SUBJECT cc MASTER

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From the Private Secretary

20 June 1990

Dear John,

CHANCELLOR'S BILATERAL: THE PUBLIC EXPENDITURE SURVEY

The Chancellor discussed the outlook for the public expenditure survey with the Prime Minister and the Chief Secretary yesterday evening.

I should be grateful if circulation of this letter could be confined only to those people with a strict need to know.

The Chief Secretary said that the bids submitted by Departments were huge: taking into account estimates for bids not yet received and consequentials in the territories, they amounted to £16 billion in the first year. That was much more in cash terms than last year's bid and represented an 8% increase on the baseline. The bids for later years represented 10% and 12% cash increases.

It would not be possible to reject all of the bids. Some represented inescapable policy commitments. Others flowed from well-known political problems - notably extra AEF to keep down community charges. And others reflected movements in interest rates and inflation. But some bids - for example those from DES and the Department of Employment - were simply unreasonably high.

The figures in his minute had been prepared before the uprating of the economic assumptions: this would affect both the base price level for this year and the inflation estimate for next year. But, whereas the projected GDE:GDP ratio in the FSBR for 1991-92 had been 38½%, the likely survey outcome would lead to a figure of $39^3/_4$% or 40%. In part this reflected cyclical factors and the slowdown in the economy.

The Chief Secretary then described the main bids and particular difficulties to be faced in the survey.

a) Department of Health, Department of Social Security and DOE had all submitted bids exceeding £2 billion. DOE were seeking increases for the Housing Corporation, the Urban Programme and green issues at the same time as a massive unspecified bid for AEF. It would be important to persuade DOE that they could not have both a reasonable settlement on AEF and the additions they were seeking for the other programmes.

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b) The DES bid represented a 16% cash increase on the baseline figure: much of it was directed towards capital spending on the polytechnics, universities and schools. The bid would have to be squeezed back substantially. The bid from DEm represented an attempt to recoup the savings secured in PES discussions last year: in the Treasury's view there was considerable slack still in the DEm baseline.

c) At first sight the Department of Transport bid had looked modest - an extra £200 million for the roads programme in the first year. However, when the additional bids still to come from LRT and BR were taken into account, the Department of Transport total bid might also be of the order of £2 billion. Despite the attractions of more money for capital projects, bids across the board on all transport programmes could not be accommodated.

d) The introduction of the health service reforms posed particular risks for the DH budget. First, Mr. Clarke was seeking additional resources to meet the direct costs of the review. Second, he would argue that extra resources were necessary to maintain services; any closures would inevitably be attributed to the reforms. Thirdly, there was a danger of further resources being sought in-year if ward closures etc. were threatened.

d) Finally, the defence programme seemed to offer scope for reductions. The announcement that the order for Tornado fighter aircraft had been cancelled for this year had created an expectation that there would be further cuts. It was important to build on this announcement in order to achieve cuts that would provide scope for accommodating inevitable increases in spending elsewhere.

The Prime Minister said that colleagues in spending Departments were not taking the public spending position sufficiently seriously. Despite the earlier Cabinet discussion, the bids had been much too high. The Treasury would have to be even firmer in dealing with these bids than might have been expected. It would be important to prune back the bids as vigorously as possible.

The Chancellor said that the Treasury would be making the maximum efforts to keep the addition to the baseline down to the very minimum that was politically acceptable. But it was important to recognise that there would still be a considerable addition to the planning total for next year to take account of higher inflation and inescapable policy commitments.

The following points were also made in discussion:

i) The PSBR figure for the first two months of this year was large and rather worrying. Part of the explanation

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lay in higher Government grants to local authorities; and, despite that, the local authorities themselves had borrowed more heavily. It would be important to see whether privatisation proceeds next year might be boosted. One attractive candidate was a further sale of BT shares. This would have to await the outcome of the Duopoly Review - and that argued for accelerating the Review as far as possible. It would be attractive to sell BT shares on a wider basis since this would make it more difficult to renationalise the company in the future.

ii) Running costs bids in general were much too high. In particular the DSS bid was substantial although this was partly for historical reasons. The MOD running costs bid had yet to be received but was also likely to be large. There were attractions in a more vigorous examination of Departments' management and running costs systems, perhaps bringing in outside expertise.

iii) It was important to appreciate how tough the decisions might have to be in order to keep down the addition to the planning total to the sort of figures indicated in the Chief Secretary's minute. The measures necessary would include a further freeze on child benefit; dropping the building of three prisons from the Home Office programme; and a sharp squeeze on local authority capital spending including that for school buildings.

iv) In order to achieve even deeper cuts it would be necessary to contemplate freezing unemployment benefit; an outright ban on police recruitment; and cutting provision for TECs.

v) The health service was a particularly difficult problem. The Health Secretary had shown no inclination to move away from his existing plans. A means needed to be found to assess whether the health authorities were sufficiently well prepared to take on the reforms without damaging political and financial consequences; or whether, as the outcome of the previous week's seminar had suggested, the Health Secretary should prepare plans for implementing the reforms at a slower pace and on a smaller scale.

vi) The September RPI was critical in terms of the impact on public expenditure. Treasury officials should investigate whether it was possible to avoid administered price increases adding to the September RPI.

vii) The future of community care was not yet resolved. It might be difficult to expect the Health Secretary to accept both that the transfer of community care to local authorities should be delayed and the introduction of the NHS reforms slowed down. The latter seemed a more important priority.

viii) The Government could not afford to put more money into AEF or allow the local authorities to take over community care responsibilities, unless and until measures were in place to ensure that the extra AEF did not leak into higher spending.

ix) Clearly it was difficult to cut defence spending in the short term. Some options could however be investigated including closures of research establishments, training areas etc.; and sales of MOD land to boost capital receipts.

x) One option for saving around £1 billion over three years was not to proceed with Sizewell B. But there were environmental and wider advantages in building the PWR reactor at Sizewell.

Summing up the discussion the Prime Minister said that the bids submitted were unacceptably large and would have to be scaled down substantially. Two main priorities were AEF and the health service reforms: any substantial addition to AEF could only go forward once the Government was satisfied that the extra grant would go to keep down community charges, not add to total public spending. Further steps should be taken to check on the preparation amongst health authorities for introduction of the NHS reforms. Unless Treasury colleagues were satisfied that the authorities could implement the reforms without serious political and financial damage, the Health Secretary should be required to prepare plans for slowing the introduction of the reforms.

While some addition to the baseline was inevitable, it was agreed that the Chief Secretary should make maximum practical efforts to minimise the size of the addition. Some difficult decisions would have to be taken. Savings should be secured from the Urban Programme; and there was a case for no addition to the resources of the Housing Corporation, which appeared to be an inefficient organisation. The size of some additions to the planning total was linked to the Rossi Index: and the September RPI figure would determine the size and cost of uprating benefits. The Treasury should investigate whether there was any scope in practice for keeping down the size of the September RPI figure. Particular attention should be paid to keeping down increases in running costs and in withstanding the huge bids from DES and DEm. The scope for cutting the DEm baseline, for example by tougher measures on the Restart programme, should be investigated. Measures to increase privatisation proceeds, for example by the sale of more shares in BT was also an attractive prospect.

The Chief Secretary should now write to colleagues as proposed. The agenda letters should be circulated after the addition to the AEF baseline had been agreed; spending Departments would be asked to identify how 5% savings could be secured on their baselines.

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I am copying this letter to Carys Evans (Chief Secretary's Office).

Yours ever,

Barry

BARRY H. POTTER

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HM Treasury.