



Ref. A085/1875

PRIME MINISTER

Economic Outlook and Public Expenditure
(C(85) 17 and 18)

BACKGROUND

On 11 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 two papers on the agenda:

- Flay A* - a. C(85) 17: the Chancellor of the Exchequer's memorandum on economic prospects;
- Flay B* - b. C(85) 18: the Chief Secretary, Treasury's memorandum on the 1985 Public Expenditure Survey.

Economic Prospects

2. C(85) 17 shows relatively few changes from the forecast produced at the time of the Budget in March and published in the Financial Statement and Budget Report (FSBR). The temporary increase in United Kingdom inflation has gone about 1 per cent further than was contemplated at the time of the Budget, but the current balance looks somewhat stronger, and the prospects for output are a little better. Consumers' expenditure is now expected to grow a little more slowly this year, but fixed investment should be higher. Inflation is still expected to fall back in the second half of this year - to 5³/₄ per cent in the fourth quarter, as against the FSBR forecast of 5 per cent. Although the United Kingdom output growth is forecast to be



slightly higher than the average of the other Economic Summit countries, United Kingdom inflation and unemployment remain significantly higher, while United Kingdom earnings are continuing to grow more rapidly. The comparisons for 1985 are:

	United Kingdom	Other Economic Summit countries
Gross Domestic Product (per cent change on previous year)	3½	3
Unemployment (year average, per cent)	13	7½
Retail prices, fourth quarter (per cent change)	5¾	4
Average earnings, fourth quarter (per cent change)	<u>8½</u>	<u>5½</u>

3. Major uncertainties remain about oil prices and the value of the United States dollar, with prospects of falls in both. Both would tend directly to reduce United Kingdom Government revenue. On the other hand slightly faster inflation and relatively buoyant output will tend to increase revenue, and the Chancellor of the Exchequer sees no need to change the FSBR forecast of £7 billion for the Public Sector Borrowing Requirement (PSBR) in the current financial year. But the financial markets are likely to remain cautious about United Kingdom prospects; although sterling is currently strong, United Kingdom interest rates are 2½ per cent above the average of the other Economic Summit countries (and unlikely to ease quickly in view of the latest adverse money supply figures), and the Chancellor of the Exchequer sees no scope for financial relaxation. Against this background he urges the importance of



continued firm control of public expenditure, not least if the Government are to make further progress towards reducing the tax burden.

Public Expenditure Survey

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

	£ billion		
	<u>1986-87</u>	<u>1987-88</u>	<u>1988-89</u>
Planning total in Cmnd 9428	<u>136.7</u>	<u>141.5</u>	
Increase in the Reserve (1985 Budget)	<u>2.0</u>	<u>2.0</u>	
Budget employment measures	0.3	0.4	
Survey baseline	<u>139.1</u>	<u>143.9</u>	<u>148.2*</u>

* assumes 3 per cent uplift on previous year's planning total, as against $2\frac{1}{2}$ per cent uplift applied to individual programmes in Public Expenditure Survey Report.

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

Departmental programmes	4.4	5.4	6.6
Local authority current expenditure (agreed by E(LA))	0.5	0.5	0.5
Nationalised industries (see E(A)(85) 42)	1.0	0.6	0.8
Total	<u>5.9</u>	<u>6.5</u>	<u>7.9</u>

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6. The Chief Secretary, Treasury proposes that the aim of the Survey should be to maintain the baseline figures for 1986-87 and 1987-88, despite the pressure for higher expenditure. In practice the overspend on local authority current expenditure is bound to exceed the ~~£500,000~~ million agreed by E(LA), which was reported to you in the Lord President's minute of 1 July and further discussed the Secretary of State for Education's minute to you of 5 July; any further excess would be a charge on the Reserve.

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7. The Chief Secretary, Treasury recognises that some of the additional bids will be very difficult to resist, although he does not indicate what proportion of them he thinks will have to be accepted. Those for social security, ECGD, civil superannuation and part of the housing bid simply reflect the higher price level or higher interest rates, and are inescapable, while that for the Intervention Board for Agricultural Products is outside the United Kingdom Government's direct control. Some increases on account of the National Health Service Pay Review Body awards and of higher expenditure on maintaining local authority housing are almost certainly inevitable, although there is still room for argument in the bilaterals on the amounts.

8. Against these increases the Chief Secretary, Treasury is ready to set the higher estimate of receipts from privatisation (now put at £4½ billion in 1986-87 and £3½ billion in 1987-88, as compared with the Cmnd 9428 figures of £2¼ billion for each of the two years), and to allocate £1 billion of the Reserve to programmes in 1986-87 and 1987-88 (giving Reserves of £5 billion, £6 billion and £7 billion for the three Survey years). The effect of this treatment of the privatisation receipts is to make room for some increases in the gross total of the programmes, while adhering to the net planning total for public expenditure; but, as the Chief Secretary, Treasury implicitly recognises, such receipts have more of the character



of financing than of reducing the PSBR and do not warrant permanent reductions in taxation (or increases in expenditure). Despite this relaxation, it is clear that difficult decisions will be needed if the remaining gap between Departments' ambitions and the proposed planning totals is to be closed; the size of the problem will also depend on the position of nationalised industries, which is due to be discussed by E(A) on 17 July (on the basis of the Chief Secretary's paper circulated as E(A)(85) 42 on 9 July).

Running Costs and Manpower

9. This year for the first time running costs have been fully integrated into the Survey, as a stage in the process of ceasing to set separate control targets for manpower as well as expenditure after 1988-89. Departments were asked to propose cash targets for their running costs in each of the three Survey years, with the aim of holding the growth in the total of these costs $\frac{1}{2}$ per cent below the level of inflation assumed in each of the years. Departments' bids, however, for 1986-87 show an aggregate cash increase of 6.3 per cent, as against the aim of 4 per cent; much of the difference is accounted for by the 7.3 per cent armed forces pay award. On manpower numbers Departments' proposals would absorb most of the contingency margin allowed for in setting the published targets.

10. On running costs, the Chief Secretary, Treasury proposes that reductions should be sought for 1986-87 which could be carried forward to the two subsequent years; in the light of this work tough but realistic targets would be agreed with each Department. On manpower he recognises the need to give higher priority to the staffing of services aimed at controlling fraud or whose costs are wholly recovered by fees; but he in effect reserves the right to ask Departments for offsetting reductions



even where bids are of this character. He does not, however, commit himself to any specific new objectives on running costs or manpower.

Pay Assumption

11. In recent years assumptions about the growth of public service pay have been set each autumn somewhat below the uplift factor used in creating the Survey provision for the following year, and the difference has been subtracted from the cash provision for each programme. The Chief Secretary, Treasury suggests that the question of setting and publishing such an assumption should be considered in September; but he acknowledges that it could not credibly be set below the uplift factor of 3 per cent underlying the 1986-87 baseline, and that there should therefore be no question of reducing the programme figures for the first year of the Survey.

Surplus Land and Empty Housing

12. On the disposal of surplus land and empty housing the Chief Secretary, Treasury seeks his colleagues' co-operation in agreeing taut targets in the context of the Survey.

MAIN ISSUES

13. The main issues before the Cabinet arise on C(85) 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 endorse Reserves of £5 billion, £6 billion and £7 billion for the three Survey years?



iii. Do the Cabinet agree with the Chief Secretary's approach to running costs, manpower and surplus land and empty housing?

The Public Expenditure Survey

14. It seems unlikely that many members of the Cabinet will suggest that the Government should relax the adjusted planning totals published in the FSBR, given the Chief Secretary's willingness to relax the gross total of programmes by crediting the projected increase in privatisation receipts to those programmes. A number of points may, however, be made about the underlying difficulty of the situation:

a. The temporary acceleration of inflation, combined with the method of determining the size of social security upratings by reference to past inflation, means that cash expenditure on benefits will inevitably be substantially higher in 1986-87 and 1987-88 than allowed for in Cmnd 9428, even if inflation dips below its previously projected path and brings the price level back to what would be consistent with earlier plans.

b. The acceleration in inflation, combined with cash limits control, means a reduction in total public expenditure in cost terms below previous plans in both 1986-87 and 1987-88, and also implies a slightly larger real reduction in expenditure between 1985-86 and 1986-87 than previously expected (£1.2 billion as against £0.9 billion).

c. Local authorities' current expenditure is certain to make a claim on the Reserve next year over and above the £500 million which E(LA) have agreed that the Government should accept now. The emerging position on teachers' pay will add to the problems.



d. The proposed approach on public expenditure implies that pay in the public services sector will again increase less rapidly than average pay elsewhere in the economy. As the gap widens further, the risks of disruptive action in the public services sector are likely to increase.

The Reserve

15. The Chief Secretary, Treasury proposes Reserves of £5 billion, £6 billion and £7 billion for the three Survey years; this implies a reduction of £1 billion as compared with the FSB in 1986-87 and 1987-88. Such Reserves are £2 billion higher than the comparable proposals last year. It would not, however, appear prudent to allocate more than the £1 billion now proposed to programmes in the first two years; the Reserve for the current year was increased from £3 billion to £5 billion in the 1985 Budget, and approaching £4 billion of this has already been committed.

Running Costs and Manpower

16. Separate controls over running costs and manpower run the risk of proving inconsistent with each other; in accordance with the objectives of the Government's Financial Management Initiative, emphasis is being switched to control over running costs as the preferred means of stimulating Departments to run their affairs in the most efficient and economical way. As the recent discussion of long-term unemployment showed, the case for arbitrary manpower constraints may be more difficult to sustain where it is clear that additional departmental employees can more than recover their costs and at the same time improve the service provided to the public. The Chief Secretary, Treasury does not ask for specific aggregate objectives to be endorsed, but rather that he should pursue possible reductions in discussion with spending Ministers. To the extent that



efficiency savings can be found to offset the costs of higher wage awards, there should be some help in terms of lower running costs and manpower numbers.

HANDLING

17. 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 with a more detailed account of his proposals on public expenditure. All members of the Cabinet will wish to contribute to the subsequent discussion, although you may wish to remind them that they had the opportunity of a lengthy discussion of priorities last month at Chequers. On this occasion there will not have been any opportunity for a prior discussion in E(A) of the nationalised industries' Investment and Financing Review; as a result, some sponsor Ministers might want also to comment on the implications of the Chief Secretary's figures for the additional bids in this area. You might discourage any extensive discussion of such points, since there will be an opportunity for this at E(A) on 17 July.

CONCLUSIONS

18. You will wish the Cabinet to reach conclusions on the following:

i. Do the Cabinet agree that the aim of the 1985 Public Expenditure Survey should be to arrive at planning totals of £139.1 billion, £143.9 billion and £148.2 billion respectively for the three years 1986-87 to 1988-89?

ii. Do the Cabinet agree that the Reserve should be set at £5 billion, £6 billion and £7 billion respectively for those three years?



iii. Are the Cabinet content with the approach proposed by the Chief Secretary, Treasury to targets for running costs, manpower and surplus land and empty housing?

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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ROBERT ARMSTRONG

10 July 1985