

CONFIDENTIAL

PRIME MINISTER

cc Mr. Ingham

PUBLIC EXPENDITURE

The papers are

- A. Cabinet Office brief
- B. Speaking note for your use in opening the discussion
- C. Supplementary speaking notes for use if necessary
- D. Note by the Lord President about RSG.

In summing up the discussion you will want to urge colleagues not to comment in public about the discussion and you might want to mention the line which will be taken with the press, which is as follows:

"At its meeting today, the Cabinet discussed the 1986 Public Expenditure Survey. As usual, the Chief Secretary will now hold bilateral discussions with colleagues working within the existing and published planning totals for 1987/88 and 1988/89 of £144 billion and £149 billion. A new planning total of £153 billion has been set for 1989/90."

Stan Chamber

Julie Bowers

Duty Clerk

PP DAVID NORGROVE

16 July 1986

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OPENING SPEAKING NOTE

cc B/UP

② Firm control of public expenditure is an indispensable part of our economic policies. It played an important role in bringing down inflation and Government borrowing, and has enabled us, in recent Budgets, to make progress in reducing the burden of taxation. The strength of the public finances has prevented us from being blown off course by the major challenges and economic shocks we have faced. Over the past seven years we have acquired a reputation for soundness which we must not destroy. The question is not whether one can cope under present circumstances, but whether one has something in hand if the situation worsens. Caution has served us well as a Government. Recent developments in the economy and in financial markets fully vindicate this cautious approach.

③ I recognise that the control of public expenditure sets any Government its most searching test. Public expenditure surveys are always painful, and if we accept the additional provision which is proposed for local authorities we must expect this year's Survey to be very tough indeed. But as a Government we must be prepared to face up to difficult decisions required in setting priorities. What we decide today must demonstrate both our unity and our resolve.

④ I ask colleagues, therefore, to give the Chief Secretary their fullest co-operation in seeking economies. I doubt if any Minister can really say that there is no element of his existing programme which is not of lower priority than items for which he has made additional bids; or that there are no further efficiency savings that can be made. Indeed, as management improves in departments and in the health service, the scope for achieving greater value for money should be increasing. The Audit Commission has shown the scope for improvement in local authority performance. The scope in central government is surely no less.

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We must not give any sign of weakening in our determination to keep public spending under firm control. To do so would make us more vulnerable to the difficult economic circumstances we face, and put at risk our undoubted achievements. The best way to signal our continuing resolve is to work within unchanged planning totals, as we have done in previous years. We must continue to face up to difficult choices, and must continue our search for better value for money.

cc B/UP
✓Points for use, if and when needed1. No time for complacency

Though the growth of public expenditure has been arrested over the past two years, we cannot afford to be complacent. Public spending this year is likely to be around 12 per cent higher in real terms than it was when we came into office. As a share of GDP it will be more or less exactly the same (around 43 per cent).

Although we have reduced taxation in recent Budgets and have substantially cut income tax, the burden of taxation as a whole is higher than when we came into office (non-North Sea taxes as a proportion of non-North Sea GDP have risen from 34 per cent in 1978-79 to 37 per cent this year). The tax paid by those below average earnings is still too high. Must not rest on our laurels.

2. Priorities/value for money/offsetting savings

The control of public expenditure is one of the most difficult tasks facing any Government. It is essential that we approach public spending by setting ourselves a limit and then living within it. We must be strong enough as a Government to face up to difficult decisions required in setting priorities.

I share disappointment that in the bids presented there is insufficient evidence of a rigorous search for offsetting savings which would allow priorities to be reordered within existing plans. I cannot believe that there are not elements within existing programmes which have lower priority than some of the bids presented.

It is disappointing that despite making more money available for vital services we have not received the credit we are due. The message I draw from this is not that more money is the answer but that it is improvements in services that matter. In achieving this, better value for money and greater efficiency have just as much to contribute.

We must avoid thinking that because we have already achieved substantial efficiency savings there is not much left to be squeezed out. I take the opposite view. With improved management in departments and in the health service the scope for finding greater efficiency should be increasing.

I share the Chief Secretary's disappointment that so few bids have been backed by targets for what they would achieve. The setting of targets is essential first to establish the merits of the bid, and second to provide a benchmark against which the success of the programme can subsequently be evaluated. I welcome the Chief Secretary's intention to press colleagues on this in bilaterals.

3. Pay

It is clear that rapidly rising pay lies behind much of the pressure for higher public expenditure. The pay bill for the public services is £45 billion. Each 1 per cent therefore costs £450 million. Neither in the public nor the private sector have settlements reflected the fall in inflation. A 1 per cent increase in current sufficient to preserve real take-home pay.

I look to colleagues to do all they can to get lower pay settlements in the next round. We need to take a tough line with the Government's own employees in pay negotiations and maintain financial pressures on local authorities and nationalised industries. We must continue to exhort the private sector both publicly and in private contacts.

4. The need to be resolute

We must not give any sign of weakening in our determination to keep public spending under firm control. Far from strengthening our position as a Government, boosting public spending would weaken it, would make us more vulnerable to the difficult economic circumstances we face and would put at risk our undoubted achievements. The best way to signal our continuing resolve is to work within unchanged planning totals, as we have done in previous years. Must continue to face up to difficult choices and must continue our search for better value for money.



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Cabinet folder

24/16/7

Prime Minister

England is settled,
Final agreement on Wales and
Scotland should have been
reached by tomorrow.

CEB9

24/16/7

in
Cabinet
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PRIME MINISTER

1986 PUBLIC EXPENDITURE SURVEY

This is the progress report on E(LA) discussions mentioned by the Chief Secretary, Treasury, in his paper of 15 July (C(86)18).

2. As regards the Rate Support Grant (RSG) Settlement, E(LA) have decided that provision should be set at local authorities' budgets for 1986/87, increased by the GDP deflator and that Aggregate Exchequer Grant (AEG) should be set at this year's percentage of relevant expenditure, which is 46.4 per cent. The consequent figures of provision and AEG for England are £25.2 billion and £12.8 billion respectively.

3. E(LA) have also agreed that the settlement needs to be backed by the abolition of grant recycling (which will require legislation early next Session) and by a further device to penalise overspending by local authorities. Subject to final clarification of some legal points, that device will consist of setting Grant Related Expenditure (GRES) at a lower level than provision (the so-called "unallocated margin").

4. It is planned to announce these decisions on 22 July for England and on 23 July for Wales and Scotland.

5. E(LA) will now consider local authority capital controls. The immediate problem here is that honouring certain Government commitments about the level of capital allocations in 1987/88 cannot be accommodated in the baseline provision for that year. It is now clear that this very complex issue cannot be resolved in time for an announcement next week but that, of course, need not hold up the RSG announcement.

6. I am sending a copy of this minute to Cabinet colleagues, the Chief Whip, Commons, and Sir Robert Armstrong.

Nicholas Gibbons

(Approved by the Lord President and signed in his absence)

Privy Council Office
16 July 1986

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Ref. A086/2098

PRIME MINISTER

Economic Prospects and Public Expenditure
(C(86) 17 and 18)

CONCLUSIONS

You will wish the Cabinet to record the following conclusions:

①

- i. that the Chief Secretary, Treasury should now hold bilateral discussions with colleagues about their individual expenditure programmes, and their targets for running costs and manpower, working within the existing published planning totals (£144 and 149 billion respectively for 1987-88 and 1988-89) and within a total of £153 billion for 1989-90;
- ii. that the aim should be to hold the provision for nationalised industries at least to baseline and where possible below that;
- iii. that Departmental Ministers should pay much greater attention to specifying the objectives to be achieved by their programmes, particularly where there is any question of additional bids above baseline;
- iv. that a small Group should be set up, if necessary, in the autumn under the Chairmanship of the Lord President of the Council to consider any outstanding issues and to report to the Cabinet.



ECONOMIC PROSPECTS

2. As C(86) 17 indicates, economic growth is slower, but inflation is better, than was expected at the time of the Budget. The United Kingdom position is heavily influenced by the world economy; fiscal policy remains tight in a number of important industrial countries (notably Japan and Germany) and real interest rates are high despite recent reductions in nominal rates. World trade has yet to respond to the sharp fall in oil prices. On the other hand, real incomes are buoyant in the industrial countries, reflecting low oil and other commodity prices and a favourable evolution of prices, and the forecasters accordingly expect an acceleration in activity later in the year.

3. The Chancellor of the Exchequer's paper does not go beyond the end of this year, and says nothing about the prospects for United Kingdom public finances against which future public expenditure plans might be judged. The outlook seems to be for United Kingdom growth in 1987 a little higher than this year's 2.5 per cent; but with world activity and commodity prices recovering, and United Kingdom unit labour costs continuing to rise much faster than our competitors', inflation and interest rates are likely to be higher. A major uncertainty remains about oil prices, affecting the Public Sector Borrowing Requirement (PSBR) and the current balance of payments; a small current deficit would be projected next year if oil prices averaged the \$15 a barrel assumed for this year, while maintenance of the present actual level of \$10 or less would add £2 billion or more to the PSBR both this year and next. Unless oil prices recover, some significant depreciation of sterling is likely - indeed the effective rate has already fallen by 2-3 per cent in the last few days.

4. Given these uncertainties the fiscal outlook for 1987-88 is inevitably clouded. Continuing fast growth in money earnings



will mean rather higher payments of non-oil taxes, offering the prospect that some modest increase might be possible in the planning total without the PSBR exceeding the £7 billion projected in the 1986 Financial Statement and Budget Report. The Chancellor has indicated that it may be appropriate to permit some additional public borrowing to the extent that this results from oil prices falling below the assumed level of \$15 a barrel. But there is clearly no room for any substantial relaxation in United Kingdom fiscal policy; the United Kingdom's performance in terms of growth, unemployment, inflation and real interest rates is generally weaker than other major countries (this is clearly shown in the east column of the Annex attached to the Chancellor of the Exchequer's paper), and the financial markets are already displaying concern about the United Kingdom's monetary and balance of payments prospects.

PUBLIC EXPENDITURE SURVEY

5. The main figures are as follows:

	£ Billion		
	1987-88	1988-89	1989-90
Planning totals	143.9	148.7	153.2
Reserve	6.3	8.0	[9.6]
Programme additional bids	3.9	4.7	6.3
Territorial consequentials of programme bids, say	0.4	0.4	0.4
Nationalised industries	0.8	0.7	0.6
Local authority current expenditure (including territorial consequentials)	3.5	[3.7]	[4.0]

(Figures in square brackets are Secretariat extrapolations.)

It should, of course, be possible to turn aside a substantial part of the additional bids, but it will be very difficult, if not impossible, to get major programmes below baseline. Taking account only of the increase in provision for local authority current expenditure arising from next year's Rate Support Grant settlement (on which the Lord President is reporting separately), the remaining 1987-88 Reserve (£2.8 million) looks inadequate to meet contingencies during the year (this year's Reserve of £4.5 billion seems likely to be fully absorbed); and this allows nothing for any increases in programmes.

6. The difficulties of the situation (including details of the RSG settlement) have been clearly set out in press reports, and colleagues may well have done the arithmetic on the lines set out above. There would be no advantage in seeking to resolve the dilemma on this occasion; the better course must be to wait until the position has been cleared in the Chief Secretary, Treasury's bilaterals, and some of the present uncertainties about the economy have been resolved. It may, however, be necessary to review the situation before the Star Chamber begins work (on previous form, in mid-October); unlike last year there is no prospect of increasing the planned receipts from asset sales, and no scope for transferring part of the Reserve to programmes. Because of this there is no margin of flexibility within which the Star Chamber could accommodate some part of the additional bids while keeping to the existing planning totals. This situation may point towards a further Cabinet discussion around the end of September. You will want to keep this possibility open, while avoiding any specific commitment now.

7. You have preferred not to repeat last year's Chequers seminar about public expenditure priorities, and some members of the Cabinet may wish to take the opportunities to give their views on this issue. But there would be no advantage in encouraging extended discussion of this, or of the underlying



aggregate position on public expenditure; this discussion is essentially a holding operation until the main problems can be tackled in the autumn.

Nationalised Industries and Local Authorities

8. Following last year's precedent, the Treasury are not seeking any separate discussion of the nationalised industries' Investment and Financing Review. The aggregate additional bids are smaller in scale than those on the main programmes, and it should be possible to eliminate the bulk of them in the course of the Chief Secretary, Treasury's bilaterals (possibly at the cost of some price increases). You will wish to emphasise in your summing up the need to reduce the provision for nationalised industries's external financing limits to baseline, and wherever possible below it. Similarly, you will not wish to invite any substantive discussion of the position reached on local authority expenditure. It will be sufficient to take note of the brief report in the Lord President's minute of earlier today on the agreement reached so far in E(LA).

Running Costs and Manpower

9. This is likely to be an area of friction between Departments and the Treasury. The aggregate baseline provides for an increase of 2.5 per cent in running costs between 1986-87 and 1987-88. Departments have sought an aggregate increase of 6.5 per cent. It appears that the Treasury would be content for running costs to increase in line with the GDP deflator (forecast at 3.75 per cent); real increases in the pay bill above that level would have to be offset by higher productivity/lower manpower. Given the pressures for more staff to deal with, and police effectively, a rising volume of social security benefit claims, it will be very difficult for Departments to achieve this; it seems unlikely that the growth in earnings in the private sector will slow down very sharply,



while the 1986 application of the Megaw principle of pay bargaining in the interquartile range means that it is likely to be very difficult to secure pay settlements in the Civil Service well below those elsewhere in the economy. As to manpower, the Treasury's objective is to retain the present targets in parallel with the controls on total running costs, and to resist the demands for extra manpower resulting from the burden of claims, etc and for Departments'. This is not entirely consistent with previous undertakings, but the issues cannot be settled now and it must be right - in the light of the overall position - for all Departmental Ministers to make every possible effort to meet the Chief Secretary, Treasury's objectives.

HANDLING

10. You will wish to invite the Chancellor of the Exchequer to open the discussion by describing the current economic background and prospects and the Chief Secretary, Treasury to follow this with a more detailed account of his proposals on public expenditure. All members of the Cabinet will no doubt wish to contribute to the subsequent discussion.

RA

ROBERT ARMSTRONG

16 July 1986

cc BTUP
cc HMT

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

16 July 1986

David Norgrove Esq
10 Downing Street
LONDON
SW1

Dear David,

BRIEFING FOR PUBLIC EXPENDITURE CABINET

... As agreed, I attach a speaking note for the Prime Minister's use at tomorrow's Cabinet, together with some supplementary notes for use as and when needed during the course of the discussion.

*Yours ever
Rachel*

RACHEL LOMAX
Principal Private Secretary

SPEAKING NOTE FOR PRIME MINISTER

Firm control of public expenditure is an indispensable part of our economic policies. It played an important role in bringing down inflation and Government borrowing and has enabled us, in recent Budgets, to make progress in reducing the burden of taxation. The strength of the public finances has prevented us from being blown off course by the major challenges and economic shocks we have faced. Over the past seven years we have acquired a reputation for soundness which we must not destroy. The question is not whether one can cope under present circumstances but whether one has something in hand if the situation worsens. Caution has served us well as a Government. Recent developments in the economy and in financial markets fully vindicate this cautious approach.

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