

CONFIDENTIAL



FROM: CHIEF SECRETARY
DATE: 3 April 1985

PRIME MINISTER

RUNNING COSTS TARGETS

I am today sending you and colleagues draft guidelines for the 1985 Public Expenditure Survey. But there is one issue - running costs control - which merits separate consideration.

2 We introduced a scrutiny of running costs for the year immediately ahead in the 1984 Public Expenditure Survey. This replaced the annual retrospective scrutiny, which had proved ineffective in bringing these costs under control. So far, the new arrangements are working well, with running costs Estimates provision for 1985-86 about 4 per cent higher than in 1984-85. If departments are able to ensure that this cash provision holds, the growth of running costs will have been brought below inflation for the first time since the running costs scrutinies began in 1980.

3 We judge that now is the time to take a further step forward. The Chancellor and I propose that in the 1985 Survey we should introduce running costs targets for each of the Survey years, with the aim of applying a progressive squeeze on all these elements - manpower numbers and grading, employment of casuals and overtime, accommodation, travel and subsistence and the rest. Our proposals are set out in detail in the attached paper. We suggest that aggregate running costs targets should be set just below the projected rate of inflation in each year up to 1988-89. This would not prejudge the question whether we still retain a pay ... assumption for use in the Estimates, although the attached paper suggests that it would be generally helpful in the pay context to do so.

4 There is one aspect of the proposal which I should particularly draw to your attention.

CONFIDENTIAL

CONFIDENTIAL

5 The manpower headcount, buttressed by successive squeezes on pay cash limits, has had remarkable success in reducing Civil Service numbers since 1979. But it has been much less successful in controlling all the associated staff and administrative costs. These running costs are dominated by pay (70 per cent) and other manpower-generated costs. In the longer term, therefore, I do not believe that it would make sense to superimpose running costs controls upon a system in which both pay and manpower numbers are centrally controlled. But we do not need to decide this finally now. Some details of the running costs control system can only be settled in the light of experience, and we shall all want to be sure that departments have management systems which will make running cost targets as successful in the future as manpower targets have been in the past.

6 Our proposal is that, to gain experience of the effectiveness of the new system in applying further pressure on manpower numbers, we should run it in parallel with the manpower targets up to the last published year for the latter - 1988. On this approach, no new manpower target for 1 April 1989 would be set in the 1985 Survey. Before 1988, I expect us to be in a position to decide that running costs targets should substitute for manpower targets after that date. We would keep manpower planning and monitoring as an important element in running costs control; and our aim after 1988 would be to fix the running cost targets at levels which would continue to bring down the size of the Civil Service, without the support of manpower targets. But the extent to which this happened would be affected by individual choices by departments as they make the most cost-effective use of their running costs, and by any flexibility we were prepared to allow in the areas where Civil Service manpower is self-financing.

CONFIDENTIAL

CONFIDENTIAL

7 Control of running costs is an integral part of the improved financial management we are seeking to introduce in the Civil Service. I am considering whether there are other innovations we can usefully introduce to further our objectives in this field. I will consult you and other colleagues about any further proposals in due course.

8 I am sending copies of this minute to Cabinet colleagues, Grey Gowrie, Robin Ibbs and Sir Robert Armstrong. It would be helpful to receive any comments by 15 April.



for PETER REES

(Approved by the Chief Secretary)

CONFIDENTIAL

CONFIDENTIAL

RUNNING COSTS TARGETS

Note by H M Treasury

BACKGROUND :

1. Since the government came to office in 1979 it has sought to improve the efficiency and effectiveness with which government itself is conducted, and to reduce its costs. Various instruments have been devised and operated to this end. This paper is concerned with two of these - control of Civil Service manpower, and the scrutiny and control of departmental running costs.

2. Reducing the size of the Civil Service has been, in part, a free-standing objective of government policy since 1979, although its justification has normally been in terms of improved efficiency and economy. But manpower numbers are only one component of the costs of running the government. Indiscriminate pressure on this one component can, perversely, increase overall running costs - for example in the Ministry of Defence, where pressure on Civil Service manpower can get in the way of achieving savings through civilianisation. There is, clearly, advantage in widening the target area to be subjected to control in order to permit - and promote - trade-offs within that target area. Considerations of this kind led to the proposal, adopted in the 1984 Public Expenditure Survey, to transform the retrospective

CONFIDENTIAL

annual scrutiny of departments' running costs into a forward-looking instrument of control, to be integrated in the public expenditure planning and control system.

3. In the 1984 Survey running costs targets were introduced for one year only. Against the general objective of keeping the growth of aggregate running costs below the growth of the GDP deflator, each department was first asked to propose a target for itself. Treasury expenditure divisions then discussed these targets with departments; they have since been translated into ceilings for Estimates provision. In aggregate the outcome is provision in the Estimates about 4% above last year's figure. If this figure holds the growth of running costs will have been brought below the growth in the GDP deflator - an outcome not achieved since the annual scrutinies began in 1980.

COVERAGE AND OBJECTIVES

4. Departments' running costs consist of pay (70%), accommodation (11%), personnel overheads (6%), office services, for example expenditure on computers, (6%), and other services, including charges for contracted-out work (7%). For the time being notional expenditure on pensions is excluded (because it does not figure in departments' PES and Estimates provision); and so is capital expenditure, mainly because of definitional problems.

5. The objectives of running costs targets are:-

- (i) to introduce the kind of discipline to departments' management of their operating costs which in a market situation might be brought about by competitive pressures;
- (ii) to operate consistently with departments' general efforts, post-FMI, to maximise the efficiency and effectiveness with which they conduct their business;
- (iii) to contain gross pay and administrative costs;
- (iv) to maintain downward pressure on manpower totals.

DISCUSSION

6. The reference in the first of these objectives to controlling the operating costs of government immediately raises an issue about definition and coverage. Clearly, the costs in question must exclude programme expenditure. But what is programme expenditure and what is an overhead? It has been argued, for example, that the costs of staffing and running prisons are not overheads and should be counted as programme expenditure rather than as running costs. On the other hand, securing economies in the running of the prison service is as much an objective of policy as achieving administrative economies anywhere else in the Civil Service. But there may sometimes be great difficulty in distinguishing between programme and running costs elements - for example, in the case of BAOR. It is proposed that 'running costs' should be given a wide coverage, starting from the basis used in the scrutinies.

7. The dominance of the pay bill in overall running costs acts as a considerable constraint upon departments' freedom of action to make switches within their running costs provision. Indeed, while rates of pay and allowances are centrally negotiated or determined, and so long as departments are bound by manpower controls, the introduction of running costs targets would limit departments' freedom of manoeuvre without materially improving control. In order to facilitate cost-effective switching between, say, manpower and office machinery, or between uniformed and civilian manpower within the MOD, there is a strong case for a single cash target which can bear down, as appropriate, on manpower numbers and grading, employment of casuals and overtime, accommodation, travel and subsistence and the rest.

8. It is proposed, therefore, that running cost targets should ultimately supersede manpower targets and not be a supplement to them. Manpower planning would continue to be necessary in departments, to provide the basis for plans to meet running cost targets. It would in any case be sensible to maintain the manpower targets up to 1988 (as in the 1985 Public Expenditure White Paper), so that there is time for running costs targets to be run in and shown to be effective. But, on this approach, no new target for 1 April 1989 would be set in the 1985 Survey.

9. A further reduction in Civil Service numbers continues to be an objective of government policy. It will therefore be necessary to ensure that running costs targets can be operated

in such a way as to generate continuing reductions in the size of the Civil Service. The extent of such reductions will, however, be affected by individual choices made by departments to make the most cost-effective use of their running costs.

10. To achieve this objective running costs targets need to be tight. In order to live within their targets departments would, as in the past, be obliged to accommodate the costs of pay settlements by economies in their general administrative expenditure and by a faster manpower run-down than allowed for in manpower plans.

11. It is proposed to set these targets generally on a gross basis: some departments have large and sometimes volatile receipts, and a control only on net costs would not provide an effective spur to efficiency in such areas. Because of this, and because running costs targets should be set tightly enough to deliver overall manpower reductions, their introduction would not in itself resolve one of the problems which tight manpower controls have created for some departments. The Department of Transport, for example, is constrained in its plans to expand the numbers of driving test examiners so as to cut lengthening waiting times - notwithstanding the fact that this service to the public is, at current fee levels, self-financing. In principle such considerations could be taken into account in setting gross running costs targets (as they could under a system of manpower targets)-

CONFIDENTIAL

but to the extent that offsetting savings could not be achieved elsewhere this would mean accepting some increase in numbers.

PAY ASSUMPTION

12. This discussion raises the question whether the pay assumption, whose usefulness has been questioned in recent years, need and should continue to exist. It would, in theory, be possible for departments to be given no Treasury guidance on the assumption to be applied to last year's pay rates when they draw up their Estimates for the year ahead, provided that their total running costs were contained within the agreed ceiling. The diversity of departments' manpower profiles, together with their different grade and incremental structures and so on, means that critics would probably be unable to deduce differences between the assumptions which would be used in different departmental Estimates on this approach. But, since a single pay assumption has been publicised in the past, departments would almost certainly be asked, by Parliament and the unions, what assumptions were being used in any future year. It would be inconsistent to negotiate pay centrally from the Treasury but to present Estimates to Parliament incorporating a range of different assumptions about the appropriate pay provision.

13. It would not, in any case, be desirable to give up a pay assumption. To do so might be seen as a sign that the government

CONFIDENTIAL

CONFIDENTIAL

were letting-up on pay. In addition, the pay assumption still has value in the Civil Service pay negotiations, and also to a lesser extent in influencing pay settlements in local authorities and nationalised industries - and, indeed, more widely.

14. If, then, there has to be a common pay assumption should it be the same number as that implied by the aggregate increase in running costs (see para 15 below)? The advantage of this would be that it would permit departments for the first time for some years to make more realistic provision for pay and to plan accordingly. The argument against is that it might yield a number which at the time would be too high a starting point for the pay negotiations, and would generally give the wrong signal. But there is no need to reach a conclusion on this at present.

WHAT TARGETS TO SET?

15. A sensible aim might be to set targets designed to ensure that total running costs reduce somewhat in real terms in each successive year. This might be achieved by setting an aggregate target increase slightly - say $\frac{1}{2}\%$ - below the forecast GDP deflator for each of the three Survey years. Within the aggregate target individual targets would be set for each department, which might vary according to need. These targets would, like other public expenditure plans, be set in cash and would not normally be expected to be changed thereafter, notwithstanding unpredicted changes in the general price level. Targets set on this basis would be ambitious figures, judged against past performance,

CONFIDENTIAL

and given the pressures on public service pay (in particular the fact that armed forces' pay accounts for no less than 22% of total running costs).

16. It is proposed that individual targets for each department should be set in the way in which they were in the 1984 Survey: ie by inviting departments to propose targets, taking account of their own particular circumstances. Some departments might have good reasons for a higher figure than the proposed aggregate percentage increase; others for a lower figure. The Treasury would negotiate with departments bilaterally, with a view to agreeing a collection of individual targets which together would imply a satisfactory aggregate target.

17. The new system would be strengthened if the targets were published, say in Public Expenditure White Papers. Departments would, clearly, need to make sure that they had systems in place which would ensure that the targets would be achieved. Arrangements - as simple as possible - should be set up for the Treasury to monitor and control departments' progress against the targets.

RECOMMENDATIONS

18. It is recommended that:

(a) running cost targets should be introduced in the 1985 Survey onwards; should have the same coverage as in 1985-86; and should be applied to gross expenditure;

CONFIDENTIAL

(b) manpower targets up till 1 April 1988 should be retained but no manpower targets should be set for 1 April 1989 and onwards;

(c) a pay assumption will continue to be required for the foreseeable future;

(d) departmental Ministers should ensure that their departments have systems in place which will deliver the agreed targets;

(e) the new running cost targets should be set so as to hold the growth in these costs, in aggregate, $\frac{1}{2}$ per cent below forecast inflation for each of the three forward years in the 1985 Survey;

(f) departments should initially propose targets for negotiation with the Treasury, in the light of the overall aim that Ministers have agreed;

(g) running cost targets should be published, and progress against them should be monitored by the Treasury.

H M Treasury

18 March 1985