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16 July 1987

David Norgrove Esq
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pa.

Dear David

PUBLIC EXPENDITURE CABINET

We shall be sending you over tomorrow the final drafts of the Cabinet papers for the Prime Minister's approval over the weekend. But I thought it might be helpful for you to see the latest drafts today; the Chancellor will be considering them overnight. I therefore enclose:

(i) the main paper on Public Expenditure;

(ii) the annex on departmental running costs;

(iii) the paper on Economic Prospects.

I am also attaching a note which sets out the arguments for the approach we have adopted, and the outcome we are seeking; and the draft briefing line for Mr Ingham after Cabinet (which should not, of course, be shown to Mr Ingham at this stage). If there are any points about which you are not clear, I or Andrew Turnbull will be glad to help.

If you think it would be helpful, we stand ready, as last year, to provide a speaking note for the Prime Minister to use at Cabinet.

Yours
Alex

A C S ALLAN
Principal Private Secretary

DRAFT PAPER FOR CABINET (No 3)

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C(87) Copy No
July 1987

1987 PUBLIC EXPENDITURE SURVEY

Memorandum by the Chief Secretary, HM Treasury

But still higher than 1978-79.

Introduction

Our policy is to bring public spending down progressively as a proportion of national income. Over the past four years we have succeeded in achieving this. Even excluding privatisation proceeds, general government expenditure (the combined spending of central and local government) has fallen from 47 per cent of GDP in 1982-83 to 44 per cent in 1986-87, and there will be a further fall in 1987-88. This has made it possible to combine a steady growth of public expenditure in real terms with a reduction in borrowing and, in each of the last five Budgets, a reduction in taxes. This restraint in public spending has made possible the strong performance of the economy which the Chancellor has described in his Memorandum (C(87)).

2. In our Election Manifesto we pledged ourselves to continue the policy of ensuring that public spending takes a steadily smaller share of our national income. This is essential if we are both to maintain the momentum of our economic performance and to deliver another of our Manifesto pledges, a reduction in the burden of taxation.

3. For this year's Survey we have established baseline totals for spending of £154.2 billion in 1988-89, £161.5 billion in 1989-90 and £165.5 billion in 1990-91. For the first two years this was done by retaining the planning totals set out in last year's Public Expenditure White Paper and for the third year we have used an uplift factor of 2½ per cent.

4. Departments were then asked to review their programmes within their baseline figures and to put proposals to me where they

felt, after a review of priorities, that additional resources were required. In my minute of July to the Prime Minister, I summarised the bids received from departments.

Objectives for the Survey

5. I have to make it clear to colleagues that bids on this scale are far beyond what can be afforded. If anything like this were accepted, we could make no further progress in reducing public spending as a proportion of GDP, as set out in the White Paper. This would not only trigger a complete reappraisal of the Government's financial standing in the markets, and stop our economic progress in its tracks; it would make our objectives for taxation unattainable.

Surely the wrong way round.

6. With the time lost as a result of the election, it has not been possible to analyse the bids as thoroughly as normal. There are major uncertainties in a number of areas which I will want to probe further, eg the large estimating changes for social security and the projections of our contributions to the European Community.

7. But it is clear that to hold to our policy on public spending we will have to face up to difficult decisions in a number of areas, in particular:

Do we want to spell these out now?

?

i. for programmes such as defence, health and education which are seeking very large increases, the bids will have to be significantly scaled back and, to the greatest extent possible, policy savings found to offset them;

?

ii. for social security we must look at policy changes to help offset the enormous estimating changes;

?

iii. we need to take a hard look at the employment programmes where, with the better prospects for unemployment, substantial savings can be found;

?

iv. we need to re-examine the basis of our regional policies. The buoyancy of the economy and in particular of investment, reflecting the increased strength of the corporate sector, is both increasing the cost of the present system of incentives and reducing the need for them. We should look for savings here partly to release resources for cost effective inner city spending;

v. we must look very carefully at the expenditure of the territories;

vi. we should go as far as we can in transferring to the private sector the responsibility for providing services hitherto provided by the public sector.

Reserves

8. In the last Survey we provided for Reserves of £3.5 billion in the first year rising to £7.5 billion in the third year. The experience of recent years shows that we need to keep a larger margin than this, especially in the later years, if we are to cope with the pressures both in-year and in successive Surveys. In particular we need to take account of the fact that the grant agreed in E(LA) may not succeed in holding local authority current spending to the figures agreed for provision. Keeping larger reserves will reduce the scope for making additions to programmes.

Departmental running costs

9. Colleagues have sought increases in their departments' running costs implying overall cash increases of 8 per cent for 1988-89 over 1987-88 with further increases in later years. The associated manpower projections reverse the downward trend we have achieved, implying a 15,000 increase over published plans for 1988-89.

10. In the last few years, the increases in spending on departmental costs agreed for each first Survey year have exceeded our aims. The figures for the later years have not been treated realistically and as a result have had to be increased substantially in later Surveys. We need to agree a realistic method for planning provision over the Survey period so that departments have a reasonably reliable basis for making medium-term plans to improve efficiency.

11. My proposals, set out more fully in the annex, are that:

i. the running costs share of total public spending should not rise over the Survey period. This implies that running costs would grow on average in line with public expenditure generally, ie by about 1 per cent a year in real terms;

But the figures the White Paper don't grow 1% a year. (They do.)

ii. cost and other pressures will need to be met to a large extent by efficiency gains of at least 1½ per cent a year in the use of all resources including manpower. These will need to be planned well in advance and departments should have contingency plans for larger improvements in case they are necessary;

iii. departments should prepare management plans to deliver these gains over the full Survey period. In any case where the plans are not suitably ambitious, or are unrealistic, I should hold over agreement on the later Survey years until the next Survey;

iv. for 1988-89, the aim should be to reduce the overall increase in provision sought by at least half.

<u>Nationalised industries</u>

12. In the 1987 Investment and Financing Review, the nationalised industries' own intial and unamended bids, made in May, exceed the baseline by £0.9 billion in the first year and £1.2 billion in the two subsequent years. These bids are clearly unrealistic and cannot be afforded. They now need to be scrutinised rigorously, and a number of industries are revising their proposals so that we will have a sounder basis for judging them. Apart from the electricity industry in England and Wales, and Scotland, where separate considerations apply, I propose that our aim should be to reduce the provision at least to baseline and, where we can in the case of individual industries, below it. Failure to achieve this would mean greater pressure on departmental programmes. There are particular problems relating to the electricity industry this year, notably the need to set new financial targets, the implications of privatisation and assessment of a new power station programme. Notwithstanding these

uncertainties, the pressure on public expenditure means that it is essential to appraise the industry's bids critically and to set challenging financial targets.

Local authority relevant public expenditure

13. We have agreed in E(LA) to set provision for relevant public expenditure in England at £27,969 million (£27,538 million for relevant current expenditure and £431 million for Rate Fund Contributions to Housing Revenue Accounts). This is an incease of £819 million above the White Paper baseline. Aggregate Exchequer Grant in England is set at £13,775 million, an increase of £750 million (5¾ per cent) on the 1987-88 settlement figure including teachers' pay. [Reference to Scotland and Wales to come.] These are substantial additions and we must recognise that they will severely limit what can be made available for other programmes.

Conclusions

14. I ask Cabinet:

i. to reaffirm the Manifesto policy of ensuring that public spending takes a steadily smaller share of our national income as set out in last year's White Paper;

ii. to note that bids will have to be substantially cut back to secure the policy objective at (i);

iii. to agree that we explore a wide range of policy changes including those listed in paragraph 7;

iv. to agree that we should aim to hold the EFLs of the nationalised industries other than electricity at least to baseline and possibly below; and that we should seek to keep the electricity industries' external finance as low as possible;

v. for running costs, to agree the proposals set out in paragraph 11 and in the Annex;

vi. to agree that I should now conduct bilaterals with colleagues on their spending programmes.

TREASURY CHAMBERS

July 1987 **[JM]**

ANNEX

1987 PUBLIC EXPENDITURE SURVEY: DEPARTMENTAL RUNNING COSTS

Departmental Ministers have sought increased provision for running costs totalling £761 million for 1988-89, £956 million for 1989-90 and £1,203 million for 1990-91.

2. If increases on this scale we agreed, overall expenditure on running costs would rise by 8 per cent in cash and 4 per cent in real terms between 1987-88 and 1988-89, with further real increases in the later years. They also imply an increase in Civil Service manpower of nearly 15,000 over the manpower plan of 583,000 for 1 April 1989 published in this year's public expenditure White Paper and further increases in later years, though some 5,000 of this rise stems from increases agreed after the last Survey.

3. In spite of large manpower reductions (135,000 since 1979 and 50,000 since 1983) and, in most years, Civil Service pay settlements at or below general inflation, running costs have continued to rise in real terms as a result of increases in non-manpower costs (eg more buying-in of services rather than providing them internally) and changes in grading mix. Tight pay settlements will continue to be the aim. But if departments are to recruit and retain the staff they need and the Government's objective of making the Civil Service pay structure more conducive to an efficient service and more responsive to labour market conditions is to be met, future pay offers cannot be expected to be immune from pay movements in the economy generally.

4. It is thus realistic to provide for some rise in overall spending on running costs; but the Manifesto pledge to press ahead with management reforms to improve public services and reduce their cost, as well as the aim of ensuring that public expenditure takes a steadily smaller share of national income, mean that the rise must be contained to well below the levels sought.

5. It is proposed as a firm objective that the running costs, share in total public spending should not rise over the Survey period. This implies that running costs would grow approximately on average in line with public expenditure generally, ie by about 1 per cent a year in real terms. It means that if increases in the volume of activity are to be met in some parts of the Civil Service, reductions or lower rates of growth will be necessary in others where demand is less or of lower priority.

6. To achieve this general objective, the bids will need to be substantially scaled down eg to less than half the additions to baseline that have been sought for 1988-89; and all departments will need firm plans to offset pay bill and other cost pressures through sustained and incremental efficiency gains. The improved budgetary and management systems stemming from the financial management drive of recent years, the Government's large and continuing investment in new technology, and further improvements in purchasing as as well as the continuing processes of scrutiny and inspection must be used to deliver further improvement in performance, benefiting both input costs and outputs. On the input side, further improvements in the use of manpower and better control of non-manpower costs will be essential.

7. These efficiency gains will be easier to make on the necessary scale if they are planned for well in advance; and if the plans are ambitious there will be greater scope for flexibility in future years. It is proposed that all departments should now prepare or revise management plans committing them, over the Survey period, to the delivery of defined and wherever possible measured improvements in outputs, and progressive overall efficiency gains of at least 1½ per cent a year, with contingency plans for larger improvements in case they are necessary. This is a fair minimum target for well managed service organisations. These plans will be especially important for departments with large executive operations.

8. Departments' plans, and their implications for restraining growth in running costs would be discussed in the bilaterals. Agreement to increases over baseline, particularly for the last two years of the Survey, would be withheld until it was clear

that ambitious but realistic plans for efficiency gains over the medium-term had been made. In some cases this might mean that the final levels of provision for 1989-90 and 1990-91 would have to be held over until the next Survey.

Civil Service manpower

9. Earlier this year it was announced that manpower targets would not be set after 1 April 1988, and pressure on Civil Service numbers would be maintained through running costs. The proposed approach to running costs will mean large reductions in the manpower projections of some departments. It is important to show that the running costs regime is an effective control on all Civil Service resources, including manpower. There will otherwise be pressure to reintroduce manpower targets.

Conclusions

10. The Cabinet is invited to agree that:

i. the aim should be to restrain running costs over the Survey period to their present share in total public spending by offsetting so far as possible any real rises in pay and other costs through efficiency gains;

ii. departments should prepare or revise three-year management plans for sustained output and cost improvement, for discussion in the bilaterals;

iii. for 1988-89 the aim should be a reduction by at least half of the £761 million additional provision sought in order to keep the overall increase in running costs in line with the medium-term objective in (i) above.

ECONOMIC PROSPECTS

The economy has been growing steadily at a satisfactory rate for the past six years. With industry competing successfully in the home and international markets the prospect this year is for faster GDP growth than in recent years - more than expected at Budget time. The principal factors behind the more buoyant growth rate are strong export performance and successful competition with imports. Unemployment has continued to fall while inflation has remained close to the expected path. So far this year, the current account of the balance of payments has been in surplus.

(Subject to the figures on ~~Thursday~~ Wednesday. Some may need to change

2. Our prudent monetary and fiscal policies lie behind this successful performance. They have stabilised financial conditions, enabled us to avoid lurches of policy, and increased confidence in the UK as a base for investment. The reduction of public expenditure as a share of GDP over the past four years has been especially important. It has provided room for lowering the PSBR and adjusting to the loss of North Sea revenues, but we have made little progress in reducing the burden of non-North Sea taxation. We are also seeing, especially in rapidly growing manufacturing productivity, some effects from the measures taken over the past seven years to improve supply performance.

3. The growth rate this year is likely to be significantly above the average level of recent years, and we cannot count on it being sustained. There are definite risks. Abroad, the world economy could be more depressed than now envisaged. At home, pay settlements badly need to fall, not least in the public sector. Above all it is essential that the Government demonstrates its firm commitment to the financial policies that have brought this success and which alone can deliver declining inflation and the continuation of steady growth in the years ahead.

WORLD ECONOMY

4. The most obvious threat to continued steady UK growth comes from a weakening of demand and output in other major developed countries. Since the fall in oil prices at the beginning of 1986, output growth in the G7 economies has been disappointing. Last year weak world demand originated in the developing countries who, as a group, cut back their imports. More recently many of the strains seem to reflect slowness in adjusting to the sharp realignment of exchange rates. Domestic demand in the US is understandably weakening; while in Germany and Japan it is not rising fast enough to offset the adverse effects of currency appreciation on their exports. Their loss of export markets has been made more acute by the increasing shares taken by the newly industrialised countries, notably in South-East Asia, who with the exception of Taiwan have held their currencies steady against the dollar.

5. Inflation rates in the major economies have been reduced, much as expected. And there are now signs of some progress in correcting the large current account imbalances in the US, Japan and Germany. The risk of further turmoil in foreign exchange markets has been reduced - although not eliminated - by successful co-operation between the G7 countries. Following the agreement at the Louvre in February, the G7 countries have succeeded in stabilising their currencies by a combination of intervention and a greater willingness to adapt their monetary policies. And there have been some further steps in Germany and even more in Japan to support domestic demand and open markets. It is vital that these measures are sustained and strengthened. Further reductions in the US Budget deficit are also needed.

THE BRITISH ECONOMY

6. A summary of the most recent Treasury assessment is shown in ... the attached annex.

7. At home we have seen a continuation of what has by now become a familiar pattern of strong and steady growth coupled with low inflation.

8. A year ago there was concern in some quarters at the mild pause in growth between mid-1985 and mid-1986. In the event, despite disappointing growth abroad, performance at home has exceeded expectations. In the first quarter of this year GDP was just over 4 per cent higher than a year earlier.

9. The prospect is for continuing strong growth in 1987, with the outcome in the year as a whole likely to be closer to 4 per cent than the 3 per cent predicted at Budget time. Domestic demand growth is balanced, with fixed investment rising in line with the growth of consumers' expenditure. With growth in 1987 above the trend of recent years, it would not be surprising if the growth rate fell back a little next year.

10. This recent performance of output has contributed to a further rise in employment and in turn to the fastest recorded fall in unemployment since the War. This welcome fall in unemployment to below the three million mark has occurred at the same time as productivity growth in manufacturing has been exceptionally high by historical standards. Indeed increased industrial efficiency has been an essential factor in the greatly improved unemployment prospect. If overall growth continues at a steady and sustainable rate, even if somewhat lower than this year, there is every likelihood that the fall in unemployment will also continue.

11. We have always known that the UK, as a major oil producer, would not benefit as much from the fall in oil prices as the other major economies. The necessary fall in sterling during 1986 largely offset the beneficial impact on inflation of the lower oil prices. However, we are still on course to achieve the Budget forecast of 4 per cent inflation in the fourth quarter of this year, and the outcome could well be a littler lower. Nonetheless, this remains uncomfortably above the average rate in other major economies. It is essential that inflation is kept firmly on a downward path over the medium term.

12. So far, lower inflation has not been adequately reflected in lower pay settlements. The deceleration of private sector pay settlements in 1986 appears to have ended: indeed if anything they

may have begun to edge up. Some public sector settlements - notably by local authorities - could also set an unfortunate precedent for the private sector and will make it more difficult to control public finances. Pay increases need to be lower if the hard-won fall in unemployment is to continue.

13. The prospects for the current account of the balance of payments now look a little better than they did at the time of the Budget. Over the past year British companies have competed successfully in the home and international markets. In spite of subdued prospects for world trade and buoyant activity at home it now looks as if the current account this year will show a smaller deficit than the Budget forecast of £2½ billion (half a per cent of GDP).

14. Since the Louvre agreement towards the end of February, sterling has generally been very steady. Indeed, during April and May there was a pronounced tendency for the pound to strengthen. This was contained by reducing interest rates and intervening in the foreign exchange markets on a massive scale. As a result, the exchange rate has stayed within a very narrow range over the past 4-5 months. [This in turn has strengthened confidence within industry.] Gratuitous.

15. Nevertheless, financial markets are closely watching the behaviour of the economy, and in particular the outlook for inflation. They will also be alert to any signs of a loosening of the firm financial policies that have brought our current success.

DRAFT CABINET PAPER ON PUBLIC EXPENDITURE

(i) As last year, do not believe an increase in planning total can be avoided.

(ii) Do not believe that can repeat last year's tactic of "working within existing planning totals" and then announcing an increase at the end. After last year, colleagues will be seeking some indication of Treasury's thinking.

(iii) But do not want to name new planning totals in July:

- no economic context in which to place them;

- would require Parliamentary statement;

- uncertainties make it difficult to name figure which we can be sure of holding to;

- to announce figures we think can be held would whet departmental appetites.

(iv) Therefore propose that no decision be taken on planning toals but that policy of reducing public expenditure as a proportion of GDP, as set out in the PEWP, be reaffirmed.

(v) Thus, while likelihood of some increase is implicitly acknowledged, aim is to keep as small as possible and in any case subject to constraint of GGE/GDP ratio. Reference to "as set out in the White Paper" means must keep to White Paper percentages or better. Any decline, however small, is not acceptable. Survey is not open-ended.

(vi) Necessary to deflate expectations. Two devices for this:

a. paper deliberately maintains a number of areas where difficult policy savings should be explored;

b. paper stresses extent of prior claims eg agreed decisions, local authority current expenditure, social security estimating changes, need to hold back more for larger Reserves.

(vii) Some colleagues may argue that their programmes cannot contribute savings/scale back bids. Paper does not seek decisions, but seeks to keep open areas for further investigation. Attempts to gain exemption should be resisted. Meeting should not attempt to discuss substance of individual issues.

(viii) On nationalised industries, recommendation is straightforward. Important to leave open option of "challenging financial targets" for electricity.

(ix) On running costs, a modified approach is suggested. Running costs limits have proved an effective way of controlling departmental operating costs for the year immediately ahead; they avoid many of the distortions of manpower control and they fit better with the delegating budgting being developed in departments. But there is evidence that for years 2 and 3 they provide departments with a less clear signal than the old manpower targets and that the figures agreed for in the future years have become pretty unrealistic.

(x) The paper proposes that departments should commit themselves to medium-term plans to improve productivity by, say, 1½ per cent a year. But where departments fail to come up with medium-term efficiency plans, it might be necessary to hold over agreement on the final levels of provision in 1989-90 over 1990-91, until the next Survey. At the same time the Government would adopt a more realistic objective for running costs, ie that they should rise in line with public expenditure as a whole or about 1 per cent a year in real terms. Previously the objective has been to keep running costs constant in real terms, while the outcome has been growth of 1¼ per cent. This represents a convergence of setting a more realistic target with an effort to secure improvement on what has been achieved in the past.

(xi) As on previous occasions, Cabinet would be asked to agree a line to be issued to the Lobby (and to be used by the Prime Minister if necessary at Questions). A draft is attached, together with suggested responses to immediate questions.

BRIEFING FOR NO 10

Line

The Cabinet had its usual July discussion of public expenditure today. It reaffirmed the policy that public expenditure should continue to take a declining share of national income, as set out in the last Public Expenditure White Paper. Within that constraint, the Chief Secretary will hold bilateral discussions in the Autumn. In the light of these, the Government will review both the individual spending programmes and the planned totals for spending and will, as usual, announce decisions in the Autumn Statement in November.

Text

"My Government ... will maintain firm control of public expenditure so that it continues to fall as a proportion of national income and permits further reductions in the burden of taxation." - Queen's Speech.

Will the planning totals be increased?

I cannot tell you whether the totals will be changed, or if so by how much, or where the money will go. None of that is decided.

There may be some change in the totals, but if so - and I stress that it is not decided - the Government will keep as close to them as possible and will in any case not exceed the White Paper percentages of GDP.

The policy that public expenditure declines as a proportion of GDP is not just an aspiration. It is what we have achieved since 1982-83.

Why might you allow an increase?

I am not saying we will. It is restraint which has brought success. There will be no let-up in the Government's rigorous approach. And we will continue to plan expenditure on a cautious view of what we can afford.

But the strength of the economy is there for all to see, though it would be unwise to plan public expenditure on the basis that it will continue to grow at this year's growth rate.

Why no decision?

Cabinet has decided to stick firmly to the policy.

Final decisions will be taken, as always, when:

- there has been further assessment of the needs of particular programmes;

- we have further information on the prospects for the economy and so on what we can afford.