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Treasury Chambers, Parliament Street SW1P 3AG

Paul Gray Esq
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2 April 1990

Dear Paul

PROSPECTS FOR 1990 SURVEY

I attach for the Prime Minister's meeting with the Chancellor and the Chief Secretary on Wednesday:

- a first assessment of prospects for the 1990 Survey;
- a draft minute from the Chief Secretary to the Prime Minister warning Cabinet colleagues of the pressures in prospect.

Yours

Carys Evans

MISS C EVANS
Private Secretary

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PROSPECTS FOR 1990 SURVEY

This note provides a first assessment of the prospects for the 1990 Survey, in the light of the revised economic and expenditure projections shown in the Budget Red Book. The outlook is highly uncertain at this stage, particularly for individual programmes, but it is already clear that the 1990 Survey will be exceptionally difficult.

1990 Red Book projections

2. The Budget Red Book contained a fresh estimate of the 1989-90 outturn and revised expenditure projections for the period 1990-91 to 1993-94. For 1989-90, we now expect a £2.3 billion overspend on the planning total, reflecting massive overspending by local authorities (the planning total for this year was set and monitored on the old definition). The ratio of GGE (excluding privatisation proceeds) to GDP may be 39 per cent, ¼ per cent above the estimate in the 1989 Autumn Statement.

3. As usual, projections for later years of expenditure within the planning totals were the figures decided in the 1989 Survey and published in the Autumn Statement. Other items outside the planning total but within general government expenditure (GGE), such as debt interest, were revised to take account of new information. This year, for the first time, we were able to take account of local authority budgets for the year ahead (since local authority self-financed expenditure has now been taken outside the planning total).

4. As a result, the projected level of general government expenditure was increased as follows (compared with the Autumn Statement):

£ billion	1991-92	1992-93
Planning total	-	-
Local authority self-financed	2	2½
Debt interest & other adjustments	1	1½
GGE (ex priv proc)	3	4

5. Projected inflation was also significantly increased:

% change	1990-91	1991-92	1992-93
GDP deflator			
1990 PEWP	5	3½	3
1990 FSBR	6½	4¾	3½

The (unpublished) forecast of the RPI in September 1990 is 8½ per cent, compared with 6½ per cent in the Autumn Statement.

6. As a result of higher projected money GDP, the additions to expenditure were consistent with the same ratios as published in the Autumn Statement:-

General Government Expenditure (excl. priv. proceeds) as % of GDP

1989-90	1990-91	1991-92	1992-93	1993-94
39	39	38¾	38½	38¼

Note : ratios are adjusted for the distortion to GDP caused by the abolition of domestic rates.

7. Existing plans therefore imply no change in the GGE ratio in 1990-91, and a very modest decline thereafter. But this apparently satisfactory position disguises the fact that the GDP figures have been adjusted for higher inflation, while those for the planning total have not.

8. This is the starting point for the next Survey.

Pressures on the Reserves in 1991-92 and 1992-93

9. The planning totals for the first two years of the new Survey include Reserves of £6/9 billion. But the scope for drawing them down (say £3 billion in each year) is already more than fully committed. The estimates for community charge benefit in the Autumn Statement were based on the community charge for standard

spending. Actual community charges are some £70 higher. The cost of meeting this excess will be a major claim on the Reserves for future years. On top of that, our present view is that a further £2-3 billion a year will be needed to finance policy decisions that have already been announced, and the consequences for demand-led (mostly social security) programmes of revised economic assumptions.

	1991-92	1992-93
Commitments (eg 1989 Health Review bodies; Jubilee Line; war widows; Budget measures)	1	1¼
Community charge benefit	¾	¾
Revised economic assumptions	1½	2½
	3½'	4½

/6bn

This means that any further additions to plans will increase the planning totals, unless we can find substantial offsetting savings. They will also add to GGE, though not necessarily by the same amount. And any additions to GGE will jeopardise our chances of keeping the ratios on a downward trend.

Main threats

10. Any assessment of the possible outcome of Survey negotiations must be extremely uncertain at this stage. But there are three main areas where substantial increases look almost inevitable: local authorities, health and transport/nationalised industries. In addition, we will come under great pressure to concede more for housing, the environment and education. The main areas where we might look for significant savings are Defence and Employment (again). Achieving another child benefit freeze will be difficult.

11. Our present assessment of the main threats is as follows:

(i) Local authorities. Given the uncertainties, there is little that can usefully be said at this stage. The baseline shows an increase in Aggregate Exchequer Finance (AEF) of around £1¾ billion (GB) between 1990-91 and 1991-92. As an illustrative figure, if it were desired to hold average community charges constant in cash terms, this might mean additions to baseline of around £3 billion (GB). There would be no offsetting savings in community charge benefit: the figures shown above assume an average charge of £350 (GB) throughout the Survey period. The extra AEF would add directly to the planning total: the effect on GGE would depend on how local authorities responded, and what measures could be taken to restrain their spending.

(ii) Health. The Department will argue that large sums of money will be needed just to stand still. The staged 1989 Health Review body awards represent a prior commitment of around £½ billion a year. A further £¼ billion a year will be needed just to cover NHS Trust interest charges and VAT on hospital construction. And it will be argued that a generous settlement is needed to float the NHS Reforms. Additions of £1/1¼ billion, on top of Review body costs, would represent a rather tougher outcome than last year's settlement.

(iii) Transport and nationalised industries. The main hazards are deteriorating performance (due to economic conditions), which may affect British Coal as well as the transport industries; extra spending on rail safety; the cost of the expanded roads programme; and ambitious new rail projects. The sums at stake are highly uncertain, but even a tough outcome might involve additions of at least £¾/1 billion (including Coal).

12. These three areas alone could therefore imply additions to the planning total of around £5 billion a year. A fuller assessment, taking account of other possible additions (and some savings) suggests total additions of about £6/7½ billion. This could imply a rise in the GGE ratio to 39½ per cent in 1991-92, with no decline thereafter. These additions have to be seen against the fiscal adjustment shown in the Red Book of only £1 billion in 1991-92.

Conclusion

13. The broad message of this note is as follows:

- The GGE ratios in the FSBR show only the most modest decline over the Survey period, but this is on the assumption that we hold to the planning totals set out in the PEWP.

- The scope for drawing down Reserves over the Survey period has already been more than exhausted by the effects of higher inflation and community charges on demand-led programmes and commitments already entered into.

- Any further additions to plans will therefore add to planning totals, and to GGE (though not necessarily to the same extent, depending what measures can be taken to restrain local authority spending).

14. The policy implications are uncomfortable: the larger the AEF settlement, the less the room for other priority programmes, within an outcome which can be credibly presented as consistent with the Government's objectives for public spending and fiscal policy. And there are great pressures elsewhere, not least as a result of higher inflation.

HM Treasury
2 April 1990

DRAFT

FROM: CHIEF SECRETARY
DATE:

PRIME MINISTER

At Cabinet on 15 March, John Major warned that a number of developments would put acute pressure on present spending plans and reminded colleagues of the absolute importance to the Government's economic strategy of ensuring firm control of public expenditure. Colleagues may find it helpful to see how this looks before we get into the annual Survey round.

2. As John Major has repeatedly indicated, we cannot afford to take risks with inflation. A tight fiscal policy, in support of monetary policy, will be essential if we are to get inflation down and keep it down. Within that tight fiscal policy, we need to make progress, as soon as it is prudent to do so, towards encouraging enterprise by reducing the disincentive effects of taxation.

3. Public expenditure restraint has thus been a central element in our economic strategy for the past decade. We have brought down the ratio of public spending to national income, by 7 percentage points in 5 years. The extent of this fall reflected the exceptional strength of the economy, and a temporary pause, or even a small rise, is to be expected as the economy slows. This year's overspend led to a small rise in the ratio from the low level reached in 1988-89, and has caused some commentators to question our resolve to maintain

firm control over spending. But that makes it all the more important that we should continue to plan for a resumed if gradual decline over the medium-term.

4. What are the prospects? First, the planning total in the financial year just ending, 1989-90, has been overshot by nearly £2½ billion, the largest such overspend for 5 years. It is more than £1 billion higher than expected than when the Public Expenditure White Paper was published in January. Local authority overspending, particularly on capital account, has played a big part in this.

5. The coming year's planning total, which excludes local authority self-financed expenditure, includes a Reserve of £3 billion. Already £700 million of this is pre-empted by extra community charge benefit, due to local authorities setting community charges far above the Government's standard spending guideline level. This is on top of other agreed commitments, such as the health review body awards and the Jubilee Line. We start therefore with big claims on the Reserve before the year begins. If we are to retain confidence in the control process, after last year's unsatisfactory performance, we must keep within the Reserve we have published.

6. Looking beyond that to the Survey years, we can already foresee some serious pressures. The fiscal projections in the Budget Red Book show the limited room for manoeuvre if we are to achieve even a minimal rate of decline in the ratio over

the medium term. Total local authority spending has been marked up sharply in 1990-91, by about £2¼ billion and £3 billion in each of the two following years but even so, the resulting projections allow for barely any real growth in this spending over the Survey period. And the lower PSDR means that we can take less credit than we previously expected from falling debt interest.

7. The fiscal projections also start from the assumption that we keep within the overall planning totals agreed last Autumn. To achieve that, only a very limited amount can be released from the Reserves in each successive Survey. Colleagues should be aware, however, that the claims already conceded for 1990-91 together with the effect of the latest inflation forecasts on indexed benefits, have already pre-empted the scope for drawing down the Reserve over the Survey period.

8. I must ask colleagues to have this exceptionally difficult background in mind when considering whether they need to submit bids in the 1990 Survey, and also when we come to consider the level of grants to local authorities. The baseline for the Survey already contains a real increase in programmes of 6 per cent between 1989-90 and 1991-92, well in excess of the likely economic growth over the same period. The scope for any increases in present programme plans will be extremely restricted for the reasons I have outlined, unless comparable savings can be found elsewhere.

9. As you said at Cabinet, the continued successful control of public expenditure is central to the Government's reputation for sound economic management, and we must ensure that this reputation is maintained.

10. I am copying this minute to Cabinet colleagues Richard Luce, Lynda Chalker, Patrick Mayhew and Peter Fraser, and to Sir Robin Butler.