



Treasury Chambers, Parliament Street, SW1P 3AG

Paul Gray Esq
Private Secretary
10 Downing Street
London
SW1

RA

5 July 1989

Dear Paul

I attach the Chief Secretary's paper for next Wednesday's Cabinet. I should be most grateful to know by this Friday whether the Prime Minister is content for the paper to be circulated.

Yours
Camps

MISS C EVANS
Private Secretary

SECRETB B *AKJ b*THIS DOCUMENT IS THE PROPERTY OF HER BRITANNIC MAJESTY'S
GOVERNMENTC(89)
July 1989

COPY NO

CABINET1989 PUBLIC EXPENDITURE SURVEYMemorandum by the Chief Secretary, Treasury

Public expenditure restraint has been a key instrument of our economic strategy over the past ten years. One of our major achievements has been to reverse decisively the upward trend in the share of national income taken by public expenditure. We have been helped recently by very strong economic growth which last year contributed to substantial savings, thus enabling us both to increase provision on key programmes, and to maintain a modest decline in the ratio of Government spending to GDP over the Survey period.

2. This year, as the Chancellor's paper points out, the economic situation carries clear risks. Bringing inflation down must continue to be our first priority. Our success in controlling expenditure has contributed to a tightening in the fiscal position, which we cannot afford to undermine. The present fiscal surplus is likely to be eroded as economic growth moderates. Against this background, any perception that we were weakening in our resolve to control public expenditure would be extremely damaging, not least to market confidence.

3. We face a difficult Survey. Commitments we have collectively undertaken since last year's plans were agreed have pre-empted our room for manoeuvre. Existing plans already take credit for the effects of recent strong growth: and we cannot expect a repeat of last year's savings through extra receipts. Higher inflation will add to demand-led programmes. Elsewhere, we must adhere to the presumption underlying cash planning that inflation is not automatically accommodated.

1

SECRET

The baseline

4. The plans we agreed last Autumn included very sharp increases for some key programmes. These plans provide the starting point for this Survey, which will be conducted using a new definition of the planning total. The methods of setting the baselines for those items affected by the change in definition were endorsed by Cabinet in March. General government expenditure is unaffected by the change to the planning total.

The bids

5. My minute of 6 July to the Prime Minister summarised the bids received from Departments. In addition we must take account of territorial block consequences, the nationalised industries, net contributions to the EC, and the Revenue Support Grant and non-domestic rate elements of Aggregate Exchequer Finance for local authorities. Additions to expenditure financed by local authorities from their own resources are outside the planning total, on the new definition, but they will still increase general government expenditure.

6. The bids imply a total increase in spending that would be irresponsible in present circumstances and probably unsustainable in the future. It would mean the first sharp increase in the share of public expenditure in national income since the beginning of the decade. This would be seen as a complete reversal of our policy of restraining the growth in public spending, and would be particularly damaging at a time when private spending is being held back by the measures needed to reduce inflation. It would mean that, for the foreseeable future, there would be no chance of reducing the tax burden as a proportion of national income, still less of getting back to the level we inherited ten years ago. This would be seen as another significant shift in policy.

7. In current economic conditions it would also cast doubt, in financial markets and more generally, on our commitment to prudent fiscal policies, and the defeat of inflation. This would provide

the worst possible basis for bringing the economy back on course before the end of this Parliament, and run a real risk that we would be forced into a painful retrenchment.

8. The only prudent course is to uphold present policy and maintain the downward trend in the ratio of total public expenditure (excluding privatisation proceeds) to GDP, and hold as close as possible to existing plans. This will leave very little room for additional spending, even on priority programmes. Commitments to expenditure made since last Autumn, together with the probable cost of statutory Social Security upratings, will more than exhaust the likely scope for drawing down the Reserve in November. The bids will need to be severely cut back, and we shall need to scrutinise Departments' baselines rigorously for policy and other savings to offset any increases that are unavoidable.

9. We shall also need to look closely at the bids for additional capital spending. The baselines already allow for some very large increases in public sector investment, much of it on construction. If we were to agree additions on the scale implied by the bids, the public sector's demands on the construction industry would rise by some 25% between this year and next. The Chancellor's paper notes worrying symptoms of capacity constraints in the construction industry, where prices are already rising too fast. Adding to the demands on the industry would mean higher imports and further pressure on prices and earnings. Fuelling inflation in this way would be damaging to our wider economic objectives. It would also mean poor value for money. The bids will need to be scaled back drastically and higher priority projects staged, to produce a growth in total public investment which takes realistic account of the capacity of the supplying industries, as well as the usual considerations of affordability.

Aggregate Exchequer Finance for local authorities

10. E(LF) has now decided on the level of central Government support for local authority current expenditure for 1990-91 in England. The settlement is designed to put downward pressure on

local authority spending, while allowing local councils to set Community Charges at around this year's average per capita rate bill, if they budget sensibly. While respecting the need for public expenditure restraint this year, this decision has added £1 billion to the public expenditure planning total and therefore clearly pre-empts the room for adding to other expenditure in the remainder of the Survey.

Running Costs

11. Running costs bids exceed £800 million, with many colleagues seeking to re-open three year running cost agreements. If the bids were agreed in full, spending on the Civil Service would rise in 1990-91 by 10% or more over this year, with further significant rises in the later years.

12. I shall be urging colleagues to look for other savings within running costs to absorb the cost of pay settlements. Further savings will be needed if we are to support high priority policies including "spend to save" initiatives such as relocation, at the same time as providing realistically for future pay settlements. I am not yet satisfied with the cost improvement proposals for some areas of the Civil Service, particularly where there are large executive operations.

13. If our management of the Civil Service is to remain consistent with our wider expenditure and economic objectives, large reductions in bids and more ambitious plans to contain costs and improve efficiency will be necessary.

Nationalised Industries

14. All of the main nationalised industries have put in very large additional bids. In scrutinising their revised bids, which are due later this month, we must make substantial reductions and bring them to realistic levels, taking account of other major bids which add to demand on the construction industry. Where large projects are involved, we must be alive to the longer term implications for future Surveys. The electricity industries will

be privatised early in the Survey period, but we should continue to examine their plans rigorously in this Survey, bearing in mind the implications for public expenditure while they remain within the public sector, and for proceeds when they are privatised.

Conclusions

15. I ask the Cabinet:

- i. to agree that we should maintain the downward trend in the ratio of public spending (excluding privatisation proceeds) to GDP, and hold as close as possible to existing plans.
- ii. to agree that spending on the Civil Service should be substantially lower than implied in running cost bids, and that we should look for more ambitious plans to contain costs and improve efficiency.
- iii. to note that, to secure these objectives, bids for expenditure and running costs must be cut back, additional capital spending phased, and offsetting savings found in many areas.
- iv. to agree that we should aim for substantial reductions in the additional bids from the nationalised industries.
- v. to agree that I should now conduct bilaterals with colleagues on their spending programmes; and to note that if it proves impossible to reach agreement in the bilaterals, it might be necessary at the appropriate time to establish a small group which would consider outstanding issues and make recommendations to the Cabinet.

JM

TREASURY CHAMBERS

JULY 1989