

PRIME MINISTER

## PUBLIC EXPENDITURE SURVEY

You will first ask the Lord President to introduce his paper. I suggest you then thank him most warmly, noting that he has carried the very heavy burden of the Star Chamber at the same time as the very difficult legislative pressures in the Lords, which most members of Cabinet do not see. You could ask Robert Armstrong to record the Cabinet's gratitude formally in the minutes. →

You will then ask the Chief Secretary to speak, followed by the Chancellor.

At the end of the discussion you could ask the Chancellor or Chief Secretary, as appropriate, to respond to points made by Cabinet colleagues.

In your summing up, you could:

(i) Thank the Lord President again, and colleagues, for their cooperation in the work of the Star Chamber.

(ii) Record that Cabinet has endorsed the proposals set out in the Lord President's paper.

(iii) Record that Cabinet has endorsed the planning totals proposed by the Chancellor.

DWS

DN

5 November, 1986.

JD3ARQ



CCB/UP  
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Ref. A086/3178

PRIME MINISTER

Public Expenditure Survey 1986

C(86) 22

## CONCLUSIONS

You will wish the Cabinet to record conclusions on:

- i. Whether the settlements on individual programmes agreed bilaterally between the Chief Secretary, Treasury and spending Ministers, or recommended by the Ministerial Group on Public Expenditure (MISC 130), are acceptable. Particular issues arise on the electricity (England and Wales), defence, Scotland and Wales programmes on which it may be appropriate for the Cabinet to give guidance.
- ii. Given that the additions to programmes arising from the 1986 Survey more than exhaust the available Reserves in each of the Survey years, what additions should be made to the public expenditure planning totals (ie how and to what extent should the Reserves be reconstituted)?
- iii. The announcement and presentation of the Government's decisions.

## BACKGROUND

2. At their meeting on 17 July the Cabinet agreed that the Chief Secretary, Treasury and spending Ministers, in carrying forward discussions of the 1986 Survey, should work within the publishing planning totals of £144 billion for 1987-88 and £149 billion for 1988-89, and within a newly set planning total of



£153 billion for 1989-90 (CC(86) 28th Conclusions, Minute 7). Since then there have been extensive bilateral discussions between the Chief Secretary, Treasury and spending Ministers and, more recently, in MISC 130 under the chairmanship of the Lord President of the Council.

3. As the Lord President's paper summarising the work of MISC 130 makes clear, settlements have been reached on all programmes. The main elements in the 1986 Survey are summarised in the following table.

Additions to Programmes

	£ billion		
	1987-88	1988-89	1989-90
Local authority current expenditure	3.4	4.3	5.1
Social Security (demand-led and administration)	1.6	1.7	2.6
Agreements reached bilaterally	1.1	0.7	1.1
Teachers' Pay	0.6	0.9	1.0
Other additions recommended by MISC 130	0.8	0.5	0.9
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Total additions to programmes	7.5	8.1	10.6
(compared with starting Reserves of	6.0	7.9	9.6)



4. As will be apparent, MISC 130 have had very little room for manoeuvre. The Rate Support Grant settlement agreed in the summer absorbed more than half the available Reserves in each of the three Survey years. Demand-led expenditure on social security (ie allowing for changes in economic assumptions, the latest estimates of take-up, and administration costs) meant irresistible increases of £1.6 billion, £1.7 billion and £2.6 billion for the three Survey years respectively, which absorbed much of the remaining balance of the Reserves. Settlements reached bilaterally by the Chief Secretary, Treasury took the process a stage further. The additional bids on the eight programmes considered by MISC 130 (net of demand-led additions to social security) amounted to £1.5 billion, £1.0 billion and £2.1 billion respectively for the three years; the settlements agreed by the Group reduced these amounts by nearly 50 per cent for 1987-88, 70 per cent for 1988-89, and 60 per cent for 1989-90. Nevertheless, despite the Group's efforts, the total additions to programmes exceed the available Reserves in each of the three years by £1.5 billion, £0.2 billion and £1.0 billion respectively.

#### Programme Agreed Bilaterally

5. Annex B to C(86) 22 summarises the settlements reached bilaterally between the Chief Secretary, Treasury and the responsible spending Ministers. A number of these reflect economic circumstances over which the Government have little or no control; examples are EC contributions, IBAP, ECGD interest support, civil superannuation and the costs of mortgage interest relief for those whose incomes fall below the income tax threshold. There are substantial increases for the work of the courts, legal aid, the Crown Prosecution Service and various elements of Home Office expenditure. Apart from the large increases agreed last week by the Cabinet for teachers' pay, there are significant increases for universities and science - both of them programmes subject to a sharp spending squeeze in



recent years. Substantial increases have been agreed for local authority capital programmes (housing, schools and other) primarily in 1987-88, in order to meet the Government's previous commitment that allocations to local authorities in that year would be no less than 80 per cent of the 1985-86 level. Additional receipts from asset sales will help to support new local authority capital investment, particularly in the later Survey years. Local authority capital expenditure is likely to be an area of continuing friction, while science and universities are unlikely to be entirely satisfied by the increases agreed; with these exceptions, the settlements agreed bilaterally seem unlikely to give rise to significant controversy.

#### Programmes Considered by MISC 130

6. Paragraphs 8-16 of C(86) 22 set out the main elements of the settlements agreed in MISC 130. A detailed commentary is --- attached at Annex A. You may like to note particularly what is said about defence, electricity and Scotland and Wales, on which some discussion may arise.

#### Implications for Public Expenditure Planning Totals

7. Some increases in the planning totals are inevitable. It will be for the Chancellor of the Exchequer to suggest how large these increases should be. Some part of them might be offset by further increases in forecast privatisation receipts, but this is unlikely to be of much help in presenting the new position to the financial markets. Since the programmes now include 'realistic' figures for local authority current expenditure (in marked contrast to last year's White Paper), and in addition full provision has been made for teachers' pay, it is arguable that somewhat smaller Reserves than shown last year would be



reasonable. But when all things are considered, increases in the planning totals of the order of £5 billion in each year seem inevitable. An inkling of this was, of course, given in today's front page article in the Daily Telegraph.

8. All of this will need to be covered in the Chancellor of the Exchequer's Autumn Statement, in which he will make clear that the current year's planning total will be overspent by £1.3 billion. The implication of these figures is that there will be a real increase in public expenditure this year of about 1.5 per cent, followed by a further increase of nearly 2 per cent in 1987-88; thereafter increases of 0.5 per cent and 1.5 per cent are in prospect. These figures need to be set against real growth in the economy, now put at 2.5 per cent for 1986 (a little lower than expected at the time of the Budget) and 3 per cent in 1987; although it has not proved possible to hold expenditure broadly flat in real terms as indicated in the 1986 Financial Statement and Budget Report, it remains clear that public expenditure will still be growing more slowly than Gross Domestic Product (GDP), and thus represent a declining proportion of GDP.

9. So far as the markets are concerned, the key to their response is likely to lie in what the Chancellor of the Exchequer says about his fiscal stance. The pattern of growth in the United Kingdom economy this year and next will be dominated by fast growth in consumers' expenditure fuelled by pay increases which have been, and are expected to continue to be, well above the rate of inflation. The implication of this is that income tax and value added tax revenue will also be moving ahead rapidly, more than counter-balancing the revenue lost through the reduction in oil prices. These additional revenues will be of substantial help in absorbing the higher level of expenditure, without resulting in public sector borrowing higher than shown in the Government's Medium Term Financial Strategy. A clear statement that the Government will



not allow the higher expenditure levels to result in higher borrowing should be of substantial reassurance to the market; the fact that revenues will be increasing relatively rapidly reduces the risk that there might need to be awkward adjustments in tax. However, the Chancellor of the Exchequer will not wish to get drawn into any discussion at this stage of the size of the fiscal adjustment, if any, available at the time of the 1987 Budget.

#### Announcement and Presentation

10. The timing of the opening of the new Parliamentary Session in relation to the privatisation of British Gas means that the Autumn Statement needs to be made without delay. The need to minimise speculation and reassure markets similarly argues for a Statement as soon as possible after the Cabinet have to the substantial increases in the public expenditure planning totals resulting from the 1986 Survey. Accordingly arrangements have been made for the Autumn Statement to be made on the afternoon of the Cabinet's discussion. This procedure has been considerably helped by the fact that all programmes have been settled, so that there are no substantial loose ends to be tied up by the Cabinet. The spending Departments have all been instructed to prepare appropriate press notices setting out the main elements of their programmes over the three years of the Survey period, and these will have been cleared as appropriate with the Treasury and other interested Departments. There remains the problem that different messages have to be conveyed to different audiences: on the one hand, it is essential that the financial markets retain confidence in the Government's determination to stick to their announced fiscal stance and to maintain firm control over the public expenditure programmes, but at the same time spending Ministers will wish to take credit for increases in their programmes as responding to demands by the population at large for the maintenance of proper standards



of public services. The Chancellor of the Exchequer will no doubt be seeking to steer a careful course addressing both audiences in his Autumn Statement.

## HANDLING

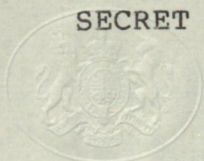
11. You may find it convenient to divide the discussion into the following parts:

- a. the results of the 1986 Survey, and any points on individual programmes;
- b. the setting of new public expenditure planning targets, in the context of the discussion of the economic outlook;
- c. announcements and presentation.

No.  
You  
decided  
the  
Chancellor  
should  
follow the  
Chief  
Secretary.

12. You may wish to invite the Lord President of the Council to report on the work of his Group and on the results of the Survey. Thereafter the Chief Secretary, Treasury might be invited to give his reactions to the results of all the discussions of the individual programmes. Other Ministers may wish to raise specific points on individual programmes; since it would be extremely awkward to reopen any of the settlements, you will not wish to encourage any extended discussion, although you may perhaps wish the Cabinet to record a specific conclusion on advancing the minehunter programme. Once the Cabinet have agreed on the programmes, you will wish to invite the Chancellor of the Exchequer to set out the economic prospects as he will be presenting them in his Autumn Statement, and to suggest how and to what extent the Reserves should be reconstituted in setting new public expenditure planning totals. Other Ministers may wish to register particular points on this part of the discussion. You will wish to ensure that the Cabinet are firmly behind the approach the Chancellor of the Exchequer would be





putting forward. On announcements and presentation, the fact that the Autumn Statement will be made the same day should considerably simplify the task of dealing with press inquiries following the Cabinet discussion; all that needs to be said is that the 1986 Survey has been completed; that agreement has been reached on all programmes; and that the Chancellor of the Exchequer will be announcing the results in a Parliamentary Statement in the afternoon.

RTA

ROBERT ARMSTRONG

5 November 1986



ANNEX A1. Defence

Some relatively small net changes were agreed bilaterally, covering the latest estimates of actual Falklands costs, some additional funds for the Agencies, and other Departments' contributions towards the cost of bringing forward the order for AOR 02. These changes apart, provision was added for actual Falklands costs in the third year (the baseline had been constructed by deducting the Falklands costs from the Falklands-inclusive figure agreed last year for 1988-89), and £33 million was transferred from year 2 to year 3, on the understanding that this would not be taken into account in next year's Survey in setting the 1990-91 baseline. The implication of the settlement is that real expenditure on defence is scheduled to decline by about 2 per cent in each of the first two Survey years, and about 1/2 per cent in the third year. Some of this decline, of course, reflects the falling costs of the Falklands operations.

The one outstanding issue is the possible advancement of the minehunter programme, so as to provide continuity of work at Vosper Thornycroft, which E(A) were inclined to support and asked MISC 130 to consider. In the event the Chief Secretary and the Defence Secretary, neither of whom has any interest in bringing forward the minehunters, have agreed outside MISC 130 that nothing should be done; in view of the Defence Secretary's earlier offer to bear 25 per cent of accelerating the orders, and of MISC 130's decision not to pursue the Chief Secretary's demand for £300 million reductions in the defence budget in each Survey year, the Cabinet might feel it would be reasonable to insist that the defence budget should absorb the whole costs of bringing the programme forward (which amount to only £29 million over the three Survey years). The arguments would be that this was necessary to defend the reputation of the Government's privatisation of the warship-yards, and that the





Ministry of Defence, while remaining a keen and competitive purchaser, should not abuse its monopsony power.

## 2. Electricity (England and Wales)

This was a very difficult programme. The industry makes net cash payments to the Exchequer, and the Department of Energy thus has no direct financial leverage. Nor has the Energy Secretary any specific power to control prices or fix financial targets; financial targets have to be agreed between the Government and the industry, and the initiative on pricing rests with the industry. For the 3-year period 1985-86 to 1987-88, the agreed target rate of return on current cost net assets is 2.75 per cent, which will be handsomely exceeded during the current year; the industry have accordingly insisted that they need only earn a little over 2.50 per cent next year, and that they should fix prices accordingly. For 1988-89, the external financing requirement figure agreed last year implied a return of 3.50 per cent; the industry have accepted this year that they will have to deliver the 'savings' agreed last year, although they have not committed themselves to a higher financial target, and clearly intend to resist doing so until after the next Election.

For 1989-90 the industry's figures were constructed on the basis of a reversion to a return to 2.75 per cent; the Energy Secretary has agreed that the additional bid resulting from this should be eliminated from the figures, but there is no commitment on the part of the industry to comply with this. The only figure which will actually have to be published at this stage is the external financing requirement for 1987-88, where MISC 130 have been obliged to accept an additional bid of £380 million; for the later years only total figures for all nationalised industries' external financing requirements are shown (although in the White Paper there is a table showing the Department of Energy's nationalised industries all taken together). Thus it will not be possible to deduce from the published figures



exactly what has been assumed for electricity in years 2 and 3.

The Group seek Cabinet endorsement that the Energy Secretary, in negotiating the financial target for 1988-89 and 1989-90, should aim at a rate of return of 3.75 per cent. On the basis of this year's experience, the industry will be reluctant, and the Energy Secretary may object that he cannot deliver. However, a target ought in principle to be agreed before next year's Survey, since the result of the Survey will effectively determine the external financing limit for 1988-89. It would certainly be useful to put the Cabinet's authority behind the requirement of a higher financial target.

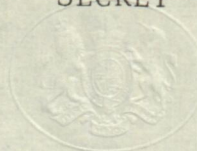
### 3. Overseas Development Administration

The Foreign Secretary asked for increases sufficient to keep aid expenditure at a constant proportion of a rising gross domestic product (GDP). The Group rejected this, and were not prepared to do more than concede the small increases required to maintain constant expenditure in real terms. As the interest subsidy element in the Aid and Trade Provision (ATP) programme expands in the third year, it will have the effect of squeezing the bilateral aid element in the overall total.

### 4. Health and Personal Social Services

The settlement here gives the Social Services Secretary two-thirds of his additional bid for 1987-88 and three-quarters or more for the two subsequent years. Substantial increases were agreed by the Chief Secretary, Treasury in advance of the Group's discussions on account of demographic growth and higher expenditure on the demand-led Family Practitioner Services. The case for the remaining additional bids was made in terms of specific requirements for identified purposes; since in practice the Health Authorities have to meet demands of all kinds as best they can out of a central allocation, the Group preferred to concentrate on the overall real change in current expenditure on





Hospitals and Community Health Services (HCHS), which are the main focus of public interest. The settlement would enable the Social Services Secretary to point to a real increase of 2.2 per cent next year in HCHS current expenditure, with 1 per cent increases in the two subsequent years. Much of these increases, of course, reflects real increases in the pay of the medical profession in line with pay elsewhere in the economy; this is likely to be a continuing problem.

#### 5. Social Security

The additions agreed by the Group essentially reflect demand-led changes resulting from revised estimates of take-up and revised economic assumptions, and would in any event have been irresistible. The 'policy' increase of £35 million in 1987-88 reflects the difficulty of delivering savings in this area; legal and procedural problems have made it impossible to introduce the capital cut-off for housing benefit as from April 1987, in accordance with the agreement reached by last year's Star Chamber. It has also been necessary to make some concession on the restriction of Supplementary Benefit payments for mortgage interest which was agreed as part of last year's settlement; this concession has been offset by not uprating the limits for board and lodging payments next April. For the second and third Survey years the Social Services Secretary has agreed to make reductions of £100 million and £250 million respectively. Some part of these savings may come from further measures to combat fraud (which should not really count as 'policy' savings) but the main substance will require new primary legislation (e.g. to impose tighter contribution conditions for unemployment benefit) to be enacted as soon as possible after the Election. No decisions have been reached about how the larger savings for the third year should be secured; one possibility would be not to uprate child benefit in April 1989 - but the figures already assumed no uprating in April 1988 when the Family Credit Scheme will be available for the first time to give assistance to the families most in need.





## 6. Arts and Libraries

The prospective overspend on the British Library is being separately investigated, and has been set on one side for the purposes of this year's Survey. The increases agreed by the Group amount to about half the remaining bid for 1987-88, and about a third for each of the two subsequent years. Despite Mr Luce's strenuous efforts, district councils are continuing to fall well short of assuming the burden formerly carried by the Metropolitan Authorities as patrons of the arts. The settlement should be just enough to avoid politically embarrassing closures (e.g. Sadlers Wells Theatre or the Royal Liverpool Philharmonic Orchestra), but continuing criticism is likely from the arts lobby. National museums and galleries will continue to have difficulty with inadequate maintenance and shortages of funds for new purchases. Ministers can, however, respond that the budget tax concessions should make it possible for arts organisations to secure substantially more income from the private sector, and that museums and galleries are free to do whatever they like with income from entrance fees.

## 7. Scotland and Wales

The arguments here focussed on the extent to which the territories should receive the benefit consequent upon the 'legitimisation of overspending' by English local authorities implicit in the Rate Support Grant (RSG) settlement for 1987-88. The territorial argument is that application of the formula keeps movements in the aggregate of central Government and local authority expenditure in Scotland and Wales in line with comparable movements in England, and that they should therefore receive the full consequential adjustments on local authority current expenditure just as they do on central Government and on local authority capital programmes. The counter arguments are that Scottish and Welsh local authority expenditure has already been settled, so that giving Scotland and Wales the additional territorial consequentials in effect gives them more money for





other programmes on which they will get the regular consequentials in any event; and that some recognition ought to be given to relative changes in population in setting the territorial baselines. In the event the Group allowed the Welsh Secretary more than two-thirds of his additional local authority consequentials, noting that some part of the reductions accepted by the Welsh Secretary would be attributed to the small change in the relative Welsh population since 1979.

In the case of Scotland, however, where the relative change in population is much more significant, and where expenditure per head on public services is 28 per cent higher than in England, the Group pressed very hard for a change in the base which would have meant a significant net reduction in the central Government and local authority capital consequentials as well as nothing in respect of the additional consequentials on local authority current. The Scottish Secretary fiercely resisted this demand for further reductions, which in his view could only be justified if clear evidence were available from a full needs assessment. He did accept, however, that there should be reductions to the extent that these could be absorbed without requiring him to make overt reductions in public service provision which were not paralleled in England and Wales. In the event the Scottish Secretary surrendered the bulk of the additional local authority current consequentials, accepting that this would in due course need to be explained in part by reference to the relative population change, as in the case of Wales.

Mr Rifkind is likely in due course to face substantial criticism in Scotland, given that he has accepted a settlement significantly less generous than that achieved by Wales. Meanwhile the Group for their part remain unpersuaded that public expenditure per head in Scotland 28 per cent higher than in England can be justified. One possible avenue would be to commission the needs study resisted last year by Mr Younger, which Mr Rifkind now says he would accept. But this would bury the issue in the





long grass for 2-3 years, during which time it would be hard to make any adjustments. This may be something which should be considered again after the next Election. Meanwhile there may be a case for reconsidering the operation of the formula so far as it affects local authority current expenditure; on the face of things it is odd that the territories should get more money for their central government programmes as a result of over-spending by English local authorities.



have agreed for Press Office to take.  
pa DLW  
5/11

The Star Chamber has completed its talks and we would expect that its recommendations will be considered by Cabinet tomorrow. Until Cabinet has approved the recommendations, nothing is decided. ~~If agreement is reached it would be possible for~~

*But* Mr Lawson ~~to make a statement tomorrow. But we can't be certain.~~  
*we hope to be able*

We can't discuss the content of any statement in advance, including the projected levels of spending. We have said repeatedly that it has been a difficult PES round. ~~Talk of tax cuts having to be sacrificed is entirely premature and~~ the possibility of an early election is not merely pure speculation but has repeatedly been scotched by the Prime Minister.



FROM: B FOX

DATE: 5 November 1986

ALL UNDER SECRETARIES AND ABOVE  
 PS/CHANCELLOR  
 APS/CHANCELLOR  
 PS/CHIEF SECRETARY  
 PS/FINANCIAL SECRETARY  
 PS/ECONOMIC SECRETARY  
 PS/MINISTER OF STATE  
 MR P GRAY  
 MR R PRATT  
 MRS R BUTLER  
 MISS SINCLAIR  
 MISS O'MARA  
 MR C MOWL  
 MR SEDGWICK  
 MR R CULPIN  
 MRS R DUNN  
 MR M STOCK  
 MISS C EVANS  
 MR C PICKERING  
 MR A RICHIE  
 MS M WALLACE  
 MISS L ADAMSON  
 MR D WALTERS  
 MR J DARLINGTON  
 MR M REES  
 MR N WICKS )  
 MR D NORGROVE ) No 10  
 MR B GRIFFITHS )

(F)

Note.

Told Tex none had  
 spoken to A. Sol anyone  
 at Telegraph tho' DN  
 had spoken to J B-G.  
 about the PM's Gurdellhill  
 Speed N-L-U

DAILY TELEGRAPH

Today's Telegraph carries a lead story speculating on the contents of tomorrow's Autumn Statement.

5-11

2. I should be gald to know, by 3.30 today, if you have spoken to Anne Segall, or anyone else at the Telegraph, in the past two weeks and, if so, the nature of the conversation. I should be grateful for nil returns, by 'phone if convenient.

B FOX