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PRIME MINISTER

BILATERAL WITH THE CHANCELLOR: PUBLIC EXPENDITURE SURVEY

Tomorrow's bilateral will also be attended by the Chief Secretary. The only subject on the agenda is this year's Public Expenditure Survey. I attach a minute from the Chief Secretary setting out his views.

First, the facts. The bids are very large, as follows:

1991-92	1992-93	1993-94
	£b	
+ 16	+ 20	+ 24

These bids represent increases on baseline of 8 per cent, 10 per cent and 12 per cent respectively. Even assuming a modest increase in the GDP deflator for next year (and taking account of the higher than expected price level this year), the bids would amount to real increases in public expenditure of at least 5 per cent. And in cash terms, the bids are larger than last year.

Secondly, what are the implications? Accommodating these bids, or even bids approaching these levels, would:

- eliminate the scope for holding the income tax burden constant in 1991/92: the Government would face an unacceptable choice between raising taxes or reverting to borrowing;

- reverse the progress made in recent years in achieving the main public spending policy target - that GGE should represent a declining proportion of GDP; and

- therefore damage the Government macro-economic credibility, with adverse implications for financial, money and exchange markets.

Third, what sort of target for the survey outcome should the Treasury set? There is a hint in the Chief Secretary's minute that, at a minimum, they would be forced to concede an addition of £5 billion to the planning total for 1991/92. In practice, a further £3 billion will be re-allocated from the reserve for that year to programme spending. (In addition local authority self-financed expenditure, i.e. spending mainly financed by the Community Charge and the use of capital receipts, will add around another £1 billion to GGE, though it does not affect the planning total).

With about £8 billion to allocate, it might seem that the Chancellor can meet around half of the £16m bids from colleagues. (Last year the Treasury managed to reduce initial bids by around 55 per cent.) But that is to understate this year's problem.

(a) At least £2½ billion is already pre-empted for the AEF settlement for local authorities. (This includes all of the addition to grant, extra transitional relief and the consequentials for Scotland and Wales.)

(b) Some extra spending on the Health Service is also unavoidable - the inevitable costs of meeting pay review awards, certain demographic changes, etc. The Treasury acknowledge that around £1½ billion will go into health next year.

(c) Public expenditure is automatically levered up by rises in interest rates (relative to previous assumptions) and in inflation. Many of the Social Security benefits are pegged to the Rossi index; and areas like export credits and some housing finance rise automatically with higher interest rates. This too will add around £2 billion at least to public spending.

(d) So in practice this leaves only £2 billion or so to meet all the major bids from other Departments. That includes the £2 billion bid from DOE for housing and environmental services; anticipated bids from Transport of between £1 and

£2 billion; the bid from Education of over £1 billion for next year; and large bids from the Home Office and Department of Employment.

In short, if the Treasury were to achieve an increase of £5 billion on the planning total, that would be an extremely good outcome. Frankly, that may be a little too ambitious.

Fourth, what are the major threats on public spending? The paper identifies the main candidates. In descending order of magnitude these are as follows.

(i) AEF and the Community Charge
Additions to AEF add directly to the planning total; increases in Community Charge feed into higher GGE. Together they point to the critical importance of keeping down local authority spending. (Thus the case for enhanced Community Charge capping). There is a further discussion on the Community Charge scheduled for Thursday. As you know, we are awaiting the Solicitor General's revised view on what is possible by strengthening existing capping powers.

(ii) Health Reforms
There is no indication, following further contact with Mr. Clarke's office, that he is even beginning to contemplate options for slowing down the pace of the NHS reforms. Around £500-£600 million (baseline plus bid) is being allowed for the reforms by Department of Health. You might take this opportunity to discuss with the Chancellor and the Chief Secretary how Mr. Clarke can be led to bring forward new options. How can the pace of reform be slackened so as to avoid the political and financial risks identified and provide scope for some savings in 1991/92?

(iii) Transport
So far Mr. Parkinson has submitted only bids for his roads programme. These are £200 million in the first year, i.e. (over and above the existing road programme). In addition, Mr. Parkinson will submit bids both for British Rail and

London Underground. As you know, this will include the money to begin East-West Cross Rail: far from offering savings in the road programmes to accommodate East-West Cross Rail, he is effectively seeking additional resources for both.

Fifth, while the above are the major threats, where are the main opportunities for achieving savings either against baseline or by not accepting bids put forward?

(i) Housing and Local Environmental Services

Notwithstanding his huge bid for extra AEF, Mr. Patten has also submitted ambitious bids on council housing and local environmental services. These include further spending on inner cities - an area which the Chief Secretary had earlier identified as offering scope for savings.

(ii) Defence

I understand from Charles that consideration of new defence strategies is still under way but that they are unlikely to offer scope for savings in the short term. That said, some savings ought to be possible on the procurement side by slowing down planned projects, perhaps fitting in with reconsideration of strategic options.

(iii) Local Authority Capital

This covers an enormous area of spending (£10b p.a.) on local roads, council houses, local authority offices and leisure facilities and schools. There has been a huge surge of spending in this area, partly related to changes in the local authority finance system. There should be scope for cutting this back and improving the allocation of resources between areas, e.g., to protect the school buildings programme, while requiring deeper cuts in areas like local authority offices.

There should also be scope for cutting the bids from Department of Employment and from the Home Office. Both however are slightly more difficult areas to take on.

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Finally, what should be the outcome of the meeting? First it is vital that you are seen to support Treasury Ministers in pursuing the battle with spending Ministers. You might like to probe with the Chancellor and the Chief Secretary how you can best get this message across - a minute to all colleagues or a supporting minute following a Treasury minute to you about the public expenditure position?

Secondly, there is the question of how far you should be involved on individual programmes. Traditionally, of course, the relevant Secretary of State negotiates directly with the Chief Secretary. Nonetheless, there may be opportunities in the margins of other meetings, etc., for you to have a word with colleagues who have submitted particularly ambitious bids, in order to urge the need for restraint upon them.

BHP

(BARRY H. POTTER)

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