PRIME MINISTER 21 June 1985

PUBLIC EXPENDITURE

There should be two objectives for Sunday's meeting. To hold the line on public spending, so that the Government does not lose control of its economic and fiscal strategy. And to get away from the reputation for endless cuts. These are not incompatible.

Since 1979, the total tax burden on an individual member of the public has risen, to say nothing of the hidden increases through public sector charges. (Tax alone, excluding the North Sea, has risen from 35% of GDP in 1979-80 to 39% this year.) The public is not impressed. The small business community and the self-employed are particularly irate, as they feel that little has been done to restrain the worst enthusiasms of the Inland Revenue. Spending has risen from £117 billion in 1979-80 to £130 billion this year (same prices): 2% per annum, not much slower growth than in the previous 20 years.

The Government is unlikely to recapture lost ground by espousing SDP-type spending policies of just a few billion more. This will not seem credible, and the electorate is more inclined to say the SDP would do it with a better smile.

Options for Reducing Spending

There are many areas where the Government has a poor record at control. Could you get agreement on some of these propositions for controlling costs?

1. No more nationalisation. Taking over JMB, Alphasteel, Edmunds Walker, and parts of the private sector steel industry through the Phoenix programmes have been costly. It does not do to say "oh well, this was Bank of England money, or it comes through British Steel's EFL" - public money was spent, and it was on things that formed no proper part of this Government's strategy. The expenditure was avoidable, undesirable, and difficult to explain.

2. The administrative overhead. This has been one of the faster-growing public expenditure programmes under this Government, with costs up by more than 9% in real terms since 1979 - despite the apparent drop in the head count. £15 billion of administration is an enormous sum of money. Defence, DHSS, Inland Revenue and Customs are the big areas. The FMI needs bite to control administration.

3. The interest rate programme. This has been the fastest growing programme under this Government. In part it reflects overshoots on the Borrowing Requirement caused

by other factors. In part it reflects the difficulties of keeping money supply under control, so that interest rates have remained all too high. In part it reflects funding techniques, with continued reliance on conventional stocks. This shows the need to control borrowing.

4. Defence. We have recognised for some time that defence procurement is an area for substantial reductions in costs. And Peter Levene is beginning to identify them. Some of these have to be passed back to the centre and not spent on a growing volume of armaments, although there must be some incentive for the Defence Department to pocket some of their own savings.

5. Under-utilised public assets. There is common agreement that more land should be sold. Housebuilding land, particularly in the South East, is far too expensive, and the public sector has urban land that it could release to help bring down the price of housing plots. There has been some quickening of pace at the DoE. But the PSA is still loitering with intent and making little effort to sell the property which it possesses. And the MMC Report shows that British Rail has a painfully slow disposal programme. Isn't it time to send in private estate agents to the large land hoarders - British Rail, PSA, the Water Boards - to

identify the sites and put them into an auction in the space of 3-6 months?

6. ECGD. One of the larger supplementary estimates approved by Parliament this week was an increase in resources for ECGD, reflecting difficulties in their loan portfolio. ECGD cries out for tougher management. It has cost us £600 million in 2 years. You need new management to halt the haemorrhage. (See David Hobson's Annex A attached.)

7. Nationalised industry programmes. The National Coal Board is still too expensive; and the figures from British Steel, British Rail and others are still large in relation to public expenditure totals. Tougher targets should be set; the industries should be given every encouragement to make more attacks upon their unit costs and to generate more sales revenue and asset sales. It is not good politics to generate a whole series of above average price increases in the energy industries in despair of doing anything else. It's costs that people want down, and sales that they want up. The targets should reflect this.

8. Grants to larger industrial companies. Could you put a moratorium on them for a year or so, to reflect the very satisfactory growth in corporate profits and

corporate liquidity which is such a striking characteristic of the last 3 years' economic progress?

9. Bus subsidies. As the new régime comes in, can more rapid progress be made in winding down the large totals of bus subsidies distributed through central and local government sources?

10. Local authority efficiency and contracting-out. The Audit Commission regularly identifies hundreds of millions of pounds of waste within the local authority sector. The DoE should consider how it can follow up those audit reports more rapidly and, along with the Audit Commission, make sure that savings are delivered as a result of pursuing contracting-out or better management within the local authority sector.

11. Northern Ireland. Northern Ireland has no Conservative MPs, a very high level of public spending per head in relation to its wealth-generation, and enormously expensive industrial support programmes that don't work. Why not make a substantial cut in the Industry, Energy, Trade and Employment programmes (£350 million in 1986/87)? And shouldn't the electricity industry make money, as it does in England?

Agreement on some of these themes could produce good savings in future years that would be politically easier than many of the ideas in circulation.

Handling PE in the Future

The present system cannot deliver easily. Departments have to be driven hard by Ministers, the press and the Public Accounts Committee, all at the same time, for something to happen. The FMI is a dead letter as a management tool. Departments play games with each other and the Treasury during the long and protracted public spending round, in the interests of maximising their take of cash as a symbol of success. In the process, the leaks about "cuts" do the Government enormous damage.

Why not discuss new ways of overcoming this problem in future? Could you have one big meeting to settle the totals; give Ministers reasonable powers to determine their own budgets; and remind Ministers that the purpose of the exercise is to find politically attractive ways of delivering targets, and not politically difficult ways. The press and Parliament will judge the spending Ministers accordingly.

You may find the growth in programmes at Annex B useful in the landscaping discussions.

JOHN REDWOOD

ANNEX A

ECGD

An additional £158.5 million appears in the Expenditure Survey for 1986-87, for interest support costs arising from the impact of higher interest rates than estimated being paid to the banks, exchange rates, and business levels.

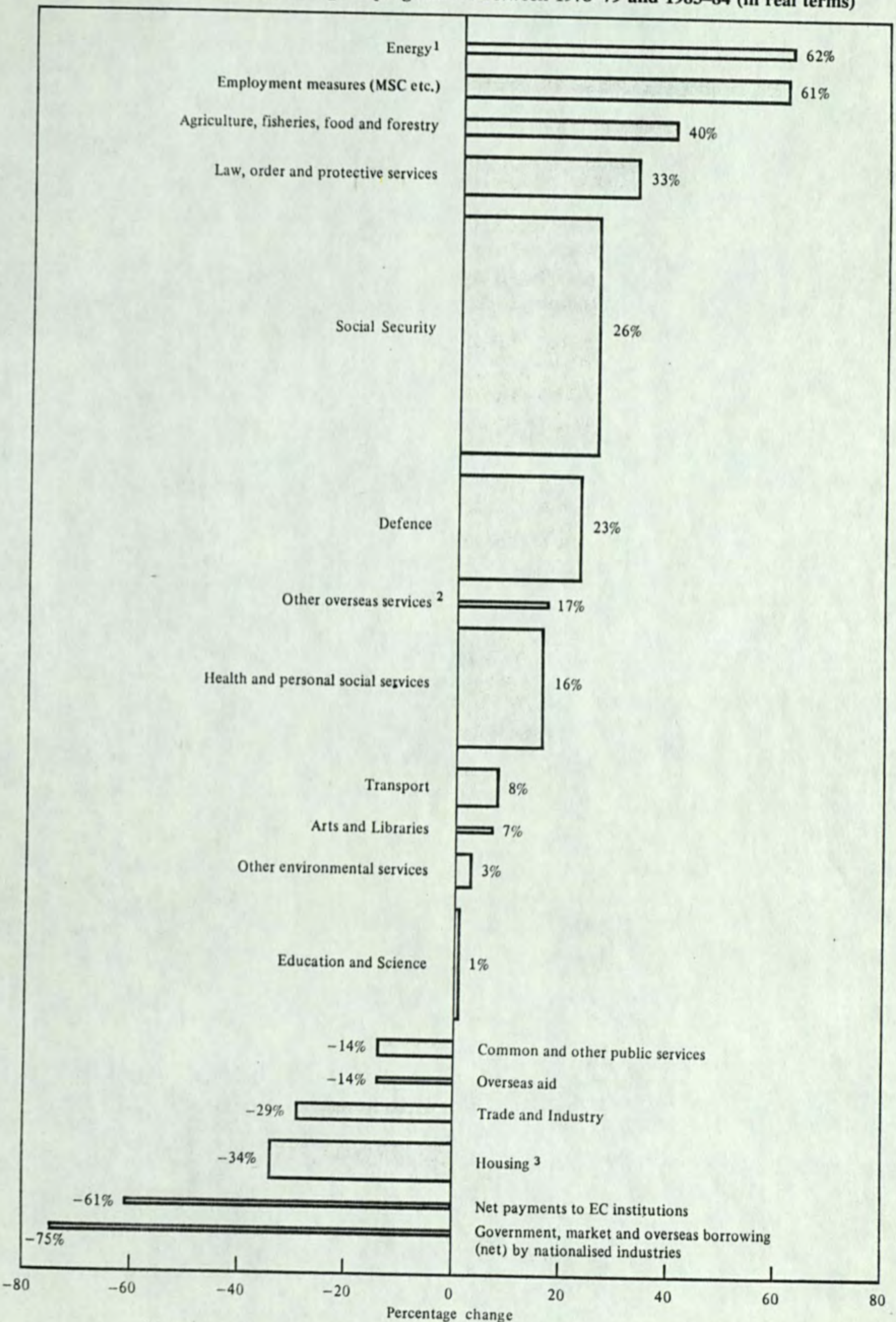
The chief cause for concern is the sovereign risk element of the portfolio. Potentially recoverable sovereign claims amounted to £2.1 billion at the end of 1983-84, including £1.1 billion of claims expected to be paid in respect of markets where debt payments were in arrear or rescheduled. The loss provision by ECGD for that year was £118.8 million, and may well not be adequate (the accounts were qualified by the Comptroller & Auditor General); the annual cost to PSBR is over £300 million, and how much will ever be recovered is uncertain.

The recent interdepartmental management review of ECGD recommends setting up a Board of part-time outsiders, with the secretary as Chief Executive. The Board would take strategic decisions, and would be responsible for submitting and monitoring the business plan and seeing that there are adequate systems for controlling the business. They would also be responsible for making proposals to the Minister for improving services to exporters and implementing such proposals as are agreed.

The Report indicated that there is a "vacuum at the top" of ECGD, with consequent administrative inefficiency. Many weaknesses have been identified in the fields of underwriting, risk management, claims settlement, service to customers, and management information. The Report suggests how these could be put right - many of them within a 12 month period. Monitoring of this programme of work is vital if it is to be carried out on a timely basis, and the recommendation that a Board should be established would seem the best way of achieving this, together with the ability to take strategic and high-level policy decisions - which is now lacking.

Leaving things as they are at present will lead to a continuing poor service to exporters, loss of market share, and probably increasing losses.

CHART 4 Total percentage change in programmes between 1978–79 and 1983–84 (in real terms)



Notes:

The width of each bar on the vertical axis is proportional to expenditure on the programme concerned in 1983–84

Expenditure in Scotland, Wales and Northern Ireland has been allocated to functional programmes

(¹) Largely assistance to the coal industry.

(²) Includes a wide variety of items: the Diplomatic Service is about 40 per cent and has not grown in real terms.

(³) Housing figures are calculated before any deduction for council house sales.

INDEX OF GENERAL BRIEFS

(1)

REVENUE EFFECTS OF ILLUSTRATIVE TAX CHANGES

£m at 1986-7 price and income levels

Full year cost/yield

Income tax Rates	
Change basic rate by 1p	1260
Change all higher rates by 1p	110
Personal Allowances and Higher Rate Thresholds	
Change single and wife's earned income allowance by £100:	360
Change married allowance by £100:	320
Change all main personal allowances by 1%:	205
Change all higher rate thresholds by 1%:	30
Corporation Tax	
Change rate by 1 percentage point	250
Indirect taxes	
Change tax (duty plus VAT) by 1p:	
Beer (pint)	80
Spirits (bottle)	1
Tobacco (20 kingsize cigarettes)	35
Petrol (gallon)	55
Change VED rate by £1	20
Change VAT rate by 1 percentage point	900
National Insurance Contributions	
Change employers' main rate by 1 percentage point	1500
Change employees' main rate by 1 percentage point	1500

Income Tax changes are from levels of allowances which assume indexation in 1986.

Main person allowances are married man's allowance single and wife's earned income allowance and the age allowances.

(a) Tax burden

Tax and NICs as a share of GDP rose sharply between 1978-79 and 1981-82 to 39 per cent, the highest level in last twenty years; since 1981-82 share broadly stable.

Tax and NICs paid by a married couple on average earnings about 29 per cent of earnings each year since 1981-82. This higher than in 1978-79 and double the share at the end of the 1950s.

	Total taxation (incl. LA rates) and NICs as a percentage of GDP at market prices[1]	Percentage of earnings of married man on average earnings taken in tax and NICs
1959-60	N.A	14.3
1973-74	33.1	25.6
1974-75	35.7	28.5
1978-79	33.9	27.8
1979-80	35.2	26.3
1981-82	39.1	29.3
1982-83	39.0	29.8
1983-84	38.9	29.6
1984-85	39.1 (FSBR est.)	29.2
1985-86	39.0 (FSBR forecast)	28.9

1 Figures include North Sea; excluding North Sea, burden has fallen slightly from 38.6 per cent in 1981-82 to a FSBR forecast of 37.7 in 1985-86.

Income tax and NICs - representative cases

Income tax and NIC payments

£ per week with 1985-86 tax rates

	Earnings	Income tax	NICs	Total	Percent of Earnings
Primary School teacher (single; contracted out)	184	42.5	13.4	£ 55.9 56	30
Registered nurse (single; contracted out)	140	29.3	10.4	£ 39.7	28
Underground miner (married; contracted out)	175	32.6	12.8	£ 45.4	26
Average male earnings (single; contracted in)	194	45.5	17.5	63.0	32
Average male earnings (married; contracted in)	£ 194	38.3	17.5	£ 55.8	29

Figures relate to estimated average earnings in April 1985 except that for a nurse which includes the pay award payable in February 1986.

Income tax and NIC payments for a married man

£ per year with 1985-86 tax rates

Earnings (£ per year)	Income tax	NICs	Total	Percent of earnings
6,000	763.5	540	1303.5	22
8,000	1363.5	720	2083.5	26
10,000	1963.5	900	2863.5	29

[£10,000 is approximately average male earnings]

(c) <u>Starting point for tax</u>

Has increased relative to earnings since 1981-82, but still lower than in 1973-74 and 1977-78:

Tax threshold as a percentage of average male earnings

	Single	Married (without children)
1973-74	26.4	34.3
1974-75	22.7	31.4
1977-78	22.5	34.7
1978-79	20.4	31.8
1981-82	18.1	28.3
1982-83	19.1	29.9
1983-84	20.1	31.4
1984-85	20.8	32.8
1985-86	21.4	33.5

(d) International comparisons

(i) Overall burden

UK burden of tax and social security contributions slightly below average for EEC countries, but well above those in US and Japan, countries with excellent growth records in recent years.

	Total tax and social security contributions as a percentage of GDP at market prices, 1983
UK	37.8
Denmark	46.1
France	44.1
Germany	37.2
Italy (1982)	38.3
Netherlands	47.0
Japan (1982)	27.2
US (1982)	30.5

Source: OECD Revenue Statistics.

(ii) Income tax and social security contributions

UK staring point for tax around middle of range for developed countries. UK starting rate of income tax is high, but combined onset rate of income tax and social security contributions about average after Budget cut in initial social security contribution rate.

Married couple (without children)

	Starting tax rate (including social security contributions)		Threshold (£s) at February 1985 exchange rates (converted using purchasing power parities [1])	
Denmark	41	(47)	3660	(2950)
France	7	(19)	4785	(4365)
Germany	22	(36)	3565	(3065)
Italy	18	(25)	2275	(2325)
Netherlands	16	(35)	4550	(4110)
Japan	15	(24)	4885	(3590)
US (Federal only)	11	(18)	5205	(3090)
UK	30	(39)	3455	(3455)
(from 1.10.85)	30	(35)	3455	(3455)

Source: Inland Revenue

[1] Purchasing power parities give a better picture of real values of thresholds because they are based on compar ing prices of the same basket of commodities in different countries.

2

THE SURVEY SYSTEM

Points to make on criticisms of system eg "odium of economy without achieving savings." (FT 19/6/85):

(i) Tough Surveys and reviews **not** a waste of time. Planning total ex-coal strike has fallen as percentage of GDP; important decisions on defence, re-shaping of social security, savings eg on housing, regional policy, agriculture.

(ii) Stresses in recent Surveys caused **not** because Treasury worked to cut totals but because of **pressures for increases** some colleagues considered irresistible. Massive additional bids every year. If **all** colleagues would accept principle of consuming their own smoke there would be no problem.

(iii) Adverse **publicity on cuts** mainly because of **leaks**; must try harder to avoid press stories.

GEP1 Division

3

EXAMPLES OF RECENT EXPENDITURE CUTS IN OTHER COUNTRIES

(a) In the United States the Senate's budget resolution for FY 1986, passed in May, included plans for a freeze in social security cost of living adjustments and a proposal that further savings be found from the Medicare programme. Among the proposals there is also a real freeze on defence budget authority and a 20 per cent decrease in urban development grants. Between FY 1986-88 proposals also save US$2.5 billion through reductions in expenditure on agricultural price support and credit programmes, and US$2.5 billion by eliminating direct loans to small businesses. In addition, there is to be a 40 per cent reduction in subsidies to Amtrak by FY 1988.

(b) In Japan unemployment benefits were cut from August 1984, and since October 1984 insured workers have been required to pay 10% of health costs. Health care insurance premiums are now levied on a substantially larger portion of taxable income.

(c) In Germany pensioners' contributions to health insurance, introduced in 1984, will rise by a further 1½% in 1985 with no offsetting increase in pensions. Pensioner contributions to social security benefits were increased again on 1 January 1985. Cuts in subsidies to industry of DM1 billion in 1986 to be included in the July Budget were announced at the beginning of June 1985.

(d) In the Netherlands the 1985 Budget proposed reductions in unemployment and disability benefits and a shift in health expenditure from the public to the private sector, with 600,000 people now being required to obtain private medical insurance.

(e) In Italy, in 1984, savings in pension expenditure were made by, among other things, cutting entitlement for those with other sources of income. Family allowances for higher income earners are being progressively withdrawn and the availability of old age and invalid pensions has been reduced. Prescription charges have been introduced for drugs unless they are for essential or for emergency treatment: the 1985 Budget proposed a further 30% increase.

(f) In Canada the 1985 Budget included proposals to index age security payments and family allowances only for the annual increase in the consumer price index greater than 3%. [Note: the real cut in family allowance is partly offset by an increase in child tax credit.] The Government has also announced that it intends to limit growth in transfer payments to provincial governments in order to effect savings of about C$2 billion by 1990-91.

(g) In Australia the Government introduced an "assets" test from March 1985 for retirement pensions (which are already subject to an income test). On 14 May the Government announced a A$1¼ million package of expenditure cuts (ahead of the usual Budget in August). Included in the savings package were tight restrictions on eligibility for disability pensions and family allowances. Patient contributions for pharmaceutical benefits were also raised by 25% (ie, from A$4 to A$5 per prescription for the general patient). Included in the austerity package was a real cut in defence spending and savings of over A$200 million in industry assistance and development - mainly from reductions in subsidy and grant levels.

(h) In Belgium both subsidies to industry and educational expenditure were cut in real terms in the 1985 Budget and the subsidy to the national airline was removed.

(4)

CONFIDENTIAL

CHEQUERS

BRIEF ON PAY

Private sector pay

This is currently becoming a serious problem. The rate of increase fell satisfactorily early in the decade, but has now flattened out. Settlements are edging up, and average earnings growth has been stuck at 7½ - 8 per cent since early 1983.

In the longer term, policies to free up the labour market should make wages more responsive to the general excess supply in the labour market. But will need a willingness by employers to be much more robust in controlling labour costs. The evidence of the last year is worrying on this score: manufacturing unit wage and salary costs were growing at 1 per cent a year at the end of 1983. The latest estimates give figures of over 6 per cent.

Even if pay became more flexible now, it would take some years for major reductions to be made in unemployment. And the longer pay remains stubbornly on its recent path (rising at 2 to 3 per cent a year in real terms before taking account of what income tax changes have done to increase take-home pay), the longer the pressure on public expenditure will continue from support for the unemployed and the various employment measures.

Public service pay

This is a key element in public expenditure: about 30 per cent of the total. Performance has been good since 1981, when comparability was swept away, leaving three-quarters of the public sector collectively bargained. Both settlements and earnings growth for this group have been

.../

significantly below the private sector's for the last four years. This has been achieved despite the special treatment given to the rest of the public services (Review Body groups; plus policemen and firemen who have index-linked pay). And the government has taken a robust attitude here too: witness willingness to modify Review Body awards.

But gap cannot widen indefinitely. There are clear signs (teachers, local authority manuals, civil service strike ballot this year) that further ratchetting down relative to the private sector (and relative to the Review Body and index-linked groups) cannot continue for much longer, without running the risk of costly industrial action, and some sort of catching up exercise. Even if that judgment were wrong, recruitment and retention difficulties will eventually require allowing public service pay to grow at close to the private sector rate, although a general jump to private sector levels **should** be avoidable.

This is not a recipe for "letting up" on public service pay. A robust line will be needed in all negotiations, because of cost and the need - in fairness to the taxpayer - to pay no more to public servants than is required to recruit, retain and motivate. But in the longer term, it is unavoidable that movements in the average pay per head in the public services will be broadly in line with the private sector: the labour market will force that on us. Satisfactory long term arrangements for pay negotiations, such as are to be explored for the non-industrial civil service, may ease the transition period, and, taking one year with another, minimise the public expenditure costs. But in the long run, reducing public expenditure by squeezing public service pay relative to the private sector is not a feasible option.

.../

The Survey Period

Colleagues will argue that public service pay growth will be a serious problem for them in the survey period, and that some allowance should be made in this year's survey, if the Reserve is not to be raided, and cash limits are not to be broken. In particular, they may argue that the running cost targets need to be set at much more generous levels than you have in mind.

You may be able to set these points aside, because the meeting is about the longer term. But if not, you might make the following counterpoints:

(a) best way to guarantee rising pay settlements is to signal that extra money is being provided to finance them.

(b) still scope for manpower savings, especially in local authorities. (Running cost targets for central government designed, in particular, to make these trade-offs more obvious.)

(c) if needed to stick to plans, service levels will have to be cut back to make room for pay.

The Longer Term

Points (b) and (c) also apply in the longer term. But you might add to that:

(d) We intend to press on with policies to free up the labour market. But union resistance and lack of management steel, suggest that average pay growth will not moderate for some time. This has serious implications for unemployment and public service pay and therefore, for the long run. Could more be done without going down the incomes policy cul-de-sac?

5

PUBLIC EXPENDITURE PRIORITIES CABINET: 23 JUNE

Background brief on Capital Expenditure

Factual

1. Pressures for increased capital and maintenance spending likely to remain strong for number of years [as emphasised in your presentation, para 13 and Green Paper, para 42].

2. Capital spending in PEWP baseline presently planned to stabilise at around £22 billion (cash) a year throughout survey period (broad definition, Table 1.13 of PEWP; details in Annex D of Survey report).

3. Substantial additional capital bids received in Survey. Details in Annex E of Survey report, summarised as follows:

Gross capital spending plus capital grants* £ million

	1986-87	1987-88	1988-89
IBAP	460	470	480
DTp	130	150	210
DOE Housing	600	900	900
DOE Other	120	120	120
DES	50	60	80
DHSS Health	60	70	100
Other	140	160	200
Total	1560	1930	2070

*There will be some further bids for maintenance (classified as current)

4. [NOT FOR USE] GEP's assessment of Survey outcome allows

for net additions to capital expenditure of only £0.4 billion, £0.5 billion and £0.3 billion in each of the Survey years. Most of this is accounted for by IBAP intervention. Small additions are allowed for roads expenditure, but none for housing; there is assessed to be scope for cutting some capital programmes.

Positive

1. Long term perspective, should focus on relative roles of public and private sector. Policies aimed at moving activity, including provision of infrastructure in some areas, to private sectors, and private sector investment currently at record levels.

2. Must ensure that projects are properly assessed and properly justified. Too much capital spending in past wasted resources. All capital bids must be justified by rates of return, as Survey guidelines asked. Accept need to take account of wider economic and social benefits.

3. If colleagues have worthwhile projects must try to find room for them within programmes. Make sure that projects with inadequate returns are squeezed out; more importantly, emphasises need to continue search for savings in current expenditure, whether from increased efficiency on other reductions.

Defensive

1. Although aggregate capital spending declining in real terms, little evidence that a significant queue of worthwhile projects being squeezed out by pressure on totals. [Accept, if pressed, that may be examples in some areas, but these would be for discussion in Survey].

2. Work on public sector built infrastructure in NEDO interesting. No doubt Departments had mutually instructive dialogue with CBI and TUC. Clearly there has been much misunderstanding of just how much the Government does; for example CBI criticisms of DTp programme have been largely confined to relatively narrow areas of cost benefit techniques, and timing and procedures. Figures NEDO quoted for backlogs etc not been borne out [although accept that there are some black spots].

4. Recognise that needs of one year funding cycle, and annual expenditure and borrowing targets can cause problems for longer term planning of capital programmes. Problems not unique to public sector, but must maintain control of aggregate expenditure in short term if long term plans are to be credible. Markets' reaction would make achievement of our objectives more difficult. Subject to this, and Parliamentary constraints, accept that should explore scope for flexibility in planning and controls system, and have introduced innovations (especially end year flexibility scheme).

5. CBI recommending greater spending on infrastructure, especially roads [in report to be published on 24 June, and possibly advanced to colleagues]. Nothing new in these recommendations, which reflect industrial make-up of CBI working party. Most of the roads schemes concerned already in DTp's programme, and tripartite discussions (see 2. above) suggest very little difference between us and CBI.

0[illegible]76

6

EFFICIENCY IMPROVEMENTS

Points to Make:

(i) Must assess how much public spending we can afford by looking at the **cash inputs** relative to other claims on resources.

(ii) But mistake to judge **results** and degree of **success/failure** of our spending policies by just looking at inputs. Have too often done so in the past. But what matters to consumers of public services is **outputs** - what we actually achieve with the resources we put in.

(iii) So answer to relentless demands for more and better public spending is **not** pumping in more and more inputs. Inputs will always have to be restrained. We must try to get more out of what we already put in - improved **efficiency, value for money** etc. Holding public spending **inputs constant** should mean **increasing outputs.**

(iv) Have already done a good deal - Rayner/Ibbs scrutinies, reviews etc. But must do more. Hence for example:

(a) **Running costs control;** will sharpen up our control over **total** administrative costs.

(b) **Purchasing;** welcome targets set by Levene and by director of the new CUP (Willacy). Scope for both immediate and continuing savings.

(c) **More efficient general management** of large public sector organisations eg NHS under Paige.

(d) **Improved budgetting and management practices** with more individual accountability - FMI etc.

Good private sector organisations already do all these things and work for **continuing efficiency improvements** each year - we must do same.

(v) Must also get away ourselves in **speeches and publications** from highlighting level of inputs as a measure of achievement. That is bound to make us vulnerable to critics. Must instead focus on outputs and value for money. Have already started, eg in PEWP, but must go further.

GEP1 Division

CONFIDENTIAL

7

NATIONALISED INDUSTRIES/PRIVATISATION

£ million

	1985-86	1986-87	1987-88	1988-89
EFLs Baseline	1318	83*	185**	192**
Bids	+330***	+897	+550	+734

* excluding BA

** excluding BGC, BAA, NBC

*** industries' latest estimated outturn

	1985-86	1986-87	1987-88	1988-89
Special sales of assets baseline	2,500	2,250	2,250	2,250

Factual/Points to Make:

1. Longer-term priorities for nationalised industry expenditure are closely bound up with the pace of the privatisation programme:

(i) To the extent that profitable industries with negative EFLs are sold, public expenditure increases although future investment requirements will no longer affect public expenditure.

(ii) PSBR may benefit from increased tax revenues from the privatised companies and dividend payments in cases where the Government retain a minority shareholding for the time being.

(iii) To the extent that equity substitutes for gilts, future interest payments fall.

2. The overall future effect of these factors is very difficult to quantify. The privatisation programme planned for the next 3 years will certainly increase above figures but impossible to forecast by how much. Many decisions yet to be taken and future market conditions cannot be predicted. Present problems with BA show how easily things can go wrong.

3. In any event wrong in principle to finance continuing additional public expenditure by one-off asset sales. Controlling gross public expenditure is key element in overall strategy. The fact that accounting conventions allow asset sales to finance increased expenditure and offset it within the planning total cannot be allowed to distort medium-term objectives.

4. E(A) has commissioned a review of privatisation prospects and colleagues are meant to bring forward their proposals for the next Parliament by the Recess.

5. Future priorities for nationalised industries remain the same as now:

(i) Industries will need to be pressed to improve productivity and reduce operating costs and increase efficiency and profitability.

(ii) Prices need to be increased to economic levels where appropriate and subsidies reduced or eliminated.

Achieving these objectives not only will reduce the financial demands of those industries remaining in the public sector but will increase the scope for privatisation.

PE2 Division

(8)

CONFIDENTIAL

THE PROSPECTIVE DECLINE IN NORTH SEA PRODUCTION AND REVENUE

Margins of error surrounding forecasts of North Sea production are enormous. But the current projections, consistent with the 1985 MTFS, for output and revenues are as follows.

	1984	1985	1986	1987	1988	1993
North Sea Oil and NGL Production (million tonnes)	125.9	120-135	110-130	95-125	85-120	40-90
	1984-85	1985-86	1986-87	1987-88	1988-89	1993-94
Total North Sea Oil and Gas Revenues						
- £bn, cash	12	13½	11½	9½	8½	6
- £bn, 1984-85 prices	12	13	10½	8½	7	4½

2. Revenue forecasts assume some fall in real sterling oil prices. Real demand is taken to leave real dollar oil prices soft and sterling is assumed to rise further against the dollar.

3. Salient points of the projections are:

a) production will decline in future years - perhaps by 10 per cent or more by 1988-89 compared to current levels. By 1993-94 production could be down to half present rates;

b) revenue will decline along with production. By 1988-89, cash revenues could be running at only two-thirds of the present rate.

c) In real terms, the revenue decline would be greater:

- 1988-89 little more than half current level.
- 1993-94 only about a third current level.

4. In spite of large margins of error, it would be unwise to bank on a more favourable revenue outcome. A less favouable situation is just as likely.

5. Recent developments in the oil market suggest that the MTFS revenue projections may be too optimistic. The internal June forecast just completed projects lower revenues up to 1988-89.

Sensitivity

For unchanged exchange rate, 1 per cent rise in the dollar oil price raises North Sea revenues by £150 million in the first year and by £180 million in a full year.

For unchanged dollar oil price, 1 per cent rise in the sterling exchange rate against the dollar reduces revenues by £150 million in first year and by £180 million in full year.

At present prices and exchange rates [Brent Spot price $26.25/barrel; Exchange rate $1.2780 = £1]

	Effect on Revenues (£ billion)	
Exchange Rate	First Year	Full Year
+ 5 cents	-0.6	-0.7
- 5 cents	+0.6	+0.7
$ Oil Price		
+$1 / barrel	+0.6	+0.7
-$1 / barrel	-0.6	-0.7

MP1 Division