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EM

Treasury Chambers, Parliament Street, SW1P 3AG  
01-233 3000

29 March 1985

Charles Powell Esq  
10 Downing Street  
LONDON  
SW1

*Dear Charles,*

**THE FOREIGN OFFICE PROGRAMME: DIPLOMATIC WING**

In his letter of 13 February Andrew Turnbull recorded that the Prime Minister had raised the question of the impact of exchange rate movements on the FCO (Diplomatic Wing) programme. Sir Peter Middleton and Sir Antony Acland have now agreed the attached report on the current arrangements for dealing with overseas price movements and on the points of differences between the FCO and the Treasury

I am copying this letter to Len Appleyard (FCO).

*Yours ever  
Rachel*

MRS R LOMAX  
Principal Private Secretary

## THE FCO DIPLOMATIC WING PROGRAMME: OVERSEAS PRICE EFFECT

BACKGROUND

Since 1982-83 the combined effect of exchange rate and overseas inflation movements - the 'overseas price effect (OPE)' - has been disadvantageous to FCO. Nearly 40% of the FCO Diplomatic Wing's provision of about £600 million is affected. The breakdown by activities is given in Annex A. The breakdown by votes is as follows:-

	Total (1985-86) £ million	Affected by OPE £ million	%
II.1 - Overseas representation	384	165	43
II.2 - International subscriptions	84	50	60
II.3 - BBC External Services	88	7	8
II.4 - British Council (2/3 of basic budget - balance comes from ODA)	48	17	35
	<u>604</u>	<u>239</u>	<u>39</u>

2. The letter of 23 July 1984 from the Prime Minister's Private Secretary said "Additional bids as a result of exchange rate changes should be treated as reflecting revised economic assumptions rather than policy changes. This treatment should not prejudice finding some offsetting savings if possible".

Treasury and FCO subsequently agreed to an arrangement described in the Foreign and Commonwealth Secretary's observations to the Select Committee on Foreign Affairs (Cmnd 9367 of October 1984) - Annex B.

3. There is agreement:

- (a) on how to measure the overseas price effect;
- (b) on the procedure for dealing with the effects of overseas price movements in the year in which they occur.

4. The continuing areas of disagreement are:

- (a) the outcome of the 1984 Survey as it affects 1986-87 and 1987-88.
- (b) the treatment of adverse overseas price movements in future Public Expenditure Surveys; in particular, whether in-year compensation should automatically be carried forward into future years, subject only to offsetting savings as defined in paragraph 7 below.

ADJUSTMENTS WITHIN ONE YEAR

5. The in-year arrangements worked satisfactorily in 1983-84 and 1984-85. For 1983-84 an overseas price effect of £8.7 million was identified. This was met mainly by agreed one-off savings - mostly extra receipts and unavoidable postponements of BBC transmitter projects. For 1984-85 the effect was £15.2 million and was met again by agreement from similar offsetting savings within FCO programmes and £9 million from the central Reserve for that year only. If the effect in both 1983-84 and 1984-85 had been carried forward, the cumulative amount would have been £25.4 million in 1986-87 and £26.0 million in 1987-88 (subject to further adjustment for recent currency changes).

FUTURE PES TREATMENT - "THE LONG TERM PROBLEM"

6. Both departments agree that, from now on, in years when the overseas price effect is favourable this should be shown as a reduced requirement for future years in the ensuing Public Expenditure Survey. The Foreign Secretary is conscious that in 1979-80 to 1981-82, when he was Chancellor, FCO surrendered underspends totalling £62 million; no reductions in baseline were made, but this was under the old volume planning system.

The FCO View

7. FCO believes that the obverse of this coin should be the consolidation into the baseline of any adverse price effect measured during the year up to the October of the Survey in question. The FCO will of course always look for offsetting savings and in its view already makes available the results of a sustained search for economies. But offsetting savings should not be such as to conflict with "the Government's foreign policy requirements" as defined for in-year purposes in Cmnd 9367 (see Annex B). Without some predictable system of adjusting the baseline sensible planning would be impossible and FCO resources would be cumulatively reduced by the vagaries of overseas price movements, so long as their net effect is adverse - as in recent years.

8. The UK's success in controlling inflation compared to other countries', combined with a particular additional price effect for the goods and services which FCO buys abroad (such as rents, maintenance and local staff salaries) suggests, in the FCO's view, that even if the sterling index remains constant, FCO now faces an adverse cumulative trend of about £10 million a year. Exchange rate and overseas inflation developments since the last base date in October 1984 may add a further requirement of about £15-20 million during 1985-86 if sterling remains at its present level.

The Treasury View

9. In the Treasury view it has not been established that the FCO faces any long-term adverse effect from overseas price movements. Nevertheless Treasury accept that any adverse effect which does occur at a particular time should be treated in PES as a changed economic assumption. This means that it becomes an additional bid (just as a favourable effect is a reduced requirement) and is fully taken into account in the Survey. As with increases in demand-led programmes, however, this does not mean that an addition to the baseline of any particular amount should necessarily be granted. Account should also be taken of the Government's overall public expenditure targets, the other additional bids being made both by the FCO and other departments and the scope for off-setting savings. As with all other departments, it should be open to Ministers to consider planned reductions over the PES period if the public expenditure situation requires this. The PES is the only forum in which the needs of the FCO can be considered alongside those of other departments. No department can have an assurance that any part of its forward plans will always be implemented regardless of the economic situation. The FCO can in the Treasury's view, however, reduce the element of uncertainty in its planning by maintaining a sufficient margin of flexibility within its provision, as is necessary for all departments under a cash planning system rather than assume that its programme is fixed in volume terms and submit every small change thereafter as an additional bid. (There were 26 cash bids of an average size of around £2 million in the last PES). Thus the Treasury does not accept that there is a "long-term problem" which cannot be dealt with under existing arrangements.

THE 1984 SURVEY

10. In the 1984 Survey MISC 106 recommended settlement at baseline, subject to minor adjustments. This followed a failure in the bilateral discussions to reconcile the Treasury's proposals for reduction below baseline of the combined FCO/ODA programmes with the FCO's bids for additional funds. The MISC 106 recommendations were accepted by Cabinet without discussion. They required the overseas price effect of £25-26 million a year referred to above, together with any bids the Foreign Secretary regarded as essential (these in his view ranged from £13 million to £21 million a year) to be offset by savings from FCO programmes in the three survey years. At the time when this calculation was agreed, it was recognised in Ministerial meetings that any net savings required might be made by relatively modest reductions in the Aid figure of £1,130 million.

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11. The scale of subsequent parliamentary interest in aid in the light of the Ethiopian famine made it clear that this presented formidable political difficulties. In those circumstances the Chancellor agreed for 1985-86 only to add £9 million to the FCO's provision by rounding up the Autumn Statement figures and to make a further £9 million available if overseas price movements between October 1984 and October 1985 were not in the FCO's favour. The Chancellor made this concession with the intention that it would give the Foreign Secretary an additional year's breathing space in which to plan reductions to come within the baseline figures for 1986-87 and beyond. This left the remaining bids to be offset by certain cuts (including 10 post closures) which the Foreign Secretary announced to the House of Commons on 22 November 1984. These will have the effect of saving £11.3 million in 1986-87 in addition to £4.2 million savings identified during the Survey. The Foreign Secretary has not accepted that the addition agreed by the Chancellor should be for one year only since in his view the political difficulties which it was intended to avoid will be equally serious in later years.

The FCO View

12. In FCO's view there should be special emphasis on the nature of the £25.4m overseas price effect which has a much greater proportionate impact on the FCO than on other departments and whose impact continues into successive years. But the FCO does not consider it is trying to exempt itself from the normal PES procedure of seeking offsetting savings. It considers that the various cuts and other savings for 1986-87 (£15.5m) should be seen as offsetting its "ordinary" bids (£21.6m) which were designed mainly to maintain existing levels of service, eg by making up for certain home risen costs and postponed capital projects. (It is prepared to deal with the £6.1m balance separately in discussion with Treasury). Offsetting savings of this sort are what would rightly be expected of any department. But offsetting savings should only be set against the overseas price effect if that can be done without conflicting with the government's foreign policy requirements.

The Treasury View

13. In the Treasury's view, in reaching their decision that FCO programmes should be held at baseline, MISC 106 and Cabinet clearly rejected the FCO's "ordinary" bids for additional provision, along with the Chief Secretary's proposals for cuts below baseline. The majority of other departments' additional bids in the Survey were also rejected. While it would be open to the FCO, if

wished, to resubmit them in the 1985 Survey, they have no present validity. Therefore the £15.5m savings identified by the FCO so far are an offset in the Treasury's view to the £25.4m overseas price effect, leaving further savings of only £9.9 million to be found in 1986-87 and a similar amount in 1987-88. These differing viewpoints are summarised in Annex C.

#### THE IMPLICATIONS FOR UK REPRESENTATION OVERSEAS

##### The FCO View

14. In the FCO view there is no prospect of making the savings required without a policy decision to make major cuts in programmes or geographical coverage. Significant efficiency savings have been made and running costs are kept under close control by an inspection system which the Public Accounts Committee has welcomed. The Select Committee on Foreign Affairs' report of 4 July 1984 said "The squeeze on the Diplomatic Service manpower has probably gone far enough and additional significant reductions would only be made at the cost of accepting a reduced level and quality of service". The demand for consular and commercial services is rising. For example, FCO Consular Department's caseload increased 40% and market information enquiries 48% between 1980 and 1984.
15. FCO points out that its £284 million running costs (see Annex A) include about £22 million for GCHQ and other agencies and about £40 million represents work on behalf of other government departments but not charged to them; to take one example, in the Washington Embassy 20% of the costs of FCO-funded staff (themselves only 37% of the total UK staff) are in support of other departments. The FCO's capital programme of only £30 million must cover vehicles, computers, communications and £18 million for the overseas estate (including much needed security works). There is a £12 million maintenance backlog and a rent bill likely to rise by 10% each year unless more of the estate can be moved into owned property.
16. In the FCO's view, the room for manoeuvre in making further reductions in the FCO's £290 million programme expenditure (see Annex A) is very limited and in all cases there is likely to be strong parliamentary opposition. The only alternative to reduction in these programmes would be to close further posts in addition to the 10 announced last November or to reduce FCO functions and services to the public. The shortfall for 1986-87 of £25.4 million represents 8% of the cost of the Diplomatic Service, equivalent to the costs of the 98

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smallest FCO posts (out of 219); or 19 the size of Helsinki or Tel Aviv; or nearly two-fifths of all commercial work. (Staff in the 10 largest posts, cut by 10% in 1979, are the ones facing the greatest workloads). Reduction on this scale would do serious damage to our credibility as a country with world wide diplomatic capability in the eyes of the United States and other allies. It would do quite disproportionate damage to HMG's ability to conduct a global foreign policy and weaken our position as a trading nation. Diplomatic resources should be seen alongside resources for defence (up 10% in real terms between 1982-83 and 1985-86) and intelligence resources which have been increased over the coming PES period on the grounds that - Sir R. Armstrong's minute of 28 January - "at a time when the world becomes more dangerous rather than less and when the dangers to British interests increase rather than lessen ..... our defences must to a large extent depend on our intelligence effort".

The Treasury View

17. The Treasury takes a different view. As to the opinion of the Foreign Affairs Committee, it points out that most departmental Select Committees add to the pressure for expenditure increases. It believes that savings of the order required could be made without the need for a large number of post closures, by such measures as:

- (i) cuts in staff in line with that projected for the Home Civil Service over the period 1979 to 1988 concentrating on the larger missions overseas and staff based in the UK;
- (ii) in addition, a reduction in the staff training margin which is currently standing at 5.5% and is considerably higher than Treasury considers necessary to cope with hard language training and transfers between posts;
- (iii) charging for services, especially commercial work;
- (iv) housekeeping measures to reduce the cost of overheads and information services;
- (v) reductions in programme expenditure eg UNFICYP and military aid.

POINTS FOR DECISION BY MINISTERS

18. (a) Should the Cabinet decision on FCO programmes in the 1984 PES be reviewed? If so, should the FCO proposal that £25.4 and £26.0 million corresponding to the overseas price effect be added to the FCO PES baseline for 1986-87 and 1987-88 respectively be accepted in whole or in part?
- (b) In future Surveys should the PES baseline be adjusted fully up or down by the amount of the overseas price effect, subject only to offsetting savings as defined in paragraph 7 above? Or should overseas price movements be taken into account as reduced requirements or additional bids on the basis in paragraph 9?



FCO EXPENDITURE : BREAKDOWN BY ACTIVITY£ million  
(1985-86)

## (i) Programme Expenditure

British Council (Diplomatic Wing contributions)	48
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## (ii) Diplomatic Service

Capital	30
Running Costs	284
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EXTRACT FROM CMND 9367

"It has now been agreed that rises in expenditure resulting from exchange rate movements and differential inflation will be considered as requirements based on changed economic assumptions. Procedures are already in operation, and are being refined, to estimate as closely as possible what the magnitudes will be. In the short term period of any one financial year, Parliament will when necessary be invited by a Spring Supplementary Estimate to vote those resources which the Foreign and Commonwealth Office cannot find from offsetting savings acceptable to Ministers in the light of the Government's foreign policy requirements and its responsibilities for British interests overseas, including cultural interests. When overseas costs move favourably the windfall benefits will be surrendered to the Consolidated Fund. In fixing the longer term programmes of the Department in the Public Expenditure Survey, account will be taken of changes of economic assumptions up or down in setting the baseline for future years. Exactly the same arrangements will apply to the problem of the British Council's overseas risen costs."

## EXPENDITURE: BIDS AND SAVINGS

£ million

1986-87

1987-88

Costs

Overseas risen costs	1983-84	9.2	9.5
Overseas risen costs	1984-85	16.2	16.5
A. Total overseas risen costs		25.4	26.0
B. Other bids for which MISC 106 did not provide funds (see below)		21.6	21.3

Savings and Offsets

During Survey		4.2	3.7
C. Since Survey (see below)		11.3	11.9
D. Total		15.5	15.6
E. <u>Balance*</u> :			
Treasury view (A-D)		9.9	10.4
FCO view (A)		25.4	26.0

## Notes

B OTHER BIDS CONSIDERED  
ESSENTIAL BY FCO  
(1986-87 BREAKDOWN)C SAVINGS AGREED SINCE 1984 SURVEY  
(1986-87 BREAKDOWN)

	£ million		£ million
Other British Council risen costs	1.6	COI cut	1.5
BBC, mainly audibility	8.4	BBC absorbing some risen costs	1.4
PSA's excess PRS charges	3.8	British Council absorbing some risen costs	1.2
Moscow Embassy	2.0	Rephasing FOLIOS	1.6
Security Works	1.4	Post closures	1.1
FOLIOS electronic office	3.2	Military training cut	0.5
One-off items, eg EC Presidency	1.2	Further aid contributions to British Council	1.0
		Miscellaneous economies	1.4
		Entry Certificates:	
		New charge	1.6
	21.6		11.3

\*E. In 1985-86 the balance was met by the aid carry-over of £6.2 million, savings agreed since the Survey of £9.3 million and the Chancellor's addition of £18 million (subject to overseas costs not moving in FCO's favour). For 1986-87 FCO plan to deal with the balance between Line B and Line D (£6.1 million) in separate discussions with the Treasury on the funding of the BBC External Services.

THE FCO DIPLOMATIC WING PROGRAMME: OVERSEAS PRICE EFFECT

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£ million

## FCO EXPENDITURE: BIDS AND SAVINGS

	1986-87	1987-88
<u>Costs</u>		
Overseas risen costs 1983-84	9.2	9.5
Overseas risen costs 1984-85	16.2	15.5
A. Total overseas risen costs	25.4	25.0
B. Other bids for which MISC 106 did not provide funds (see below)	21.6	21.3
<u>Savings and Offsets</u>		
During Survey	4.2	3.7
C. Since Survey (see below)	11.3	11.9
D. Total	15.5	15.6
E. <u>Balance*</u> :		
Treasury view (A-D)	9.9	10.4
FCO view (A)	25.4	26.0

## Notes

B OTHER BIDS CONSIDERED  
ESSENTIAL BY FCO  
(1986-87 BREAKDOWN)

	£ million
Other British Council risen costs	1.6
BBC, mainly audibility	8.4
PSA's excess PRS charges	3.8
Moscow Embassy	2.0
Security Works	1.4
FOLIOS electronic office	3.2
One-off items, eg EC Presidency	1.2
	<u>21.6</u>

C SAVINGS AGREED SINCE 1984 SURVEY  
(1986-87 BREAKDOWN)

	£ million
COI cut	1.5
BBC absorbing some risen costs	1.4
British Council absorbing some risen costs	1.2
Rephasing FOLIOS	1.6
Post closures	1.1
Military training cut	0.5
Further aid contributions to British Council	1.0
Miscellaneous economies	1.4
Entry Certificates:	
New charge	1.6
	<u>11.3</u>

\*E. In 1985-86 the balance was met by the aid carry-over of £6.2 million, savings agreed since the Survey of £9.3 million and the Chancellor's addition of £18 million (subject to overseas costs not moving in FCO's favour). For 1985-87 FCO plan to deal with the balance between Line B and Line D (£6.1 million) in separate discussions with the Treasury on the funding of the BBC External Services.

Foreign PA 12

Strategy

12 11 10 9 8 7 6 5 4 3 2 1

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