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Treasury Chambers, Parliament Street, SW1P 3AG

Paul Gray Esq
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6 July 1988

Dear Paul,

PUBLIC EXPENDITURE CABINET

As noted in your letter of *30* June to Moira Wallace, it was agreed that the Chief Secretary would let the Prime Minister see a draft of the paper on public expenditure which he would be putting to Cabinet for discussion on 14 July. I now attach the paper. I would be most grateful for any comments by the close on Friday.

You will see that the section (and conclusion) on local authority current expenditure is yet to be written. We intend to draft passages in the light of the discussion at E(LA) this evening, and will send over the draft as soon as possible.

We will also be sending over a suggestion as to the line that might be taken with the Press after the Cabinet meeting.

A draft of the Chancellor's paper on the overall economic prospects is being sent over separately.

I am copying this letter to Moira Wallace.

Yours,

Jill

JILL RUTTER
 Private Secretary

DRAFT CHIEF SECRETARY PAPER FOR CABINET 14 JULY

1. Our objective is to bring public spending down progressively as a proportion of national income. Over the past five years we have succeeded in achieving this, reversing the overall trend of the 1960s and 1970s. As a result of our success in this, and in our supply side reforms, we have been able to combine a steady but controlled growth of public expenditure in real terms with a reduction in borrowing and with reductions in personal taxation. ✓ *The elimination of public sector*

2. These policies have laid the foundation for our economic success. And it is because the economy has been strong that we have been able to afford a steady shift of resources ^{more} into our priority public spending programmes. It is particularly important that we continue to follow these policies, not least given the overriding need to maintain confidence both at home and overseas, as the Chancellor points out in his paper.

3. There remains a major task ahead of us. The overall burden of tax (excluding the North Sea), at 37.7 per cent, is still well above the 34.3 per cent figure we inherited in 1979. If we are to get below that figure, and maintain confidence, public expenditure must continue to grow significantly less rapidly than GDP.

4. But the plans in the last Public Expenditure White Paper involve growth in expenditure only just below that of GDP - an average of $2\frac{1}{4}$ per cent real growth a year in spending on departmental programmes (ie the planning total excluding privatisation proceeds), compared with a reasonable assumption for the trend growth of the economy of $2\frac{1}{2}$ per cent a year.

The bids

5. The baselines for this year's Survey are based on those plans. They total £172.1 billion in 1989-90, £181.2 billion in 1990-91, and, with an uplift factor of 2½ per cent, £188.9 billion for 1991-92. Departments were asked to review their programmes within their baseline figures and to put proposals to me, where they felt, after a review of priorities, that additional resources were required. My minute of [7 July] to the Prime Minister summarised the bids received from departments. In addition we must take account of higher expected net payments to the EC, and of pressures for extra provision for local authority relevant current expenditure and for the nationalised industries. ??

6. The size of these bids clearly puts our objectives at risk. If anything like this were accepted, the growth rate in real terms of the planning total (excluding privatisation proceeds) would exceed that of the economy as a whole. Public expenditure would rise as a percentage of GDP, as would the tax burden. [There would be no prospect of progress towards a 20p basic rate.] This would reverse the progress we have hitherto made towards our objectives. We would be seen in the financial markets and more generally as having lost our grip on public expenditure, at a time when the battle against inflation clearly calls for restraint; and as having built up massive spending commitments for the period up to 1991 on the basis of the exceptional rate of economic growth in 1987 and 1988 which is not sustainable over a period of years. Letting expenditure rip in this way could only lead to painful retrenchment later in this Parliament - precisely the kind of short term reversal that our careful planning has enabled us to avoid.

7. If these consequences are to be avoided, we need to keep as close as possible to the existing planning totals, and ensure that the ratio of total public expenditure (excluding privatisation proceeds) to GDP continues to decline steadily over the three Survey years. To achieve this, the bids ^{must be cut} ~~will need to be~~ ^{any Net are} ~~substantially scaled~~ back, and we shall need to look for policy changes and other savings to help offset ~~them.~~ ^{unavoidable.} ✓

8. In particular, for a number of years the Government's capital programmes have benefited from increases in construction prices below those of inflation generally. But there are now clear signs that pressures in the construction industry are causing prices to move against us. A number of the bids have a large construction content; we will need to consider very carefully whether we should be adding to those pressures, which may well exceed the industry's physical capacity to deliver.

Running Costs

X
where?
9. Running costs bids are also ^{much too} high. They imply a real rise of 5% in Civil Service costs in 1989-90 over 1988-89, an increase in Civil Service numbers of 20,000 to more than 600,000 by 1990-91, and a rise in the share of public expenditure devoted to administration.

X
10. We should be criticised for reversing our past achievements on Civil Service manpower and losing control of Civil Service costs if we were to allow increases on anything like this scale. I hope therefore that colleagues will cooperate in settlements which will enable me, as agreed last year, to hold roughly constant the running costs share in planned expenditure. This means that all departments will need to settle for less than their bids, in most cases ^{much} ~~substantially~~ less.

11. We agreed last year that realistic three-year running costs settlements would be conditional on the development of satisfactory management plans. I am grateful to colleagues for the personal impetus they have given to this process.

12. In a few cases it is doubtful whether there is yet a satisfactory framework for adjusting provision. In some cases there should be scope for aiming for clearer and more ambitious efficiency targets. I shall ask my officials to explore that scope with departments before the bilaterals.

13. For departments with satisfactory management plans underpinning agreed three-year settlements, I should be willing, on a limited scale, to consider a small extra margin of provision where they commit themselves to increasing receipts for services for which they charge and for which demand pressures are strong. I also propose in future White Papers to show administration costs both gross and net of receipt income.

14. These small modifications to the running costs system are outlined in the annex. They should provide some increase in flexibility and bring out more clearly the costs of financing Government administration. They give no ground for relaxing our efforts to contain these costs, or for the unacceptably high level of bids received in this Survey.

Nationalised industries

15. Some of the nationalised industries are already bidding for more than their baseline provision, and all of them have the opportunity to put in revised bids this month. I propose that our aim should be to keep overall provision to baseline or less and to bring individual industries below it where that is possible. We plan to privatise the Water and the Electricity industries during the present Survey period. We will need, therefore, to take account of the loss of their substantial negative External Financing Requirements; this will need careful handling in the Autumn Statement although it does not become a major factor until the last of the Survey years, 1991-92. In the meantime, we should continue to examine their plans rigorously - as for the other industries - bearing in mind the implications both for public expenditure while they remain within the public sector and for proceeds when they are privatised.

Local authority current expenditure

now attached - see at end.

16. [Local Authorities: to be completed on Thursday when position clearer].

Conclusion

17. I ask Cabinet:

(i) to agree that public expenditure should be held as close as possible to the existing planning totals, and that, after excluding privatisation proceeds, the ratio of total public expenditure to GDP should continue to decline steadily over the three Survey years.

(ii) to agree that the share of running costs in planned public expenditure should be held constant; and to agree the proposals in the Annex.

X
X
X
(iii) to note that, to secure these objectives, bids for expenditure and running costs ^{must be} ~~will need to be~~ substantially cut back and difficult decisions will ~~have to be faced in~~ many areas. _{need to be taken}

(iv) to agree that we should aim to hold the External Financing Limits of the nationalised industries at least to baseline and where possible below.

(v) [local authorities - to be completed on Thursday].

(vi) To agree that I should now conduct bilaterals with colleagues on their spending programmes, and to note that, if it proved impossible to reach agreement in these discussions, it might be necessary at the appropriate time to establish a small group which would consider outstanding issues and make recommendations to the Cabinet.

Running costs: Treatment of Receipts

1 When we introduced the running costs system in 1986 it was agreed that running costs expenditure should generally be planned and controlled on a gross basis. We also agreed that where blocks of work can be made entirely self-financing and can demonstrate satisfactory management control systems they can be exempt from gross control. Six such exemptions have already been agreed and more applications have been made in the present Survey. To reflect the rising scale of this exemption from gross control I propose to provide a supplementary analysis in the 1989 White Paper showing trends in administration costs both gross and net of receipts.

2 The exemption arrangements provide an important element of flexibility in the running costs system. But they cannot usually be applied where receipts are insufficient to finance in full the blocks of work which generate them. To increase the incentives for generating more receipts and our capacity to respond to marginal demand pressures in such cases, I should be willing in this and future Surveys to consider marginal increases in agreed gross running costs provision where these are backed up with undertakings to increase receipts over and above existing trends and forecasts and departments have management plans suitable for three-year settlements of their main running costs provision.

ECON POL: Public Expenditures

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16. Cabinet on 7 July endorsed the decisions that had been reached in E(LA) about the RSG Settlements for England and Wales for 1989-90. We have agreed to make provision for "relevant current" expenditure by local authorities in England of £29,140 million and in Wales of £1,785 million. Taken together, these new plans represent an addition to programmes for 1989-90 of just under £1½ billion; we will need to take account in the remainder of the Survey of this substantial increase. I am discussing the equivalent settlement for Scotland with the Secretary of State.