Prime Minister (2)
Duty Clerk
PP AT 17/2

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

PRIME MINISTER

PUBLIC EXPENDITURE AND THE FISCAL STANCE

The purpose of our policy of encouraging asset sales is to reduce the size of the public sector. At the same time, this process generates receipts which reduce the PSBR. In some cases where the sale of assets is associated with a specific policy objective (for example, the sale of council houses) we recognise this by allowing departments to net off receipts from their public expenditure programmes thus, in effect, financing a higher level of gross public expenditure than would otherwise be the case. In most cases, however, including all the main industry privatisations, we score the receipts separately as special sales of assets to ensure they are not diverted to other purposes.

2 We are constantly receiving new proposals for selling assets and analogous financial transactions. That is all to the good: other things being equal, we want to encourage such proposals.

3 Increasingly, however, as the more obvious candidates are sold, the schemes being put forward are becoming more complex and often focus more on purely financial transactions than on the transfer of physical assets. Local authorities refinancing their mortgage books is an example. John Heddle's recent PQ asked about the effect this would have on the monetary aggregates and the PSBR.

4 John Heddle's Question is a factual one and I am answering it in factual terms (copy attached). But it does illustrate the complex factors which we have to take into account in deciding whether a new scheme should,

exceptionally, be allowed and if so, how to allow for its monetary impact in setting the PSBR and the public expenditure total. Often these proposals are cosmetic devices aimed simply at allowing higher public expenditure.

5 To ensure the factors underlying this decision are fully understood, and that we maintain a consistent approach, I propose to circulate guidance to departments codifying our approach to such cases. The key point is that (1) we cannot accept that receipts from financial transactions should offset public expenditure unless the transaction brings other benefits in terms of the management and use of real assets. (2) Where this can be demonstrated, these benefits must still be sufficient to outweigh any costs (e.g. higher financing charges) that may be associated with the scheme.

6 The need to ensure that asset sales really do bring about a change in the management of physical assets is not a new one. But the increasing number of often cosmetic financial transactions being proposed lead me to conclude I should restate it in formal guidance to our colleagues. I thought you should know beforehand how I intended to proceed.

Duty Clerk
H.

PETER REES

approved by the Chief Secretary and signed in his absence

008/111

TREASURY

C - Mid Staffordshire

MR JOHN HEDDLE: To ask Mr Chancellor of the Exchequer, what the effect would be on: (a) the money supply and (b) the public sector borrowing requirement if the funds currently lent on first mortgages by local authorities were transferred with the borrowers' consent to building societies or other approved financial institutions in the following sums in each respect: (i) £1 billion, (ii) £2 billion, (iii) £3 billion and (iv) £4 billion; and if he will make a statement.

REPLY

"Providing other expenditure does not increase, then transferring local authority mortgages to the building societies or other approved financial institutions would reduce the public sector's borrowing requirement. The effect on the money supply would depend on the response of those who took on the mortgages, but it is likely that monetary conditions in the economy would be very little changed. If public expenditure did increase in line with the transfer of mortgages then the PSBR would revert to its original level, but because monetary conditions had been largely unaffected by the initial fall in the PSBR this increase would imply some loosening of financial conditions, and would thus be inflationary unless offset by higher interest rates."

Tuesday 5 February 1985

Q7. **Mr. Heddle** asked the Prime Minister if she will list her official engagements for Tuesday 5 February.

The Prime Minister: I refer my hon. Friend to the reply that I gave some moments ago.

Mr. Heddle: Will my right hon. Friend take time today to consider the position of local councils that have lent on mortgage £4,000 million over 15, 20 or 25 years? Would it not be better if those local councils made that money available to building societies and other financial institutions and so re-invested the money in rehabilitation, modernisation and improvement of the 23,500 houses they have left empty for more than 12 months?

The Prime Minister: Yes, I believe that my hon. Friend is right. I notice that he has tabled a question to the Chancellor of the Exchequer about some of the complexities of what would emerge from such a policy, and I shall leave my right hon. Friend to answer that in fuller detail.

Prime Minister (2)
Duty Clerk
PP AT 17/2

5

File

Treasury Chambers, Parliament Street, SW1P 3AG

17 February, 1985

Andrew Turnbull, Esq.
10 Downing Street,
London, SW1

Dear Andrew

PUBLIC EXPENDITURE: TREASURY AND CIVIL SERVICE SELECT COMMITTEE (TCSC) HEARING

The Chief Secretary has been asked to appear before the TCSC at 5.00 pm on Monday, 18 February to give evidence on the public expenditure White Paper. Following the discussion in Cabinet last Thursday, he has given particularly careful thought to what he should say if the Committee press him, as he expects they will, on the realism of the planning totals published in the White Paper. He proposes to keep closely to the substance of the attached notes both during and after the Committee hearing.

Duty Clerk pp.

R. J. BROADBENT
Private Secretary

CHIEF SECRETARY TO THE TREASURY

Q.1 Is the Reserve/planning total realistic?

A.1 As the Committee knows (footnote on p.10), the White Paper figures were compiled in December. Since then life as moved on: most obviously in relation to the coal strike where the White Paper assumed an end-December finish. The costs in 1984-85 will be higher. There may be implications for future years too.

The 1985 MTFS - to be published on Budget Day - will set out the latest estimates of receipts, expenditure and borrowing. These will of course take account of latest developments, including the latest prospects for the exchange rate, interest rates and so on. The run-up to the Budget is the right time to consider prospects for revenue, expenditure and borrowing. As part of that process, we are currently reviewing the White Paper expenditure figures (see para 8 of Vol. 1).

Q.2 Will the Reserve and the planning total be increased in the Budget?

A.2 It is too soon to say.

Q.2(a) In which direction at present do the factors you set point - upwards or downwards?

A.2(a) Well of course <u>those</u> pressures point upwards.

Q.2(b) Are there any factors pointing the other way?

A.2(b) As Chief Secretary, I have rarely found pressures the other way.

Q.3 Are you saying that the White Paper has been overtaken by events?

A.3 To some extent it has, yes. Most obviously because of the coal strike. But we are reassessing the figures. It is too soon to give new ones.

Q.4 What has happened to your cash-planning policy? Are you saying that these cash plans may need to be altered in the light of developments in the economy?

A.4. We are certainly holding to cash planning. But we have always said that our cash plans are not immutable, could be revised - upwards or downwards - in certain circumstances.

Q.5 In what circumstances? If inflation is higher than expected when the plans were set?

A.5 I do not think it would be fruitful to try to give a definition for all time of when we would think it right to alter expenditure plans. We have to make an assessment each year, as we review the MTFS, of the particular circumstances of the time. Our reassessment applies to the revenue and spending prospects alike.

Q.6 Does this mean you are re-opening Defence/Social Security/any other particular programme?

A.6 Not generally. But for example, we shall have to review EFLs after the coal strike.

ECO POL
cc P.M.s meetings with Ch. Ex. 10/83

PRIME MINISTER

MS

The Chancellor has asked if he can come and have another talk with you in preparation for the economic discussion at Cabinet next Thursday.

As the Treasury have looked closer at the public expenditure prospects, he is becoming more and more worried about it. It is beginning to look impossible to maintain the planning total for next year. He would like to share the problem with you, and discuss with you how you feel that it should be approached.

Since you have the YC speech on Saturday, and then have a dinner on Sunday evening after you return from Chequers, the best time for a talk with him looks likely to be tomorrow evening after you have finished preparing the YC speech. So we have put the Chancellor in the diary provisionally at 1700. But he has no engagements during the evening, and if you need more time on the YC speech he will be perfectly happy to come in later in the evening.

F.E.R.B.

Didn't happen

7 February, 1985.

PublizExp

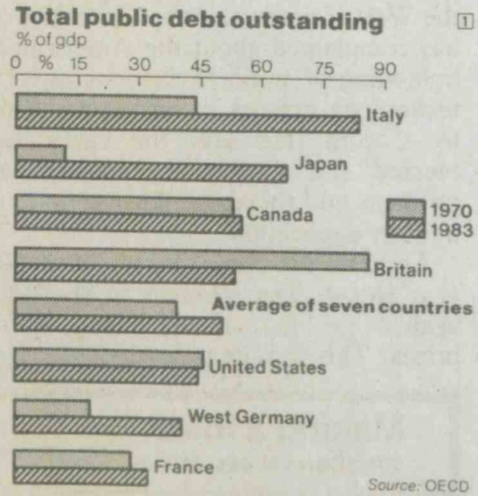
The burden of public debt grows heavier

Governments trying to cut spending are running into a new bind. Interest on their earlier debts is uncuttable—and rising fast. That is leaving governments with awkward choices that some are choosing to duck. Their successors—and taxpayers—will not be amused.

Politicians have been running up debt for centuries. Economists have been debating its significance for almost as long. Most had concluded that public debt was benign. Now the mood is changing. The managing director of the International Monetary Fund, Mr Jacques de Larosière, said last year that public debt is "the origin of many past, present and—in the absence of corrective measures—future problems". A few months later, the Organisation for Economic Cooperation and Development (OECD) called debt interest "a major policy concern".

Why the change of mind? Part of the answer lies in the rapid growth of public debt. For the seven largest industrial countries, outstanding public debt rose from 40% of gnp in 1970 to 51% in 1983. The average includes a rise from 44% to 84% in Italy, and from 12% to 67% in Japan (see chart 1). The ratio also rose rapidly in most smaller OECD economies: eg, from 14% to 31% in Spain, 31% to 67% in Sweden, 11% to 63% in Denmark and 73% to 116% in Belgium.

Debt has an obvious cause: budget deficits. If they were cyclical—ie, if they grew in recession and swung into surplus



during recoveries—public debt would not accumulate. But many governments have been running "structural" deficits—those that would still be there even if their economies were at full employment. Funding them has meant that debt piles up, in good times and bad.

Don't worry about it, said many economists in the 1950s and 1960s. They claimed that debt need never be a burden if an economy grew fast enough. The extra revenues the government obtained from successful reflation would be more than enough to service its extra borrowing. An early proponent of this view was Mr Evsey Domar, an academic and also a governor of the Federal Reserve.

For years, this comforting analysis seemed correct. Indeed, inflation proved as much a boon to debtor governments as to any small businessman or housebuyer who had borrowed on fixed interest rates. Britain's rapid inflation in the 1970s was the main reason why its ratio of public debt to gdp fell from 86% in 1970 to 54% in 1983.

Government debt interest payments as % gdp

	1970	1975	1980	1985*	1989*
United States	2.2	2.5	3.3	5.5	5.7
Japan	0.6	1.2	3.2	4.7	3.8
W. Germany	1.0	1.4	1.9	3.0	2.7
France	1.1	1.3	1.6	3.2	3.7
Britain	3.9	4.0	5.6	4.3	4.3
Italy	1.7	4.0	6.3	10.1	13.6
Canada	3.8	4.0	5.6	7.9	8.4
Average	**1.9**	**2.3**	**3.4**	**5.2**	**5.4**

*Source: OECD *forecast*

In the past few years, however, Mr Domar's reassurances have gone sour. His claim that deficits were not a burden rested on a single equation that, paraphrased, required real economic growth to be higher than real interest rates. So it was, for years on end. But by the late 1970s real interest rates began to rise, just as growth slowed down.

The higher interest rates were the result of tighter monetary policies imposed by central banks to curb inflation. Much of that inflation had been caused by central banks monetising budget deficits rather than funding them. And the slower gdp growth was partly due to the distortions wrought by that same inflation. The factors that had once combined to make deficits seem painless turned round to make them doubly painful.

By 1980 the real rate of interest exceeded the gdp growth rate in all seven of the big OECD countries. Their ratios of public debt to gdp began to soar. So did the cost of servicing their debt—from 1.9% of gdp in 1970 to an estimated 4.9% last year. The bills have been biggest for countries with high interest rates and a lot of debt. The Canadian government, for instance, had an interest bill equal to 7.6% of gdp; Italy's was even higher, at 9.6%.

In the United States, the annual debt bill has doubled in cash terms over the past four years, to $111 billion. It now accounts for about 13% of federal spending. There, as in many other countries, debt interest is the fastest growing item of government expenditure.

Where will it stop? That depends partly on whether the Domar world—fast economic growth, low real interest rates—returns. Growth has picked up in every industrial country since the 1981-82 recession, but real interest rates have yet to fall far. In some countries they have risen. America's gdp grew last year by more than 6½%; but real interest rates on government bonds averaged about 7¼% (see chart 2).

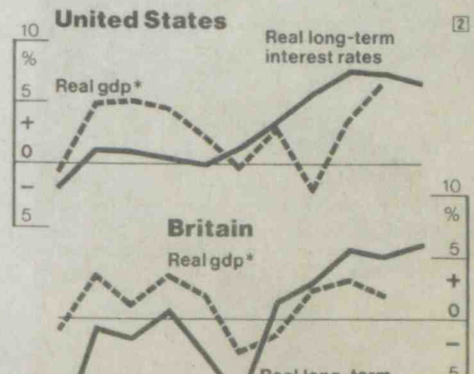
The Domar equation has one scary implication. If (a) budget deficits excluding debt interest do not fall as a proportion of gdp; and (b) real interest rates are higher than gdp growth; then (c) debt interest will keep rising indefinitely as a percentage of gdp. It is not enough for governments to say that debt interest is "beyond their control": it really will be unless they make room for it by cutting the spending they can control, or else raise taxes. Either way, they need to cut their structural deficits.

There is a third option, of course. If policy makers dislike high interest rates, more taxes and less spending, they may be tempted to start monetising, rather than funding, their deficits. The inflation that reduced the real value of debts before would do so again.

Or would it? Once people anticipate faster inflation, long-term interest rates would go higher still. If the exchange rate also fell, the result would be faster inflation and higher interest rates.

So far, governments in the big industrial countries seem to have realised these risks and are shunning the inflation "solution". Some are even having success in cutting their structural deficits. The OECD estimates that West Germany ran a small structural surplus last year, while Japan, France, Britain and Italy reduced their structural deficits.

North America has been less virtuous. The OECD reckons that the United States' structural deficit rose from 2% of gnp in 1983 to 2.2% last year, while Canada's went from 3% to 3.2%. Many of their politicians understand the danger of rising structural deficits. They are less good at heading it off.



AT

Public expenditure File

10 DOWNING STREET

From the Press Secretary

29 January 1985

Dear Hugh,

The Lord President has asked me to send to you a copy of the attached background note on public expenditure which has been approved by the Chief Secretary. He hopes that it will be circulated among your group of MPs for use in the press and on radio and television.

Yours sincerely

Bernard Ingham

BERNARD INGHAM

Copied to all Ministers + Heads of Information on Economic + Social Policy Group

Hugh Taylor, Esq.,
PS/The Home Secretary.

AT

PUBLIC EXPENDITURE

BACKGROUND

The government has just published its expenditure plans for the next 3 years. In total the plans are unchanged from those published last year. And the year before that.

Firm control over expenditure - sticking to the plans - is central to the government's economic policy. The Medium Term Financial Strategy sets out the path to lower borrowing and so to lower interest rates. Control over spending is the first step along this path. Lower inflation and scope to make tax cuts are the goals.

It is not an easy task. Every day brings some new demand for more spending on someone's pet project - often accompanied by a wholly inconsistent call to cut taxes. But gradually the government is getting on top of the problem.

In the last 20 years, public expenditure has risen in real terms - i.e. in addition to inflation - by 90 per cent. Gross Domestic Product has risen by 50 per cent. So public spending has been taking a steadily greater share of national income. Since 1981, this trend has been reversed.

Over the next 3 years, the government plans to keep expenditure constant in real terms.

This does not mean "cut, cut, cut" as some have depicted. It means sticking to the overall plans published last year and the year before. It means that as the economy grows, spending will fall further as a proportion of national income.

The government is not indiscriminate. Spending in some areas has risen - for example, on health, pensions and child benefits as well as on defence and law and order. There have had to be economies in other areas to balance the books. The government adopts the sort of approach you would expect to seek out economies:

- it asks if a particular spending is necessary;

- it asks if that particular job could be undertaken by the private sector instead;

- it asks if the service could be provided more efficiently, cutting out waste.

It is important that the government achieves its latest plans. It is determined to do so. Controls over spending, especially by local authorities, have been improved. Provision has been increased for the programmes where the amounts required are difficult to forecast accurately - for example, social security where the amount spent reflects eligibility and take-up. Reserves for contingencies are higher than in previous years.

Why is it important?

-Because there is only so much money to go round. So, by holding down public expenditure, there will be more cash available for the private wealth-creating sector. And that will provide productive investment and help to create real jobs.

-Because by holding down public spending, the Government will reduce its need to borrow money to finance its programme. That will help to ease the pressure on interest rates and so reduce industry's costs - another way of encouraging the creation of more jobs.

-Because holding down public spending will create more room for tax cuts. And the more successful the Government is in curbing spending, and the more the economy grows - and we have now had nearly 4 successive years growth - the more the Government can ease the excessive burden of taxation

That is good in itself. But it also encourages people to take jobs, to work harder and be more enterprising. So holding down public expenditure contributes to higher employment

The central objective of government policy is to hold down - and drive down - inflation. It is only if we do this that there is a chance of sustaining economic growth, keeping British industry more competitive and putting more people to work.

Recent events in the markets show just how important it is that we achieve these objectives. They show that holding down public expenditure is neither dogmatic nor a fad. It is directed at two of the main concerns of Government - reducing unemployment and bringing inflation down. And it brings the prospect of a reduced tax burden.

What is more, holding down public expenditure does not necessarily mean worse services to the people. This is because there is such a thing as greater efficiency - of getting more value out of the money put into a particular project.

This is a "value for money" Government and here are just a few examples of how it is making taxpayer's money do more work:

- the size of the Civil Service has been redued by 16 per cent since 1979 and by 1988 it will have fallen by 20 per cent;

- there is a substantial and sustained efficiency programme in the National Health Service: for example 900,000 more in-patients and day cases were treated in 1983 than in 1978 and there were 2½ million more out-patient attendances;

- more social security beneficiaries are being helped with fewer staff;

- on Defence, resources are being switched from support staff - the backroom boys - to front line units.

Prime Minister ④

AT 23/1

Fle

23 January 1985

THE PHARMACEUTICAL INDUSTRY

MG

The trend to greater control over the drugs budget is worldwide.

In Japan, the Government in March 1984 ordered an average 16 per cent cut in drug reimbursement prices, bringing the total cut to nearly 40 per cent since June 1981.

In the United States, a "cost containment programme" was introduced, and the Waxman Bill encourages the further use of generics.

In Europe, some governments have adopted the limited list technique.

Despite the pressures on drug companies, their margins are still lavish and their prices high. The UK Stock Market still thinks so: the FT table for 22 January 1984 shows that UK pharmaceutical companies' share prices were 22.4 times the earnings per share. This compared with a market average for the 500 share index of 12.6 times earnings per share. The drug companies are thought almost twice as attractive as the average share in the Stock Market, reflecting the guaranteed income they receive from Government health purchasing worldwide, and from the more than generous margins they are allowed.