty. About four-fifths of total expenditure was represented by large and growing programmes, with the burden of adjustment falling on the remaining one-fifth. It was doubtful within the objective could be achieved without securing savings from larger programmes. The Chief Secretary identified a number of areas which were putting strain on the public expenditure totals; the growth of social security expenditure; local authority expenditure, both current and capital; the difficulty of maintaining recent restraint on public sector pay; the pressure for some expenditure on employment measures; and the aftermath of the coal strike. At the same time, it would be difficult to sustain the recent rate of asset sales.

On past form, the Treasury expected to be faced with irresistible bids in the next Survey of £2-2½ billion for which offsetting savings would need to be found. The Treasury would maintain the pressure for savings from better house-keeping but the bulk of the savings would have to come from the larger programmes which had hitherto not suffered major reductions. The Chief Secretary listed as the main areas where economies should be found - social security, defence, industrial subsidies, housing, health, and gas prices. Where reviews were not already in hand they should be set up. In addition, it was essential to make stick the various mechanisms for restraining local authority expenditure.

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In discussion it was noted that controlling public expenditure was not a once-a-year exercise but a continuing process. Access to the contingency reserve should be stringently controlled. Summing up this part of the discussion, the Prime Minister agreed that if the objective of maintaining public expenditure constant in real terms was to be achieved it was essential to widen the choice of programmes from which savings were to be secured. To achieve this, Departments must be prepared to look at their programmes in a more fundamental way. The Treasury should seek substantial savings from among the programmes listed by the Chief Secretary.

The discussion then turned to the procedures for the Public Expenditure Survey. It was recognised that most of the difficulties of the 1984 Survey arose from the tough nature of the assignment rather than from deficiencies in the procedures. Nevertheless, it was worth considering where improvements could be made. It was argued that maintaining the same procedure each year allowed Departments to build up resistance to the system and encourage them to argue their case through to the end. It was argued that a further defect of the present timetable was that the announcement of public expenditure totals was divorced from that of the tax changes in the Budget. This allowed criticism of unpopular public expenditure cuts to mount before the resulting benefits in terms of tax cuts could be produced. Most other countries managed to bring both sides of the account into one budget. Against this it was argued that fiscal policy in the UK was not as disjointed as appeared. Unlike many other countries, tax and expenditure decisions were the responsibility of a single Department; furthermore, the Budget brought together tax and expenditure in a medium-term framework. There was a tension which it was difficult to reconcile between the interests of Departments, local authorities and nationalised industries who, for management reasons, wanted expenditure decisions as early as possible before the start of the financial year, and the interests of the Treasury who wished to take decisions on tax and borrowing as close to the start of the financial year as possible. One option would be to move the Budget to the autumn with a Finance Bill in the Spring, though it was noted this would frequently require an amended Budget in the Spring.

Summing up this part of the discussion, the Prime Minister said it was unlikely that bringing tax and expenditure announcements together would produce a significant improvement for the Government. There was, however, merit in announcing the programme totals for three years ahead at the time of the Autumn Statement.

The meeting then considered ways in which collective discussion of public expenditure could be improved. Arrangements could be made to bring more explicitly to colleagues' attention any politically sensitive decisions agreed in bilaterals. Another possibility was to hold a

meeting of Cabinet Ministers to discuss priorities. It was agreed that if such a priorities discussion were held, it should be after the public expenditure totals had been agreed, should be outside the normal run of Government business and should be held on a "seminar" basis without detailed papers. It was agreed that even on this basis there could be no guarantee that such a meeting would not add to pressure on the Treasury to increase expenditure.

It was argued that a weakness of the present system was that once public expenditure totals had been set all discussion was on a bilateral basis either with the Chief Secretary or the Star Chamber. Departmental Ministers were not forced to consider priorities between programmes. One response to this would be the so-called envelope system in which expenditure was grouped into a number of blocks and Ministers were required to argue for their programmes with other Ministers in the same block. It was noted that Canada had adopted such a system but was now abandoning it. One defect was that it would group together programmes of unequal size. It was unrealistic to expect small programmes to bear the brunt of changes in very large programmes, e.g. social security. Conversely, where the large programme was not growing rapidly, it would be difficult to secure economies from smaller programmes.

Summing up this part of the discussion the Prime Minister said the difficulties with the Survey lay more with the tough objective which the Government had set itself than with the procedures. The Star Chamber had proved its worth and should be retained. The Chief Secretary should consider whether arrangements could be devised which would inform colleagues more fully about unpopular decisions, though without making the taking of such decisions more difficult. She would consider further whether a meeting to discuss priorities on the basis suggested would be helpful.

I am copying this letter to Janet Lewis-Jones (Lord President's Office), Richard Broadbent (Chief Secretary's Office, H.M. Treasury), Hugh Taylor (Home Office) and to Richard Hatfield (Cabinet Office).

Yours sincerely

Andrew

ANDREW TURNBULL

Mrs. Rachel Lomax,
H.M. Treasury.

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SPEAKING NOTE ON THE CANADIAN 'ENVELOPE' SYSTEM FOR DETERMINING PUBLIC EXPENDITURE PRIORITIES

We have given some thought to whether it might be worth considering introducing an 'envelope' system for determining public expenditure priorities, of the kind which the Canadians used for a while, but have now abandoned.

Such a scheme would involve grouping some programmes together - say the overseas programmes (defence, aid, FCO); industrial support (DTI, MAFF, ECGD, Employment); social programmes (social security, health and education) - splitting the public expenditure ^{total} into sub-totals for each group; and leaving the Ministers concerned to reach conclusions about relative priorities within each 'envelope'.

I believe that the main attraction of this idea - that it might take some of the fire off the full Cabinet, the Prime Minister and Treasury Ministers - is illusory. When the expenditure totals really bite, nothing would prevent colleagues joining forces to argue that their envelope as a whole was insufficiently funded; nor would a colleague, whose programme was singled out by others within his envelope for large and politically sensitive cuts, feel inhibited about bringing his case to Cabinet or to the Prime Minister.

The mechanism would, moreover, serve in some cases to protect small programmes (eg the FCO) from the Survey's squeeze at the expense of large programmes (eg defence). There would be real penalties for efficiency and economy if less pressure was generally applied to small departments than to large.

Finally, it is doubtful if the mechanism would work. Why should eg Michael Jopling be any ^{the} more ready to agree a cut in agricultural support if he was told that it was needed to permit expansion of the special employment measures programme?

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