FILE BEGINS 2/7/87 ENDS 16/7/87

PO -CH /NL/0011

PART A

PUBLIC EXPENDITURE SURVEY 1987

FOR DISPOSAL ADVICE SEE INSIDE COVER

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PO -CH /NL/0011 PART A

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REFER TO	DATE	REFER TO	DATE
PA(16/7/87) PAR	10/1/94		

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

Alex

[illegible]

SS/MOD → CH/EX 30/4

Covering SECRET AND STRICTLY PERSONAL

cc Mr FER Butler
Mr Robson

ACSA 30/4.

MINISTRY OF DEFENCE WHITEHALL LONDON SW1A 2HB

TELEPHONE 01-218 9000
DIRECT DIALLING 01-218 2111/3

MO 8E

30th April 1987

Ch
For meeting (when fixed)
AA

Dear Nigel,

I enclose an aide memoire which, if you have the chance, you may care to glance at before our meeting with John MacGregor this evening.

I am sending a copy to John MacGregor.

Yours ever,

George

George Younger

The Rt Hon Nigel Lawson MP

Covering SECRET AND STRICTLY PERSONAL

AIDE MEMOIRE

The Savings Measures

1. The effects of various levels of provision for the defence budget can be measured in terms of the collective and cumulative impact of the savings measures needed to reduce the programme into line with that provision, while also taking account of any enhancements incorporated. In the 1987 costing of the programme (LTC 87), more than 600 measures have been put forward in four broad bands or "Baskets" of increasing difficulty from a military, international, industrial and political perspective. Moreover, room has not been found, for example, for the final 2 AWACS aircraft which have high military and political visibility. Full details of all these measures have been provided to Treasury officials. Given the number of savings measures involved, only a small number of examples can be referred to here; it is, however, in their totality that they have to be judged.

2. The impact of the "Baskets" can be illustrated as follows:

a. Baskets 1 and 2 contain over 500 measures affecting all aspects of the defence programme - force levels, the fuel, spare parts, exercises needed to keep our forces ready for war, our ability to sustain our forces in battle with reserves of ammunition, fuel and missiles, and the equipment modernisation programme. To pick out some examples, there would be a further spacing out of the naval warshipbuilding programme, with serious industrial implications, the reduction in ammunition war reserves would leave the Army meeting only 60% of the requirement, and there would be arbitrary reductions in RAF spares provision whose impact cannot be precisely predicted.

b. Basket 3 contains more serious force level reductions and equipment changes including a 20% reduction in the Sting Ray programme, the deletion of lightweight Sea Wolf from the carriers and Type 42 destroyers (a Falklands lesson to which we are committed), the re-introduction of a standby squadron of destroyers/frigates, reductions right across the Army equipment programme, a reduction in the Harrier GR5 attrition buy affecting force levels, and the further deferment of key RAF weapons programmes.

c. Basket 4 includes a reduction in the destroyer/frigate force below the level envisaged in John Nott's White Paper on the forward programme, the deletion of most of the remaining new items in the Army equipment programme, the abandonment of the expansion of the Territorial Army, and a halving of the Harrier GR5 attrition buy (on which a decision needs to be taken very soon).

3. The clear advice of the Chiefs of Staff is that the line has to be drawn from a military point of view somewhere in Basket 2. To give a feel for the international reverberations, which could not come at a worse time in terms of seeking to maintain NATO's cohesion and conventional defence effort, we judge that at some point in Basket 3 NATO would invoke special review procedures.

The Bids

4. I have asked for:

	1988/9	1989/90	1990/1
£M	350	500	550

These figures still leave the costed programme under-funded but if they were granted I would issue instructions that:

a. only Baskets 1 and 2 should be implemented now;

b. Basket 3 equipment measures would need to be addressed on a case by case basis over the coming months as regards financial commitment but there would be no need to decide now that the more sensitive force level changes had to be proceeded with;

c. Basket 4 measures could be reprieved.

5. The presentational handling of a-c would be manageable.

6. The Chief Secretary's offer is:

£M	250	300	300

(It needs to be confirmed that, as with my bid, the figure for 1990/1 would be additional to a basic figure for that year uplifted by 3% not 2½%, compared with 1989/90.)

7. The difference between my bid and this offer is:

£M	100	200	250

The value of the Basket 3 savings is:

	1988/9	1989/90	1990/1
£M	190	266	387

ie there is a gap between my bid and the Chief Secretary's position of £550M or two thirds of the value of Basket 3. Since realistically there must be a high risk that it will be necessary to take some of Basket 3 even on our own best forecasts, the consequence of accepting the Chief Secretary's offer is that I would have

either a. to authorise at least two thirds of Basket 3 now for incorporation into forward planning and the preparation of the annual NATO DPQ return - contrary to the advice of the Chiefs of Staff on the military acceptability of these measures;

or b. to retain them in the programme for the present knowing that I had agreed a funding basis for the defence programme which did not provide for these items, and as decisions are needed (some are pressing) continue to stall because I would otherwise overcommit. This will be visible and progressively unsustainable.

8. In judging between these, we need to consider now what is to be said in presenting SDE 87 to the HCDC, preparing now and submitting by July the Defence Planning Questionnaire to NATO, and, if relevant, the Conservative Party manifesto and the

presentation of the defence case in an early election campaign. To come clean now that substantial programme changes were being made would seem likely to be electorally very damaging. (Our difficulty would be compounded if, as must be possible, it became known that we had proceeded against the clear advice of the Chiefs of Staff.)

9. Equally, it would not seem acceptable to go to the country on what would be a false prospectus that the programme and budget were in balance and then subsequently to proceed with changes of the precise kind now on the table. The Government would rightly be charged with having acted in bad faith.

10. Since it is already clear that the Opposition parties will be questioning the Government closely on these issues over the coming months, these political/presentational issues cannot be avoided. The essential effect of the Chief Secretary's initial proposal would therefore be that it would be necessary for us to make clear soon that we intend substantially to alter the defence programme - in the way which our opponents have charged would indeed be necessary. My bid avoids such a need.

11. Even if my bid is accepted, all will not be plain sailing. Given the risks inherent in my bid, and given too the number of projects with force structure implications which are <u>not yet</u> in the costed programme, the warnings in SDE 87 of hard decisions and care about the timing of commitments will remain valid and essential. But I could argue with conviction that the Government is committed to providing the resources needed to sustain our forces and the essential nuclear <u>and</u> conventional equipment

programmes required to underpin our main defence roles. It is through the scale and character of our defence programme that my Ministry expresses the policy commitment to Defence which the Government has given domestically and internationally.

Handling of PES 87

12. We would now have settled PES 87, except for the agreed need to adjust further if the Autumn 1987 inflation forecasts differed from those at the end of PES 86. This is an essential underpinning of the above calculations. This apart, the settlement would stand at least until PES 88 when both MOD and Treasury would be free to propose changes to the provision for 1989/90 onwards, if they so wished.

RT4.44

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

16 June 1987

Robert Culshaw Esq
Foreign and Commonwealth Office
Downing Street
LONDON
SW1

Dear Robert

... I enclose a letter from the Chancellor to Signor Fanfani. I should be grateful if this could be delivered via the Embassy in Rome.

I am copying this letter to Charles Powell (No.10).

Yours ever,

Tony

A W KUCZYS
Private Secretary

RA3.75

CHANCELLOR OF THE EXCHEQUER

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

16 June 1987

His Excellency Senatore Amintore Fanfani
Rome

Dear Prime Minister

I am sorry that our General Election prevented my attending more than a small part of the Venice Economic Summit last week. But I - like others on the British delegation - was most grateful for the warmth and unfailing courtesy shown by the Italian Government as host, and for the efficient way in which the proceedings were conducted. That the plenary sessions went so smoothly and satisfactorily was a considerable tribute to your chairmanship.

I should be grateful if you could convey my thanks also to Giovanni Goria for his role as chairman and host of the Finance Ministers.

Yours sincerely
Nigel

NIGEL LAWSON

RA3.75

His Excellency Senatore Amintore Fanfani
Rome

~~DRAFT LETTER FROM THE CHANCELLOR TO SR. FANFANI~~
~~[courtesies about Italian elections]~~

like

I am sorry that our General Election prevented my attending more than a small part of the Venice Economic Summit last week. But I - ~~and the~~ others on the British delegation - ~~were~~ was ~~all~~ most grateful for the warmth and unfailing courtesy shown by the Italian Government as host, and for the efficient way in which the proceedings were conducted. That the plenary sessions went so smoothly and satisfactorily was a considerable tribute to your chairmanship.

I should be grateful if you could convey my thanks also to Giovanni Goria for his role as chairman and host of the Finance Ministers.

NIGEL LAWSON

uardian

overseas aid 'lowest ever' 10

Ben Laurance

THE SHARE of Britain's national output devoted to overseas aid has fallen to an all-time low, according to figures released yesterday.

For every £100 of gross national product last year, just 28p went towards helping the Third World.

The figure for 1986 was 31p and in 1979 about 52p from every £100 of gross national product was channelled into overseas aid.

The figures, released by the OECD, show that in the league table for the seven major industrialised countries whose leaders met in Toronto this week, Britain has slipped from first place in 1979 to sixth place last year, says the World Development Movement.

As a proportion of national output, only the United States gave less money than Britain in 1987.

"In the league table of all 18 Western aid givers, Britain has dropped to fourteenth place in 1987 compared to twelfth in 1986 and sixth in 1979," said the WDM.

Mr John Mitchell, the movement's director, yesterday appealed to the Government "to restore spending on aid to at least the level of its second full year of office, 1981, when it provided 0.43 per cent of GNP as aid."

Overseas Aid as % of Gross National Product

	1979		1987
UK	0.52	France	0.51*
Canada	0.48	Canada	0.46
Germany	0.46	Germany	0.39
France	0.35*	Italy	0.32
Japan	0.27	Japan	0.31
USA	0.20	UK	0.28
Italy	0.08	USA	0.20

*excluding overseas departments and territories. Source: World Development Movement.

The **Guardian** "

West's attitude to Third World debts 'unrealistic' 10

Paul Melly

THE President of the Berne Union, the international association of export credit insurers, yesterday attacked Western governments' approach to rescheduling Third World debts as "unrealistic".

Speaking at a London seminar, Roberto Ruberti said the government creditors grouped in the Paris Club could not expect middle-income debtor countries to repay on commercial terms. He argued that nations such as Brazil, Mexico or Argentina would have to be offered concessional rescheduling. "It is inevitable that conditions must be reconsidered," said Mr Ruberti, who is chief executive of the Italian government export credit insurer, SACE.

His view that the middle income debtors of Latin America must be offered concessional repayment terms by the Paris Club is likely to be contested by many Western governments, including Britain.

A key principle of the special debt package agreed at this week's Toronto summit is that only the world's poorest nations should be offered soft repayment terms. These are mainly in sub-Saharan Africa, and most of the big Latin American countries are too rich to qualify.

But Mr Ruberti wants to break the cycle of repeated reschedulings as middle-income debtors fall short of repayment targets year after year.

PM's PQ 52

23 JUN 1988

FINANCIAL TIMES

Pup

Western help for Third World fell last year 4"

BY GEORGE GRAHAM IN PARIS

WESTERN leaders have some ground to make up if they are to bring their deeds into line with their promises to the developing world at the Toronto summit.

The seven leading industrial nations may have promised to help the poorest Third World countries by writing off some of their debts, but figures published yesterday by the Organisation for Economic Co-operation and Development revealed that they had in fact reduced their aid to the Third World last year.

The Development Assistance Committee of the Paris-based OECD, which groups 18 of the leading industrialised nations, said that member countries had given $41bn of aid to the developing world last year, 2 per cent less in real terms than the previous year.

Total aid to the Third World dropped to 0.34 per cent of gross domestic product in DAC member countries, compared with 0.35 per cent in 1986.

This leaves the industrialised nations a long way short of the target of 0.7 per cent of GDP fixed by the United Nations nearly 20 years ago and solemnly reaffirmed at last year's economic summit in Venice.

Only four countries reach this target aid level: Norway (1.1 per cent), the Netherlands (0.98 per cent), Denmark (0.88 per cent) and Sweden (0.85 per cent). Two further countries, France and Finland, just break the barrier of 0.5 per cent.

Much of the decline in aid stems from the US, the UK and West Germany, all of which cut their aid effort as a percentage of GDP.

The UK's aid disbursements fell by 2.8 per cent in sterling terms and by 7 per cent in volume, reaching $1.887bn. British aid slipped to 0.28 per cent of GDP from 0.31 per cent in 1986, dropping behind Switzerland and Japan.

The US remained the second least generous industrialised nation, ahead only of Austria, with aid falling to 0.2 per cent of GDP from 0.23 per cent in 1986. US aid fell 8.2 per cent to $8.776bn in national currency terms, a drop of 10.9 per cent in volume.

Smaller industrialised countries such as Australia, New Zealand, Austria and Ireland made even sharper cuts in their aid efforts, often to meet overall budget cutback targets.

Overall net resource flows to developing countries, however, showed an increase for the first time since 1981, rising from $82bn in 1986 to $84bn in 1987 – or $91bn if South Korea's massive prepayments of its bank debt are excluded.

Net bank lending to developing nations recovered by 35 per cent in volume terms, and direct investment also recovered. Bond lending fell sharply, thanks to a drop in new issues and heavy repayments by Mexico and Argentina, to constitute a net outflow of $3bn.

British aid at all-time low

BY MICHAEL HOLMAN

BRITAIN'S overseas aid as a percentage of gross national product has fallen to its lowest level since records began in 1950, according to an analysis by the World Development Movement of yesterday's OECD aid figures.

Mr John Mitchell, director of the London-based organisation which campaigns for changes in British assistance to poor countries, noted the UK percentage, at 0.28 per cent last year, was a marked fall from 0.31 per cent in 1986 and 0.52 per cent in 1979, the year in which Mrs Thatcher took office.

According to WDM, the highest aid level as a percentage of GNP was achieved in 1961 at 0.59 per cent, when Harold Macmillan was prime minister.

Britain had dropped last year to 14th place among 18 aid givers covered by the report, compared to 12th in 1986 and sixth in 1979.

"Britain's declining aid performance is in sharp conflict with government's commitments at the London, Bonn and Tokyo economic summits to maintain and where possible increase aid," said Mr Mitchell.

15/2

Tony

can we have another word about these pps

M.

BRIEF

K/040

CONFIDENTIAL

FROM: JOHN GIEVE
DATE: 20 July 1987

Note at end

1. MR F E R ~~BUTLER~~
2. CHIEF SECRETARY
CHANCELLOR

Ch
A few comments
AA

cc Sir P Middleton
Sir T Burns
Mr Anson
Mr Monck
Mr Kemp
Mr Scholar
Mr Luce
Mr Moore
Mr Sedgwick
Mr Turnbull
Mr Hawtin
Miss O'Mara
Mr Culpin
Miss Walker
Mr Tyrie

see below

(plus I think you need a letter table of GGE/GDP % & implications for each PE — I'll organise tomorrow)

BRIEFING FOR CABINET ON 23 JULY

I attach a pack of speaking notes and background briefs for Cabinet on Thursday.

2. You will see that in the draft speaking note for the Chief Secretary, we have included the section on particular programmes that has been deleted from the Cabinet paper. We understand that the Prime Minister would prefer these points to be raised in discussion.

(see Norgrove letter below)

3. Mr Anson held a meeting this afternoon with Principal Finance Officers of the main departments at which he circulated a draft of the Chief Secretary's Cabinet paper. The PFOs noted that we were not seeking endorsement for the current Planning Totals and that there might be room for increases within the White Paper path for the percentages of GDP. They did not press us on how great those increases might be but, no doubt, they are working on the figures now.

4. There was rather more discussion of the proposals on running costs. On the whole they seemed to take the point of the proposals reasonably well. A number of departments argued that we should take account of the different positions in different departments (in particular the mix of work and the degree to which they had already made gains in efficiency). The PFO from Employment was concerned that the policy should not discourage increases in running costs which brought gains in efficiency in the use of programme expenditure (a similar point was made by the Revenue Departments). Finally a number of departments said that their bids already reflected plans for gains in efficiency and sought reassurance that these would count against their 1½ per cent target.

5. Mr Butler is meeting Cabinet Office officials this evening. He will emphasise in particular our concern that departments should not be allowed to opt out of the study of potential policy savings and that the minutes should leave open the option of establishing the Star Chamber in the autumn without a further full discussion in Cabinet.

6. We will be submitting a speaking note for the PM tomorrow. I am submitting separately a table showing the bids and our latest forecast outcome.

J St. Gieve

JOHN GIEVE

I have briefed Mr. Unwin and Mr. Monger.

I underlined our need to get endorsement of the conclusions in the Chief Secretary's paper, of the speaking note for Mr. Ingham, of the need to pursue policy savings in specific areas and of the establishment of the Star Chamber when required.

FERB

20.7.

SECRET

Prep

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

20 July 1987

Dear Alex,

PAPERS ON PUBLIC EXPENDITURE: CABINET 23 JULY

The Prime Minister has seen the draft papers by the Chancellor and the Chief Secretary for Cabinet next Thursday attached to your letter to me of 17 July.

The Prime Minister would be content for the Chief Secretary, in discussion, to list the areas where difficult decisions will be needed (paragraph 7 of his paper), but she would not wish this to be circulated as part of the paper.

She is otherwise content for the papers to be circulated tomorrow, Tuesday.

Yours,

David.

DAVID NORGROVE

Alex Allan, Esq.,
H.M. Treasury.

CH/EXCHEQUER
REC. 20 JUL 1987
ACTION CST
COPIES TO Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Anson
Mr Monck
Mr Scholar Mr Luce
Mr Sedgwick
Mr Culpin
Mr Grieve
Mr Turnbull
Mr Tyrie
Mr Cropper

SECRET

K/041

SECRET AND PERSONAL

FROM: JOHN GIEVE
DATE: 21 July 1987

CHIEF SECRETARY
CHANCELLOR

cc Mr F E R Butler
Mr Anson
Mr Monck
Mr Turnbull
Miss Walker

SURVEY PROSPECTS

SURVEY PROSPECT

As background for Cabinet on Thursday, I attach a summary table showing the baselines, bids, and forecast outcomes for each department.

2. The increase that we forecast is likely to come out of this Survey's negotiations has been reduced since our last assessment. This reflects the settlement now agreed in E(LA) in which the increase in provision for LA relevant was some £300m lower in 1988-89 than we had provided for in our earlier forecast. As you know, this reduction in provision is a saving on paper only and we must allow in the Reserve for a higher overspend.

JG. Gieve

JOHN GIEVE

SECRET Date of last update: 20/7/87

SUMMARY SCORECARD

(£million)

	1988-89 BASELINE	1988-89 DEPT BIDS	1988-89 FORECAST OUTCOME	1989-90 BASELINE	1989-90 DEPT BIDS	1989-90 FORECAST OUTCOME	1990-91 BASELINE	1990-91 DEPT BIDS	1990-91 FORECAST OUTCOME
Ministry of Defence	18,980.0	551.0	221.0	19,464.0	815.0	435.0	19,892.0	954.0	514.0
FCO - Overseas Development Administration	1,399.0	83.0	32.5	1,441.0	158.1	64.3	1,477.0	238.6	88.8
FCO - Diplomatic, Information, Culture	730.0	-2.1	-9.2	747.0	4.6	-6.9	765.0	6.1	-6.3
European Communities	440.0	50.0	50.0	1,060.0	450.0	450.0	1,087.0	130.0	130.0
Intervention Board for Agricultural Produce	1,782.0	-131.5	-100.0	1,878.0	-94.0	-100.0	1,925.0	18.8	0.0
Ministry of Agriculture, Fisheries and Food	747.0	36.7	30.0	749.0	49.5	30.0	768.0	42.7	15.0
Forestry Commission	54.0	6.9	5.0	55.0	11.4	10.0	56.0	10.9	10.0
Department of Trade and Industry	973.0	253.8	201.8	971.0	326.8	254.6	1,007.0	266.3	171.2
Export Credits Guarantee Department	111.0	-8.6	-8.6	47.0	76.7	76.7	48.0	69.9	69.9
Department of Energy	286.0	27.0	6.8	282.0	34.6	8.8	289.0	36.5	8.1
Department of Employment	4,117.0	207.4	149.3	4,216.0	237.4	151.9	4,322.0	235.2	103.0
Department of Transport	2,166.0	95.7	40.0	2,214.0	115.5	40.0	2,264.0	99.0	39.8
DOE - Housing	2,443.0	395.0	311.0	2,503.0	562.0	347.0	2,566.0	689.0	394.0
DOE - Other Environmental Services	904.0	174.0	75.0	913.0	188.0	70.0	936.0	184.0	67.0
DOE - Property Services Agency	-99.0	45.4	20.0	-101.0	42.0	0.0	-104.0	48.6	0.0
Home Office	1,237.0	101.6	80.0	1,294.0	155.3	80.0	1,326.0	230.6	110.0
Lord Chancellor's Department	726.0	36.4	26.8	781.0	38.9	31.4	801.0	82.8	70.6
Department of Education and Science	3,851.0	557.8	241.0	3,966.0	687.9	317.7	4,065.0	782.9	342.3
Office of Arts and Libraries	367.0	49.9	19.3	377.0	62.9	29.3	386.0	68.6	36.5
DHSS - Health and Personal Social Services	16,932.0	956.0	610.0	17,743.0	1,384.0	827.0	18,187.0	2,196.0	1,353.0
DHSS - Social Security	47,258.0	1,201.5	1,026.0	49,123.0	1,545.1	1,352.5	50,351.0	2,997.0	2,847.5
Scotland: negotiable	4,687.0	16.3	-17.5	4,863.0	26.8	-9.0	4,984.0	29.2	-18.3
Scotland: formula		221.8	131.0		304.0	161.9		425.4	235.9
Wales: negotiable	1,933.0	47.6	30.7	1,995.0	40.7	25.2	2,045.0	42.7	27.2
Wales: formula		108.0	63.6		149.7	79.9		206.9	114.4
Northern Ireland: negotiable	5,048.0	18.5	18.5	5,217.0	32.3	32.3	5,348.0	60.5	60.5
Northern Ireland: formula		109.0	78.3		157.1	108.0		195.4	131.0
Chancellor's Departments	2,304.0	182.1	136.4	2,411.0	242.0	169.5	2,472.0	293.1	218.1
Other Departments	1,938.0	22.0	15.3	2,025.0	56.6	41.7	2,076.0	102.8	86.0
Nationalised Industries	348.0	927.3	730.0	-56.0	1,211.7	750.0	-56.0	1,237.7	400.0
IFR memo items	175.0	11.0	0.0	137.0	0.0	0.0	140.0	0.0	0.0
Local Authority Relevant	32,206.0	1,045.0	1,045.0	33,054.0	1,361.0	1,361.0	33,880.0	1,567.0	1,567.0
Privatisation Proceeds	-5,000.0			-5,000.0			-5,000.0		
[illegible]D TOTAL		7,395.5	5,259.0		10,433.6	7,189.9		13,548.2	9,186.2
Total Central Government	111,359.0	4,513.9	3,118.4	115,773.0	6,865.7	4,714.2	118,615.0	9,689.0	6,883.0
Total Local Authority Capital	4,021.0	760.0	278.0	4,127.0	724.0	207.0	4,230.0	726.0	146.0
Total Local Authority Other	4,931.0	12.2	5.7	5,176.0	26.3	11.4	5,305.0	31.3	12.5
Total Other Public Corporations	870.0	133.4	91.6	962.0	244.9	146.6	986.0	296.4	177.9

2131/1

SECRET

Alex

ARITHMETIC

Copy No 2 of 8 Copies

FROM: A TURNBULL
DATE: 21 JULY 1987

MR F E R BUTLER

cc PS/Chancellor
PS/CST
Mr Gieve
Mr Culpin

SURVEY ARITHMETIC

You asked for notes on:

a. how we defined the path in the White Paper which the Cabinet paper seeks to hold to;

b. what PFOs and outside analysts might calculate as the scope for raising the planning total.

2. I attach notes on these points.

3. On (b), there is no 'right' way to do the calculation and other routes could be used. If, for example, a PFO took the White Paper percentages, excluding privatisation proceeds, applied them to the FSBR money GDP figures to derive "new" GGE, he could compare it with GGE in the PEWP. This produces somewhat lower figures, ie permitted increases of £2¼ billion and £3¼ billion. The longer method used in the note has the advantage of making the increase in GDP between PEWP and FSBR explicit.

VMBrown

pp A TURNBULL

SURVEY ARITHMETIC

What precisely do you mean by sticking to the White Paper pathfor public spending as a proportion of GDP, excluding privatisation proceeds?

(i) The last White Paper gave figures for GGE, including privatisaiton proceeds, of:

	1986-87	1987-88	1988-89	1989-90
Per cent of GDP	43¼	42¼	41¾	41¼

Source: Table 1.10 and Chart 1.1

(ii) Privatisation proceeds were projected at:

	1986-87	1987-88	1988-89	1989-90
£ billion	4.75	5.0	5.0	5.0
Per cent of GDP	1¼	1¼	1¼	1

(iii) Therefore excluding privatisation proceeds, the ratios become

	1986-87	1987-88	1988-89	1989-90
Per cent of GDP	**44½**	**44**	**42¾**	**42¼**
Latest published figures	44			
NOT FOR USE				
[Forecast outturn		43]		

SURVEY ARITHMETIC

What, using White Paper and FSBR, can be calculated about scope for raising planning totals?

Numbers can be derived in several ways. One method would be as follows:

(i) Money GDP figures are not given explicitly in PEWP but applying ratios to general government expenditure one can derive:

	1986-87	1987-88	1988-89	1989-90
a) GGE incl pp	164.4	173.7	179.6	187.8
b) Ratio incl pp	43¼	42¾	41¾	41¼
c. Implied money GDP ie a ÷ b	380.1	406.3	430.2	455.3
(ii) FSBR provided figures for money GDP of:				
	382	411	437	464
		(FSBR Table 2.6)		
(iii) Increase in money GDP between PEWP and FSBR is therefore				
Per cent	+0.5	+1.2	+1.6	+1.9
(iv) GGE excluding privatisation proceeds in White Paper				
	169.2	178.7	184.6	192.8
(v) Applying percentages in (iii) to (iv) produces for 1988-89 and 1989-90 permissible increases in GGE of				
£ billion			**2.95**	**3.66**
OR				
(vi) Planning total excluding privatisation proceeds in White Paper				
	145.2	153.6	159.2	166.5
(vii) Applying percentages in (iii) to (vi) produces for 1988-89 and 1989-90 permissible increases in planning total of:				
£ billion			**2.54**	**3.16**

Conclusion

Using figures published in PEWP and FSBR an analyst might calculate that **even if no change were made to FSBR forecast of money GDP,** GGE could be increased by £3.0 billion in 1988-89 and £3.7 billion in 1989-90. If he further assumed that there was no increase in the elements between the planning total and GGE, this would be the permitted increases in the planning total.

Alternatively, the analyst might apply the percentage increases in money GDP to the existing planning totals, to produce increases of £2.5 billion and £3.2 billion.

If the analyst further assumed that the level of the money GDP path would be raised by 1 per cent in the Autumn Statement, he might increase the scope in line (v) by a further £1.9 billion, ie to £4.8 billion and £5.6 billion.

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

22 July 1987

David Norgrove Esq
10 Downing Street
LONDON
SW1

Dear David

PUBLIC EXPENDITURE CABINET: LINE TO TAKE

The Chancellor and the Chief Secretary have been giving some thought to what might be said after the Public Expenditure Cabinet. They suggest the following:-

> The Cabinet had its usual July discussion of public expenditure today. It reaffirmed the policy that public expenditure should continue to take a declining share of national income, as set out in the last Public Expenditure White Paper. Within that constraint, the Chief Secretary will hold bilateral discussions in the Autumn. In the light of these, the Government will review both the individual spending programmes and the planned totals for spending, and will, as usual, announce its decisions in the Autumn Statement in November.

The Chancellor would be grateful to know if the Prime Minister is content.

I am copying this letter to Bernard Ingham.

Yours
Alex

A C S ALLAN
Principal Private Secretary

CONFIDENTIAL

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

David Norgrove
No.10 Downing Street
LONDON SW1

22 July 1987

Dear David

BRIEFING FOR PUBLIC EXPENDITURE CABINET

... As agreed, I attach a speaking note for the Prime Minister's use at tomorrow's Cabinet. I understand that the Cabinet Office brief will cover the point that the Prime Minister's summing-up should (as last year) refer to the plan to set up Star Chamber if agreement cannot be reached at the bilateral.

Yours
Alex

A C S ALLAN
Principal Private Secretary

CONFIDENTIAL

SPEAKING NOTE FOR THE PRIME MINISTER

The Chancellor's paper provides an encouraging picture of the economy, but it is important to draw correct messages from this and to avoid complacency.

i. Although public spending has been coming down as a proportion of national income, its share this year (around 43 per cent) is likely to be about the same level as we inherited in 1978-79.

ii. Although taxes have been cut in each of the last five Budgets, the burden of non-oil taxes is still significantly higher than it was in 1978-79.

iii. The strength of the economy has been built on sound finance and the restraint of public spending. We have achieved a consistency of policy which has given confidence, which in turn has transformed the investment climate in this country.

iv. Although inflation is low by historical standards, at 4 per cent it is still above the average for our major competitors.

2. Looking to the future, we must set spending plans which sustain this confidence. The Chancellor and Chief Secretary seek a continuation of the Manifesto policy of reducing public spending as a proportion of national income. And by this they rightly mean not just any decline, however small, but one at least as fast as we set ourselves in the last White Paper. This is essential if we are to achieve another of our Manifesto pledges - a further reduction of taxation.

3. Restraint of public spending is also the best way to build up our public services. For it is the resulting strength of the economy which will provide the resources we need to carry out our Manifesto programme.

4. Although growth this year looks like being faster than the recent trend, we must not fall into the trap of previous governments of basing our spending plans on over-optimistic projections. We must plan on a cautious assessment of what can be afforded.

5. It is clear that the bids submitted are inconsistent with the policy we are following. The bids will have to be substantially cut back or policy savings found to offset them. As the Chief Secretary's paper points out, this may involve difficult choices. But now, at the start of a Parliament, is the time to face up to them. Across the whole range of spending, I hope there will be a thorough review of the options, not just within bids but within baselines as well.

6. Meanwhile, the pursuit of better value for money must continue. I welcome the Chief Secretary's proposal to establish medium-term efficiency plans for departmental running costs. We must also seek greater effectiveness for departmental programmes.

2131/2

FROM: A TURNBULL
DATE: 22 JULY 1987

MR CULPIN

cc PS/Chancellor
PS/CST
Mr F E R Butler
Mrs R Butler
Mr Gieve
Miss Walker
Miss Chapman

HISTORICAL DATA

GGE AS A PROPORTION OF GDP

You asked for the historical figures for GGE/GDP. I attach two tables. The first gives the ratio for financial years back to 1961-62 (as far as can be done on this basis); the seconed takes the figures back even further but only on a calendar year basis. I suggest that any figures you supply should be rounded to the nearest ¼.

2. The figures substantiate the claims of:

i. five years of declining ratios (avoid the formulation of "successive years" as 1984-85 was, on a rounded basis, no better than 1983-84 as a result of the coal strike;

ii. a five year decline is the longest since 1950 when the rundown of the war economy was complete. It is not the largest decline, a prize which goes to the IMF between 1975-76 and 19877-78.

Ch
I have added an Ato couple of tables below

AT

A TURNBULL

GGE AS A PERCENTAGE OF GDP

	GGE/GDP	GGE ex p.p /GDP	
1961-62	35.70	35.70	35½
1962-63	35.36	35.36	35½
1963-64	35.81	35.81	35¾
1964-65	35.50	35.50	35½
1965-66	36.84	36.84	36¾
1966-67	38.42	38.42	38½
1967-68	42.03	42.03	42
1968-69	40.58	40.58	40½
1969-70	40.05	40.05	40
1970-71	40.42	40.42	40½
1971-72	40.91	40.91	41
1972-73	40.75	40.75	40¾
1973-74	42.55	42.55	42½
1974-75	47.99	47.99	48
1975-76	48.51	48.51	48½
1976-77	45.97	45.97	46
1977-78	42.24	42.60	42½
1978-79	43.23	43.23	43½
1979-80	43.33	43.51	43½
1980-81	46.00	46.18	46¼
1981-82	46.40	46.59	46½
1982-83	46.88	47.05	47
1983-84	45.79	46.17	46¼
1984-85	45.62	46.27	46¼
1985-86	44.07	44.82	44¾
1986-87	42.94	44.09	44
1987-88*	42¼	43½	43½

SOURCE: LATEST CSO DATA

NOTE: PRIVATISATION PROCEEDS FOR 1986-87 AS IN SURVEY DOCUMENT

* 1987-88 figures are ~~[illegible]~~ projected outturns as in FSBR.

Data prior to 1961-62 available only on a calendar year basis

HISTORIC TRENDS - GENERAL GOVERNMENT EXPENDITURE AS A PERCENTAGE OF GDP

	GGE (1)	GDP(A) (2)	GGE/GDP(A)	GGE (3)	GDP(E) (4)	GGE/GDP(E) (5)
1890				131	1,456	9.00
1895				157	1,543	10.17
1900				281	1,950	14.41
1905				242	2,059	11.75
1910				272	2,233	12.18
1913				305	2,517	12.12
1915				958	3,139	30.52
1917				1,516	4,537	33.41
1918				2,427	5,243	46.29
1920				1,592	5,982	26.61
1921				1,430	5,134	27.85
1922				1,177	4,579	25.70
1923				1,025	4,385	23.38
1924				1,027	4,419	23.24
1925				1,072	4,644	23.08
1926				1,106	4,396	25.16
1927				1,106	4,613	23.98
1928				1,095	4,659	23.50
1929				1,107	4,727	23.42
1930				1,145	4,685	24.44
1931				1,174	4,359	26.93
1932				1,138	4,276	26.61
1933				1,066	4,259	25.03
1934				1,061	4,513	23.51
1935				1,117	4,721	23.66
1936				1,187	4,905	24.20
1937				1,304	5,289	24.65
1938				1,587	5,572	28.48
1939				1,960	5,958	32.90
1940				3,905	7,521	51.92
1941				5,338	8,831	60.45
1942				5,860	9,591	61.10
1943				6,265	10,208	61.37
1944				6,303	10,272	61.36
1945				5,779	9,831	58.78
1946	4,584			4,530	9,959	45.49
1947	4,330			4,130	10,655	38.76
1948	4,381	12,067	36.31	4,215	11,724	35.95
1949	4,459	12,804	34.83	4,423	12,384	35.72
1950	4,522	13,352	33.87	4,539	12,932	35.10
1951	5,371	14,866	36.13	5,208	14,419	36.12
1952	5,962	16,031	37.19	5,777	15,632	36.96
1953	6,172	17,180	35.93	6,048	16,836	35.92
1954	6,145	18,167	33.83	5,976	17,755	33.66
1955	6,466	19,596	33.00	6,143	19,105	32.15
1956	7,041	21,057	33.44			
1957	7,633	22,224	34.35			
1958	7,971	23,169	34.40			
1959	8,461	24,525	34.50			
1960	8,944	26,212	34.12			
1961	9,756	27,756	35.15			
1962	10,401	29,125	35.71			
1963	10,976	30,893	35.53			
1964	12,002	33,758	35.55			
1965	13,324	36,354	36.65			
1966	14,476	38,717	37.39			
1967	16,686	40,719	40.98			
1968	18,311	44,148	41.48			
1969	19,006	47,456	40.05			
1970	20,897	52,052	40.15			
1971	23,494	57,931	40.56			
1972	26,409	64,806	40.75			
1973	30,496	74,284	41.05			
1974	39,165	83,743	46.77			
1975	51,470	105,518	48.78			
1976	58,496	124,590	46.95			
1977	61,790	145,364	42.51			
1978	72,105	167,367	43.08			
1979	85,342	196,863	43.35			
1980	104,060	230,006	45.24			
1981	116,813	253,073	46.16			
1982	128,545	276,449	46.50			
1983	138,688	300,314	46.18			
1984	146,564	321,757	45.55			
1985	157,772	353,284	44.66			
1986	163,165	376,126	43.38			

SOURCE:

(1) CSO database
(2) CSO database
(3) A.T. Peacock and J. Wiseman - The growth of public expenditure in the United Kingdom.
(4) C.H. Feinstein - National Income Expenditure and Output of the United Kingdom 1855 to 1965
(5) Note that these percentages are calculated from data from two different sources. It was not possible to obtain GGE and GDP figures from the same source.

RA7.50

HISTORICAL STATISTICS

	GGE as % GDP		Non-North Sea taxes as % non-North Sea GDP
	(a) including privatisation proceeds	(b) excluding privatisation proceeds	
1970-71	40 ½		36.2
1971-72	41		
1972-73	40 ¾		
1973-74	42 ½		
1974-75	48		35.7
1975-76	48 ½		
1976-77	46		
1977-78	42 ¼		
1978-79	43 ¼	43 ¼	34.1
1979-80	43 ¼	43 ½	35.2
1980-81	46	46	36.2
1981-82	46 ¼	46 ½	38.8
1982-83	46 ¾	47	38.4
1983-84	45 ¾	46 ¼	37.9
1984-85	45 ½	46 ¼	37.8
1985-86	44	44 ¾	37.2
1986-87	43 ¼	44 ½	37.7
1987-88			
(a) PEWP/FSBR	42 ¾	44	37.8
(b) June forecast	41 ½	43	38.0

CHANGES IN FORECASTS ETC.

	86-87	87-88	88-89	89-90
Money GDP (£ bn)				
PEWP	380	407	431	455
FSBR	382	411	437	464
June forecast	383	416	(449)	(481)
Money GDP (% increase)				
PEWP		7	6	5½
FSBR	6	7½	6½	6
June forecast	6¼	8½	(7¾)	(7)
GDP deflator				
PEWP	3	3¾	3½	3
FSBR	3	4½	4	3½
June forecast	3	5	(5½)	(5)
GGE/GDP				
(a) Including privatisation proceeds				
PEWP	43¼	42¾	41¾	41¼
FSBR	43	42¼	41¼	40¾
June forecast	43	41½	(41¼)	(41¼)
(b) excluding privatisation proceeds				
PEWP	44½	44	42¾	42¼
FSBR	44¼	43½	42½	41¾
June forecast	44¼	43	(42¼)	(42¼)

SECRET

OK (one v. small pt on p3). ~~stick up~~ I wd not make change on p7. PS/ believe Lawson goes ... the balance of ... for Cab.

FROM: ROBERT CULPIN
DATE: 22 JULY 1987

CHANCELLOR

cc Chief Secretary
Sir P Middleton
Mr F E R Butler
Sir T Burns
Mr Anson
Mr Cassell
Mr Monck
Mr Luce
Mr Scholar
Mr Turnbull (see esp p.9)
Mr Pickford
Mr Tyrie

Ch

OK? One comment on p7.

NB last page is part of "statistics" section of your existing briefing. The figure marked is wrong (according to both AS & PEWSP).

AA

LINE ON THE PUBLIC EXPENDITURE CABINET

I attach - for the last time! - my briefing pack. As you know, it now reflects discussions with Mr Ingham and others.

2. Subject to any final comments, I should like to send pages 1-5 to Mr Ingham tomorrow morning. I shall draw on pages 6-9 myself, as necessary.

3. I remain concerned that we (and No.10) need clear lines in defence of the RSG announcement, to make sure that the DOE do not shoot us in the foot - my note of this morning, reflected in Miss Rutter's letter to Mr Ridley's office. I still have no briefing on that.

arrived 9PM
— see separate folder.

RC

ROBERT CULPIN

Encs

PUBLIC EXPENDITURE CABINET

Line

The Cabinet had its usual July discussion of public expenditure today. It reaffirmed the policy that public expenditure should continue to take a declining share of national income, as set out in the White Paper. Within that constraint, the Chief Secretary will hold bilateral discussions in the Autumn. In the light of these, the Government will review both the individual spending programmes and the planned totals for spending, and will, as usual, announce decisions in the Autumn Statement in November.

Text

"My Government .... will maintain firm control of public expenditure so that it continues to fall as a proportion of national income and permits further reductions in the burden of taxation." - Queen's speech.

MAIN POINTS

1. Overriding objective is that public expenditure should take a declining share of national income

- policy in Manifesto
- and Queen's Speech
- figures in Public Expenditure White Paper

2. Cabinet interpreted strictly

- no increase on White Paper shares of GDP in any year
- excluding privatisation proceeds

3. Not just aspiration - considerable achievement

- fifth year public sector's share has come down
- longest sustained fall since 1950

4. Restraint has brought success

- strength of economy
- but not prudent to plan on assumption that growth continues at this year's pace

5. No change in planning totals. Cabinet agreed on need to keep as close to them as possible - as well as meeting commitment to steadily declining share of GDP

6. All planning now done in cash. No trace of the funny money the Government inherited.

"DECLINING SHARE" IN WHITE PAPER

See bottom line

Table 1.10 General government expenditure as a percentage of GDP; plans and outturns

per cent

	1983–84	1984–85	1985–86	1986–87	1987–88	1988–89	1989–90
March 1984 FSBR		44½	43½	42½			
March 1985 FSBR			45	43½	42¼		
January 1986 White Paper				42¾	41¾	41	
This year's White Paper					42¾	41¾	41¼

19

Q AND A

Will the planning totals be increased?

I can't tell you whether the totals will be changed, or if so by how much, or where the money will go. None of that is decided.

The Cabinet has not changed the totals.

At the end of the day, there may be some change, but if so - and I stress that is not decided - the Government is determined to keep as close to them as possible, and will in any case not allow public spending to take a higher share of national income than is set out in the White Paper.

The policy that public expenditure declines as a proportion of GDP is not just an aspiration. It is what we have achieved since 1982-83. And this is the first Government in a generation to have brought it down for five years in a row.

Why might you allow an increase?

I am not saying we will. It is restraint which has brought success. There will be no let-up in the Government's rigorous approach. And we will continue to plan expenditure on a cautious view of what we can afford.

The strength of the economy is there for all to see - though it would be unwise to plan public expenditure on the basis that the economy will continue to grow at this year's rate.

Why no decision?

Cabinet has decided to stick firmly to the policy.

Final decisions will be taken, as always, when:

- there has been further assessment of the needs of particular programmes
- we have further information on the prospects for the economy and so on what we can afford.

Abandoning cash planning?

Rubbish. All planning done in cash. No funny money. No automatic compensation for inflation.

Star Chamber?

No doubt: established part of the system.

TREASURY NOTES FOR SUPPLEMENTARIES

Why not come clean and raise totals?

Acknowledged frankly that planning totals may change. Not clear that they will. Not sensible in those circumstances to set new figures.

Planning totals never revised in July.

Open ended?

Certainly not. Commitment to take steadily smaller share of GDP is a binding constraint.

WHAT smaller share?

No increase on the White Paper percentages in any year. Continuing on down in the new final year.

If we can improve on the White Paper percentages, we will.

Including or excluding privatisation?

Excluding.

Applied to what GDP?

Our best estimate. Latest published is in FSBR.

When GDP next revised?

Current and following year: in Industry Act forecast in Autumn Statement.

Full MTFS: in 1988 FSBR.

More real growth in GDP means more expenditure?

No entitlement, but may permit it.

New doctrine?

Rubbish. "It would, of course, always be open to the Government to decide, once the virtuous circle of lower taxes and higher growth had been established, to devote some of these resources to improved public services rather than reduced taxation." - 1984 Green Paper.

Maximum possible increase in planning totals?

Not going to speculate. But two things.

First, commitment that public expenditure should grow less fast than the economy as a whole is a major constraint.

Second, if any change at end of day, Cabinet firmly commited to minimise it.

Why have planning totals only to raise them?

False premise. But better a really demanding target which you may sometimes have to raise a bit than an undemanding one.

Proof of the pudding: public expenditure is falling as a proportion of GDP for the fifth year in a row. Longest sustained fall since 1950.

What precisely do you mean by sticking to the White Paper path for public spending as a proportion of GDP, excluding privatisation proceeds?

(i) The last White Paper gave figures for GGE, including privatisation proceeds, of:

MR TURNBULL PLEASE CHECK

	1986-87	1987-88	1988-89	1989-90
Per cent of GDP	43¼	42~~¼~~¾	41¾	41¼

Source: Table 1.10 and Chart 1.1

(ii) Privatisation proceeds were projected at:

£ billion	4.75	5.0	5.0	5.0
Per cent of GDP	1¼	1¼	1¼	1

(iii) Therefore excluding privatisation proceeds, the ratios become

Per cent of GDP	**44½**	**44**	**42¾**	**42¼**

Latest published figures 44

NOT FOR USE

[Forecast outturn 43]

K/021

LIST OF BRIEFS

PUBLIC EXPENDITURE CABINET: LIST OF BRIEFS

A Note on tactics

B Speaking note for Chief Secretary on public expenditure

C Supplementary brief on public expenditure

D Fact sheet on public expenditure

E Running costs and manpower

F Nationalised industries

G Local authorities

H Privatisation proceeds

I Current pay developments

J Speaking note for Chancellor on the economy

K Speaking note for Chancellor on Public Finance (to use if necessary)

L Domestic economy - supplementary brief

M Public Sector finances - supplementary brief

N World economy

O Fact sheet on tax

SECRET

A

PUBLIC EXPENDITURE CABINET: NOTE ON TACTICS

A

The aims of the meeting are to provide the Chief Secretary with the best platform for the conduct of the bilaterals; and externally to retain confidence that the Government's expenditure policy is being adhered to.

2. More specific objectives are:

i. While not setting new planning totals, to secure Cabinet confirmation of the policy of reducing public spending as a proportion of national income, as set out in the White Paper.

ii. While acknowledging that some increase in the planning total may be consistent with (i), to dampen expectations of what this means for individual programmes.

iii. To secure endorsement of a serious search for policy savings in a number of areas and to ensure that nothing is off-limit.

iv. To secure endorsement of the specific targets for nationalised industries and running costs, and of the new approach to running costs over the medium term;

v. To keep open options for handling of later stages of Survey.

vi. To secure agreement to the post Cabinet line.

3. On (i), it is essential to get across that the decision not to endorse the existing planning totals or set new ones does not leave the Survey open-ended. If confidence in the Government's expenditure policy is to be sustained, expenditure as a proportion of GDP cannot be brought down in infinitesmally small steps, but must be held at least to the percentages in the White Paper or better.

4. On (ii), colleagues may probe for an indication of the size of increase in order to assess how hard they should press their bids. They may interpret the Chancellor's report on the economy as implying substantial scope while adhering to the White Paper ratios. Departments will be able to calculate that, in 1988-89, money GDP in the FSBR is 1½ per cent up on that underlying the PEWP, and 2 per cent up in 1989-90; and they may infer that the figures may be revised up even further. This would lead them to the conclusion that a minimum of £2½ billion could be added to the planning total in 1988-89 and £3¼ billion in 1989-90. Recent newspaper articles (eg The Guardian on 15 July) have suggested figures as high as £4 billion in 1988-89.

5. If faced with suggestions of this kind, you should avoid an argument about detailed figures but point out that the scope for additions which can be made to departmental programmes in the Survey are restricted by:

- decisions already taken;

- the increase in provision for LA current expenditure agreed in E(LA);

- the large estimating changes for take-up of social security which are swamping the benefit from lower unemployment;

- a possible increase in EC contributions;

- the need to hold back more to constitute larger reserves.

6. On (iv), the Cabinet paper does not identify the areas for policy savings which the Treasury has in mind. Instead the Chief Secretary will mention them orally. Some colleagues may seek Cabinet agreement that savings of the kind suggested in the paper cannot be found in their area. This should be resisted on the grounds that Cabinet is not being asked to take decisions but only to acknowledge that further savings will need to be explored. The Prime Minister will be briefed not to allow any opting-out.

7. On (v), there could be requests for Cabinet to review the position in October. Any specific commitment should be avoided as public knowledge that there was to be a substantive discussion would simply raise the same handling problems as for the July Cabinet. Indeed, it would be vital for helpful if the Prime Minister could mention the possibility of establishing a smaller group if programmes are still unresolved at the end of bilaterals. While this would not rule out discussion of public expenditure on 1 October, it means it would not be necessary to hold a meeting solely for the purpose of authorising the establishment of the group.

8. On (vi), a copy of the proposed wording of the post-Cabinet announcement is attached. Colleagues should be warned against embellishing this or creating the impression that this provides substantial scope for increases. The binding nature of the GGE/GDP constraint should be emphasised.

K/032

B

B

DRAFT SPEAKING NOTE FOR CHIEF SECRETARY AT JULY CABINET

1. Our last White Paper set out our plans for reducing public expenditure in proportion to national income and we reaffirmed our commitment to this in the Manifesto.

2. It is clear that this will not be easy despite the relatively favourable state of the economy. In some areas large increases are unavoidable. Latest estimates of the cost of social security show a massive increase; we have just agreed to increase the provision for local authority relevant spending next year by around £1 billion; we have to accommodate decisions we took before the election for example on Airbus and rate relief. We need also to preserve large Reserves within our plans in view of the uncertainties we face for example on our EC contributions and the risk that local authority spending may again exceed the provision agreed in E(LA).

3. It is against that background that I have approached the bids I have received from colleagues. They go far beyond not only the cash planning totals but also what can be afforded in terms of our manifesto commitment. To agree to bids on anything like this scale would be a major reverse of our expenditure policy, jeopardizing our objectives on taxation and borrowing and triggering a reappraisal of our financial policy by the markets. It would thus also jeopardise improvements in public services which can only be built on a vigorous and strong economy.

4. If we are to hold to our manifesto policy and set ourselves on a sustainable course at the start of this Parliament, we will have to face up to difficult decisions in a number of areas, in particular:

i. for programmes such as defence, health and education which are seeking very large increases, the bids will have to be significantly scaled back and, to the greatest extent possible, policy savings found to offset them;

ii. for social security we must look at policy changes to help offset the enormous estimating changes;

iii. we need to take a hard look at the employment programmes where, with the greatly improved trend on unemployment, substantial savings can be found;

iv. we need to re-examine the basis of our regional policies. [The buoyancy of the economy and in particular of investment, reflecting the increased strength of the corporate sector, is both increasing the cost of the present system of regional incentives and reducing the need for them.] We should look for savings here partly to release resources for cost effective inner city spending;

v. we must look very carefully at the expenditure of the territories;

[vi. we should seek every opportunity to transfer to the private sector the responsibility for providing services hitherto provided by the public sector.]

Nationalised Industries

5. We need to take a similarly rigorous approach to the nationalised industries. Their bids are clearly unrealistic and I propose that, leaving aside electricity, we should aim to hold the aggregate provision at least to baseline and where we can, in the case of individual industries, below it. There are particular problems relating to the electricity industries, but there too, we need to appraise their bids critically and set challenging financial and efficiency targets.

Running Costs

6. On departmental running costs, my proposals are to keep them to their existing share of total public spending. On present plans this implies real growth of about 1 per cent a year, though no department should consider that an entitlement. Rises in demand, pay, and other costs will create pressure for higher growth. If we are to resist this, the gap must be bridged by efficiency gains

of at least 1½ per cent a year in all departments. These will have to be planned well in advance, so we should aim, as soon as management plans for efficiency improvements are robust enough, to make reasonably realistic provision for years 2 and 3, as well as for year 1. The bids made for year 1 will need to be scaled down by at least half. And since they imply a large expansion of the Civil Service, I hope colleagues will agree that I should probe department' manpower plans very carefully.

<u>Summary</u>

7. I propose that I should explore the position on individual programmes in my bilaterals in September and I am not asking for decisions today. But I seek Cabinet's agreement to the framework for these discussions, namely:

i. public spending leaving aside privatisation proceeds, should take a steadily smaller share of our national income as   in last year's White Paper and in line with our manifesto commitment;

keep as close to planning total as possible

ii. the bids will have to be substantially cut back to secure that objective;

iii. we should explore a wide range of policy changes including those in the areas I have identified with a view to making reductions in the costs of some programmes and offsetting unavoidable increases elsewhere, and

iv. we should adopt the proposals on nationalised industries and running costs set out in the paper.

C

SECRET

PUBLIC EXPENDITURE CABINET: DEFENSIVE POINTS

Why have you not provided a total for all the bids?

As last year,

I have circulated a full summary of departments' proposals. The total for bids made by departments was around £5¼ billion in 1988-89, rising to over £10 billion in 1990-91, but since, as I have made clear, nothing like this can remotely be afforded, no significance can be attached to these figures.

[To these figures can be added bids of £0.9 billion rising to £1.2 billion for the nationalised industries plus around £1.0 billion in 1988-89 for local authority current expenditure - later years not settled.]

Will the planning totals be increased?

unavoidable

Some change in the planning totals may be ~~possible~~ but it is essential that the Government keeps as close to the existing totals as possible and does not in any circumstances exceed the White Paper percentages of GDP.

Why cannot we take a decision on the planning totals now?

if colleagues press up / will press hard... / explain

Final decisions best taken when:

- there has been a further assessment of the position of particular programmes;

- we have further information on the prospect for the economy and what can be afforded.

But we must decide now to stick firmly to the policy of reducing spending as a share of GDP.

But we can afford quite large increases and still have a declining path

not just presentation

Not good enough to have any path so long as it is downwards. If policy is to remain credible must hold at least to the White Paper percentages and, if possible, go below. Otherwise we will be seen to be in retreat.

Also economy and tax

Increase in money GDP in FSBR points to an extra £2¼ billion in 1988-89 and £3¼ billion in 1989-90 consistently with maintaining PEWP percentages

Some increases may be affordable consistently with PEWP percentages, but wrong to draw conclusion that there is substantial scope to increase departmental programmes in the Survey:

- have to accommodate pre-Survey decisions, eg nurses' pay, Airbus, rate relief;

- large estimating changes for social security which are swamping benefit from lower unemployment;

- need to allow for increase in provision agreed in E(LA) for local authority current expenditure;

- need to set aside more for reserves than in previous years especially in light of E(LA) decision on grant which is likely to lead to a big overspend next year.

My room for manoeuvre is thus very limited.

But Chancellor has told us growth even higher than in FSBR

What matters for planning public expenditure is output over the medium-term. Wrong to extrapolate growth in one particularly good year. Our prudence in basing plans on a cautious view of future resources has enabled us to withstand a number of difficulties. Insofar as higher money GDP is due to higher prices, wrong to presume an automatic adjustment. Would destroy basis of cash planning and the in-built resistance of system to inflation.

But how can we endorse the conclusion in paragraphs 12(i) and (ii) if the Treasury will not give an indication of the increase in the planning total that is available?

Paragraph 12(i) asks Cabinet to endorse the policy of reducing public expenditure as a proportion of GDP, in line with the plans we have already set ourselves. There can be no quarrel about that. I am not proposing a change to the planning totals at present. While we should aim to keep as close to them as possible, it may be possible to afford somewhat more within the constraint. But if asked to go firm on figures now, I would have to ask for endorsement of the existing figures.

Will GDP deflator be increased and if it is will there be an opportunity to adjust Survey settlements?

Cannot say what forecasts will be published. But even if deflators are higher plans are set in cash terms with no automatic right to adjustment.

Will there be any extra privatisation proceeds?

I am not proposing any change in the figures. There are still too many uncertainties over the timing of proceeds from water and electricity. But in any case the issue is not relevant to what can be afforded on departmental programmes. Markets rightly take the view that it is wrong to raise spending on the back of higher asset sales and our plans will, therefore, be judged after excluding privatisation proceeds. Furthermore, just as departments' programmes were not cut back when there was a shortfall in receipts, as happened in 1986-87, so there would be no case for expanding programmes if receipts came in faster.

How will science and technology spending be dealt with now that E(ST) has been set up?

As minutes of the first meeting of E(ST) made clear, the Committee will review policies and priorities and will consider the consequent allocations between departments but detailed negotiations and final decisions on programmes will be settled in the Survey. I will be monitoring the position through the Survey and will report back to Cabinet in the autumn.

PARTICULAR PROGRAMMES - next sheet

CONFIDENTIAL

PARTICULAR PROGRAMMES

General

You will note wish to get involved in discussion of particular programmes at Cabinet. Generally you can say that you are not asking for decisions on particular policy areas but only agreement that you should explore the options. In case your colleagues press you on their own programmes we set out below the level of bids together with some lines to take in response to some comments they may make.

	1988-89	1989-90	£m 1990-91
Defence (allowing for inflation adjustment	550	815	950

"Bids would leave 1990-91 below 1986-87 in real terms".

Bids massive. Defence has benefit of substantial real growth in earlier period. Right to explore scope for reducing increases, eg by improved efficiency.

Health	955	1380	2200

"Key element in election campaign, bids already assume painful measures".

Acknowledge the pressures, but the bids are enormous. There is no limit to the demands (from consumers and producers) for free health care and we must look carefully at ways of holding back growth including efficiency and charging.

Education	560	690	785

"High political priorities - schools capital, universities and science".

Massive discretionary bids, 15-20% of a programme which is already substantial and more or less level in real terms. And that on top of other priorities - school reforms and schools maintenance - covered in the RSG increase. Cannot be afforded: throwing money at problems has never been our approach.

Social Security 1200 1545 3000

"Increases cannot be avoided, policy bids extremely modest, already committed to painful measures".

Massive increases in benefits proposed, less than year after your predecessor said provision was now realistic. Right to explore scope for offsetting savings, particularly in context of introducing new benefit structure in 1988. And huge staffing bids cannot be jusified following equally huge increase agreed only 6 months ago.

Employment (no net bid other than agreed changes eg January measures)

"Manifesto offered "to do more to help those out of work" not cuts".

Not proposing to renege on Manifesto's three guarantees and the aim for the long-term unemployed but programme has doubled in size since 1979 and, now that unemployment is coming down, right to review it. In any event the aim for the long-term unemployed is for the whole Parliament.

"Killing the golden goose which has reduced unemployment".

Measures are important but it is largely economic growth which is bringing down unemployment.

Territories (small bids and formula additions for blocks)

"Are you re-opening block arrangements?"

Not intending to dispense with concept of a block built up from formula additions but need to examine the results of formula from time to time. No secret that we believe Scotland in particular is over-provided relative to need.

"Political suicide in Scotland?"

Political position will have to be taken into account before we reach decisions but should not rule out a thorough examination of the position and options.

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CASE FOR REDUCTION IN REGIONAL ASSISTANCE

	1988-89	1989-90	1990-91
	£m	£m	£m
REGIONAL POLICY (inc. development agencies):			
PES:	567.2	566.2	580.3
BIDS:	+151.9	+175.1	+184.1
(of which RDG/RSA)	(+119.8)	(+129.0)	(+132.6)
URBAN INITIATIVES:			
PES:	407.8	416.8	427.2
BIDS:	+62.0	+83.0	+85.0

- Major bids for regional assistance reflect success of general economic policies in encouraging industry to invest. Cost of assistance increasing just as it is becoming less necessary. Paying many companies RDG for investment they would undertake anyway: study suggest about 50% of project decisions and 70% of location decisions not affected by receipt of RDG. This high deadweight likely to increase as investment more buoyant.

- Growth in RDG undermining shift from demand-determined (RDG) to selective assistance (RSA) agreed as part of 1984 review. Strong case for radical shift away from demand-determined grants and generally becoming more selective.

- Regional programme not well suited to dealing with higher priority, inner city problems for which we also have substantial bids. Need to shift away from bricks and mortar towards improving ability of residents to compete for jobs

- Major arguments for fundamental review of regional assistance to make it more relevant to current policy priorities and constraints.

D

PUBLIC EXPENDITURE FACT SHEET

The following are agreed baseline figures, except where indicated. Real terms changes are calculated using the FSBR projections for the GDP deflator, except where otherwise stated.

1. Planning total

£billion

	1978-79 outturn	1982-83 outturn	1986-87 outturn	1987-88 plan	1988-89 plan	1989-90 plan	1990-91 plan*
Cash	65.7	113.5	140.0	148.6	154.2	161.5	168.1
Percentage change		+14.6 (annual average)	+5.4 (annual average)	+6.1	+3.8	+4.8	+4.1
Percentage change in real terms		+1.4 (annual average)	+0.9 (annual average)	+1.6	-0.2	+1.2	+0.5
(implied by White Paper)				(+2.1)	(+0.2)	(+1.7)	

* Projection in MTFS.

2. General Government Expenditure as percentage of GDP

	1978-79 outturn	1982-83 outturn	1986-87 outturn*	1987-88 White Paper Plans	1988-89	1989-90
GGE (including privatisation proceeds)	43.25	46.75	43.00	42.75	41.75	41.25
GGE (excluding privatisation proceeds)	43.25	47.00	44.00	44.00	42.75	42.25

*Latest CSO figures.

NOTE: revised MTFS published in FSBR implied lower percentages in future years (41.25 in 1988-89, 40.75 in 1989-90).

3. Public Sector Capital Spending

£billion

	1984-85 outturn	1985-86 outturn	1986-87 outturn	1987-88 plan	1988-89 plan	1989-90 plan	1990-91 plan
Cash	21.5	21.5	22.4	22.1	22.0	22.4	23.0
Percentage change in real terms		-6.0	+1.4	-5.6	-4.4	-1.5	-0.6

4. Science and Technology

The level of planned expenditure on science and technology will be monitored during the survey. The figures below are the agreed baselines for research and development expenditure: other components will be added to reach a baseline for total science and technology.

£billion

	1982-83 outturn	1986-87 outturn	1987-88 plan	1988-89 plan	1989-90 plan	1990-91 plan
Cash	3.7	4.6	4.7	4.8	4.8	4.9
Percentage change in real terms		+1.1 (annual average)	-1.1	-2.1	-3.0	-0.4

5. Manpower and Running Costs

Manpower Plans

Thousands, whole time equivalents

	1978-79 actual	1982-83 actual	1986-87 actual	1.4.88 target	1.4.89 plan	1.4.90 plan	1.4.91 plan
Civil Service Manpower	734.0	657.6	596.3	588.0	581.6	583.3	583.3

Running Cost Totals

£million

	1982-83 outturn	1986-87 outturn	1987-88 plan	1988-89 plan	1989-90 plan	1990-91 plan
Departmental Running Costs	9,049	12,487	13,054	13,342	13,710	14,052
Percentage change - cash		+8.4 (annual average)	+4.5	+2.2	+2.8	+2.5
- real terms		+3.7 (annual average)	0.0	-1.7	-0.7	-0.5

6. Economic Assumptions

	1987-88	1988-89	1989-90	1990-91
PEWP increases in GDP deflator (%)	3.75	3.5	3.0	
FSBR increases in GDP deflator (%)	4.5	4.0	3.5	3.0
increases in RPI to September (%)	4.25	3.75	3.25	
GB unemployment (millions)	2.7	2.7	2.7	

1987 SURVEY BASELINES

	1987-88 PLANS	1988-89 BASELINE	1989-90 BASELINE	1990-91 BASELINE	PER CENT CHANGE 87-88 to 90-91 (real terms)+
Ministry of Defence	18,780.0	18,980.0	19,460.0	19,890.0	-4.5
DHSS - Health and Personal Social Services	16,200.0	16,850.0	17,660.0	18,100.0	0.8
DHSS - Social Security	47,260.0	47,260.0	49,120.0	50,350.0	-3.9
Other central government	30,970.0	33,630.0	34,600.0	35,480.0	3.3
Local Authority Relevant	31,090.0	32,210.0	33,050.0	33,880.0	-1.7
Local Authority Capital (net)	4,250.0	4,000.0	4,130.0	4,230.0	-10.2
(gross)	6,630.0	6,360.0	6,470.0	6,630.0	-9.8
Nationalised Industries	690.0	350.0	-60.0	-60.0	
European Communities	870.0	440.0	1,060.0	1,090.0	
Reserve	3,500.0	5,500.0	7,500.0	7,500.0	
Privatisation proceeds	-5,000.0	-5,000.0	-5,000.0	-5,000.0	
PLANNING TOTAL	148,600.0	154,200.0	161,500.0	165,500.0	0.5
Debt interest*	17,900.0	18,000.0	19,000.0	19,000.0	-4.3
National accounts adjustments*	7,000.0	8,000.0	8,000.0	8,000.0	3.1
GENERAL GOVERNMENT EXPENDITURE	173,500.0	180,000.0	188,000.0	193,000.0	0.3

+NB: 0.5% real terms decline built into baseline for 1990-91.
*FSBR projections.

E

BRIEF E: RUNNING COSTS

SURVEY POSITION

Running costs

£m

E

	1987-88	1988-89	1989-90	1990-91
Baseline	13054	13342	13710	14052
Bids		761	956	1203
year on year % increases if bids accepted		8.0	4.0	4.0

Manpower

	1.4.88	1.4.89	1.4.90	1.4.91
1987 Survey baseline	588,000	581,600	583,300	583,300
Bids	8,580	15,865	16,310	17,415

OBJECTIVES

- Agreement that running costs share of total public expenditure should remain roughly constant, implying real increases of about 1% a year.

- Departments to prepare efficiency plans showing efficiency improvements of at least 1½% year on year for discussion in the bilaterals.

- Reduction by at least half of the 1988-89 running cost bids.

- Maintain momentum for leaner Civil Service.

DEFENSIVE POINTS

Efficiency Improvements

Q1 Justification of minimum 1½% annual efficiency improvements?

A1 This rate of continuing annual efficiency gain is considered to be a very reasonable minimum target for service organisations e.g Banks, insurance companies etc and foreign Civil Services (e.g USA, Australia). Also consistent with Government expectations for cost improvement programmes in the National Health Service.

Q2 Efficiency improvements already in the baseline?

A2 Accept that some departments already have some efficiency improvements in the baseline, e.g lowering of manpower projections when computer projects come on stream. Individual cases to be probed in the bilaterals. But the key point is that all departments should plan and deliver <u>at least 1½% efficiency improvements in their total running costs spending each year</u>; with contingency plans for higher efficiency gains in case they should be needed.

Q3 Have already produced savings which are offset against the bids. Do these count towards the 1½%?

A3 Emphasis now on at least 1½% efficiency gains a year on total running costs spending. Departments must show they are on track for this. Detailed relationship with bids for discussion in bilaterals, though only very high priority bids can be accepted if running costs share of public expenditure is to be properly contained.

Q4 Reductions in demand be included in efficiency plans?

A4 No - windfall savings do not count towards increases in efficiency.

Q5 Are 1% growth and 1½% efficiency maximum and minimum for all departments?

A5 Proposal is 1% real total increase - likely to be some areas of greater increase and some less. But all should meet 1½% efficiency proposal: and some should be able to go higher.

Efficiency plans

Q6 What exactly do you want by way of efficiency plans?

A6 Summaries of the forward plans stemming from financial management systems introduced in recent years. Forward three year planning nothing new - was required, for example, by manpower targets which were for whole PES period. Don't want reams of paper. Require simple projections for each department of anticipated demands and resources showing the requiste efficiency gain of at least 1½% a year on total planned running costs expenditure.

Q7 If Treasury not satisfied with plans?

A7 Agreement on later years deferred until next Survey so that position can be improved in the meantime. But if colleagues accept overall strategy hope they will encourage departments to co-operate fully and quickly.

Later years provision

Q8 The emphasis on realism for the later years is new. Can we submit revised bids for them in this Survey?

A8 The first issue is departments' efficiency gain plans. Once it is established that these are ambitious and realistic, can consider any arguments about the need for extra provision in the later years. So don't send in any bids for cash that are unsupported by efficiency plans.

Efficiency plans timing

Q9 What will be your line at bilateral discussions?

A9 My assumption will be that no extra provision can be agreed until departments have shown they have realistic plans or at least 1½% efficiency gains on total running costs spending. To help the bilaterals go smoothly departments should provide my officials with the appropriate material as quickly as possible and explore any problems with them before the bilaterals.

<u>Squeeze</u>

Q10 Are you not just imposing a further squeeze of 1½%?

A10 This argument is not accepted for NHS and there is no reason why it should be accepted for the Civil Service. The aim is to introduce greater realism and ambition in forward planning. Accept that there are costs pressures but consider these can be met by efficiency gains.

<u>Pay</u>

Q11 What pay assumptions will Treasury be working on for (a) 1988-89 and (b) later years?

A11 For 1988-89 departments already invited to make (and identify) pay increase assumptions they considered realistic for their mix and type of staff. Most have done so - often at about 1½% above general inflation through the exact level for their judgement. It would be sensible to adopt similar approach to later years. Treasury will not normally contest increased assumptions but will probe hard to efficiency levels assumed and, of course, the need for and priority of demand-led bids.

Q12 Extra provision for past pay awards (including 1987 Civil Service pay round)?

A12 Expectation in past survey settlements that pay awards would be absorbed. There is no change on that. [If pressed -

confirm that Chancellor said at MISC(66) in the Spring that departments in extremely serious difficulty from 1987 Civil Service pay round could approach him in the autumn].

Manpower

Q13 Are you going to allow any manpower increase?

A13 Pressure on Civil Service numbers maintained through running costs. Numbers are an end product of agreement to running costs figure not vice versa. Some manpower increases may be necessary where pressures of demand are high but collective responsibility to ensure that the overall reduction which we have worked so hard to achieve, is maintained.

Q14 Does 1½% p.a efficiency imply more Civil Service manpower reductions?

A14 Emphasis now on running costs - no overall manpower targets to be set. Minimum of 1½% efficiency gain a year certainly implies making more economical use of manpower; and inconsistent with large increases in manpower projections some departments have put in. Doesn't necessarily imply much smaller Civil Service size. The efficiency gain should be an overall spending (of which 40% non-manpower). And on manpower some departments may be able to go for cheaper grade mix and better delegation, without necessarily reducing crude numbers.

Q15 What about Department of Employment and DHSS manpower additions agreed since 1986 Survey - constrains other colleagues.?

A15 While we retain a collective interest in the size of the Civil Service increases in individual departments cannot fail to have implications for others.

Control of running costs

Q16 Controlled running costs on a net basis?

A16 Cabinet agreed that running costs should be controlled gross. E(A) agreed criteria for exemption from gross running costs regime and these still stand, including:-

a. Full costs recovered in charges and

b. Adequate efficiency criteria and performance yardsticks.

Two organisations (driver testing and the Civil Service College have met the criteria). Several other cases are under consideration.)

F

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Nationalised Industries

1. The initial opening bids in IFR total (£ million*):

1988-89	1989-90	1990-91
939	1,221	1,209

(*Including the Redundant Mineworkers Payments Scheme).

F

2. Aim is, apart from the electricity industry in England, Wales and Scotland, where separate considerations apply, to reduce the provision at least to baseline and, where we can in the case of individual industries, below it.

3. There are particular problems in assessing the electricity industry's bids this year, notably the need to set new financial targets, the implications of privatisation, and assessment of a new power station programme. However no less important to appraise these bids critically.

4. General points:

(i) Opening bids not as frightening as they look. Made in May. Many of industries traditionally include fat and reinstate bids rejected in the last round.

(ii) Economic prospects remain generally favourable for the industries, with continued low inflation, and stable growth.

(iii) Must squeeze current costs and stop productivity improvements being absorbed by real wage increases.

(iv) Until further work by officials completed, and revised bids examined, initial bids provide no basis for assuming increases over baselines negotiated last Autumn are necessary. [Assume colleagues will ensure revised bids (due end July) are realistic].

5. On some of the major industries:

(i) **Coal**. Still waiting for up-to-date plan. Must have it as soon as possible. Then critically examine, particularly investment and manning proposals.

(ii) **Electricity**. More realistic assumptions on new power station programme and on new financial target could give big savings. Privatisation an important new consideration. Officials examining other options.

(iii) **Water**. Bidding for some additonal investment. Not apparent that balance between real price increases and very large investment programme agreed last year is now wrong.

(iv) **Transport**. Not clear that bids from BR and LRT for new investment will necessitate any increase in baseline provision.

(v) **DTI**. Not clear at this stage that any increases will be necessary for BS. BSC should not need increases, in view of recent and prospective performance. PO must contain new capital investment proposals to stay within baseline.

NATIONALISED INDUSTRIES: INVESTMENT AND FINANCING REVIEW

1. Electricity industries in England and Wales, and Scotland

Initial bid	**1988-89**	**1989-90**	**1990-91**
Electricity (E & W)	+ 337	+ 668	+ 935
" " (Scotland)	+ 187	+ 173	+ 73
Sub-total	+ 525	+ 841	+1,009

Cabinet Paper Objectives:

> "There are particular problems relating to the electricity industry this year, notably the need to set new fiancial targets, the implications of privatisation and assessment of a new power station programme. Notwithstanding these uncertainties, the pressure on public expenditure means that it is no less important to appraise the industry's bids critically and to set challenging financial targets."

Issues:

The industry in England and Wales has bid for an extra £700 million or so over the survey period for new power stations (apart from Sizewell B). But the need for this depends crucially on forecasts of demand and other factors on which we have yet to come to a view within Government. It also put forward its bid broadly on the basis of the continuation of the exisiting financial target (2¾% in real terms). Something more ambitious is required whether in terms of the Government's own objectives for the return on public sector assets or in the light of returns available in the private sector. Indeed, the need to prepare the industry for a successful privatisation will be particularly important in considering its new financial target. This last point applies equally to the industry in Scotland which has also made substantial bids.

2. **Other industries:**

	1988-89	1989-90	1990-91
Coal	+ 77	+ 74	- 32
Steel	+ 63	+ 45	- 20
PO	+ 7	+ 29	+ 13
Rail	+ 83	+ 84	+ 163
Shipbuilders	+ 30	+ 31	+ 41
Water	+ 46	+ 60	+ 31
London Regional Transport	+ 44	+ 43	+ 21
Other (inc RMPS)	+ 64	+ 14	- 17
Sub-total	+ 414	+ 380	- 200
Total (including electricity)	+ 939	+ 1221	+ 1209

Cabinet Paper objectives:

> "aim should be to reduce the provision at least to baseline and, where we can in the case of individual industries, below it. Failure to achieve this would mean greater pressure on departmental programmes."

3. **Water**

Essential that we address what needs to be done to put the industry into good shape for privatisation. Means, in particular, continuing the policy of real terms increases in charges each year. (Current average rate of return on assets is still under 2 per cent).

G (revised)

LOCAL AUTHORITY RELEVANT PUBLIC EXPENDITURE

1. Agreed figures for 1988-89 relevant public expenditure provision (£ million):

	Provision	Increase on Cm56 baseline for 1988-89
England	27969	819(1)
(of which: relevant current	27538	838)
Wales	1642	51
(of which: relevant current	1640	51)
Scotland	3640	169
Total:	33251	1039

(1) excludes £45m transferred to Urban Programme capital provision and £35m for an agreed irresistable bid in the Survey for the housing benefit costs of a 5% real LA rent increase.

2. Agreed quantum of Aggregate Exchequer Grant:

- England, £13,775 million;
- Wales, £1,256 million;
- Scotland, £2,372 million.

In total, £1,014 million higher than 1987-88 RSG settlements, after teacher's pay.

3. Service distribution of agreed total for England to be considered first by Treasury officials, who will then consult officials in other interested departments. Proposals can then be considered by Ministers in E(LA). Mr Ridley has suggested Ministers delay consideration until September to take into account effects on distribution of grant; Treasury has no objection. Service distribution in Scotland and Wales a matter for territorial Secretaries of State.

4. Other RSG matters - unallocated margin, nets and caps, GREs etc - to be considered in the autumn.

5. Provision and service distribution for 1989-90 and 1990-91 to be considered in the autumn.

6. Aggregate provision for 1988-89 and AEG to be announced on 23 July by Secretaries of State for Environment, Scotland and Wales.

7. Increases in provision reduce Reserve available for 1988-89 by over £1 billion. And prudent to allow in Reserve for the possibility of substantial overspend over new provision unless local authorities in all 3 countries cut back rate at which their spending is increasing (19% since 1985-86). [NOT FOR USE: latest forecast is overspend over new provision of £1.9 billion.]

8. On pay, provision includes realistic cover for 1988 police and firemens pay, and for full cost in 1988-89 of Baker pay award to teachers which was staged in 1987. Treasury officials will allow explicitly for a teachers' pay award from 1 April 1988 in the service distribution of provision.

29/342

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LOCAL AUTHORITY RELEVANT PUBLIC EXPENDITURE

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England	27969	819(1)	
(of which: relevant current	27538	838	)
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(of which: relevant current	1640	51	)
[Scotland	3634	163	]
[Total:	33255	1033	]

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[- Scotland, £2,371 million.]

In total, [£1,011] million higher than 1987-88 RSG settlements, after teacher's pay.

3. Service distribution of agreed total for England to be considered first by Treasury officials, who will then consult officials in other interested departments. Proposals can then be considered by Ministers in E(LA). [**NOT FOR USE** : We understand Mr Ridley has in mind to delay Ministerial consideration of service distribution until September, so that the effects on distribution of grant can be taken into account. We have no objection to this delay, but service departments may not welcome it.] Service distribution in Scotland and Wales a matter for territorial Secretaries of State.

* Figures for Scotland are in [--] because they have not yet been settled.

4. Other RSG matters - unallocated margin, nets and caps, GREs etc - to be considered in the autumn.

5. Provision and service distribution for 1989-90 and 1990-91 to be considered in the autumn.

6. Aggregate provision for 1988-89 and AEG to be announced on [23 July] by Secretaries of State for Environment, Scotland and Wales.

7. Increases in provision reduce Reserve available for 1988-89 by [over £1 billion]. And prudent to allow in Reserve for the possibility of substantial overspend over new provision unless local authorities in all 3 countries cut back rate at which their spending is increasing (19% since 1985-86). [NOT FOR USE: latest forecast is overspend over new provision of £1.9 billion.]

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RATE SUPPORT GRANT SETTLEMENT: SPEAKING NOTE FOR CABINET (Parliamentary Business)

1. RSG settlements now agreed for England, Scotland and Wales for 1988-89. To be announced this afternoon (23 July) by Environment, Welsh and Scottish Secretaries. Public expenditure provision for relevant current spending by local authorities to be increased from 1987 White Paper baseline by:-

England;	£838m to £27,538m.
Wales;	£51m to £1,640m.
Scotland;	£169m to £3,640m.

Taking into account also agreed changes in public spending on rate fund subsidies to LA housing accounts, this is an increase above baseline of £1,039 million.

2. This increase above 1987 White Paper baseline is smaller than £2½ billion increase above 1986 White Paper agreed for 1987-88. But this is mainly because 1987-88 baseline in 1986 White Paper had been set artifically low at a cash freeze on 1986-87 plans.

3. Aggregate Exchequer Grant in each country to be increased by:-

England	£750m to £13,775m	(5.8% increase , compared to 9.8% for 1987-88)
Wales	£82m to £1,256m	(7.0% increase, compared to 9.3% increase for 1987-88)
Scotland	£182m to £2,372m	(8.3% increase compared to 8.4% for 1987-88)

Total increase in AEG at settlement therefore £1,014 million; less than £1,430 million agreed for 1987-88.

G

LOCAL AUTHORITY CAPITAL EXPENDITURE

The baseline for spending on the main local authority capital cash limit (DOE/LA1) incorporates a £260 million fall in gross provision between 1987-88 and 1988-89. Spending power from accumulated receipts continues to grow. So the room for allocations consistent with the baseline is likely to be much lower than the £2,640 million agreed for 1987-88.

2. Allocations are distributed in five blocks - Housing, Transport, Education, Personal Social Services and "Other Services". The proposal in the previous Chief Secretary's letter of 7 May that baseline allocations should be distributed between the blocks in proportion to net provision has been accepted. Additional bids (which amount to just over £600m) have been based on the agreed provisional assumption that baseline allocations will be £2,250 million. But this figure now looks optimistic. Our current expectation, based on latest outturn information, is that baseline allocations may have to be set about £200 million lower (ie at £2050 million). This will result in a slightly smaller upward adjustment in local authority capital bids, adding to Survey pressures.

3. LG will be discussing further the level of baseline allocations with DOE and other departments concerned, and aim to put agreed recommendations to Ministers by the end of this month. The figures for baseline allocations and additional bids can then be adjusted as necessary well before the bilaterals get under way. Briefing for bilaterals involving local authority capital expenditure will of course cover arguments for resisting the additional bids and possible ways of achieving reductions.

2200/6

SECRET

BRIEF H

PRIVATISATION PROCEEDS

[Background briefing: not for disclosure to departments]

Targets

Published estimate for 1986-87 was £4.75 billion. Outturn was approximately £4.4 billion.

Published estimates for 1987-88, 1988-89 and 1989-90 are £5.0 billion p.a.

Internal Treasury meeting on 1 July agreed to increase estimate for 1988-89 and future years to £6.0 billion. To be announced in Autumn Statement and not revealed to colleagues until final Cabinet before that

Proceeds: 1988-89

Likely to be about £5.4 billion, without BT:-

	£ m	
Gas debt	250	
Gas II	1,600	
BAA II	725	(approx)
Miscellaneous	100	
BP II	2,700	(approx)

1989-90

Certain of about £3.0 billion, mainly BP. Can be topped up from BT and (possibly) Steel.

1990-91

No certainty.
Main possibilities are Water, Electricity and Steel.

H

I

I CURRENT PAY DEVELOPMENTS

1986-87 Pay Round

About 70 per cent of employees have received pay increases in the 1986-87 pay round, which covers settlements falling in the period 1 August 1986 to 31 July 1987. The likely out-turn is below.

	1986-87 Settlements	1986-87 Average Earnings	1985-86 Settlements	1985-86 Average Earnings
Whole Economy	5¾	7¾	6	7½
Public Sector	6½	7½	6½	7½
- trading	5	7	6	8¼
- services	7	7½	6½	7¼
Private Sector	5	7¾	5¾	7¾

2. In the private sector settlements have been ¾ per cent lower than in the previous pay round but average earnings continued to increase at 7¾ per cent, because of more overtime working and higher productivity payments in the expanding economy. In the public services settlements averaged 7 per cent. As in previous years the pattern was high settlements for some local authority groups (police 7½%, fire 7%, teachers 16.4%) and Review Body groups (nurses 9.5%, doctors 7.7%) offset by lower settlements for the civil service (5¼%) and Health Service employees not covered by Review Bodies (likely to settle at 5¼%). The settlements-earnings gap of ½ per cent (lower than the private sector because there are less opportunities for overtime, productivity payments etc) meant average earnings growth of 7½ per cent.

Prospects for 1987-88 Pay Round

3. As many public service groups settle on 1 April their 1987-88 pay round settlements (1 August to 31 July) affect public expenditure in the 1988-89 financial year. Public service paybill is about £50 billion: one-third of total public expenditure. The approximate split is: Local Authorities 50%; Review Body groups 25%; collectively bargained Central Government groups 25%.

4. The latest Treasury-Department of Employment assessment of prospects, which was set out in E(PSP)(87)(9), is set out below:

	Settlements	Average Earnings
Whole Economy	5¾	7½
Public Trading Sector	5-5½	7½
Public Services	6-6¼	7
Private Sector	5-5½	7½

5. In the private sector settlements are expected to remain at their present level or edge up slightly in line with inflation, but the average earnings increase to edge down as overtime stops growing from its record level.

6. The public services forecast reflects:

a. Local Authority Groups The manuals seem likely to conclude a 10.6 per cent settlement, which will influence craftsmen and white collars. The police and firemen, who are indexed to average earnings will receive 7¾% and 7% respectively. Teachers increase will be in line with private sector average, after last year's big "restructuring" increase.

b. Review Body Groups Recommendations close to outside average earnings (7½-8 per cent) but first year cost reduced by staging.

c. Central Government Settlements around average private sector settlement. This would represent an achievement. These groups have had lower settlements than the private sector and rest of the public services since 1981 and are pressing for "catching-up" rises. It is assumed that running cost and public expenditure limits together with more flexibility in the pay systems to deal with particular recruitment and retention pressures will hold down the average settlement level.

Line to Take

7. These numbers, implying a growth in the overall public service paybill of 7 per cent (Local Authority slightly more; Central Government slightly less) will obviously put public expenditure under pressure. Hence DHSS bid for 1½ per cent "real pay growth" for NHS staff. Some colleagues may argue for more "realistic" ie higher public expenditure totals to reflect these pressures. We suggest the following line to take:

i. Acknowledge pressures from public service pay;

ii. But, not a reason to increase provision;

iii. Rather incentive to use existing paybill more effectively and seek efficiency savings to offset cost of pay settlements;

iv. And, need to make finance determine expenditure in the matter of pay;

v. No real increase in LA provision to influence local authorities and make clear to Review Bodies that there is a limit on money available for pay.

J

BRIEF J: SPEAKING NOTE ON THE ECONOMY

UK economic prospects for this year better than forecast at Budget time, in spite of disappointing performance by rest of OECD as a whole.

World economy

Real GDP growth in the major 7 this year could, if anything, be lower than the 2½ per cent forecast at Budget time. Low growth in Japan and Germany reflects failure of domestic demand to rise to offset the adverse effects of dollar depreciation on their exports. Prospects for world recovery depend on continued success of attempts to achieve more exchange rate stability, and better rate of growth of domestic demand in Japan and Germany. + need to cut US budget deficit further next year.

J

UK economy

We have seen a continuation of steady growth and low inflation - GDP(O) up over 4 per cent up in the year to 1987Q1, while excluding effects of mortgage interest payments RPI up just 3½ per cent over the year to June.

For 1987 as a whole GDP growth likely to be nearer 4 per cent than the 3 per cent forecast at Budget time. The strength of output is being reflected in renewed pick up in employment growth and a fast decline in unemployment. RPI inflation this year may, if anything, a little below the Budget forecast.

While inflation low by the UK's past standards, it is high by the standards of our competitors - partly because UK did not get the same benefit from the fall in oil prices. ~~Prospects of further progress in the immediate future are not particularly promising:~~ And although pay settlements have fallen in the current round the limited extent of their response to lower price inflation has been disappointing. Essential to ensure that inflation is kept on downward path over medium term. That means ~~falling~~ lower earnings growth in private and public sectors.

cm
brfG

Sterling has been very steady since the Louvre agreement. But markets have shown signs of edginess about the strength of the UK economic upswing, and would react unfavourably to any signs of policy loosening or deterioration in trade performance.

Perhaps main risk to further sustained growth is danger that markets might lose confidence in government's resolve to hold and reduce inflation, and the consequences of the monetary measures that might be necessary to reassure markets in that eventuality.

K

SPEAKING NOTE ON PUBLIC FINANCES

1. Good progress in recent years in reducing public sector borrowing. Even excluding privatisation proceeds, PSBR down to 2 per cent of GDP for 1986-87 - lowest since 1971-72. Achieved despite falls in NS revenues. This fall in borrowing has occurred while economy has grown at satisfactory rate. Essential factor behind steady and satisfactory growth performance.

2. Two special factors behind last year's reduction in PSBR [and the continued strength of public finances].

- Exceptional buoyancy of revenues from certain non-North Sea taxes - particularly corporation tax. Rise in CT receipts reflects scale of improvement in profitability of business.

- continuing restraint on public expenditure which reduced GCE as a percentage of GDP.

too cautious

3. Outlook for this year promising. Do not at this stage anticipate PSBR turning out higher than £4 billion forecast at Budget time - though margin of error on PSBR forecasts notionally high.

4. But tax burden (non-North Sea) has not fallen in last few years. Essential for it to come down. Scope for further tax cuts in next year's Budget will depend on continuing restraint on public expenditure.

K

~~2.75~~

3/4

−108

(−400)

L

BRIEF L: DOMESTIC ECONOMY

Factual

(i) **Output**

GDP (average measure) 87Q1	on year earlier	+ 3.3 per cent
(output measure) 87Q1	" " "	+ 4.2 per cent
Manufacturing output (three months to May)	" " "	+ 4.6 per cent

(ii) **Inflation**

RPI (June)	" " "	+ 4.2 per cent
RPI excluding mortgage payments (June)	" " "	+ 3.5 per cent
TPI (June)	" " "	+ 2.5 per cent
Underlying average earnings (May)	" " "	+ 7¾ per cent

(iii) **Current account** surplus totalled £~~¾~~ 1/4 billion in first ~~four~~ five months of 1987, following virtual balance in 1986. ~~[To be updated after publication of May figures]~~

L

(iv) **Unemployment** fell by almost 290,000 in the 12 months to June, and has fallen by over 110,000 during the last three months alone.

(v) **Employment** growth has picked up again over the last year with an estimated 105,000 rise in the employed labour force in GB in 1987Q1 alone, and a total increase over the last year of about 260,000.

(vi) **June DTI Investment Intentions** survey indicates 8 per cent rise in industrial investment this year.

(vii) **Private housing starts** in five months to May up 12 per cent on year earlier.

(viii) In three months to May volume of **retail sales** almost 1 per cent higher than in previous three months. June provisional implies 2½ per cent QII / QI but distorted – see note

Positive

(i) **GDP** growth in 1986 now estimated at almost 3 per cent, compared with 2½ per cent at Budget time; growth in 1987 expected to be higher than the 3 per cent forecast at Budget time, probably nearer 4 than 3 per cent.

(ii) **Prospects** for RPI inflation this year are, if anything, marginally better than forecast at Budget time.

(iii) **Current account** performance this year also better than forecast at Budget time (modest surplus so far recorded contrast with forecast deficit of £2½ billion in 1987). ~~[To be revised in light of May figures]~~ But May figures have distorted markets.

(iv) In sum, the change in prospects since the Budget reflect a significantly improved **supply** performance.

(v) Latest **OECD Economic Outlook** shows UK 1987 growth (at 3¼ per cent) faster than any other of the major 7 and 1 per cent faster than the growth rate for the OECD area as a whole.

(vi) Fall in **unemployment** over last year largest twelve-month fall in post war period.

(vii) Recent **CBI surveys** show continuing buoyant prospects for output. June survey showed highest ever balance of firm expecting output to increase.

(viii) **Export volumes** (excluding oil and erratics) up ~~[ ]~~ 6½ per cent over year earlier in three months to May.

Defensive

(i) **Shortages of capacity?** CBI surveys show little change in reported capacity utilisation over the last two years although balance of firms reporting capacity as a constraint on output has risen and is now at its highest level since 1973. However, the excellent supply performance this year does not suggest serious capacity constraints.

(ii) **Skilled labour shortages?** CBI surveys show proportion of firms quoting skilled labour as a constraint on output remaining at historically low levels.

(iii) **Inflation set to rise in 1988:** Considerable range of views amongst forecasters, but the LBS, for example, expect consumer prices to rise by only 3.3 per cent in 1988; even the National Institute expect only a 4.1 per cent rise in the RPI in the year to 1988Q4.

(iv) **House price inflation?** Strong growth in real incomes normally leads to buoyant house prices - encouraging feature has been the strong response of housing starts. Construction output up 11½ per cent in the year to 1987Q1 also reflects ready supply response to increased demand.

(v) **Current balance worsening?** Current account for year so far in surplus, against £2½ billion deficit for year as a whole forecast in FSBR. ~~Excellent~~ Good performance given the background of slow world trade growth.

3785/21

M

PUBLIC SECTOR FINANCES

A. PSBR Trends

	PSBR		PSBR Excluding Privatisation proceeds	
	Cash	% GDP	Cash	% GDP
1969-70	- 0.6	- 1¼	- 0.6	- 1¼
1971-72	1.0	1¾	1.0	1¾
1973-74	4.3	5¾	4.3	5¾
1975-76 (peak)	10.3	9¼	10.3	9¼
Average 1974-75 to 1978-79	8.2	6¾	8.3	6¾
1978-79	9.2	5¼	9.2	5¼
1980-81 (peak under Cons Govt)	12.7	5½	13.1	5½
1983-84	9.8	3¼	10.9	3½
1984-85	10.2	3	12.3	3¾
1985-86	5.8	1½	8.5	2¼
1986-87	3.3	¾	7.7	2
Average: 1979-80 to 1986-87	8.7	3¼	10.2	3¾
1987-88 (Budget forecast)	3.9	1	8.9	2¼

M

B. Latest PSBR Figures

	April-June 1987	April-June 1986	Difference
PSBR	0.6	2.2	- 1.6
PSBR excluding privatisation proceeds	3.0	3.3	- 0.3

C. Fiscal Adjustments in 1987 MTFS

£ billion

	1988-89	1989-90	1990-91
From previous year	-	3	5
Annual	3	2	2

D. Oil Revenues

	1985-86	1986-87	1987-88*	1988-89*	1989-90*	1990-91*
Total North Sea Revenues	11.3	4.8	3.9	4	4	4

* 1987 FSBR projections

Assumed **oil prices** averaging $15 a barrel in 1987-88, and thereafter broadly unchanged in real terms.

Actual oil prices averaged $18½ a barrel in 1987Q2 (currently higher than this).

Assumed for Industry Act Forecast **exchange rate** "close to its current level" and for MTFS "no major change ... in exchange rate from year to year". (£/$ rate has been higher than assumed, reducing revenues).

Ready Reckoner: a $1 a barrel difference in the oil price in 1987 would change revenues by about £350 millions in 1987-88 and £400 million in a full year.

4112/034

CONFIDENTIAL

N

PUBLIC EXPENDITURE CABINET, 23 JULY

WORLD ECONOMY

i. Real GNP growth in the G7 countries as a whole is expected to remain around 2½ per cent in 1987, but may pick up slightly in 1988:

Percentage change on year earlier	1985	1986	1987	1988
Real GNP	3	2½	2½ (2¼)	2¾ (2½)
Domestic demand	3	3¾	2½ (2¼)	3 (2¼)
Net exports (contribution to growth)	-	- 1¼	- ¼ (-)	- ¼ (¼)

Note: figures in brackets show latest OECD forecasts

ii. In the United States domestic demand has weakened and achieving a reasonable rate of GNP growth over the next few years depends on a good export performance. In Japan and Germany domestic demand growth has picked up, but not sufficiently to offset the adverse effects on their exports of the appreciation of the yen and the deutschmark.

iii. Consumer price inflation in the G7 countries fell sharply in 1986. As the direct effects of the oil price fall work out of the comparison, inflation can be expected to pick up slightly, but should remain lower than in 1985:

N

Percentage change on year earlier in consumer prices	1985	1986	1987	1988
United States	3½	2	3¾ (4)	4½ (4½)
Japan	2	½	- ¼ (0)	0 (1¾)
Germany	2	- ½	½ (¾)	½ (1½)
France	5½	2½	3½ (3¼)	2¾ (2½)
Major 7	4	2	2¾ (3)	3 (3½)

Note: figures in brackets show latest OECD forecasts

iv. The current account imbalances of the US, Japan and Germany remain large:

$ bn	1985	1986	latest twelve months
United States	- 118	- 141	- 145
Japan	49	84	93
Germany	14	37	41

v. Since the Louvre Agreement the exchange rates of the G7 have traded within fairly narrow bounds:

Exchange rate of US dollar against:	Plaza Meeting (22.9.85)	Louvre Meeting (22.2.87)	Washington Meeting (9.4.87)	Latest (16.7.87)
Yen	240	154	143	150
D-Mark	2.84	1.83	1.80	1.84
Franc	8.68	6.09	6.01	6.11
Sterling *	1.37	1.53	1.62	1.63
Lira	1920	1300	1290	1330
Canadian Dollar	1.38	1.33	1.30	1.32

* $/£ rate

vi. Since the beginning of 1987 the US, Japan and Germany have shown some willingness to adjust interest rates in order to encourage greater exchange rate stability. Thus, rates have risen by over 1 percentage point in the United States and fallen by ½ percent in Japan and by 1 percent in Germany.

vii. Further steps are needed to ensure that fiscal policy in the major three also supports exchange rate stability. This requires principally major cuts in the US Federal budget deficit, but may also need some relaxation of policy in Japan and Germany.

TAX BURDEN

Overall burden

1. Real increase in taxes 1978-79 to 1987-88:

	£ bn (1985-86 prices)
Taxes on income and capital (inc. North Sea ACT set-off)	7.2
North Sea taxes	2.6
Taxes on expenditure	21.8
Total taxes	**31.5**
NICs	3.2
Total taxes and NICs	**34.7**

2. Tax burden up more than 4 percentage points since 1978-79. Even if stick to public expenditure planning totals, keep public sector borrowing at around 1 per cent of GDP, and use the resulting fiscal adjustment to cut income tax, tax burden in 1990-91 still likely to be above 1978-79 level.

Total taxes (inc. LA rates) and NICs as a percentage of GDP at market prices

	inc. N. Sea	excl. N. Sea
1964-65	29.6	29.6
1973-74	33.1	33.1
1978-79	33.8	34.1
1981-82	39.4	38.8
1986-87 (estimated outturn)	38.2	37.7
1987-88 (forecast)	38.0	37.8
1990-91 (MTFS projection)	36.4	36.3

Burden on individuals

3. Share of earnings taken in income tax and NICs up since 1978-79 for a married man on 85 percent or less of average earnings. Share for a man on average earnings more than double that in early 1950s:

Percentage of earnings paid in income tax and NICs by a married man with no children

Multiples of average male earnings	½	¾	1	2
1950-51	5.9	9.5	12.1	23.5
1973-74	16.2	22.5	25.6	28.2
1978-79	16.0	23.8	27.8	31.4
1987-88	18.7	24.4	27.3	29.6

4. Average nurse pays over £45 a week in income tax and NICs; average teacher pays £75 a week.

	£ per week		
	Earnings	**Income tax and NICs**	**Tax and NICs as a percentage of earnings**
Primary School teachers (married; contracted out)	280 (from November)	75.9	27
Nurses (registered; single; contracted out)	170	45.8	27
Average male earnings (married; contracted in	227	62.1	27½

5. Including indirect taxes, married man on average earnings now pays over 40 per cent of earnings in tax and NICs:

Percentage of earnings paid in income tax, NICs, and indirect taxes (exc. LA rates) by a married man with no children

Multiples of average male earnings	¾	1
1978-79	36.5	39.5
1987-88	38.0	40.4

6. Tax threshold for a married man lower relative to average earnings than in 1973-74.

Income tax threshold as a percentage of average male earnings

	Single	Married
1950-51	28.6	45.7
1973-74	26.4	34.3
1978-79	20.4	31.8
1987-88	20.5	32.1

7. **Tax cost of extra expenditure**

Each £1.3bn extra expenditure is equivalent to 1p on basic rate.

Each £1.1bn extra expenditure is equivalent to 1 percent point on VAT rate.

International Comparisons

8. UK burden well above US and Japan, though below many EC countries.

	Tax and social security contributions as a percentage of GDP, 1985
UK	38.6
Denmark	49.4
France	45.6
West Germany	38.0
US (1984)	29.0
Japan (1984)	27.4

[**NB:** These figures are on a receipts basis; those in paras 1-2 were on an accruals basis.]

9. UK starting tax rate high by international standards; UK threshold relative to average earnings about average for developed countries, but well above US.

Starting tax rates and thresholds for a married man with no children, 1987

	Tax rate (%)	Tax plus social security rate (%)	Threshold £
UK	27	34	3795
Italy (1986)	12	19	3425
France (1986)	19	31	6070
West Germany	22	36	3180
Japan (1986)	15	24	3530
USA	11	18	4320

2136/9

CONFIDENTIAL

OK as amended by you & not subject to views of CST

FROM: A TURNBULL
DATE: 23 JULY 1987

CHANCELLOR

Ch
OK?
(discuss with CST?)
AA

cc Chief Secretary
Sir P Middleton
Mr F E R Butler
Mr Anson
Mr Monck
Mr Gilmore
Mr Hawtin
Mr Moore
Mr Odling-Smee
Miss Peirson
Mr Scholar
Mrs R Butler
Mr Gieve
Mr Pratt
Mr Potter
Mr Fellgett
Mr G C White
Miss Walker
Mr Tyrie

PUBLIC EXPENDITURE: TREATMENT OF LOCAL AUTHORITIES

Following your meeting on 3 July, three pieces of work were commissioned:

i. a note for the Prime Minister summarising the proposals;

ii. a note on the treatment of expenditure outside the planning total, eg debt interest and locally financed spending and the reserve inside the planning total;

iii. a note comparing plans with outturn for local authority expenditure.

These are attached.

2. The third note, however, is only an interim report. It shows that, looking one year ahead, it is possible to project the shares of different local authority services with reasonable accuracy. The ranking of the five major services for example was always in the correct order. The errors on <u>shares</u> are generally smaller than the errors arising on the <u>level</u> of spending. LG will be investigating two further propositions:

i. whether the stability of the shares remains true if one compares plans for three years hence with outturn;

ii. whether the projections for the detailed elements within the main services are reliable.

3. We are anxious to know whether the Prime Minister is content for proposals on a new planning total to be broached with colleagues so that we can get on with preparatory work. It would be helpful, therefore, if the note could go to her for the weekend and if you could discuss it with her during the course of next week.

This was ridiculous – they take 3 weeks to prepare paper & expect you to clear it in 12 hours!

V M Brown

pp A TURNBULL

CONFIDENTIAL

DRAFT MINUTE FOR THE CHANCELLOR TO SEND TO

Prime Minister

I have been giving some thought to the way in which local authority expenditure is treated in our public expenditure planning and control systems. Our present arrangements treat local authority spending on all fours with that of central government and do not recognise that central government's responsibility for and control of local authority spending is indirect. The [introduction of the community charge ~~forthcoming changes in the Abolition of Domestic Rates Bill~~] provides a context in which to rethink the present definition of the public expenditure planning total and its relationship with our medium-term objectives for public spending. You may remember that ~~I mentioned this with Sir Geoffrey Howe~~ raised a similar point at the public expenditure Cabinet last week.

I alluded to this when writing to you on [illegible] one or two others

2. The attached paper sets out briefly the case for a new planning total which concentrates on the expenditure for which central government is directly responsible and which accordingly brings grant to local authorities more explicitly into our plans. It also considers how such a change could be made without creating the impression that the Government is drawing back from its wish to restrain the growth of local authority spending.

3. [~~I would welcome an opportunity to discuss this with you.~~] If you [agree that ~~think~~] the proposals should be pursued I [shall ~~would then~~] put them to colleagues and set in hand the discussions which will be needed between departments.

[NL]

CONFIDENTIAL

A NEW PLANNING TOTAL

One of the characteristics of the way the Government in this country plans its expenditure is that it includes the spending of both central and local government in its planning total. Very few other industrial countries do this. For federal states such as Germany, the US or Canada this would be inappropriate; but even in other unitary states such as France or the Netherlands, the government makes direct plans only for central government expenditure.

2. There are understandable reasons why our system has developed in this way ~~good reasons for planning expenditure for the whole public sector.~~ The Government makes and legislates for policies which may be implemented by either central or local government. Responsibility for education, roads and law and order is shared between the two. It is helpful in planning policy to draw together all the expenditure, irrespective of the level at which it is incurred.

3. The Government also has policies for the burden of taxation, and rates and the community charge are just as much taxes as VAT. Finally, the Government has policies for the role and scope for the public sector as against the private sector, and its share of total national output.

4. But ~~While~~ drawing all public sector spending together, either in aggregate or for individual departmental programmes, has a number of advantages, it also has disadvantages. ~~In recent years we have come to see the public expenditure Survey as setting out not just projections, but plans which we mean to adhere to.~~ [~~The main disadvantage of~~] Our present procedures [is that it] lumps together expenditure for which government has differing degrees of responsiblity, and blurs the status of the various aggregates. Thus, if the planning total is exceeded, it is not immediately clear whether responsibility for this lies with central or with local government.

5. A further disadvantage is that by counting ~~scoring~~ the total expenditure of local authorities in the planning total, insufficient attention is paid to the grants which central government provide to local authorities (because they are transfers between parts of the public sector they do not count ~~score~~ in the consolidated spending of the two sectors). Yet grant is extremely important - it is

a major influence on what local authorities spend and it represents money which central government has to raise in taxes.

6. The "Paying for Local Government" reforms provide both an opportunity and a justification for rethinking our system. One of the objectives is to increase local accountability, ie to make it clear to local electorates when local spending rises whose responsibility this is, so that they can draw the appropriate conclusions. The present arrangements do not do this.

We therefore see advantages in

7. ~~It would be possible to~~ restructuring our planning of public spending on the following lines:

There would be no change in our underlying

i. ~~At present we express our medium-term~~ objectives ~~in the MTFS~~ for public spending in terms of general government expenditure (ie central plus local spending) as a proportion of GDP. ~~This would not be changed.~~

But within General Government Expenditure,

ii. The planning total itself would ~~be changed to be~~ become the sum of central government's own expenditure, the grants it provides to local authorities, the permitted level of local authority capital spending and the external finance of public corporations, plus a reserve.

iii. The current expenditure which local authorities at present finance for themselves through the rates, and in future from the community charge, would be outside the planning total but still within GGE as debt interest is now. The attached table shows how the accounts would look.

General Government Expenditure

8. The new planning total would have a number of advantages:

i. It would comprise those elements for which central government is directly responsible and it would exclude that spending which local authorities decide for themselves. ~~If the planning total is exceeded it will not be possible for central government to blame local authorities.~~

ii. It would contain the grants paid to local authorities. These would have to be planned for 3 years ahead and not just one as at present. This would not only give local authorities a better basis on which to plan their finances, but would make it clearer to the local electorate who was responsible for increases in local taxation. It would also create a baseline against which next year's discussion about grant would take place. At present the discussion about RSG is dominated by the percentage of local spending being financed, but this leads us into accommodating whatever excessive level of spending local authorities decide upon. Under the new arrangements, there would be greater focus on the amount of grant and whether it might be afforded within the planning total.

9. There is one danger in adopting such a system. It could be interpreted as a decision by central government to give up its attempt to influence locally financed spending and to cut the local authorities free. ~~If this happened it would be extremely damaging.~~ This can be avoided if the change is made in the proper context. The new Bill will:

i. ~~increase~~ introduce central control over non-domestic rates;

ii. increase pressures of accountability through the community charge.

To make the change in the context of these reforms will make it clear that the Government is still concerned about local authority spending. Continuing to express our objective in the MTFS in terms of general government expenditure (ie central <u>and</u> local) will also make it clear that the Government is still concerned about the level of taxation and borrowing for the whole public sector.

10. One possibility would be to introduce such a change in the 1988 Survey so that the 1988 Autumn Statement/1989 White Paper set out planning totals on the new basis. Announcing three-years' plans for grant in the autumn of 1988 would give local authorities a better basis on which to plan for the transition to community charge from April 1990. If, following discussions with departments, we were to go ahead on this timetable, we could

announce our intentions in the January 1988 White Paper (though this itself would still be on the old basis). We are also planning to bring out more clearly the role of the different tiers of government in our presentation of the expenditure plans in this year's Autumn Statement and 1988 White Paper. This is a worthwhile improvement in its own right but it would also provide a helpful stepping stone to a larger change on the lines above.

H M TREASURY

July 1987

CHANCELLOR OF THE EXCHEQUER

Ch

OK to send ~~these~~ attached note to No 10, with objective of getting agreement to consult a few key DoE officials on a strictly confidential basis before your meeting with PM in September?

Fine.

AA

CONFIDENTIAL

FROM: A TURNBULL
DATE: 4 AUGUST 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Sir P Middleton
Mr F E R Butler
Mr Anson
Mr Hawtin
Mrs R Butler
Mr Gieve
Mr Pratt
Mr Potter

TREATMENT OF LOCAL AUTHORITIES IN PUBLIC EXPENDITURE

The Prime Minister is clearly concerned that the introduction of a new planning total could ease the pressure on local authorities, or could be seen as having that effect. We have prepared the attached note which seeks to explain that the new planning total would not be a relaxation, but is intended to reinforce the pressures flowing from the Paying for Local Government reforms. This could be sent off straight away, but could also be on the agenda for the meeting to be held in September.

2. It would be helpful to us if the Prime Minister's embargo on discussion with Mr Ridley and a few key officials in DOE could be lifted before the September meeting. We are concerned that the option of introducing the change for the 1988 Survey may be lost if we cannot make an early start on the preparations to reorganise the database. Perhaps this is something which could be discussed between the Private Offices.

AT

A TURNBULL

NEW PLANNING TOTAL: ARE WE QUITTING ON CONTROLLING LOCAL AUTHORITY EXPENDITURE, OR APPEARING TO DO SO?

Points to make

(i) Not quitting on local government expenditure. Government policy expressed in terms of general government expenditure, which includes local authority expenditure. So we care about limiting as much as ever.

(ii) Present arrangements not effective. Grant is our most important instrument in restraining local authorities. At present grant as such is not included in the planning total. So increasing it appears painless. Argument is conducted in terms of financing a set proportion of whatever local authorities decide to spend. Cedes initiative to them.

(iii) Reform of local government finance will provide greater central government influence over local authorities' income from non-domestic rates and will increase pressure of accountability on community charge. New planning total would complement this by putting the spotlight on grant. Thus pressures on all three sources of local authority current income would be intensified.

(iv) Reform of local government finance intended to clarify distinction between central and local government responsibility. New planning total would do precisely that. If forward plans for grant are set out as part of the planning total local authorities will find it harder to blame increases in community charge on changes in grant.

3467/002

FROM: N I HOLGATE

DATE: 6 August 1987

1. MR ~~FELLGETT~~ Rob Fellgett 6/8

2. CHANCELLOR

Thanks. It seems that there wd be something to be said for changing the purpose of the LA provision breakdown figs when we go to the new presentation by making them explicitly a repetition of the outturn shares for the latest completed year, thus as a signal that we decide how much is spent by LAs on what. This wd not stop HMG taking a view on

cc PS/CST
Sir P Middleton
Mr F E R Butler
Mr Anson
Mr Turnbull
Mr Gilmore
Mr Hawtin
Mrs R Butler
Mr Gieve
Mr Potter (o/r)
Mr G C White
Miss Walker
Mr Tyrie

PUBLIC EXPENDITURE: TREATMENT OF LOCAL AUTHORITIES

In his submission of 23 July, Mr Turnbull included an interim report which compared the allocation of provision to the main local authority (LA) services in plans with the distribution at outturn. This submission reports on two further analyses.

i. The accuracy of the distribution in the plans for the <u>third year</u> of the survey (eg the plan for 1987-88 in the 1985 White Paper.)

ii. The accuracy of the distribution <u>within</u> the major services for the year ahead.

(that there shd be a shift from x to y.)

<u>Background</u>

2. The tables attached to Mr Turnbull's submission are summarised in table 1. This shows generally small errors in the planned share of LA current spending for main services in the immediate year ahead.

3. This is not surprising, because the shares of each major service do not change dramatically over a short period. You noted the point that outturn shares in the previous year could be just as good a prediction of outturn as the plan. This is illustrated in table 2, which shows the differences between estimated outturn for each year and the estimated outturn for the previous year. The average change is much the same as for table 1 for the first two years and is lower in the second two years.

But it might change the ~~[illegible]~~ character of the annual battle in E(LA). I expect it appeals to CST the [illegible] & officials wd consider this. ~

Looking three years ahead

4. Tables 3 and 4 repeat the analysis of tables 1 and 2 for the plans for the third survey year. (The table does not give figures for 1984-85 because the data base for 1982 is not readily comparable).

These show that

a. the errors remain generally small;

b. the shares for each service in the plan are almost as accurate three years ahead as they are one year ahead;

c. the planned shares are slightly better at predicting outturn three years ahead than the latest outturn data. (This is mainly because the trend fall in the share of road maintenance and increases in teachers' pay were predicted, at least to some extent).

Disaggregation of services

5. Table 5 examines the accuracy of plans for the four main services that can be disaggregated into several sub-programmes: transport, environmental services, law and order and education. These show that

a. apart from law and order, plans within each major service are less accurate than the distribution between major services.

b. accuracy has improved for all services over the three years from 1984-85 to 1986-87.

6. Table 6 shows the differences in distribution between the outturn shares of each year and the year before. Once again, the previous year's outturn is about as good a predictor as the plan: the average differences in share were smaller, using outturn as a predictor, for environmental services and education, similar for transport and larger for law and order. In part, this represents a vain attempt by service departments to influence LA priorities, by putting an unrealistic split into the White Paper.

Conclusion

7. The shares of spending between major LA services change only slowly. Both plans and past outturn are therefore reasonably accurate predictors.

8. The planned distribution within major services is less reliable than that between major services. The distribution within services is also a slightly less reliable guide than outturn data, although some service departments would argue that this is because detailed plans represent government priorities which are not followed by LAs. And there has been some improvement in the accuracy of plans within major services between 1984-85 and 1986-87.

N I Holgate

N I HOLGATE

TABLE 1: LA SPENDING BY SERVICE - COMPARISON OF PLAN AND OUTTURN

	Change in share: plan to latest outturn (percentage points)				Provision
	1984-85	1985-86	1986-87	1987-88	1987-88 (£m)
Agriculture	0.0	0.0	0.1	0.0	120
Industry & employment	0.0	0.0	0.0	0.0	165
Arts and Libraries	0.1	0.1	0.0	0.0	453
Transport	1.0	0.5	-0.2	-0.5	1950
Non-HRA housing	0.1	0.2	0.0	0.2	135
Other environment sve	-0.2	0.3	-0.5	0.4	2850
Home Office	0.1	-0.5	-0.4	0.2	4115
Education and Science	-1.0	-0.4	1.2	-0.3	12850
Personal social sve	-0.4	-0.5	-0.4	-0.1	2847
Social security	0.2	0.2	0.2	0.0	186
Average absolute change in share	0.3	0.3	0.3	0.2	

TABLE 2: LA SPENDING BY SERVICE - COMPARISON OF OUTTURN AND PREVIOUS YEAR'S OUTTURN

	Change in share (percentage points)				Provision
	1984-85	1985-86	1986-87	1987-88	1987-88 (£m)
Agriculture	0.0	0.0	0.1	0.0	120
Industry & employment	0.0	0.0	0.0	0.0	165
Arts and Libraries	0.0	0.1	0.0	0.0	453
Transport	-0.1	-0.9	-0.4	-0.5	1950
Non-HRA housing	0.0	0.1	0.0	0.0	135
Other environment sve	-0.2	0.5	-0.6	0.1	2850
Home Office	1.1	-0.5	0.2	0.2	4115
Education and Science	-0.9	0.4	0.6	0.1	12850
Personal social sve	0.0	0.2	0.1	0.1	2847
Social security	0.1	0.0	0.1	0.0	186
Average absolute change in share	0.3	0.3	0.2	0.1	

TABLE 3: LA SPENDING BY SERVICE - COMPARISON OF PLAN AND OUTTURN (THREE YEARS AHEAD)

	Change in share: plan to latest outturn (percentage points) 1985-86	1986-87	1987-88	Provision 1987-88 (£m)
Agriculture	0.0	0.1	0.1	120
Industry & employment	0.0	0.0	0.1	165
Arts and Libraries	0.2	0.1	0.0	453
Transport	0.0	-0.3	-0.8	1950
Non-HRA housing	0.3	0.2	0.1	135
Other environment sve	0.2	-0.3	-0.3	2850
Home Office	-0.5	-0.3	-0.1	4115
Education and Science	-0.5	0.6	0.9	12850
Personal social sve	-0.4	-0.4	-0.4	2847
Social security	0.6	0.3	0.3	186
Average absolute change in share	0.3	0.3	0.3	

TABLE 4: LA SPENDING BY SERVICE - COMPARISON OF OUTTURN AND OUTTURN THREE YEARS EARLIER

	Change in share (percentage points) 1985-86	1986-87	1987-88	Provision 1987-88 (£m)
Agriculture	0.0	0.1	0.1	120
Industry & employment	0.0	0.0	0.0	165
Arts and Libraries	0.0	0.0	0.0	453
Transport	-1.2	-1.4	-1.8	1950
Non-HRA housing	0.2	0.0	0.1	135
Other environment sve	0.4	-0.3	0.0	2850
Home Office	0.9	0.7	-0.1	4115
Education and Science	-1.2	0.2	1.1	12850
Personal social sve	0.4	0.4	0.5	2847
Social security	0.3	0.2	0.1	186
Average absolute change in share	0.5	0.3	0.4	

TABLE 5:COMPARISON OF PLAN AND OUTTURN BY SUB-PROGRAMME

MAIN PROGRAMME: ROADS AND TRANSPORT

	Difference between plan and outturn 1984-85	1985-86	1986-87	Provision 1986-87
	(% points)			(£m)
Roads	-10.9	-7.0	-3.7	1104
Car parks	-0.2	1.0	0.1	-54
LA administration	1.2	1.2	1.1	189
Public transport	11.0	5.6	3.6	273
Concessionary fares	0.2	1.5	2.5	224
Other	0.1	-0.1	0.0	11
Rail EFL	-0.5	-1.0	-3.6	65
Bus EFL	-1.0	-1.2	0.0	0
Total	0.0	0.0	0.0	1812
Average absolute change in share	3.1	2.3	2.1	

MAIN PROGRAMME: OTHER ENVIRONMENTAL SERVICES

	Difference between plan and outturn 1984-85	1985-86	1986-87	Provision 1986-87
	(% points)			(£m)
Town and country planning	0.0	-1.5	-1.3	329
Recreation	1.2	-1.0	-0.7	650
Other local services	4.4	6.7	0.0	863
General local admin.	-2.8	-0.2	2.2	15
Refuse disposal	-2.7	-3.3	0.1	608
Rate collection	-0.2	-0.8	-0.2	164
Registration of births	0.0	0.0	0.0	16
Total	0.0	0.0	0.0	2644
Average absolute change in share	1.6	1.9	0.7	

MAIN PROGRAMME: LAW AND ORDER

	Difference between plan and outturn 1984-85	1985-86 (% points)	1986-87	Provision 1986-87 (£m)
Court services	-0.3	-0.1	0.0	160
Probation	-0.2	-0.2	0.0	163
Police	0.8	-0.3	-0.8	2707
School crossing	0.0	0.0	0.0	17
Civil defence	0.0	0.0	0.0	14
Fire	-0.1	0.7	0.8	583
Registration of electors	-0.1	0.0	0.0	23
Total	0.0	0.0	0.0	3666
Average absolute change in share	0.2	0.2	0.2	

MAIN PROGRAMME: EDUCATION

	Difference between plan and outturn 1984-85	1985-86 (% points)	1986-87	Provision 1986-87 (£m)
Primary schools	-1.0	-1.2	-0.7	2748
Secondary schools	-1.8	-1.4	-0.6	4088
School meals and milk	1.4	1.3	1.1	280
Schools (other)	0.2	0.0	-0.1	223
Under 5s	-0.1	-0.1	0.1	339
Special schools	0.2	0.2	0.2	421
School transport	-0.1	0.0	-0.2	214
Student awards	0.3	0.2	0.1	154
Advanced Further Education	0.4	0.2	-0.2	673
Non-AFE	-0.1	0.5	-0.1	899
Adult education	0.3	0.3	0.2	71
Youth services	0.2	0.2	0.1	118
Research and other	0.2	0.1	0.1	50
Administration	0.1	-0.3	-0.1	526
Total	0.0	0.0	0.0	10804
Average absolute change in share	0.5	0.4	0.3	

TABLE 6: COMPARISON OF OUTTURN BY SUB-PROGRAMME WITH THE OUTTURN FOR THE PREVIOUS YEAR

MAIN PROGRAMME: ROADS AND TRANSPORT

	Difference between outturn and prior year outturn			Provision
	1984-85	1985-86	1986-87	1986-87
	(% points)			(£m)
Roads	-0.4	8.5	1.9	1104
Car parks	-0.3	-0.6	-0.4	-54
LA administration	0.0	0.3	-1.4	189
Public transport	0.3	-10.7	5.8	273
Concessionary fares	0.5	1.9	0.5	224
Other	0.0	0.1	0.0	11
Rail EFL	0.0	0.2	-3.1	65
Bus EFL	0.0	0.2	-3.3	0
Total	0.0	0.0	0.0	1812
Average absolute change in share	0.2	2.8	2.4	

MAIN PROGRAMME: OTHER ENVIRONMENTAL SERVICES

	Difference between outturn and prior year outturn			Provision
	1984-85	1985-86	1986-87	1986-87
	(% points)			(£m)
Town and country planning	-0.5	-0.8	-0.9	329
Recreation	0.7	0.1	-0.9	650
Other local services	1.9	1.7	-0.7	863
General local admin.	-0.1	0.0	1.1	15
Refuse disposal	-0.9	-0.7	1.1	608
Rate collection	-1.0	-0.2	0.3	164
Registration of births	0.0	-0.1	0.0	16
Total	0.0	0.0	0.0	2644
Average absolute change in share	0.7	0.5	0.7	

MAIN PROGRAMME: LAW AND ORDER

	Difference between outturn and prior year outturn 1984-85	1985-86 (% points)	1986-87	Provision 1986-87 (£m)
Court services	-0.3	0.2	0.0	160
Probation	-0.1	0.4	0.1	163
Police	1.3	-1.7	0.0	2707
School crossing	0.0	0.1	0.0	17
Civil defence	0.0	0.0	0.0	14
Fire	-0.9	0.9	-0.2	583
Registration of electors	0.0	0.0	0.0	23
Total	0.0	0.0	0.0	3666
Average absolute change in share	0.4	0.5	0.1	

MAIN PROGRAMME: EDUCATION

	Difference between outturn and prior year outturn 1984-85	1985-86 (% points)	1986-87	Provision 1986-87 (£m)
Primary schools	-0.3	0.2	0.9	2748
Secondary schools	-0.3	-0.1	0.6	4088
School meals and milk	-0.1	-0.1	-0.3	280
Schools (other)	0.1	0.0	-0.1	223
Under 5s	0.1	0.1	0.0	339
Special schools	0.0	0.0	0.0	421
School transport	0.0	0.0	-0.1	214
Student awards	0.0	0.1	0.0	154
Advanced Further Education	0.1	0.0	-0.3	673
Non-AFE	0.3	-0.5	-0.7	899
Adult education	0.0	0.0	0.0	71
Youth services	0.0	0.1	0.0	118
Research and other	0.0	0.0	0.0	50
Administration	0.1	0.1	-0.1	526
Total	0.0	0.0	0.0	10804
Average absolute change in share	0.1	0.1	0.2	

Mck3/1

I am uneasy about all this, but on balance prepared to go along with it.

CONFIDENTIAL

THE NEW PLANNING TOTAL: THE USE OF THE RESERVE

At his meeting on 3rd July the Chancellor asked for a note about the operation of the Reserve following the removal of locally financed local authority expenditure from within the planning total. He asked that this note should also cover the treatment of debt interest.

2. Both these issues should be seen against two objectives:

(a) The Government wishes to ensure that the planning total consists of elements that are the responsibility of central Government and not of others;

(b) but it wishes also to ensure that the relationship between the planning total and GGE is sufficiently consistent to enable it to deliver its medium term objectives as expressed in terms of GGE.

<u>The Present Position</u>

3. The difficulty is not new. Debt interest is at present outside the planning total but within GGE. The arguments for this treatment were set out in the paper attached to Mr. Turnbull's minute of 10th April to the Chancellor. A copy of the relevant paragraphs is attached at Annex A.

4. Changes in forecasts of debt interest are taken into account in successive rounds of the MTFS and in subsequent Surveys. Such changes will affect the level of the maximum affordable planning total which is consistent with achieving the desired path for GGE. No attempt, however, is made to control or offset variations between forecast and outturn in-year and hence changes to debt interest are not charged

to the Reserve. This is justified on the grounds that there is no reason to expect any systematic bias in the forecast of debt interest and, providing debt interest forecasts are central, variations between forecast and outturn in any one year should not affect the Government's ability to deliver its medium term objective over a run of years.

Local Authority locally financed expenditure

5. In principle, the treatment of local authority locally financed expenditure could be the same as that for debt interest - provided that forecasts of local authority expenditure were not subject to systematic bias.

6. In practice, local authority expenditure has been subject to systematic under provision in the past. This has been partly to give a signal about the Government's intentions for local authority expenditure, and partly to help justify a lower level of central government grant. To avoid systematic under-forecasting of the planning total, the Reserve has contained an element to be transferred to local authority provision in successive Surveys and to meet claims arising from local authority expenditure overruns in-year.

7. Unless offsetting action is taken, systematic under provision will lead to repeated overshoots of GGE. While GGE has exceeded forecasts in the past, the main factor has usually been overspends on the planning total. A series of overruns as a result of overspends on below-the-line local authority expenditure would reduce the credibility of the planning total as a means of delivering GGE and could suggest that the government had lost interest in controlling local authority spending.

The options

8. The options for dealing with this are:-

a. More realistic forecasts of local authority expenditure. The new presentation and the new arrangements foreshadowed in Paying for Local

Government (PLG) should reduce the pressures for systematic under provision. The national non-domestic rate will extend central government control from about half to about three quarters of local authorities' current income. This and the other restraints imposed by the new regime should reduce the need for signals about the appropriate level of local authority spending. Nevertheless, it is likely that some under provision will remain.

b. <u>Putting the Reserve outside the planning total.</u> It would then be intended to deal with fluctuations in the planning total and with the items below-the-line. But since the characteristic of the planning total is that the Government takes responsibility for delivering it each year, (ie as opposed to GGE, for which there is a medium term objective) the Government needs a Reserve <u>within</u> the planning total through which fluctuations in expenditure within its own responsibility can be offset, leaving the planning total intact. This produces the convenient equivalence of monitoring claims on the Reserve and monitoring the outturn for the planning total. The effect of this option would be to turn GGE into the planning total.

c. <u>A second Reserve outside the planning total.</u> This would look peculiar and would also indicate that we half expect our forecasts of local authority locally-financed expenditure and/or debt interest to be overspent, thereby undoing any signal we were trying to give on locally financed spending.

d. <u>Building within the Reserve a margin to cover possible overruns on locally financed local authority expenditure</u>

Such a margin could be used to transfer provision into local authority locally financed expenditure in successive Surveys, and/or to cover local authority overruns in-year. To the extent that central government grant is increased from the Reserve in successive Surveys, total local authority provision will, in effect be increased. But if it became obvious that further transfers were regularly being made in Surveys to below-the-line local authority expenditure, this would, to some extent, undermine the purpose of the change and its public justification. Nevertheless it would be open to us to use some of the Reserve in this way.

Deliberately to underspend the Reserve in-year as a regular occurrence would also undermine the purpose of the change and would be difficult to achieve in practice. Moreover, it is not axiomatic that a reduction in the planning total in-year would always be the right policy response to higher locally financed expenditure. Apart from changes to balances, extra local authority expenditure would be financed by higher local taxes. Unless central government taxation were reduced to compensate, this would leave total taxation higher than planned but would have no effect on borrowing. While it would be open to us to attempt to underspend the planning total in-year, we would only do so if prompted by wider financial policy and not as a matter of course.

Conclusion

9. The way forward may thus be a judicious combination of a and d. in para 8, ie:

– a clumsy combination (d) than (a)

(i) In-year the Reserve would retain its present role as being a mechanism for monitoring and control of the planning total. There would not be a formal mechanism for charging overspending outside the planning total to the Reserve within it.

(ii) Some element of the Reserve in future years would be included with the tacit purpose of transferring it to local authority provision outside the planning total in subsequent Surveys.

(iii) The possibility of deliberately underspending the planning total in-year (by tightening control on the Reserve, or even seeking cuts in departmental programmes) would be kept open but only where wider financial policy indicated that a reduction in public borrowing or in central government taxation (to offset higher local taxation) would be the appropriate policy response.

Presentation

10. If asked about this aspect of the change, we might say:

(i) Control of the planning total would remain the means to the end of delivering policy objectives set for GGE.

(ii) Below-the-line expenditure would be forecast as accurately as possible to avoid systematic bias and central government would continue to use all the influence it has on LAs to deliver GGE.

(iii) If locally financed expenditure were running ahead of plans, the normal response would be to take this into account in the Survey either by taking measures to slow the growth of such expenditure, or by setting the planning total lower relative to the objective for GGE. Within the planning total, reducing the grant to local authorities would be considered as this would still help rein back the overspend.

(iv) Taking one year with another, the Government would expect this to be at least as effective in meeting the MTFS as present arrangements, given the inevitable uncertainties in forecasting such large revenue and expenditure flows.

(v) This would not rule out taking action within the planning total, in-year, to offset below-the-line overruns where GGE objectives were threatened. In such circumstances a decision could exceptionally be taken to sterilise part of the Reserve and aim for an underspend on the planning total.

EXTRACT FROM MR TURNBULL'S PAPER ON PUBLIC EXPENDITURE: TREATMENT OF LOCAL AUTHORITIES

ANNEX A

(ii) Debt interest

23. The exclusion of debt interest from the planning total (while including it in GGE) has been justified on the grounds that debt interest is not subject to control by government. This argument is weak. It is true that the coupon on existing gilts cannot be changed whereas rates of social security benefit and the conditions of export support in principle can. But qualitatively there is not much difference between the two in the short-term. In the longer term the government does determine the amount of borrowing and makes choices between different funding instruments - between long and short gilts, for example, or between gilts and different National Savings instruments. Finally, the response to a rise in interest rates should be greater reluctance to accept increases elsewhere. These pressures would be maximised by inclusion in the new planning total.

24. There are, however, other arguments for exclusion. First, although the level of borrowing is affected by the totality of programmes, no individual departmental Minister is going to feel responsible for a rise in debt interest. As the debt interest projections tend to fluctuate up and down, there is a risk that colleagues will be unwilling to ofset increases but will seek to benefit from decreased. Secondly, interest rates are an instrument of economic policy. It may be undesirable to constrain monetary policy in order to achieve a target for spending. For example, with debt interest included in a new planning total the Government might be inhibited about raising interest rates at times when other expenditure was running ahead of plans; yet it might be exactly what was required to prevent monetary conditions from getting out of control. There could also be conflicts between funding policy and controllability. For example, the former may indicate a switch to variable rate borrowing, while the latter might point to more fixed rate funding in order to achieve greater predictability. There could also be a bias in favour of tax-free instruments.

25. The arguments are finely balanced but our preference is to maintain the present position of exclusion from the planning total but inclusion in GGE. In this way there would be no presumption that in-year movements in debt interest should be contained in the planning total, but that within a GGE objective higher debt interest would constrain the scope for other spending in the medium term.

7.8c.e

FROM: F E R BUTLER
DATE: 7 AUGUST 1987

CHANCELLOR OF THE EXCHEQUER

cc: PS/CST
Sir P Middleton
Mr Anson o.r
Mr Turnbull o.r
Mr Gilmore
Mr Hawtin
Mrs R Butler
Mr Gieve
Mr Potter o.r
Mr G C White
Miss Walker
Mr Tyrie
Mr Fellgett
Mr Holgate

Ch/ You have Mr Holgate's report.
AT 7/8

On wh. I have already commented

PUBLIC EXPENDITURE: TREATMENT OF LOCAL AUTHORITIES

Mr Holgate's report on the forward figures for local authority services show that extrapolations of past figures give a reliable forecast of future expenditure. But it is absurd to publish these as "plans".

Yes, but that is not really the point. The point is whether it makes sense to publish 'plans' @ all in this context (given that LAs decisions rather than ours). They are our 'plans' yet philosophically dysfunctional rather than conventional projections.
NL

F.E.R.B.

F E R BUTLER

Alex

Ch

Do you want to do a short thank-you to Fanfani or Goria? Or not (who I may be able to thank Goria personally on Monday @ the ECOFIN ?!).

AA

No Lawson to

a long letter to

F, & another

to [illegible] on

[illegible] to

Goria

Covering CONFIDENTIAL

From: **J ODLING-SMEE**

12th August 1987

CHANCELLOR OF THE EXCHEQUER

cc Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr Cassell
Mr Evans
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mr S Davies
Mr Grice
Mr S Matthews
Mr Melliss
Mr Mowl
Mr Riley
Mr Bredenkamp
Mr Kelly
Ms Turk
Mr Cooper
Mr Franklin
Mr Cropper

Thanks. A useful demolition of some of the ~~practicalities~~ usefulness of the so-called cyclically-adjusted PSBR and the alleged effect of PSBR changes on output. N.

THE CYCLICALLY-ADJUSTED PSBR

We have been updating our estimates of the cyclically-adjusted PSBR, and comparing them with other published estimates. The attached note presents the main conclusions and surveys the various arguments that have been made about how cyclically-adjusted measures of the PSBR should be used in policy and economic analysis. The conclusions are summarised on the first three pages.

2. Also attached is a longer paper which goes into some of the technical arguments in a little more detail, in a form suitable for discussion with economists and others outside government.

3. No decisions are required. The note is for general information and the longer paper for those who need more detail.

[illegible]

J ODLING-SMEE

jc7

THE CYCLICALLY-ADJUSTED PSBR

This note presents our latest estimates of the cyclically-adjusted PSBR since the mid-1960s and compares them with other published estimates. It then surveys the various arguments that have been made about how cyclically-adjusted measures of the PSBR should be used in policy and economic analysis. These fall under three headings, with the cyclically-adjusted PSBR being advocated as:

- a target for fiscal policy
- a measure of discretionary fiscal policy changes
- a measure of the impact of fiscal policy on demand and activity

2. The main conclusions are:

- in recent years when growth has been fairly steady our measure of the cyclically-adjusted PSBR has been close to the actual PSBR (Chart 1). The cyclical adjustments for earlier years do not exceed about 1% of GDP and are generally less than this (paragraphs 4-11);

- other estimates of the cyclical adjustment tend to be larger than ours, which has led people to draw policy conclusions which we do not agree with (see below). Those of the OECD and the NIESR, for example, are 3%-4% of GDP for the 1980s, and the cyclically-adjusted PSBRs are sometimes negative (paragraph 11);

- the differences between their measures and ours are mainly attributable to different estimates of trend output, but partly also to different estimates of the effects of a given output gap on the PSBR. We assume that trend output can be represented by a line passing through the middle of the actual output series (Chart 2). Both the OECD and the NIESR use estimates of potential output which show little slowdown after 1973 and hence a very large output gap in the 1980s (paragraphs 7-8);

Chart 1: PSBR and Cyclically Adjusted PSBR

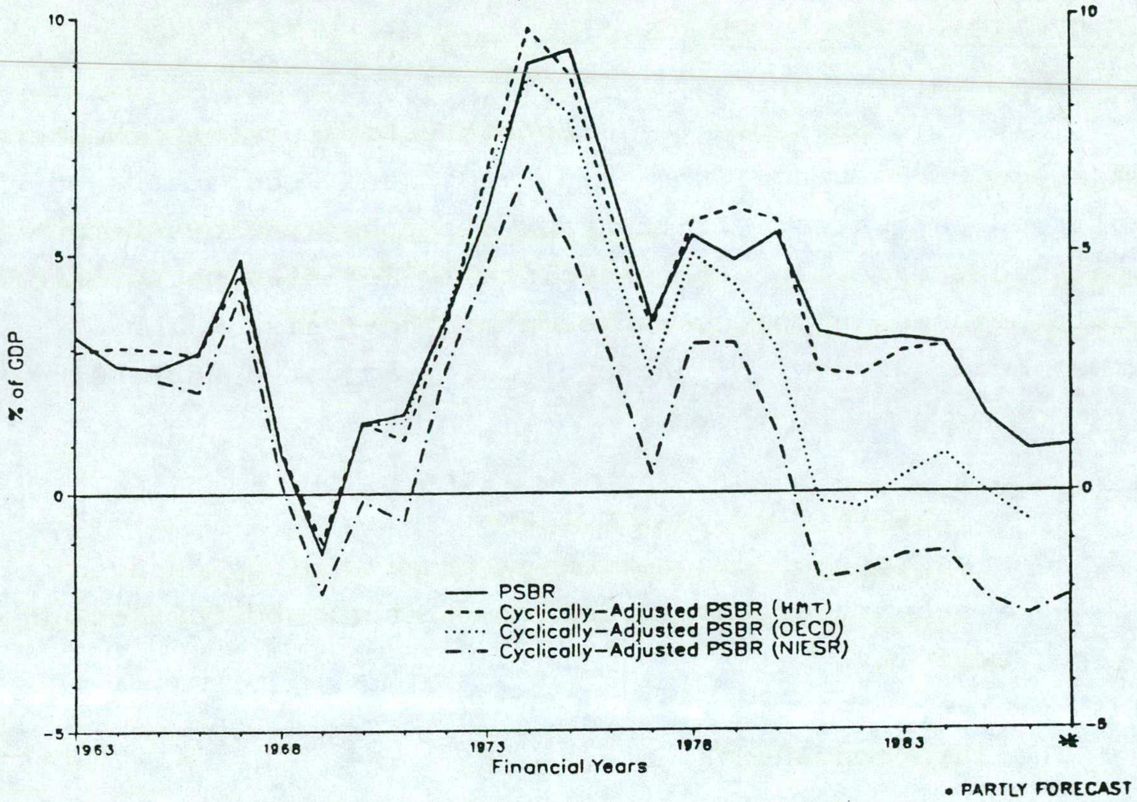
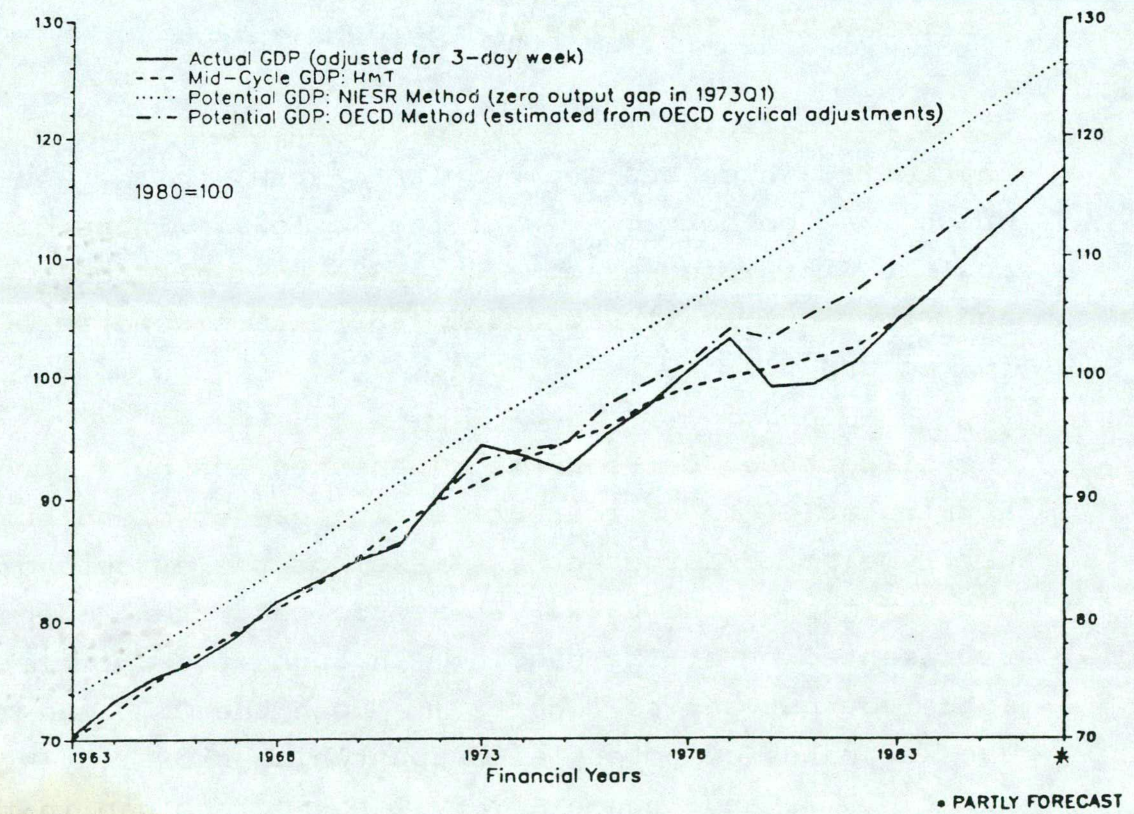


Chart 2: Actual and Mid-Cycle/Potential Output



- changes in the cyclically-adjusted PSBR have dominated changes in the PSBR due to the automatic stabilisers, as measured by the cyclical adjustment itself (Chart 3);

- the cyclically-adjusted PSBR has tended to move in a pro-cyclical way, sometimes because of the effects of unexpected changes in variables such as interest rates, oil prices or tax receipts and sometimes as the result of conscious acts of policy - such as in 1980-81 and 1981-82 when priority was given to supporting the disinflationary stance of monetary policy rather than to stabilising cyclical fluctuations in the economy (paragraphs 12-13);

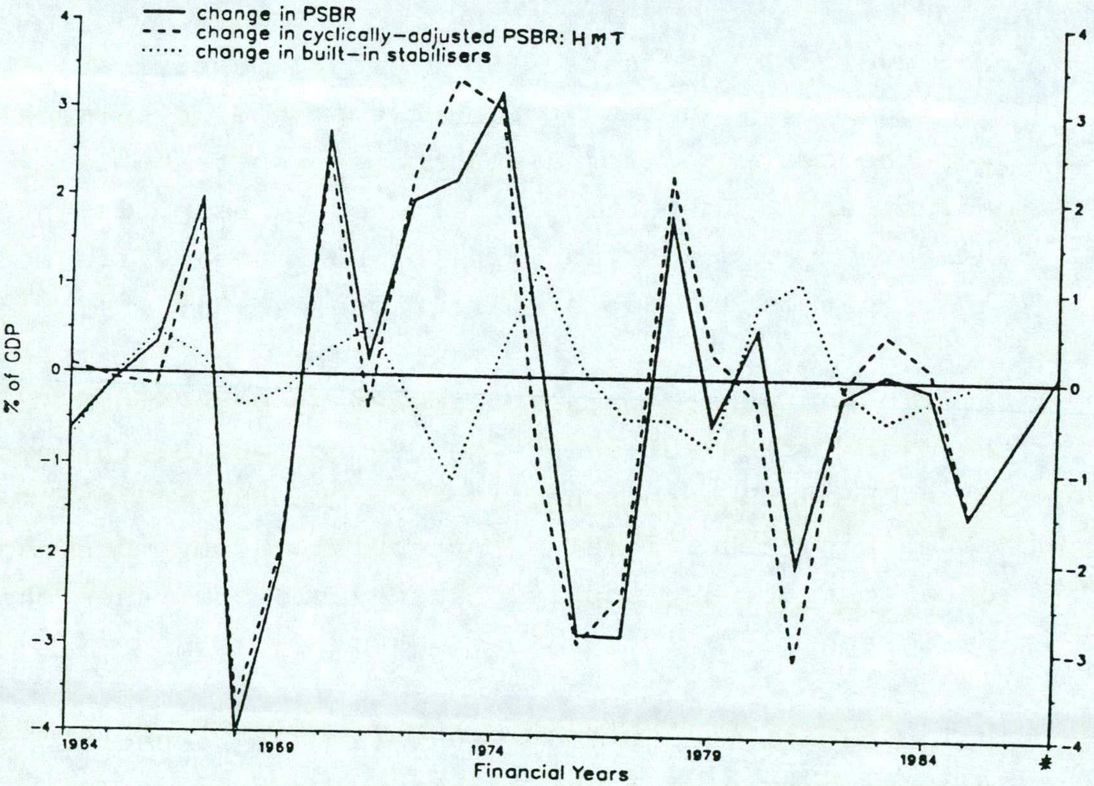
- the cyclically-adjusted PSBR may be useful as a benchmark for describing and monitoring the stance of fiscal policy over the cycle and for assessing its sustainability over the medium term. In particular, it could help us judge what short-term fluctuations in the PSBR around its medium-term path might be desirable (paragraphs 14-18);

- the argument that fiscal policy has been much too tight since at least 1981 because some measures of the cyclically-adjusted PSBR are negative is based on the erroneous assumption that a level of potential output much higher than actual output was (and is) achievable in the short term (paragraph 19);

- the cyclically-adjusted PSBR is not a useful measure of discretionary fiscal policy changes because it is affected by many things outside the government's control (eg unexpected changes in interest rates, oil prices or tax receipts) and because the government's acquiescence in changes in the automatic stabilisers is as much an act of fiscal policy as changing tax rates is (paragraphs 20-21);

- the cyclically-adjusted PSBR is not a useful measure of the impact of fiscal policy on demand because the automatic stabilisers themselves have effects on demand which are not dissimilar from those of other aspects of fiscal policy (paragraphs 22-23);

Chart 3 : Changes in PSBR and Cyclically Adjusted PSBR



* PARTLY FORECAST

- a number of studies have found a strong correlation between changes in a measure of the cyclically-adjusted PSBR and subsequent changes in output or employment. This has been used to argue that the fall in the measure in 1979-81 was a major cause of the recession and faster output growth could be achieved by expanding fiscal policy. But biases in the measures of the cyclically-adjusted PSBR that have been used have probably led to an over-estimation of the impact of fiscal policy on output (paragraphs 24-26).

3. The remainder of this note sets out the arguments in a little more detail. The attached paper presents them in a form suitable for discussion with economists and others outside government. Also attached is our last public statement on the subject in the February 1981 issue of the EPR.

Measures of the cyclically-adjusted PSBR

4. The cyclical adjustment is a measure of that part of the PSBR that is attributable to cyclical deviations in output from some benchmark level. There are two stages involved in calculating cyclical adjustments to the PSBR. First, an assessment must be made of the gap between output and the benchmark level. Secondly, an estimate must be made of the effect of this "output gap" on revenues and public expenditure. Both stages of the calculation pose considerable, though in practice not insuperable, difficulties.

5. There are two broad types of methodology for determining the output gap. The first is to relate output to some measure of potential output, or the "natural rate" of output: underlying this methodology is a notion of "equilibrium" output and employment. The second is more mechanical, and involves essentially drawing a trend line through the output series so as to produce a "mid-cycle" level of output.

6. The potential output or "natural rate" method poses very considerable conceptual and measurement difficulties. It is highly dependent on the precise definition of equilibrium and the underlying economic model. And there is no reason to suppose that the output gap will average out to zero over a complete cycle.

7. It has been particularly difficult in recent years to say what has been happening to potential output. Some people have argued that the rise in unemployment means that potential output has been growing faster than actual output since the late 1960s, and especially between 1979 and 1982. This view lies behind the National Institute's estimate of potential output shown in Chart 2.

8. An alternative view is that potential output growth declined after 1973 and perhaps again after the second oil price shock because of the need to make structural changes, although it has risen again in recent years. This could justify the use of a trend line drawn through actual output, as shown by the moving average series in Chart 2. Another justification is that, although in the long run there is no reason to believe that unemployment cannot fall to the levels prevailing before 1973, the time it could take is unpredictable and likely to be long. It would be unwise to assess fiscal policy as though current high unemployment were merely a cyclical fluctuation. These arguments lead us to prefer the mechanical approach to defining benchmark output. Our measures of the cycle are therefore based on deviations of output from a five-year moving average. These deviations average out to zero over a complete cycle, which is a desirable property when assessing the medium-term sustainability of fiscal policy and its implications for public sector debt.

9. In principle the effect on the PSBR of a change in the output gap depends on the nature of the cycle in output and the composition of accompanying changes in expenditure: it depends, for example, on whether the cycle is export or consumption led because the tax contents of the two are very different. The effect also depends on the operation of monetary policy over the cycle, because of the implications for debt interest; on how long any given output gap is sustained; and on the particular model used for the calculations, especially the equations for tax and public expenditure.

10. There is thus no uniquely correct way of calculating the effects of a change in the output gap on the PSBR. However, in practice the numbers are moderately robust to the precise assumptions about monetary policy and the pattern of expenditure

used for the calculation. Our estimates use the Treasury model to calculate cyclical effects on the PSBR, on the assumption that monetary policy is non-accommodating over the cycle and the pattern of expenditure remains broadly unchanged. On this basis a 1% increase in output relative to trend reduces the PSBR by about ¼% of GDP in the first year, and nearly ½% in the second year - very similar to the numbers quoted in the February 1981 EPR.

11. Our estimates of the cyclically adjusted PSBR are shown in Chart 1 alongside the actual PSBR and estimates based on the OECD and National Institute methodologies. On our estimates the cyclical adjustments never exceed about 1% of GDP, and are generally much less than this. In recent years, given comparatively steady growth of output, the adjustments have been close to zero. In general the adjustments are much smaller than those made by other institutions: those of the OECD and NIESR, for example, are in the range 3%-4% of GDP for the 1980s, and the cyclically-adjusted PSBRs are sometimes negative. The difference between the estimates is mainly attributable to the different estimates of benchmark output (Chart 1); the estimates of the effects of a given output gap on the PSBR are relatively less important.

12. The main feature of the estimates of year-to-year changes in the cyclically-adjusted PSBR in Chart 3 is that these changes dominate changes in the PSBR due to the automatic stabilisers. Secondly, the cyclically-adjusted PSBR has tended to move in a pro-cyclical way. In the recession years of 1966-67, 1971-72, 1975-76, 1980-81 and 1981-82, when Chart 3 shows that the automatic stabilisers were contributing to an increase in the PSBR, the cyclically-adjusted PSBR was actually falling. The converse, an increase in the cyclically-adjusted PSBR in peak years, occurred in 1973-74, 1979-80 and 1983-84 but not in 1968-69.

13. The pro-cyclical movement of the cyclically-adjusted PSBR was not necessarily a conscious act of policy. Some of it resulted from other factors such as unpredicted changes in oil prices, interest rates, exchange rates, or revenues. But sometimes policy was deliberately designed to counteract wholly or in part the effects of

the automatic stabilisers. This was the case, for example, in 1980-81 and 1981-82 when fiscal policy was aimed primarily at supporting the disinflationary stance of monetary policy rather than at stabilising cyclical fluctuations in the economy.

A target for policy

14. Two main arguments have been advanced for using the cyclically adjusted PSBR (or budget deficit) as a target for policy in preference to the unadjusted PSBR. The first is that it gives a better indication of the sustainability of fiscal policy in the medium to longer term. The second is that it is appropriate to let the automatic fiscal stabilisers work, so as to smooth out cyclical fluctuations in the economy. The aim of policy in the short- to medium-term would then be to keep the cyclically-adjusted deficit rather than the actual deficit on some desired medium-term path.

15. There is some force in the first argument. Abstracting from the effects of cyclical changes on the PSBR may give a better indication of the average deficit likely to be sustained over a complete cycle, and hence the underlying trend in debt. But many other factors have to be taken into account in any assessment of the sustainability of fiscal policy in the medium or longer term. In the UK context, privatisation proceeds and oil revenues are obviously very important since neither will be sustained indefinitely. The growth of pension liabilities is also important, particularly if they are unfunded: only a minority of countries, notably Japan, take them into account explicitly in setting fiscal policy. Thus although cyclical adjustment may help in assessing the sustainability of fiscal policy in the medium term, it is only part of the story.

16. Since the beginning of the MTFS the Government has accepted that it may be appropriate for the PSBR to vary over the cycle relative to its trend in the medium term. The Chancellor said in January 1980 when he was Financial Secretary that "the cycle and the medium-term trend might be expected to produce a "stepped" profile, with the PSBR not changing much as a proportion of GDP in recession years, but falling sharply in non-recession years". The recession

in 1980 and 1981 was cited as justification for raising the PSBR path in the 1981 MTFS; the 1984 MTFS mentioned the cyclical position of the economy as one of many factors to be taken into account in setting the PSBR path. One way to do this would be to aim to keep to a smooth path for the cyclically-adjusted PSBR over the cycle. The actual PSBR would move countercyclically as the automatic stabilisers operated, and this would help to damp fluctuations in output, money GDP and credit.

17. But there is no particular reason to believe that the precise scale of the resulting PSBR fluctuations will be appropriate. The tax and benefit system were not designed primarily with that in mind. And monetary policy also has a role to play in stabilising economic fluctuations. The Government has to decide on the relative weight to be given to monetary and fiscal stabilisers, taking into account both the state of the economy and the relative desirability of stabilising tax and benefit rates rather than interest rates. Sometimes it might make sense to allow the PSBR to fluctuate by more over the cycle than would be consistent with a constant cyclically-adjusted PSBR, and sometimes by less.

18. However, in general it is likely that the desired path of the cyclically-adjusted PSBR should be smoother than that of the unadjusted PSBR. This suggests that it could be useful as a benchmark for describing and monitoring the stance of fiscal policy over the cycle, as well as for assessing its sustainability over the longer term. We would not, however, recommend going so far as to express fiscal policy objectives in terms of the cyclically-adjusted PSBR because of the disadvantages of relying on an uncertain and potentially controversial measure. But the same objectives can be achieved by presenting the PSBR path in the MTFS as we do now, namely as the average path over the cycle about which we are prepared to see some fluctuations in response to cyclical movements in output.

19. It is sometimes argued that fiscal policy has been too tight in the 1980s because the cyclically-adjusted PSBR has, on some measures, been negative. This can be countered as follows. First, one notes that it depends on the assumption that potential output is

well above actual output as in the often-used National Institute measure; and on the policy prescription that the automatic stabilisers should be allowed to work. But full employment as in the 1960s is not attainable in the short term and it would therefore be highly inflationary to operate fiscal policy as though it were an achievable objective. In addition there was a need in the early 1980s to give priority to disinflation over counter-cyclical stabilisation and hence a decline in the cyclically-adjusted deficit made sense.

A measure of discretionary policy changes

20. It is often argued that the cyclically adjusted PSBR has a useful role to play as a descriptive device because it distinguishes between discretionary and automatic changes. To the extent that this is so, it shows how the authorities have responded to the various changes impinging on the economy.

21. However, the case for cyclical adjustment on these grounds is not convincing. First, the cyclically-adjusted PSBR does not measure discretionary changes alone; it also includes many automatic changes - eg due to changes in oil prices, compositional changes, changes in interest rates and exchange rates. Secondly, it is not obvious why one should want to focus on discretionary changes, defined in this way, when considering either the effects of fiscal policy or the appropriate policy stance. Acquiescing in an "automatic" PSBR change is an act of fiscal policy, just as a change in tax or benefit rates is, with similar effects on demand and activity in the short to medium term.

A measure of the impact of fiscal policy on demand

22. Broadly speaking, two justifications have been given for focusing on the cyclically-adjusted PSBR when considering the impact of fiscal policy on demand. The first argument suggests that the private sector largely discounts short term fluctuations in taxes and public expenditure when taking its own decisions about expenditure, employment, etc. But there is no reason to believe that adjusting for the automatic stabilisers alone will necessarily

be the right adjustment to make. And it is anyway hard to believe that all individuals and firms make decisions entirely independently of variations in their cash flow: higher social security payments and lower taxes do at least partly cushion the effects of a downturn in activity on spending.

23. The second argument is that focusing on the actual PSBR when trying to estimate the impact of fiscal policy on demand is likely to be misleading because of the feedback from changes in activity. The true relationship is likely to be obscured because higher output reduces the PSBR and conversely for lower output. It is certainly important to take account of feedbacks - both discretionary and automatic - in assessing the effect of fiscal policy on demand, and there are appropriate econometric techniques for doing so. But there is no reason to argue that automatic changes in the PSBR have entirely different effects from all other changes - for example that they have zero effects - or that the cyclically-adjusted deficit gives a better indication ex post of the fiscal impact on demand.

24. Economists have used estimates of the cyclically-adjusted PSBR as measures of the stance of fiscal policy in studies of movements in aggregate demand or output. A significant role for fiscal policy in this sense has often been found, and this has provided the basis for claims that fiscal policy was a major cause of the recession in 1979-81.

25. However, there are reasons for believing that the strength of the apparent link between output and the cyclically-adjusted PSBR is partly spurious as it results from biases in measuring the cyclical adjustment. In particular, those measures which assume a high level of potential output greatly exaggerate the increase in the cyclical adjustment in those years when attainable output growth was slowing down perhaps because structural unemployment was rising. In addition, the size of the cyclical adjustment effect associated with any given change in output is usually over-estimated because the measures assume that:

(a) the automatic stabilisers operate in full whereas in practice discretionary fiscal policy appears to have at least partly offset them;

(b) the whole impact of the automatic stabilisers occurs in the first year whereas we estimate that it is spread over two years in the proportions 55%/45%.

Our own measure suffers from (a) but not (b).

26. As a result of these measurement errors, the estimated cyclical adjustment is likely to be too high when output is below trend, especially in the 1980s when unemployment has been high. The cyclically-adjusted PSBR is correspondingly too low to an extent which is correlated with output, hence probably giving rise to the over-estimation of the impact of fiscal policy on output.

Economic Progress Report

Published by the Treasury

No. 130 February 1981

The impact of recession on the PSBR

This article explains how fiscal policy is set, how estimates of the public sector borrowing requirement (PSBR) are derived from the setting of fiscal policy, and how economic developments, especially the recession in 1980, affect the PSBR. The PSBR is what the public sector needs to borrow to make up the difference between its cash expenditure and its total receipts. The public sector comprises central government, local government and public corporations (including the nationalised industries). 'Fiscal' policy means policy on both taxation and public spending.

Public expenditure

The Government's first medium-term plans for public expenditure, at constant prices, were set out in the White Paper (Cmnd. 7841) published on Budget Day, 26 March 1980, *The Government's Expenditure Plans, 1980-81 to 1983-84*. These plans covered government departments, local authorities, and public corporations and included the programmes for individual services, a contingency reserve and debt interest.

Over a wide area of public expenditure, cash limits for spending in 1980-81 were set in early 1980 in order to superimpose cash controls over the plans at constant prices (i.e. the volume plans). The contingency reserve is also operated as a control, setting an upper limit on decisions to incur additional expenditure in volume terms.

Some programmes are not subject to cash limit control, mainly those, such as social security benefits, where the Government set the rates of benefit, and expenditure is determined in the short-term by the number of qualifying applicants. Such 'demand-determined' expenditure accounts for about one-third of the total. Debt interest payments reflect the level and structure of past borrowing and past and present interest rates, and cannot be controlled directly.

The planning total of public expenditure – as defined in line 13 of table 1.1 in Cmnd. 7841 – is the sum of programmes, the contingency reserve, total borrowing by the nationalised industries, and a general allowance for shortfall,* less special sales of assets, all expressed in constant prices. Table 1 shows the plans for 1980-81, as they were in Cmnd. 7841, expressed in 1979 Survey prices (which were a mixture of prices ranging from late 1978 prices to estimated 1979-80 prices). On average, actual prices are estimated to have been some 30 per cent higher, giving a total of some £100 billion (including debt interest).

Table 1 PUBLIC EXPENDITURE
1979 SURVEY PRICES, 1980-81

Programmes	£ bn.
Central government (including government finance for the nationalised industries)	51½
Local authorities	17½
Certain public corporations	1
Expenditure on programmes	70
Contingency reserve	1
Special sales of assets	½
General allowance for shortfall	1
Planning total after shortfall	69½
Debt interest	3½

The outcome for public expenditure in volume terms depends on:

(a) policy, i.e. the observance of the control totals;

(b) for the demand-determined categories, divergences between expected and actual levels of demand, including those affected by economic developments (such as unemployment);

(c) any volume shortfall below the planning totals, whether induced by inflation turning out higher than allowed for when the cash limits were set or for other reasons.

The outturn for public expenditure in cash terms depends on the observance of cash controls; on factors (b) and (c) above; and on the impact of inflation on areas of expenditure not subject to cash limits.

Expected outturn

An estimate of the expected outturn of the volume of expenditure (the planning total) in 1980-81 will be given in the next White Paper on government expenditure. In total, the volume of expenditure has been greater than planned, with: extra spending on defence; higher expenditure on unemployment and other social security benefits and some special employment measures as a result of the fast rise in unemployment; and there is a risk that the local authorities will prove to have overspent on current account, despite the Government's measures to ensure that their spending is within the planned level. Moreover, the expectation of a general

***The amount by which actual spending falls short of plans.**

volume shortfall compared with plans does not seem to have been realised.

There have also been increases in the external financing limits of some nationalised industries, but these have been charged to the contingency reserve, which is likely to be fully spent, and have therefore not added to the planned total. In addition, the amount of debt interest payments has been higher (reflecting extra borrowing and higher interest rates).

All these factors have also increased public expenditure in cash terms above the level forecast at the time of the Budget. These increases have been offset to some extent by a number of savings, of which the most important was the reduction negotiated in May 1980 in the UK's net contribution to the EC budget.

It should be clear that despite cash controls over a large part of total spending, the forecast of total cash expenditure – needed for an estimate of the PSBR – is subject to a considerable margin of uncertainty. In 1980-81, a difference of 2 per cent on the total of public expenditure (including debt interest payments) is equivalent to £2 billion in cash terms.

Revenue

Taxation policy consists of setting the rules of the tax system – the rates and allowances of income tax, for example – together with decisions on the structure of the system itself: the rules for determining which incomes and expenditure are to be subject to tax, who collects the tax, when is it due, etc.

In addition to taxes, the Government receive revenue from other sources such as national insurance contributions and interest on money lent to the private and overseas sectors. A comprehensive listing is provided in the public sector tables in Parts IV and V in the 1980 *Financial Statement and Budget Report* (FSBR or 'Red Book'). Table 2 sets out the main sources of revenue forecast for 1980-81.

Table 2 GENERAL GOVERNMENT RECEIPTS

National Accounts basis
(taken from table 14, FSBR 1980-81)

	£ billion
Taxes on income	31½
Taxes on expenditure, (including local authority rates)	40
National insurance contributions	14½
Taxes on capital	1
All other receipts	8
Total	95

The Government's receipts depend on: the structure of the revenue system; the rules of the tax system; together with the incomes and expenditure liable to tax and national insurance contributions; the financial assets of the public sector on which interest is due; the rate of interest payable and so on. In principle, forecasts of revenues by the Treasury and the Revenue Departments need to take all these factors into account.

Receipts of taxes and other revenues are therefore not uniquely determined by the policy laid down at Budget time, but require in addition forecasts of incomes, expenditure, interest rates, the exchange rate, etc. In principle it is necessary to forecast many different types of income (because rates of tax differ as between the income of companies and individuals and, for instance, between employment and investment income), different sizes of income (because of the progressive nature of the income tax system) and different types of expenditure (because the tax rate on some commodities, such as tobacco, is much higher than on others, such as clothing).

The PSBR

So the outcome for the PSBR depends not only on the Government's expenditure plans and revenue policies, but also on the development of the economy. Some of the more important influences on the PSBR are:

- the levels of output, employment and unemployment ('recession')
- the composition of demand
- the size and composition of incomes
- the level of interest rates
- the rate of inflation, and its composition.

Typically, all these factors – forecasts of which are subject to wide margins of error – will be interrelated, and it will not be easy to separate out the individual influence of, for example, an economic recession.

Fiscal policy

The **setting** of fiscal policy therefore consists of making plans for expenditure and taxation (and other receipts). These plans may be adhered to – if, for example, tax rates and allowances are not subsequently changed within that financial year, and if control totals for public expenditure are observed. Yet the PSBR may be widely different from that which was expected when the plans were set – for instance, because taxable expenditure by the private sector was less than expected and so tax receipts lower.

In such circumstances, what can be said about the outcome of fiscal policy: was it according to plan – since nothing went wrong with the observance of expenditure plans and taxation policies – or was it very different, because the balance of the Government's receipts and expenditure turned out very differently from expected?

This problem has been most often discussed in the context of the economic cycle, the effects of which are obvious, at least in direction. A fall in economic activity reduces government receipts and increases expenditure, so tending to increase the PSBR for any given setting of expenditure plans and revenue policies. The following list, which is not exhaustive, sets out the main ways in which a lower level of economic activity increases expenditure and reduces revenues:

Expenditure

1) higher unemployment and supplementary benefit, because of higher unemployment;
2) higher payments out of the Redundancy Fund, because of higher redundancies;
3) a higher take-up of special employment measures, such as the short-time compensation scheme;
4) larger loans to nationalised industries and to state supported firms, because their internal finance – generated largely by sales revenue – is diminished by the fall in demand in the economy. If, however, these extra loans or grants are charged to the contingency reserve, then there need be no impact on the PSBR;
5) earlier deliveries by private firms carrying out government contracts as a result of the fall in orders from the private sector.

Receipts

1) lower receipts of income tax and national insurance contributions because fewer people are employed and less overtime is worked;
2) lower receipts from company taxes, because profits fall in a recession;
3) lower receipts from expenditure taxes, because of a lower volume of sales;
4) perhaps some delays in handing over tax due.

Economic models

Most of these recession effects are captured in models of the economy, such as the Treasury model, which embodies a detailed specification of public sector activities. Such a model can be used to estimate the effects of a change in output on the finances of the public sector. The results will depend on:

a) the origin of the change in output (for example, a fall in demand for goods by individuals or companies);
b) the policy response of the public sector (for example, any moves to keep the national insurance fund in balance); and
c) the response of the private sector (for example, the extent to which companies try to reduce their holdings of stocks of goods in response to a fall in demand) embodied in the model.

On the basis of these assumptions, simulations can be made with an economic model (see, for example, Government Economic Service Working Paper No.34). The effects given by the current version of the Treasury model are as follows, starting in 1980-81.

Table 3

EFFECTS ON THE PSBR, OF A 1 PER CENT FALL IN OUTPUT DUE TO:

	A higher personal sector savings (lower consumers' expenditure)	B Worse trade performance (lower exports)
	£ billion	
First year	+0.8	+0.5
Second year	+1.3	+0.9

In case A, the main contribution to a higher PSBR in both years comes from lower receipts, especially of expenditure taxes. Public expenditure is higher because of the rise in unemployment and the increase in debt interest payments as a result of the higher borrowing. The numbers in case A are larger than those in case B, mainly because consumers' expenditure has a higher tax content than exports. The effects get larger in the second year mainly because of the lagged response of unemployment to lower demand and because some tax receipts, especially those of corporation tax, become due only after a time lag. The calculations make the following assumptions about government policies:

(i) Public expenditure on demand-determined items (such as unemployment benefit) increases; and the extra expenditure is not charged to the contingency reserve.

(ii) The national insurance fund, after the first year, is assumed to balance by increasing the contribution rates in order to pay for the larger number of people claiming NI benefits.

(iii) Nationalised industries' external financing limits are increased to offset part of the shortfall in their sales revenues; and (contrary to policy) the extra public expenditure is not charged to the contingency reserve.

(iv) Apart from these three elements, expenditure and taxation plans are unchanged; and interest rates and exchange rates are assumed not to change.

PSBR in 1980-81

These experiments with economic models attempt to provide estimates of PSBR effects which are generally valid (though the £ million figures depend on the ruling price level). Recently, however, attention has focussed on 1980, and its particular circumstances. Two questions have been raised:

- **What would the PSBR have been in 1980-81 if there had been no recession?**
- **What would the PSBR have been in 1980-81 if the recession had been as expected in official forecasts made at the time of the Budget?**

The answers to both questions require precise definitions of recession, and its consequences. Recession, usually defined in terms of output and unemployment, may describe a situation where output falls, or where output falls relative to some past trend, or where unemployment rises. It is important to specify which consequences of recession are to be taken into account. For example, there was a large fall in both profit margins and wage settlements in 1980: most estimates, including those given here, assume a response of wages and prices typical of the past 10 or 15 years, rather than the actual response, so far as it can be judged, in 1980.

No recession in 1980-81. Total output in 1980-81 looks like being about 4 per cent lower than in the previous financial year. It would be possible to construct (in a number of different ways) a hypothetical picture of the UK economy in which output in 1980-81 was constant — as a result of some combination of higher demand or more profitable supply in the private sector. The differences between this picture of 1980-81 and what actually took place could then be taken as estimates of the effect of recession upon the economy, and on the PSBR in particular. The simulations quoted above suggest that a 4 per cent difference in total output would have an effect on the PSBR ranging from £2 billion to over £4 billion.

Recession as forecast at Budget time. A comparison between the forecast of the public sector accounts made at Budget time and the latest estimates can throw light on recession effects. Latest estimates suggest that the fall in output between the financial years 1979-80 and 1980-81 may turn out to be 2 per cent more than forecast at the time of the 1980-81 Budget. Events in 1980 may be looked at from the broader perspective of financial surpluses and deficits. At Budget time, the public sector was expected to reduce its financial deficit at the expense of a larger deficit in the private sector. In the event, the private sector, particularly companies, moved quickly by shedding labour and stocks to improve its position, and so forcing the public sector into larger deficit and pushing the overseas sector into deficit. The recession was thus deeper than expected and reflected to a much greater extent than expected a fall in domestic demand, rather than a deterioration in net trade.

PSBR revision

Analysis of the differences in income tax receipts, expenditure tax receipts, social security benefits etc. can attempt to separate out effects due to recession. Any division will be rough and ready: in particular it will be difficult to distinguish between (i) errors in forecasting total output; that is, the extent of the recession and (ii) errors in forecasting particular aspects of the 1980-81 recession (including larger than normal falls in manufacturing output and employment).

For all the difficulties, this method of approaching the problem takes explicit account of the circumstances of 1980, and provides a rough estimate of the effect on the PSBR of the changed view of output and unemployment. In his statement to Parliament on 24 November, the Chancellor of the Exchequer indicated that, of the upward revision to the PSBR since the Budget, over £1½ billion could be ascribed to the effect of the recession being deeper than expected. This estimate was derived from the method outlined in this section: direct simulations on the Treasury model, including those set out here, might have suggested a lower figure. The difference

£1½bill ...

arises partly because the fall in the demand for labour allowed for in the simulation was less than was observed in 1980. Moreover, there was a speeding up of deliveries, particularly of defence equipment: and it is possible that faster billing by the private sector on government contracts, and slower payment of taxes, also contributed to a higher PSBR in ways not allowed for in model simulation.

The tendency for the PSBR to rise when the economy moves into recession carries with it implications for the setting of fiscal and monetary policy instruments. It has sometimes been suggested that this tendency should be formalised by the construction of a 'cyclically-adjusted' PSBR which should be the focus of fiscal policy. Indeed, it has also been suggested that a 'cyclically-adjusted' PSBR gives a better definition and measurement of the stance of fiscal policy than the actual PSBR. While it does not describe the **outcome** for fiscal policy the 'cyclically-adjusted' PSBR may help to define the **setting** of fiscal policy. Treasury Working Paper number 1, by N. Hartley and C. Bean on the *Standardized Budget Balance* sets out methods of calculation in greater detail, and discusses the limitations of the results.

It has been shown here that the most appropriate method of defining and calculating recession effects on the PSBR must depend on the purposes of the exercise. Apart from any implications for policy, these purposes include the analysis of PSBR forecasts and the need to account for the large overrun on the PSBR in 1980-81; and analysis of public expenditure, in order to distinguish changes in policy and failures to maintain control totals, from demand-induced increases in expenditure. But a range of possible estimates can be made of the effects of recession on the PSBR, the usefulness of which must depend on the purpose of the exercise. ■

THE CYCLICALLY-ADJUSTED DEFICIT AS A MEASURE OF FISCAL STANCE

I INTRODUCTION

1. It has become commonplace in recent years, wherever fiscal policy is discussed, to make use of cyclically-adjusted, structural or "high employment" deficits as a measure of fiscal stance. Different writers have constructed different measures, and applied different interpretations, not always giving full consideration to the conceptual problems involved.

2. The purpose of this paper is to discuss some of the claims that have been made for the cyclically-adjusted (CA) deficit, and to assess its usefulness as a concept. We also review the problems involved in measuring the CA deficit and offer some estimates of our own.

3. The next three sections of the paper correspond to the three possible functions of a "budget indicator":

- as an aid to deciding what fiscal stance should be,
- as a means of describing what the stance of fiscal policy is, or has been, and
- as a measure of the effects of fiscal policy on the economy.

We will describe how relevant the CA deficit is to each, with reference to the views of those who have made practical use of the CA deficit. In these three sections, the CA deficit is taken to be some measure of what the actual deficit would be if output were at some cyclical average or "high employment" level. The adjustment thus removes from the actual deficit fluctuations due to cyclical movements in output, operating through the "automatic stabilisers". It is important to note that these stabilisers, and hence measures of the CA deficit, depend on the particular structure of the tax and benefit system. The actual deficit itself can of course be measured in a variety of ways (the PSBR and public sector financial deficit, in real or nominal terms, being the most widely-used). But the choice between these is a separate issue and is not discussed further in this paper.

4. The fifth section discusses the problems which arise in measuring the two constituent parts of the CA deficit - the gap between actual and "trend" output, and the resulting adjustment factors for tax revenues and public spending. We

then compare estimates using our preferred methodology with those given by the OECD and NIESR, and point out some of the difficulties which measurement error may cause for interpretation of the CA deficit.

5. The final section gives an overall assessment. Our conclusion is that the CA deficit is of considerably more use for some purposes than others, and in all cases needs to be interpreted with care. It can be useful as an indicator of what current fiscal stance implies for levels of debt in the medium term. And it may also be helpful in assessing how fiscal policy should be set over the cycle, so as to minimise fluctuations in aggregate demand (and tax rates). In this case, however, it has to be recognised that there may well be circumstances in which the authorities would wish to override (or reinforce) the automatic stabilisers. The CA deficit, as a concept, is <u>least</u> convincing when used as a measure of fiscal impact on aggregate demand: except under rather special conditions, the <u>unadjusted</u> deficit is likely to be more appropriate for this purpose. Even where the CA deficit is useful in principle, it will be misleading if it is not measured appropriately. In particular, the cycles in economic activity to which the measures relate must be postulated to be around some level of activity that is achievable in the short term, and not some hypothetical level which - for structural or other reasons - could only be reached in the long term, if at all.

2-1

II THE CA DEFICIT AS A NORMATIVE INDICATOR

6. Two reasons are advanced in support of the argument that the CA deficit may be a more appropriate target for policy than the unadjusted measure (see, for example, Price and Muller (1984)). First, it may be useful as a guide to medium-term or long-run sustainability. Secondly, it may provide a helpful benchmark for setting fiscal policy in the short term. These are discussed in turn in this section. We defer until Section V a discussion of the implications which this interpretation has for the measurement of the CA deficit (especially regarding the choice of a trend output measure).

7. Abstracting from the cyclical element gives a better idea as to the level of the "permanent" deficit, or that deficit which will persist, on average, over the cycle. It is argued that this measure can be used to form a judgement about the sustainability, or "soundness" of fiscal policy - and a target for the CA deficit set accordingly.

8. However, there is one caveat here which has not been brought out in the literature. It is a well-known result in time-series analysis that even variables which follow a pure random walk (ie are equal to their own lagged value, plus a constant, plus a white noise error) can appear to follow cycles around a deterministic trend. These cycles are a statistical artefact, and have no economic significance. A "true" cycle, on the other hand, does have economic significance - in the sense that those forces which, in the past, tended to push the variable back to its long-run trend can be expected to do so again in the future. From the point of view of assessing the sustainability of current fiscal policy, it is therefore crucially important to determine whether output really does follow a systematic cycle (ie is "trend-reverting"), rather than a random walk masquerading as a cycle. If the latter were true (supporting evidence is provided by Nelson and Plosser (1982), and Campbell and Mankiw (1986) for the US) then there would be no grounds for believing that "low" output now would tend towards higher (trend) output later - it could just as easily fall further. The argument for removing the "cyclical" component of the deficit in calculations of long run sustainability (namely that this part of the deficit will disappear in the long-run) would then no longer hold.

9. It is also the case that there are many factors other than the CA deficit which affect the government's solvency. Some examples include:

- the ability of the government to raise finance through the inflation tax on money or (once-for-all) on bonds;

- the balance between current expenditure and worthwhile capital investment (worthwhile in the sense that the investment is both efficient and generates income itself or provides services for which people are prepared to pay higher taxes);

- the effect of the budget on potential output growth; if the composition of taxes and spending has high efficiency costs, the ability of the economy to support a given level of debt is impaired;

- transitory income from exhaustable resources, such as North Sea oil;

- changes in unfunded pension liabilities, or contingent liabilities (eg government credit guarantees).

10. Any meaningful assessment of long-run sustainability must make allowance for all these factors, and this will generally involve some attempt (however crude) at a full balance sheet, or net worth, calculation (see Odling-Smee and Riley (1985)). Cyclical adjustment may be a worthwhile element in this, since the deficits' cyclical components ought to sum to zero in the long-run, and will not therefore affect net worth. But the CA deficit cannot be the sole indicator of long-run sustainability.

11. There may, however, be a case for monitoring the CA deficit in the short to medium-term, once a desired medium term level for the deficit has been set. Some of the factors referred to in paragraph 9 may change only very slowly over time, and could be regarded as constant for the medium term. Others, such as North Sea oil revenues, may fluctuate sharply even in the short term, and would have to be discounted. Deviations in the CA deficit could then be interpreted, in isolation, as movements away from (or towards) a sustainable fiscal policy.

12. The second argument for using the CA deficit as a normative indicator is that in the normal course of events it is correct to allow the "automatic stabilisers" to operate. The Government might then find it most convenient to set its fiscal plans in terms of a particular path for the CA deficit. This path would have to take account of any desired discretionary changes in fiscal stance, over and above those represented by the automatic stabilisers, as well as of other factors (eg structural factors affecting receipts or expenditure, tax elasticities, oil price movements) expected to affect the deficit.

2-1

13. The case for allowing the automatic stabilisers to operate rests on the following points:

(a) they help to dampen fluctuations in output and money GDP;

(b) the effect of cyclically high public sector deficits on money demand tends (it is claimed) to be offset by cyclically low private sector credit demand, especially if financial markets are forward looking and do not react unfavourably to purely cyclical fluctuations in borrowing;

(c) pro-cyclical adjustment to offset the automatic stabilisers (thereby heightening booms and deepening recessions) will fail to control the deficit, ex post, to the extent that it generates offsetting feedback on tax revenues and transfer payments.

Two additional points are relevant in the special case where no discretionary changes in fiscal policy are planned:

(d) disruptive adjustments to real public spending and/or tax rates over the cycle are avoided;

(e) reliance on the automatic stabilisers alone removes the risk that discretionary counter-cyclical policy is in fact destabilising because of the operational difficulties (eg forecasting errors, difficulty of fine-tuning in general).

14. Against this, it has to be recognised that the CA deficit is not necessarily the <u>optimal</u> fiscal target. Whether or not public sector borrowing and private sector credit requirements move in a precisely offsetting way over the cycle (for a given CA deficit target) is an empirical question; as is the effect of pro-cyclical adjustment of fiscal instruments (tax rates etc) on the ex post deficit.

15. Moreover, in the absence of adjustment costs, the "optimal deficit", unlike the CA deficit, will be independent of the institutional factors which distinguish the discretionary from the automatic stabiliser components of fiscal stance. Sometimes it might be appropriate to use discretionary fiscal policy to add to the counter-cyclical impact of the automatic stabilisers, so that the CA deficit would move counter-cyclically and the unadjusted deficit even more so. At other times, for example when a major reduction in inflation was desired, it might be appropriate to use discretionary policy to offset the impact of the automatic stabilisers. This could be achieved by holding the unadjusted deficit unchanged. In practice, if monetary policy is also operated counter-cyclically - so as to share with fiscal policy some of the burden of stabilisation - the choice will depend in part on judgements about the costs of allowing tax rates rather than interest rates to vary over the cycle. Given these complications,

the various factors which determine the optimal path for the deficit can only properly be allowed for in the context of a full macro-economic model, taking into account also the setting of monetary policy.

16. To summarise, in most circumstances it is likely that the optimal policy will imply that the CA deficit should follow a smoother path over the cycle than the actual deficit. This is especially so if the costs of regularly adjusting tax rates and spending plans are substantial and fine-tuning cannot be done efficiently. In extreme cases the optimal policy might be to eschew all discretionary use of fiscal policy and rely on the automatic stabilisers alone.

17. In cases where the optimal policy implied a smoother path for the CA deficit than for the unadjusted deficit, it could in principle be useful to present policy and monitor developments in terms of the CA deficit. If the problems of measurement are not prohibitive, this might make it easier to produce the right responses to unexpected fluctuations in output or money GDP and it would give clearer signals to the private sector about the stance of policy.

III THE CA DEFICIT AS A DESCRIPTIVE MEASURE

18. The use of the term "discretionary" to distinguish the underlying component of the deficit from the cyclical component implies that the former is within the government's control and the latter is not (or at least not directly). Some studies (eg Biswas et al (1985), Tullio (1986)) have gone on to interpret the discretionary/automatic distinction as having relevance for the effects of fiscal policy. This is discussed in Section IV. The OECD, on the other hand, (prior to Price and Muller) suggested that the CA deficit was a way of identifying ex ante changes in fiscal stance, irrespective of what the effects of such changes were ex post. To quote from the OECD's 1982 Economic Outlook (p41):

> ".... one objective behind the calculation of the cyclically-adjusted budget is taxonomic: it is useful to know to what extent budget changes are due to passive responses, stemming from the institutional characteristics of the tax and expenditure system, with respect to changes in employment, or to deliberate fiscal decisions by the government".

19. This is, on the face of it, a rather less ambitious claim for the CA deficit than that implied by the other interpretations discussed in this paper. However, even this fairly limited interpretation has its flaws.

20. Leaving aside problems of measurement and model dependency, the main criticism of the CA deficit as a device for distinguishing between "active" and "passive" changes in fiscal stance is that the definition of the discretionary component is much too broad to be interpreted in this way. Although it excludes cyclical effects, it includes:

(i) the effects of changes in interest rates, and consequently debt interest payments;

(ii) the effects of changes in oil prices and exchange rates;

(iii) the effects of changes in the composition of income and expenditure (measured at "benchmark" output levels, eg potential or mid-cycle GDP);

(iv) other items like EC contributions or the cost of public sector pay settlements.

21. Arguably, these factors are either de facto out of the government's control, or else are functions of monetary rather than fiscal policy. In any case, changes in the deficit due to, say, changes in the (world) oil price are no more or less "discretionary" than changes due to cyclical fluctuations in output.

22. Of course, it could be claimed (and has been, by the OECD, in respect of changes due to fiscal drag) that if the authorities acquiesce in a change in the deficit due to a falling oil price, or whatever, then that change can be regarded as discretionary - since its effects could have been offset by changes in tax rates or spending plans. But precisely the same argument can be applied to the case of changes in the deficit due to cyclical fluctuations in output. Depending on the sort of considerations discussed in the previous section, the government may be both willing and able to exercise discretion over the whole deficit, irrespective of the extent to which this involves so-called "discretionary" changes rather than changes due to the automatic stabilisers. The mix of stabilisers and intervention will vary across countries and over time, depending on the particular institutional framework employed, and this will imply different estimates of the CA deficit for any given unadjusted deficit. The force of this point is recognised by the IMF:

> "Consider, for example, two countries alike in all respects save that one has automatic fiscal stabilisers while the other has none. Each is striving to reach the same real output target in the face of a deflationary shock. [In doing so, the] country with the automatic stabilisers will show a smaller discretionary (exogenous) change in its budget than the country without them. Yet, in some sense, fiscal policy has been equally expansionary in both countries" [Heller et al (1986), p2].

23. Strictly speaking, then, it will only be valid to use the CA deficit as an indicator of relative tightening and loosening of fiscal policy for a given set of automatic stabilisers. This may be feasible for consecutive administrations in the same country (or for a particular administration over a period of years), but is unlikely to be so when comparing completely different countries. And, even if CA deficits can be made comparable on this criterion, it is important to recognise that there are a number of factors other than the cycle which can affect the size of the deficit, but which are out of the government's immediate control.

IV THE CA DEFICIT AS A MEASURE OF FISCAL IMPACT ON DEMAND

24. Several US empirical studies (eg Eisner and Pieper (1984), Tullio (1986)) have used the CA deficit explicitly as a measure of fiscal impact on demand - invariably with little or no discussion as to the validity of doing so. NIESR, who also adopt this approach (Biswas et al (1985)), are only slightly more forthcoming. They argue that cyclical adjustment is appropriate because it:

(a) abstracts from "short-lived cycles", thereby allowing assessment of longer-term movements in fiscal stance, and

(b) allows for "simultaneity" - that is, it identifies the effect of the deficit on output by removing the effects of output on the deficit.

25. The implication of the first point is that only longer-term movements in fiscal stance affect the path of output over the cycle. It is not clear why this should be the case. One can envisage a model in which private sector agents are very forward-looking, and (when deciding on their expenditures) discount fluctuations in wealth which will be unwound over the cycle. But if individuals were this forward-looking, it could be argued that they would discount <u>any</u> changes in the deficit, structural or otherwise, for the usual Barrovian reasons (anticipating future tax liabilities etc). In this case fiscal policy, however it was measured, would not affect aggregate demand. In short, although some discounting of the cycle may be justifiable, complete discounting seems too extreme an assumption.

26. The second line of argument, concerning simultaneity, sounds plausible enough (and is probably in the minds of most researchers who use the CA deficit measure in reduced-form output equations). But it is subject to the same general criticism as the "taxonomic" interpretation discussed in the previous section. The distinction between changes in deficits due to automatic stabilisers and changes due to intervention, though it may shed some light on the institutional framework for tax and expenditure decisions, has no necessary <u>economic</u> significance. To put the point another way, the effect of output on the deficit depends on the government's policy reaction function (ie reacting to changes in output). Under some circumstances, and for reasonably short periods of time, this may be reasonably well-proxied by the automatic stabilisers. But to the extent that governments are not entirely passive in the face of cyclical fluctuations, cyclical adjustment will not altogether avoid the problem of simultaneity between output and the deficit (see section V). If the aim is to avoid simultaneity, there are econometric techniques available (eg instrumental

variables) which are preferable to simply removing the direct effect of output on the deficit.

27. Begg (1986) takes a rather different tack, claiming that the CA deficit "should in fact be interpreted as the total impact of stabilisation policy, not merely of its discretionary components". He considers a simple Keynesian model with constant potential output, automatic stabilisers, and a discretionary (closed-loop) element to fiscal policy which is itself a function of the level of output relative to potential. He shows that, in this case, the CA deficit is a function of both "discretionary" policy and the structure of tax (and benefit) rates, which determine the size of the automatic stabilisers (the algebra is set out in Annex A).

28. However, in the conventional terminology, the automatic stabiliser element of policy is not, as Begg suggests, defined in terms of the level of tax rates (changes in which are clearly discretionary), but as the product of given tax rates and the gap between actual output and "benchmark" output. The issue is whether excluding this part of the deficit, as the cyclical adjustment process tries to do, leaves one with a better or worse measure of fiscal effects on aggregate demand.

29. The IMF (Heller et al (1986)) also subscribe to the view of the CA deficit as a measure of fiscal impulse, though their approach to cyclical adjustment is a rather idiosyncratic one. For simplicity, they assume that a "neutral" fiscal stance is one in which tax revenues and government expenditure are maintained as a constant proportion of actual and potential GDP[1] respectively (the proportions being determined in some base year, where actual and potential output are judged to have been equal). In cyclical upturns, this has the effect of ascribing any rise in tax revenues due to progressivity in the tax system, or fall in government expenditure as a result of reduced benefit payments, to the measure of fiscal impulse. The IMF's CA deficit indicator is therefore something of a hybrid, with part of the conventionally-defined automatic stabiliser included. It is nevertheless subject to the same criticisms as all other CA deficit measures described in this paper.

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[1] The argument for using potential GDP here is explained in Dernberg (1975) as follows: "when actual output falls short of potential output, the government does not encroach on the share of output available to the private economy if [it maintains expenditure as a share of potential GDP]. Indeed, to lower its expenditure at such a time would, because of multiplier effects, lower even more the output received by the private sector" [p829]. This line of reasoning is rather contentious and leaves unexplained the asymmetrical treatment of tax and expenditure.

30. Most writers (OECD (1982), Buiter (1985), Miller (1985)) acknowledge that the distinction between the "cyclical" and "structural" components of a given deficit has no relevance for the impact of that deficit on aggregate demand.[2] Indeed, automatic stabilisers, as such, would be completely useless if the cyclical components of the deficit had no effect on demand, as use of the CA deficit in this context implies.

31. A further line of argument, which actually applies not only to the CA deficit but also to the "raw" deficit and the inflation-adjusted deficit measures as well, has been pursued strongly by Buiter (1984, 1985) and Begg (1986). This is that the impact on demand from a change in fiscal stance depends on the interactions between the fiscal instruments and the rest of the economy. It is impossible, therefore, to ignore, for example:

- the level and composition of taxes and spending (separately);
- the determinants of private sector spending (eg the role of wealth, the formation of expectations);
- the stance of monetary policy;
- the inflation tax (hence the use of inflation-adjusted deficits).

32. It follows from this that the only comprehensive measure of fiscal impact on demand would be that obtained from the comparison of two model simulations of alternative fiscal policies, with all the relevant assumptions made explicit. Needless to say, the results would be dependent on the nature of the model and assumptions used, which is why such measures are of limited use in practice.

33. NIESR and OECD both recognise the force of this argument. NIESR makes some allowance for the particular composition of a given deficit by "demand-weighting" its constituent elements,[3] but admits that the other factors mentioned above

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2 ".... any change in the ex post budget would, in conventional models, have the same (multiplied) effect on the economy whether it was spent as a result of a decision now or (automatically) as a result of a decision in the past" [OECD (1982), p41].

3 ie applying first-round (but long-run) multipliers to the different tax and expenditure categories. See Odling-Smee and Riley (1985) for a discussion of the problems involved in this kind of procedure. Since we are arguing here that the CA deficit is fundamentally flawed as a measure of fiscal impact, demand-weighting is something of a side-issue, though there may well be a case for demand-weighting the actual deficit (if it could be properly done).

have not been allowed for. Their response, and that of the OECD, is that the CA deficit is only one influence on output among many, and its use does not prejudge, for example, the issue of crowding out.

34. It is arguable whether a deficit measure which does not take full account of private sector behaviour and the overall policy framework is a useful analytical concept. But the main point - that "cyclical" and "structural" components of the deficit are largely indistinguishable in their effects on demand - holds true in any case. Only in circumstances where the automatic stabilisers adequately represent governments' fiscal responses to fluctuations in output, will it be correct to interpret the CA deficit (demand-weighted or not) as a measure of fiscal impulse.

35. A further implication of this argument is that one should not necessarily regard the maintenance of a given (unadjusted) deficit in the face of cyclical fluctuations as being "pro-cyclical". Whether such a policy is pro-cyclical or not depends not on whether some cyclically-adjusted measure of the deficit has changed, but rather on whether the implied compositional changes within the given deficit total have a (net) positive or negative effect on demand. For example, we need to assess whether raising taxes to pay for additional unemployment benefit is expansionary or contractionary. As we have argued above, such questions can only properly be answered by reference to a fully-articulated macroeconomic model.

36. Given these arguments, it is hard to see why cyclical adjustment of the government deficit should have been so widely accepted as a measure of fiscal stance, whereas, for instance, cyclical adjustment of monetary aggregates as a measure of monetary policy has not. We conclude that, in most circumstances, the actual deficit is a better measure of fiscal policy than the CA deficit.

V MEASURING THE CA DEFICIT

37. The measurement of the cyclically-adjusted deficit can be thought of as having two stages. The first involves making an estimate of the output gap - ie the difference between actual output and the benchmark level of output (relative to which the cycle is defined). In the second stage, it is necessary to calculate how tax revenues and public expenditure would change if the output gap were closed. From this, adjustment factors can be derived which convert actual deficits into cyclically-adjusted deficits.

38. In this section we discuss briefly a number of different methodologies for each of the two stages, and then compare the results of using our preferred methodology with those from some of the suggested alternatives. We also consider the problems that possible measurement error implies for interpretation of the CA deficit.

The output gap

39. The methods which have been used to estimate the output gap fall into two broad categories:

- "equilibrium" methods, and
- "time series" methods.

40. The distinguishing feature of "equilibrium" methods is that they attempt to use economic variables to define the theoretical maximum level of output which the economy could obtain at any given time, if it were to reach equilibrium instantaneously.

41. One example of this approach is to calculate what output would be at full employment, based on an assessment of equilibrium labour supply and trend productivity. There are two problems with this. Firstly, neither equilibrium labour supply nor trend productivity are directly observable, and can only be defined with reference to an economic model of some kind. Secondly, market imperfections, particularly in the labour market, may mean that full employment on this definition can be achieved only in the very long run - or indeed that it may never be attained. Hence, the "full employment deficit" could significantly underestimate the minimum level of the deficit attainable within a period which is short enough to be called "a cycle".

42. An alternative method is to define the maximum sustainable level of employment as being that which is consistent with stable inflation. This deals with the problem of market imperfections, in principle at least, but also makes the measure of the output gap even more model-dependent. The difficulty in obtaining reliable estimates of the NAIRU may explain why very few empirical estimates of the CA deficit are based on this approach.[4]

43. Far more commonly used are the simple "time series" methods, of which there are three kinds:

- trends derived by interpolating between output peaks;
- fitted trends (ie using regression analysis), and
- moving averages of actual output.

44. The peak-to-peak method is generally interpreted as a proxy (albeit a very crude one) for measurement of true potential output. Since peaks may well occur at a level of employment above the natural rate, there is clearly a risk that this approach will, like the "full employment" method, exaggerate the contribution of the automatic stabilisers and hence underestimate the CA deficit. For operational purposes, it also suffers from the disadvantage that current estimates of the CA deficit will rely on a forecast of the next peak in output (both of its size and timing).

45. The fitted trend and moving average methods make no pretensions to measure potential output on any definition. They are simply devices for smoothing out temporary fluctuations in actual output, so as to identify the underlying trend. In this role, the moving average method is arguably the more flexible of the two, since it picks up changes in trend automatically (though with a lag). The fitted trend method, in contrast, requires either split-period estimation or ad hoc adjustment if it is to accommodate structural shifts in trend output growth.

46. One feature of the fitted trend and moving average methods, not shared by "equilibrium" or peak-to-peak methods, is that they guarantee that cyclical fluctuations in output will sum to zero in the long run. What this implies for the appropriate choice of benchmark output will depend partly upon how the

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[4] Heller et al (1986) record that, for <u>some</u> countries, the IMF use measures of potential output based on the NAIRU.

resulting CA deficit figures are to be interpreted. Price and Muller (1984) argue that if one is interested primarily in sustainability, it is necessary that the estimated cyclical components of the deficit cumulate to zero - otherwise long run debt levels will be a function not only of the CA deficit but also of the average size and duration of the cycle. If on the other hand, the CA deficit is viewed as an appropriate target for stabilisation purposes (the aim of stabilisation being to resist divergence between actual and potential output), the cycle should be measured relative to "equilibrium" output. In this case, cyclical fluctuations will cancel out only by chance.

47. Our view is that, on balance, a centred[5] moving average is the most useful measure of benchmark output. This is partly because it is helpful to know the average or underlying fiscal stance over a complete cycle (which only a deficit measure based on some form of mid-cycle benchmark will provide); but, most importantly, it avoids the risk that the cycle will be defined relative to some notional level of potential output which is only attained, if ever, in the very long run.

Adjustment factors

48. The size of the cyclical adjustments to tax revenue and public expenditure depend not only on the size of the output gap, but also on how the composition of output is assumed to differ (if at all) over the cycle. A different mix of consumption and investment, or of wages and profits, for example, could affect the tax revenue generated by a given level of output.

49. In principle, the relationship between cyclical fluctuations in output and changes in its composition will depend on what causes the cycle in the first place. OECD, for example, assume that all cyclical fluctuations can be ascribed to changes in stockbuilding, and estimate other compositional effects using their macroeconomic model (INTERLINK).

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[5] Using a centred moving average means, of course, that (as in the case of the peak-to-peak method) the current value of trend output will depend partly on a forecast. However, it could be argued that the margin of error on a forecast of average future output will be much less than that on a forecast of precisely when the next peak will occur, and at what level of output.

50. However, given the likelihood that, at any one time, deviations of output from trend will be the result of a whole range of factors (possibly inter-related), we favour the more agnostic approach adopted by NIESR, which assumes no change in the structure of the economy over the cycle.

51. The final stage in the calculation - estimating revenue and expenditure effects - invariably involves the use of relationships from an economic model. Both OECD and NIESR focus in this case on the individual model equations which directly relate changes in output to changes in tax revenues and demand-led expenditure. (The latter requires an assumption about the relationship between output and unemployment.) From these, they obtain point estimates of tax yield and spending elasticities which can be applied to the output gap to generate cyclical adjustment factors.

52. Our preferred approach differs from this in two ways. Firstly, we use full model simulations, so as to allow for the interaction between output changes and other factors which might affect the public sector deficit - for example, the level of interest rates and the exchange rate.[6] This method also enables us to test the sensitivity of the results to different assumptions about monetary policy and private sector expectations. (In the event, we found that the adjustment factors were not much affected by these assumptions.)

53. Secondly, rather than measuring full-year effects only (as OECD and NIESR do), we allow for the possibility of lags between changes in output and changes in the deficit. Our simulations suggest that a 1 per cent increase in GDP will reduce the budget deficit by around 0.25 per cent in the first year and by 0.45 per cent in the second and subsequent years.[7]

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[6] These may have indirect as well as direct effects on the deficit (eg via their impact on prices and wages in the economy.)

[7] NIESR's estimate of the full year effect is similar to ours; OECD's is higher, at around 0.6 per cent.

Empirical estimates

54. Chart 1 plots an index for actual GDP over the period 1963-64 to 1987-88 against:

(i) a five-year centred moving average of GDP;

(ii) the OECD's estimate of potential GDP (obtained by working backwards from their published cyclical adjustment factors); and

(iii) NIESR's estimate of potential GDP (which assumes that it equalled actual output in the first quarter of 1973, and grew by 2.7 per cent per annum up to 1973 and at 2 per cent per annum thereafter).

The cyclical adjustment factors implied by these three measures of trend output are shown in Chart 2.

55. Two obvious features in these data stand out. The first is that the turning points for the adjustment factors tend to coincide for all three measures; this simply reflects the fact that, in each case, trend output is a "smoothed" version of actual output. Secondly, and more significantly, the adjustment factors based on potential output are very much bigger than those based on mid-cycle output - in the early 1980s, by as much as 4 per cent of GDP.

56. Chart 3 plots year-on-year changes in the actual PSBR, the cyclically-adjusted PSBR on the three different bases, and the implied contribution of the automatic stabilisers, all expressed as a share of money GDP. (Annex II gives data for three other deficit measures: the PSBR excluding privatisation proceeds, the public sector financial deficit and the general government financial deficit. The same cyclical adjustment factors are applied to each.) Looking at year-on-year changes, rather than levels, abstracts from the large cumulative divergences between actual and benchmark output which are a feature of the OECD and NIESR measures.

57. Indeed, on this basis, the results from the various cyclical adjustment methodologies are more remarkable for their similarities than for their differences. All three measures indicate that, since the early 1970s, changes in the deficit via the automatic stabilisers have more often than not been accompanied by "discretionary" changes in the opposite direction. In fact, in most years, "discretionary" changes are sufficiently large to more than offset the automatic stabilisers, implying pro-cyclical fiscal policy even in ex post (ie non-cyclically adjusted) terms.

58. In the late 1960s, by contrast, the automatic stabilisers appear mostly to have been reinforced by "discretionary" policy. However, it is still the case here, as in subsequent years, that shifts in "discretionary" policy dominate the automatic stabilisers, in terms of the size of year-to-year changes. In general, UK fiscal policy over the past 20 years or so has operated in such a way that the automatic stabilisers have not worked fully.

Chart 1: Actual and Mid-Cycle/Potential Output

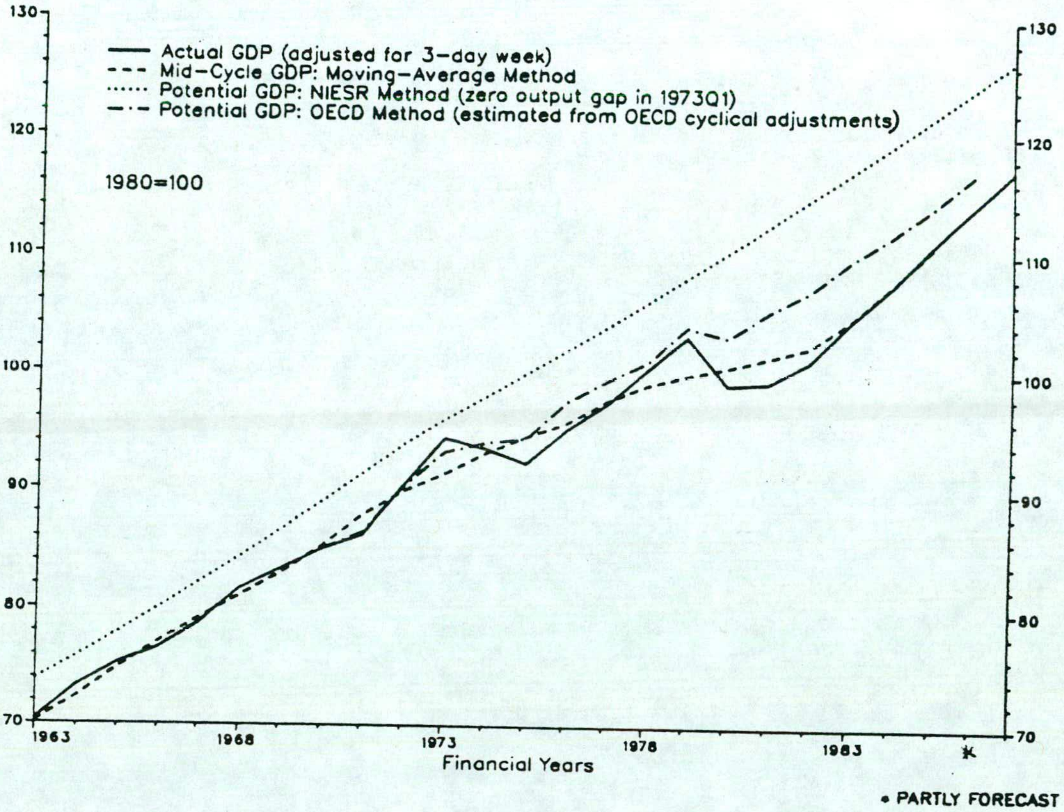
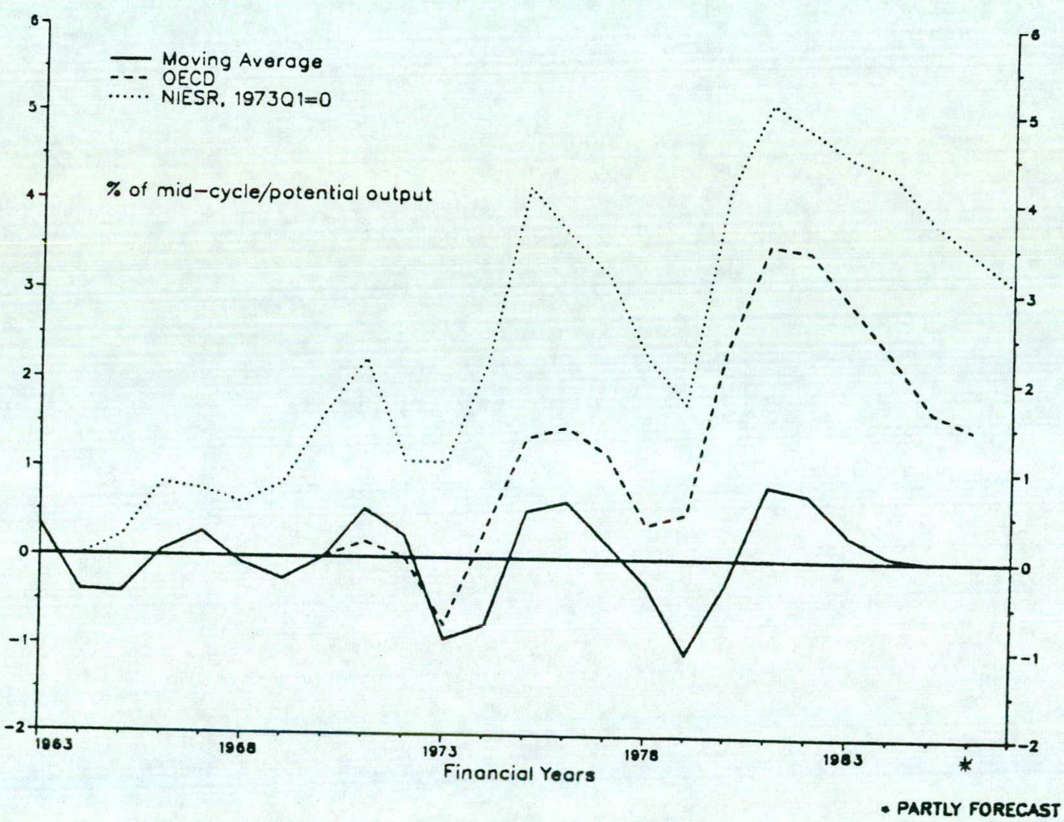


Chart 2: Alternative Cyclical Adjustments



2-1

Chart 3A: Changes in PSBR and Cyclically Adjusted PSBR

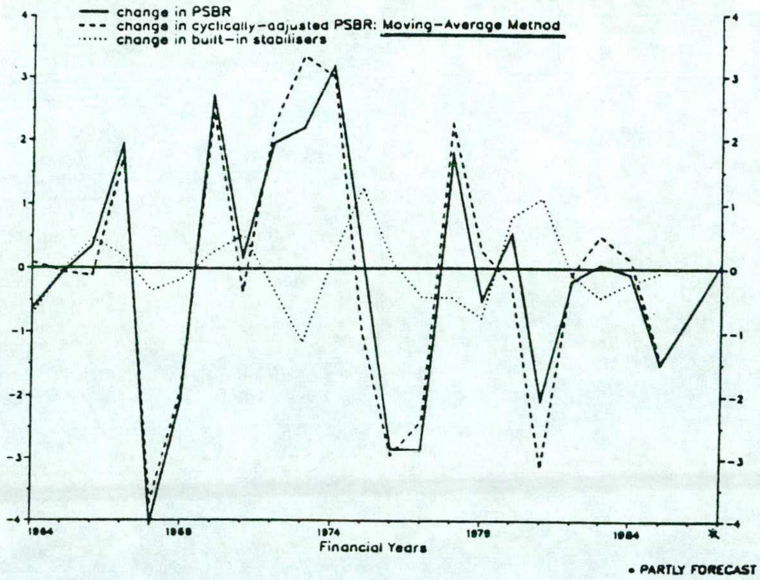


Chart 3B: Changes in PSBR and Cyclically Adjusted PSBR

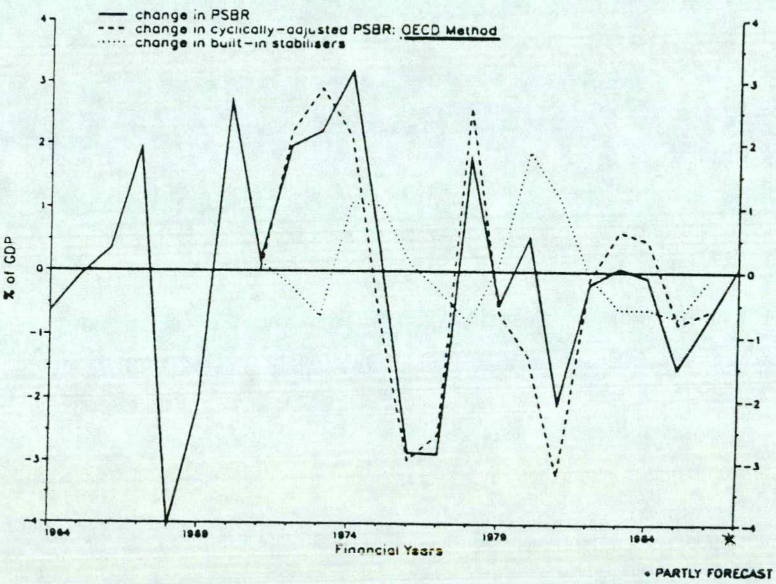
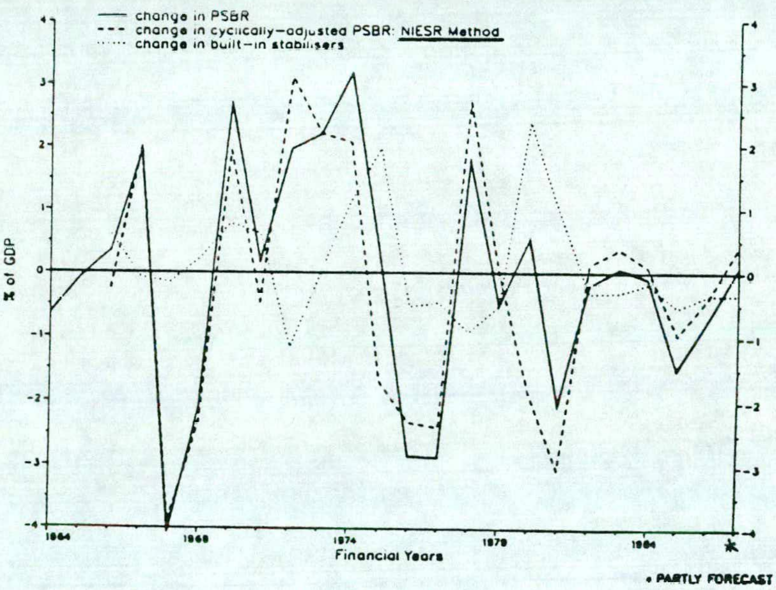


Chart 3C: Changes in PSBR and Cyclically Adjusted PSBR



Measurement Error

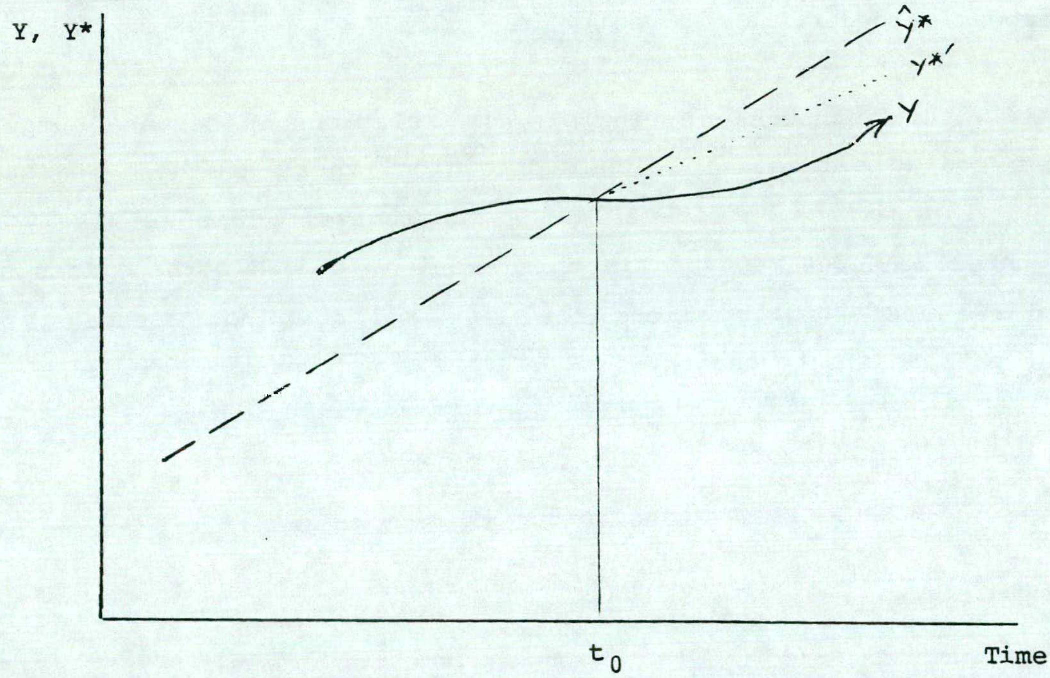
59. As we have said earlier, one of the motives for cyclically adjusting the deficit is to obtain a measure of fiscal impulse which can be used to "explain" changes in aggregate demand or output (eg Layard and Nickell (1985)). A positive relationship is taken to mean that changes in the CA deficit cause changes in output.

60. The difficulties associated with measurement of the CA deficit, as described in this section, suggest an alternative explanation - measurement error bias. Positive bias (implying that the estimated effect of the deficit on output is exaggerated) can occur at either stage in the measurement process:

(i) if the output gap is estimated with error, and the errors are positively correlated with the true output gap, or

(ii) if the effect of changes in output on the deficit are over-estimated.

61. An example of the first is illustrated in the diagram below. Suppose Y* is potential output and is estimated by a simple straight-line trend, $\hat{Y}^*$. At time t_0, growth in Y* is reduced to Y*' by some adverse supply shock (eg an increase in oil prices). If the authorities refuse to accommodate the inflationary pressure associated with this supply shock, there may be a recession in which actual output falls by even more than potential output.



62. With no change in $\hat{Y}^*$, the depth of the recession relative to potential, or benchmark output will be exaggerated (the estimated output gap will be Y - $\hat{Y}^*$;

the true output gap is Y - Y*'). In cyclically adjusted terms, fiscal policy will therefore appear tighter than it actually is, and its contribution to the fall in output will be correspondingly overstated. This source of bias may have been quite significant over the past 10 or 15 years, during which there have been major shifts in oil and other commodity prices (in real terms).

63. Two examples of the second source of bias - where the "feedback" effects of output on the deficit are measured with error - have already been referred to. The first is the case where the authorities operate an active discretionary fiscal policy over the cycle, so that the "feedback" effects represented by the automatic stabilisers are only part of the total feedback effects. If, as we suggested in paragraph 57, discretionary policy is pro-cyclical (for example, because of a public commitment to a particular path for the unadjusted deficit), a cyclical adjustment technique which only takes account of the automatic stabilisers will induce a spuriously high coefficient in a regression of output on the CA deficit.[8]

64. Secondly, the failure to allow for lags in the relationship between changes in output and changes in tax revenues, benefit payments and so on (see paragraph 53), may mean that the size of the short run stabilisers is over-estimated. When output rises, this implies that a higher proportion of any given deficit is defined as "cyclical", and a smaller proportion "discretionary". As a result, the correlation between output changes and discretionary policy changes may appear stronger than it really is.

65. To summarise, even though in principle the relationship between output and the CA deficit could be biased in either direction, there are good reasons for believing that, in practice, positive bias predominates. This is likely to be true for all three measures reported in this section, though perhaps less so for our preferred measure - which allows for lags and does not assume a fixed, "peak", output path as its benchmark.

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[8] Whether this is described as simultaneity bias, as earlier, or measurement error bias, as here, is unimportant; its effects are the same.

VI CONCLUSIONS

66. In this paper, we have attempted to highlight the main conceptual problems associated with the cyclically-adjusted budget deficit. We have argued that one of the most common interpretations - that is, of the CA deficit as a measure of fiscal impact on aggregate demand - is also one of the least convincing. The proposition that cyclical adjustment is a way of allowing for simultaneity bias in the relationship between fiscal policy and output is recognised. But in principle simultaneity bias will remain even after cyclical adjustment, except in the rather unlikely circumstance that "discretionary" policy is unaffected by fluctuations in output (ie the authorities are entirely passive over the cycle). The evidence presented here suggests that, in fact, it may have operated pro-cylically. We conclude that, if simultaneity bias is to be avoided, a proper instrumental variable approach is required.

67. At a less technical level, it is clear that a given change in the fiscal deficit will have the same effect on aggregate demand whether it is generated by the automatic stabilisers or by so-called discretionary policy, except of course insofar as the composition of revenues and expenditures may be different. Cyclical adjustment, on the other hand, effectively discounts the role of the automatic stabilisers in the demand management process altogether. We argue, therefore, that the CA deficit is not a useful measure of fiscal impact on demand - it is simply an indicator of the extent to which the authorities are acting with or against the automatic stabilisers.

68. It is possible, under certain circumstances, to make a case for using the CA deficit as a guide to the setting of fiscal policy. A smooth path for the CA deficit would ensure that the automatic stabilisers are allowed to work, contributing to greater stability in money demand than would be obtained with an unconditional target for the unadjusted deficit. Given the costs involved, for the private sector as well as the authorities, in continually changing tax rates and spending plans, and given the difficulties associated with "fine tuning", this may be a reasonable starting point.

69. On the other hand, the tax and benefit system will not normally have been designed primarily to give the most appropriate stabilisation properties. Nor is fiscal policy the only element in the stabilisation process; monetary policy also has a role to play. In practice, therefore, the authorities may decide to exercise some discretion in setting fiscal policy over the cycle, taking into

account amongst other things the relative desirability of stabilising tax and benefit rates rather than interest rates; and the importance attached to medium term objectives for inflation.

70. A second argument for setting fiscal policy in terms of the CA deficit is so as to avoid significant changes in the level of public sector debt (or its ratio to money income) in the long run. Provided that the cycle is appropriately defined, the cyclical component of the deficit should cumulate to zero, and will not therefore affect the long run debt-income ratio.

71. The main caveat here is that there are a number of factors other than the CA deficit which are likely to affect the government's long run solvency (examples include changes in the value of fixed assets in the public sector, or in unfunded pension liabilities). It follows that a policy which maintains a constant CA deficit does not necessarily ensure that government's net liabilities are constant in the long run, and in this sense such a policy may not be sustainable.

72. As far as the measurement of the CA deficit is concerned, the problems are both conceptual and empirical. The appropriate definition of "benchmark" output, relative to which the cycle is measured, depends partly on how the resulting estimates for the CA deficit are to be interpreted. We favour a moving-average trend in this context, mainly because it avoids the risk that, by opting instead for a potentially over-optimistic estimate of "equilibrium" output, too big a proportion of any given deficit will be classified as cyclical.

73. In calculating cyclical adjustment factors, we use full model simulations, assuming that the composition of output is more or less constant over the cycle and that monetary policy is non-accommodating (though the results are not particularly sensitive to these assumptions). We also allow for lags: our results suggest that when output changes only about half the full year effect on the deficit comes through in the first year.

74. Using a mid-cycle concept of "benchmark" output, as we do, generates fairly small cyclical adjustments; the largest is around one per cent of GDP, and the absolute average over the past 20 years considerably less than ½ per cent. Other institutions have produced much larger adjustments by measuring the cycle relative to an estimate of potential output. Since this level of output is probably not attainable in the short term without excessive pressure on inflation

(if at all), the resulting measures of the CA deficit give a misleading impression of the scope for fiscal stabilisation. Unrealistic estimates of potential output, and other measurement error biases, may have also contributed to the exaggeration of the importance of fiscal policy as a determinant of output and demand.

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ANNEX A

BEGG'S (1986) MODEL

1. Let

y, y^* = actual and potential output;
c = marginal propensity to consumer;
t = net tax rate;
vy = discretionary element of policy;
g = government spending (constant over the cycle);
u = demand shock ($E(u) = 0$);
f = budget surplus;

Suppose that output is determined from the income-expenditure identity:

$$y = c\,(1 - t - v(y, y^*))\,y + g + u \tag{1}$$

2. The parameter v, determining discretionary policy (in Begg's terminology), is a function of the output gap. Assuming discretionary policy is operated counter-cyclically:

$$v_y > 0 > v_{y^*}$$

and

$$v(y^*, y^*) = 0$$

3. The budget surplus is defined as:

$$f = ty + v\,(y, y^*)y - g \tag{2}$$

Cyclical adjustment of the budget surplus involves evaluating net tax revenues at y^*, using current values of t and v:

$$f^* = ty^* + v(y, y^*)\,y^* - g \tag{3}$$

Suppose also that g is set equal to its long-run equilibrium value (ie when $y=y^*$). From (1), this implies:

$$g = y^*(1 - c) + cty^* \tag{4}$$

Substituting in (3) and dividing through by y^* gives the CA surplus as a proportion of potential output:

$$f^*/y^* = (c - 1)(1 - t) + v(y,y^*) \tag{5}$$

4. Begg argues that since the CA surplus is a positive function of both t and v, it can be interpreted as an indicator of total fiscal stance, including both automatic stabilisers and discretionary policy.

5. But this simply reflects the choice of terminology. In all other studies, the "automatic stabiliser" is defined as the product of the net tax rate, t, and the gap between actual and potential output - not as the value of t itself (which is discretionary).[1] It is this product, $t(y - y^*)$, which the CA deficit attempts to exclude and the issue is whether, in doing so, it becomes a better or worse measure of fiscal impulse.

---

[1] The more conventional representation, using Begg's notation, would be:

$$f = ty - d$$

$$f^* = ty^* - d$$

where d represents net discretionary spending and is (formally) independent of output. The difference between f and f* is defined as the automatic stabiliser:

$$f - f^* = t(y - y^*)$$

TABLE I - BASIC DATA

Year	UNADJUSTED PSBR	UNADJUSTED PSFD	UNADJUSTED GGFD	UNADJUSTED PSBR adj for priv proceeds (a)	CYCLICALLY ADJUSTED (c) PSBR	CYCLICALLY ADJUSTED (c) PSFD	CYCLICALLY ADJUSTED (c) GGFD	CYCLICALLY ADJUSTED (c) PSBR adj for priv proceeds
	% of Money GDP							
1952	5.0	3.5	1.8	5.0				
1953	3.5	4.1	2.6	3.5				
1954	2.1	2.4	0.9	2.1				
1955	2.4	2.0	-0.2	2.4				
1956	2.7	2.6	0.7	2.7				
1957	2.2	2.4	-0.1	2.2				
1958	2.1	1.9	-0.5	2.1				
1959	2.3	2.2	-0.1	2.3				
1960	2.7	2.7	0.9	2.7				
1961	2.5	2.6	0.7	2.9				
1962	1.9	1.8	0.0	1.9				
1963/64	3.3	3.3	1.7	3.3	2.9	3.0	1.4	3.0
1964/65	2.6	2.3	0.6	2.7	3.0	2.7	1.0	3.1
1965/66	2.6	1.7	-0.0	2.6	3.0	2.1	0.4	3.0
1966/67	2.9	2.6	0.3	2.9	2.9	2.6	0.3	2.8
1967/68	4.9	4.2	1.8	4.9	4.6	3.9	1.5	4.6
1968/69	0.8	0.8	-0.5	0.8	0.9	0.9	-0.4	0.9
1969/70	-1.2	-1.7	-2.9	-1.3	-1.0	-1.5	-2.6	-1.0
1970/71	1.5	-0.5	-2.4	1.4	1.5	-0.5	-2.4	1.4
1971/72	1.6	1.1	-0.6	1.6	1.1	0.6	-1.1	1.0
1972/73	3.6	3.0	1.9	3.5	3.4	2.8	1.6	3.3
1973/74	5.8	4.6	3.5	5.8	6.7	5.5	4.4	6.7
1974/75	9.0	6.7	4.4	8.7	9.7	7.4	5.1	9.5
1975/76	9.3	7.4	4.9	8.9	8.7	6.8	4.4	8.4
1976/77	6.4	5.8	4.4	6.4	5.8	5.1	3.8	5.8
1977/78	3.6	4.4	3.5	3.9	3.4	4.2	3.4	3.7
1978/79	5.3	4.9	4.2	5.3	5.6	5.2	4.4	5.6
1979/80	4.8	3.9	2.7	5.0	5.9	5.0	3.9	6.1
1980/81	5.4	5.0	4.0	5.5	5.6	5.3	4.2	5.8
1981/82	3.3	2.2	1.9	3.5	2.5	1.4	1.0	2.7
1982/83	3.1	3.0	2.7	3.3	2.4	2.2	2.0	2.6
1983/84	3.2	4.0	4.0	3.6	2.9	3.7	3.7	3.3
1984/85	3.1	4.2	3.8	3.7	3.0	4.2	3.7	3.7
1985/86	1.6	2.3	2.5	2.3	1.6	2.3	2.5	2.4
1986/87(b)	0.9	2.9	3.0	2.0	0.9	2.9	3.0	2.1
1987/88(b)	1.0	2.4	2.7	2.2	1.0	2.4	2.7	2.2

(a) Treasury estimates of central privatisation proceeds from 1977/78. Previous data are central government transactions in UK company securities, amended for proceeds of iron and steel disposals over the period 1960-64.

(b) FSBR forecast.

(c) based on moving-average measure of "benchmark" output

ALTERNATIVE

TABLE II - CYCLICAL ADJUSTMENTS

Year	------ Output Gap (a) ------			-- Cyclical Adjustments (b) --		
	------------ % of mid-cycle/potential output			-------------		
	MA method	OECD (c)	NIESR (d)	MA	OECD (e)	NIESR
1963/64	0.3	na	4.9	0.3	na	na
1964/65	1.3	na	3.4	-0.4	na	na
1965/66	0.6	na	3.4	-0.4	na	0.2
1966/67	-0.7	na	3.1	0.1	na	0.8
1967/68	-0.5	na	4.3	0.3	na	0.8
1968/69	0.7	na	3.3	-0.1	na	0.6
1969/70	0.4	na	3.9	-0.2	na	0.8
1970/71	-0.3	0.0	4.5	-0.0	0.0	1.6
1971/72	-1.9	0.3	5.8	0.5	0.2	2.2
1972/73	0.5	-0.8	3.8	0.2	-0.1	1.1
1973/74	3.2	-1.3	2.4	-0.9	-0.8	1.1
1974/75	0.4	0.5	4.6	-0.7	0.3	2.2
1975/76	-2.4	2.3	7.9	0.5	1.4	4.2
1976/77	-0.6	2.5	6.8	0.6	1.5	3.6
1977/78	-0.2	2.0	6.5	0.2	1.2	3.2
1978/79	1.3	0.6	5.5	-0.3	0.4	2.3
1979/80	3.2	0.8	4.8	-1.1	0.5	1.7
1980/81	-1.5	4.0	10.7	-0.3	2.4	4.1
1981/82	-2.1	5.9	12.5	0.8	3.5	5.1
1982/83	-1.2	5.8	12.7	0.7	3.5	4.8
1983/84	-0.1	4.8	11.3	0.3	2.9	4.5
1984/85	-0.1	3.8	10.5	0.0	2.3	4.3
1985/86	0.1	2.8	9.3	-0.0	1.7	3.8
1986/87(f)	0.1	2.5	8.5	-0.0	1.5	3.4
1987/88(f)	0.2	na	7.8	-0.1	na	3.1

(a) Logarithmic percentage differences.

(b) Positive numbers indicate structural deficit lower (or greater surplus) than unadjusted balance. MA adjustments based on mid-cycle output, OECD & NIESR on potential output.

(c) OECD output gaps estimated from published cyclical adjustments.

(d) Normalised to 1973Q1 equals zero. Adjustments estimated after 1983/84. Source: NIER No 113, Aug 1985, No 115, Feb 1986.

(e) Source: Price & Muller (1984) and OECD Economic Outlook, financial year estimates from calendar year data.

(f) FSBR projection.

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Price Waterhouse

12 August 1987

Rt Hon Nigel Lawson Esq, MP
Chancellor of the Exchequer
Her Majesty's Treasury
Parliament Street
LONDON SW1P 3AG

Ch
Most interest bits are pp 51-66 on experience of those playing spending ministers, plus pp 69-70 on PES treatment of LAs
AA

pso ack.

Dear Chancellor,

Just over six months after leaving the Efficiency Unit for Price Waterhouse I had the opportunity to take part in a seminar run by the Public Finance Foundation and financed by PW to simulate the Cabinet's public expenditure discussions. Under the chairmanship of Edmund Dell, who played the part of Prime Minister, Ministerial roles were assumed by academics who are familiar with departmental issues.

The results are contained in the enclosed report which I thought might interest you. There are no earth-shattering conclusions. But two important themes emerged:

- "Ministerial" role players made little advance on reality; the discussion may have started off being more technical than the real thing but the underlying thrust was closely similar and the bargaining ended up being much the same;

- The way the discussion went was perhaps inevitable given the focus on control - holding to the totals of public expenditure; any switch to management - achieving specified results by a certain time and within budget - may need a different structure from the outset.

It seems unlikely that experienced Ministers would gain much from looking at the results. But we hope that aspirant Ministers, and civil servants who are likely to be part of the process, might gain from using the results for teaching purposes.

Yours sincerely,

Ian Beesley.

Ian B Beesley

Encs.

Ch
(para 3 below)
Not v attractive to offer London
(certainly not if Cypriots
offer themselves). Note
especially significance
of Sept 88 date!!
AA

From: Sir G.Littler
Date: 27 August 1987

MR PARTRIDGE

c.c. Mr Alex Allan

GOVERNMENT HOSPITALITY FUND: 1988/89 ESTIMATES

Thank you for your minute of 18 August.

2. Subject to anything Mr Allan may offer, I am not conscious of any exceptional Treasury calls on GHF for 1988/89 - with the possible exception which you mention: the Commonwealth Finance Ministers Annual Meeting.

3. The position on this is that the September 1988 venue has not yet been fixed. It should be decided at this year's meeting around 24 September, at which point we could give GHF a definitive reply. Meanwhile the position is that an European venue will be wanted and Cyprus last year offered that they would provide it. We are not sure (most of the Seretariat are on leave) whether this has been confirmed.

3. Could Mr Allan please sound the Chancellor on:

- whether he would be prepared to confirm the offer of London if there is a gap to be filled (I would recommend doing so);
- whether he would positively want to offer London if the prior Cyprus offer is confirmed (optional, I think - if he did, the Cypriots might be offended although I guess London would be more attractive to many others!).

4. Meanwhile, in case of need, you agreed to see if you could check what would be involved on the GHF front.

I feel strongly that Cyprus shd be given 1st refusal.
But if ~~that~~ that fails, then - without ~~great~~ great enthusiasm -
I wd be prepared to offer London.
NL

(Geoffrey Littler)

Attachment I.

LOCATIONS OF COMMONWEALTH FINANCE MINISTERS MEETINGS.

1971 Bahamas

1972 London

1973 Dar es Salaam

1974 Ottowa

1975 Georgetown

1976 Hong Kong

1977 Barbados

1978 Montreal

1979 Malta

1980 Bermuda

1981 Bahamas

1982 London

1983 Port of Spain

1984 Toronto

1985 Maldives

1986 St Lucia.

5/DB5

Ch/ Content?

b.f. 28/9

FROM: C D BUTLER
270 4410
Room 31/2
DATE: 21 September 1987

25 30/9

Agreed PEM

1. SIR PETER MIDDLETON

2. CHANCELLOR

OK

cc Sir Robert Armstrong
Mr R Griffiths
Ms Boys
Mr Meadows

CHEQUERS TRUST

I should like to propose that we use the occasion of the recent machinery of government changes to tidy up an anomaly in the financial responsibility for the Chequers Trust.

2. The Trust, which meets some 79 per cent of the cost of maintaining Chequers, should appear on the Vote of the new Office of the Minister for the Civil Service (Class XX, Vote 1) along with the cost of other premises which the Prime Minister occupies. It is a historical accident that the Treasury carries responsibility at present. The MPO agree the proposed change. As a quid pro quo the Treasury wouold accept responsibility for funding George Cross annuities. The Treasury Vote already contains provision in its Honours and Dignities subhead for the cost of medals and associated expenditure.

3. This minor change can be included in the Transfer of Functions Order transferring responsibility for certain functions of the Minister for the Civil Service to the Treasury. We need first to obtain the consent of the Prime Minister. And, as a matter of courtesy, we should clear lines with the Lord Privy Seal, as Chairman of the Trustees, before the submission to the Prime Minister goes forward. If you agree, I invite you to send minutes to the Prime Minister and the Lord Privy Seal on the lines of the attached drafts.

CDB

C D BUTLER

42

5/DB5-EOG

Ptl. type for Ch. sig.

~~DRAFT~~

LORD PRIVY SEAL

TRANSFER OF RESPONSIBILITY FOR THE CHEQUERS TRUST

I am writing to you in your role as Chairman of the Board of Administrative Trustees to seek ~~seeking~~ your agreement to the transfer of responsibility for the Trust from the Treasury to the Minister for the Civil Service.

2. The grant in aid to the Chequers Trust is currently provided from the Treasury Vote. The other costs of the Prime Minister's residences and her office are currently met by the Management and Personnel Office and will be transferred to the new Office of the Minister for the Civil Service. I think that responsibility for the Prime Minister's office and residences should be concentrated on the one Vote.

3. I propose therefore that, when the new Office is created, responsibility for the Trust should be transferred to the Minister for the Civil Service.

4. This change will not affect the status or running of the Trust and I hope you can agree that I should invite the Prime Minister to concur.

5. I am sending a copy of this to Richard Luce.

[N.L.]

5/DB5-EOG

Pse type for Ch sig.

PRIME MINISTER

TRANSFER OF RESPONSIBILITY FOR THE CHEQUERS TRUST

Financial responsibility for the grant in aid to the Chequers Trust currently rests with the Treasury. With his agreement, I suggest that it should be transferred to the Office of the Minister for the Civil Service.

2. The grant in aid to the Chequers Trust meets the deficiency between income from the Chequers Trust and the total maintenance costs of Chequers. The grant currently accounts for 79 per cent of the cost.

3. The existing Management and Personnel Office is already responsible for the other costs of your office and official residences. When its title changes to the Office of the Minister for the Civil Service certain functions will be transferred to the Treasury. I should like to use that occasion to transfer responsibility for the Chequers Trust. This will concentrate expenditure and accountability on one Vote. The Lord Privy Seal, as Chairman of the Trustees, is content with this proposal.

4. This change will require no transfer of staff or public announcement. A Transfer of Functions Order is needed to transfer the powers in Section 2 of the Chequers Estate Act 1958 from the Treasury to the Minister for the Civil Service. But this can be included in the Order which is needed to transfer functions from the Minister for the Civil Service to the Treasury.

5. I should be grateful for your authority to proceed with this transfer, to take effect at the same time as the other chnages. I am sending a copy of this minute to the Lord Privy Seal, the Secretary of State for the Environment, who appoints one trustee, the Minister of State, Privy Council Office and Sir Robert Armstrong.

[NL]

~~1. Alex~~
2. C.

35/954

UNCLASSIFIED

This article would be timely in directing attention to the ratio of GGE to GDP following the autumn statement and I hope you will agree to its publication.
FERB
2.10.

FROM: **G C WHITE**
DATE: **2 October 1987**

1. **MR F E R BUTLER**
2. **CHANCELLOR OF THE EXCHEQUER**

Copies attached for:

Chief Secretary
Financial Secretary
Economic Secretary
Paymaster General

cc Sir P Middleton
Mr A Wilson
Mr Anson
Mr Scholar
Mr Turnbull
Mr Spackman
Mr Odling-Smee
Mr Culpin
Mr Gieve
Mrs R J Butler
Mr Pratt
Miss Walker
Mr Towers
Miss Chapman
Mrs Sigler
Mr Tyrie
Mr Kenny - CSO

Ch
Odd to publish this in November with [illegible] from last year. AS.
Needs updating. AA

C/content for article to be published?
CR 5/10

OK. I have made one or two amendments. But the main point is that of AC8A. [illegible]

LONG TERM TRENDS IN PUBLIC EXPENDITURE

You will recall that towards the end of last year we published a short article in the Treasury's 'Economic Progress' Report on trends in public expenditure (copy attached for convenience). We thought that a further article covering a longer time period would be useful as a reference point for information on historical figures and could be drawn on for speeches, debates, hearings, etc. As a result we have put together the attached article which we would like to publish in the CSO's publication 'Economic Trends'.

2. The new article is intended as a statistical compilation of figures with supporting material on sources and definitions. It includes a certain amount of discussion on particular incidents that had a major impact on trends but tries to avoid any detailed discussion on the political issues.

Somewhat [illegible] will be out of date by the time it appears. If possible do not [illegible] ~~A [illegible]~~ (the charts) [illegible] for the Oct Book; I suggest it appears in the New Book.

3. If you are content for the article to be published we would suggest that we include the article in the October issue of Economic Trends. This will be published in the middle of November and can be drawn on for the debate/hearings on the Autumn Statement.

G C WHITE

Where auditors think any spending is illegal they may take them to court. If the courts find the spending to be unlawful, they may order that the money should be repaid by the councillors or local authority officers responsible and disqualify them from holding office.

Other responsibilities

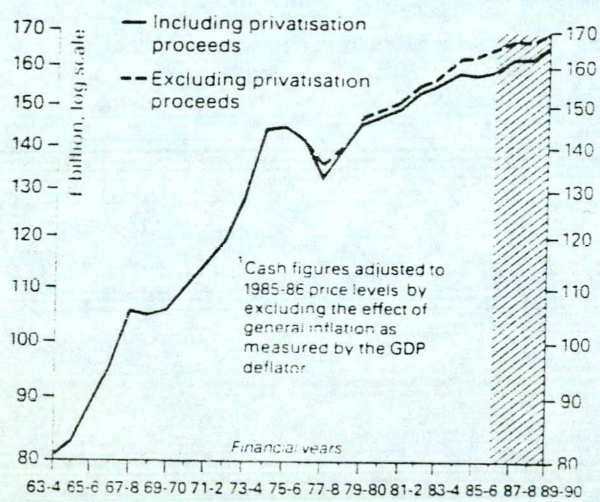
In addition to its auditing and VFM responsibilities, the Commission is required to report on the impact of the law and of directions from central government on efficiency in the provision of local government services. Reports have so far been produced on the *Block Grant Distribution System* and on *Capital Expenditure Controls in Local Government in England*. Those reports have been followed up by the National Audit Office, which is charged with responsibility to Parliament on the economy, efficiency and effectiveness of central government. The Public Accounts Committee of Parliament has drawn on these reports in order to produce its own reports to central government.

Conclusion

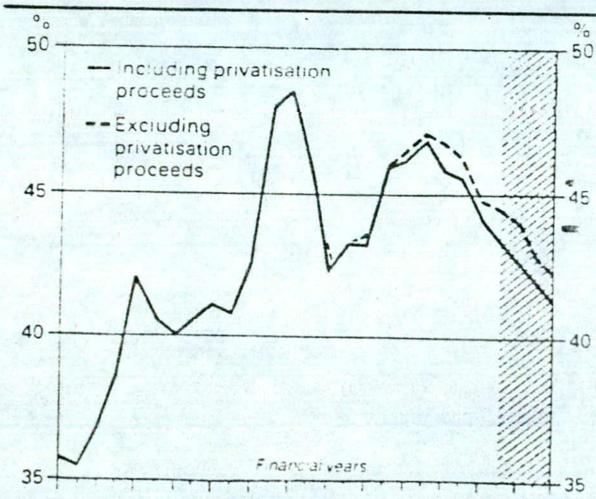
The Audit Commission plays an important role in protecting ratepayers against improper spending by local authorities and in helping local authorities get maximum value of money from their spending. Their VFM studies have identified potential savings by local authorities amounting to almost £2 billion a year.

Trends in public expenditure

General government expenditure in real terms[1]



General government expenditure as percentage of GDP



Before the first world war, general government expenditure* seems to have taken up less than 15 per cent of national income. When the war started this proportion rose rapidly, to over 50 per cent by 1918. It fell just as sharply when the war ended, and then stabilised at around 25 per cent through the 1920s and 1930s.

During the second world war it rose again, reaching nearly 75 per cent at its peak. After the war the proportion fell gradually, to around 35 per cent by 1950. It stayed at about this level until the mid-1960s.

As the charts show, public spending, measured by general government expenditure, then moved onto a rapidly rising trend, both as a percentage of gross domestic product (GDP) and in real terms. In the 15 years from 1963-64 to 1978-79 public spending grew significantly faster than real GDP. As a result public spending as a proportion of GDP rose from around 35 per cent in the early 1960s to 43 per cent in 1978-79, having been as high as 48 per cent in the mid-1970s.

Since 1982-83 public spending as a proportion of GDP has been falling progressively and the plans set out in the Autumn Statement show public spending planned to grow more slowly than output, implying a further fall relative to national income.

In the 1960s and 1970s public expenditure grew by nearly 4 per cent a year in real terms on average. However this average conceals large fluctuations. For example, spending grew by 13 per cent in a single year, 1974-75, and then fell by 4 per cent between 1976-77 and 1978-79. Since 1978-79 the rate of growth in public spending, excluding privatisation proceeds, has decelerated to an average of about 2 per cent a year.

The Chancellor, Mr Nigel Lawson, said in the debate on the Autumn Statement:

> 'Public expenditure increased in real terms by about 3 per cent a year . . . over the 10 years before 1978-79 . . . During the first Parliament under' this 'Government, we reduced that increase to 2¼ per cent a year. During this Parliament we have reduced it further to 1¾ per cent a year so far. Over the three years to come, we plan to reduce it further to 1 per cent a year.' (*Hansard*, 6 November 1986, Col. 1095.)

*General government expenditure is the combined expenditure of central and local government, including debt interest. To eliminate double-counting it excludes payments from central to local government, such as rate support grant and lending.

Draft article for Economic Trends

Long term trends in public expenditure

Graham White and Helen Chapman, HM Treasury

Introduction

There are a number of different measures of public spending. A key measure is general government expenditure (the combined spending of central and local government including both capital and current spending plus net lending). This is useful for analysing overall trends in public spending and in the formulation of macro-economic policy. It is broadly a measure of the amount which the Government has to raise by taxation and borrowing and is the key public spending aggregate used in the Medium Term Financial Strategy.

2. General government expenditure differs in a number of respects from the public expenditure planning total, the other key public spending aggregate which is used by the Government in its annual review of detailed public expenditure plans and forms the basis of the control totals set each year. The main differences in coverage are the inclusion in general government expenditure of gross debt interest and the finance which public corporations raise direct from the market rather than from Government. Other differences are explained in more detail in an Annex to Part 2 of the 1987 public expenditure White Paper (Cm 56-II) and in the Financial Statistics Explanatory Handbook.

3. This article discusses long term trends in public expenditure and concentrates on general government expenditure. The national accounts include detailed figures of government spending which comprises a number of different elements. General government expenditure on goods and services is the government's direct contribution to the expenditure measure of GDP; total current and capital expenditure also includes interest payments and transfer payments such as subsidies and grants; and general government expenditure in total also includes net lending. Figures for general government expenditure are published in the Blue Book (United Kingdom National Accounts) and Financial Statistics.

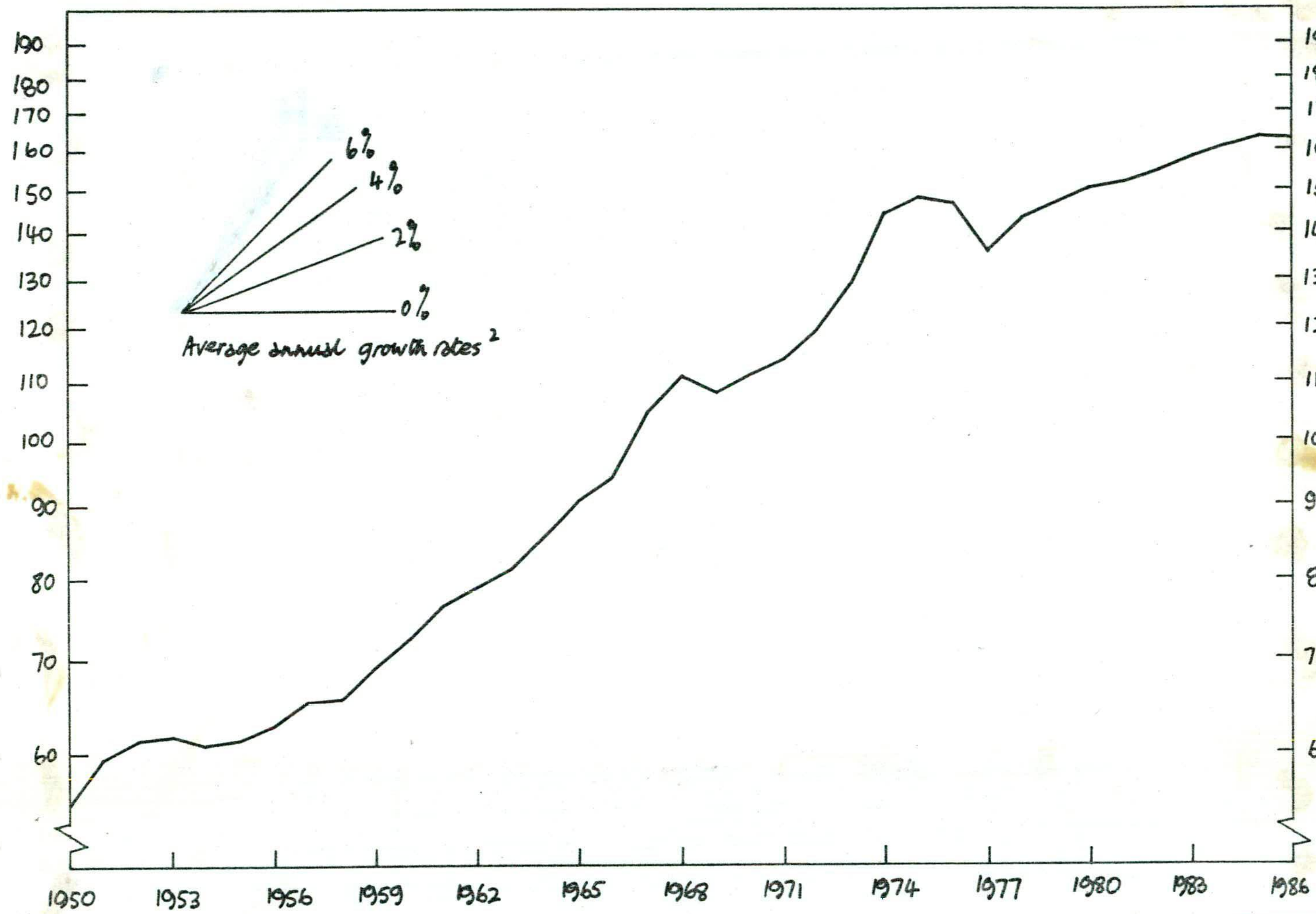
General government expenditure since 1950

4. The Central Statistical Office (CSO) has a consistent series of general government expenditure figures back to the late 1940s. **Chart 1** shows general government expenditure from 1950 to 1986 in real terms. Real terms figures are the cash figures adjusted to 1986 price levels by excluding the effect of general inflation as measured by the GDP deflator.

5. General government expenditure has increased in real terms over the years, showing a small peak in 1968 and a much larger peak in the mid-1970s. After the peak in 1968 efforts were made to reduce government expenditure in 1969, mainly by the acceleration of the withdrawal of British forces east of Suez, a postponement of the general increase in social security benefits, and deferment by two years of the raising of the school leaving age. As a result government expenditure fell in real terms, but soon started to follow

an upward ~~rising~~ trend again to reach the peak of the mid-1970s. Following negotiations with the International Monetary Fund (IMF) in the latter half of 1976, public expenditure plans for 1977-78 were revised downwards by £1 billion and it was announced that £500 million of government-owned shares in the British Petroleum Company were to be sold in 1977-78. (The proceeds from the sale counted as negative expenditure). The planned reductions were spread across most public expenditure programmes but actual expenditure in 1977-78 was even lower than expected - about £4 billion below the revised plans set in January 1977. Much of this was due to underspending which was difficult to forecast in advance. This reduction in spending coincided with the introduction of cash limits in 1976.

Chart 1 General government expenditure in real terms[1], 1950 to 1986 — log scale, £ billion



1 Real terms figures are the cash figures adjusted to 1986 price levels by excluding the effect of general inflation as measured by the GDP deflator.

2 The different slopes of the lines represent different rates of annual growth. The steeper the gradient the greater the growth rate. By comparing the slopes with particular sections of the graph the reader can determine the appropriate rate of annual growth over that period.

6. Since the reduction in the late 1970s general government expenditure continued to increase in real terms, but at a slower rate. Over this period the main increases have been on employment measures, defence, social security, law and order and the health service. In other areas there have been reductions. Spending on public sector housing and subsidies to trade, industry and energy have fallen substantially. This is a reflection of Government policies for sales of publicly owned houses and for a greater share of

housing needs to be provided by the private sector, and for support to both private and public sector industry to be reduced as profitability increases.

7. During the 1950s general government expenditure rose in real terms by about 2¾ per cent a year. This increased to 4½ per cent a year in the 1960s and 3 per cent a year in the 1970s but has now fallen to 1¼ per cent a year since 1980. Since 1982-83 the average annual growth rate has been about 1¼ per cent a year and even after excluding privatisation proceeds, in order to show the underlying trend, the rate has been 1¾ per cent a year, lower than the corresponding rates in the 1950s, 1960s and 1970s.

General government expenditure as a percentage of GDP since 1890

8. General government expenditure is often expressed as a percentage of GDP.This compares growth in government spending with growth in the economy ~~and is an indicator of the amount of money flowing through government channels~~. It does not represent the share of GDP "consumed" by government, as public spending includes transfer payments, such as grants and loans, which transfer spending power to the private sector. The government's own consumption is measured by public spending on goods and services only. However, the larger measure shows the extent to which the government has to raise taxation and borrow on financial markets to finance its activities and is the statistic most widely used in discussion of public spending comparisions with GDP.

9. The definition of public expenditure used in the comparison with GDP has varied over the years. The different definitions which have been used in Treasury documents are discussed in an article in the August 1985 edition of Economic Trends. General government expenditure was introduced as the numerator of the GDP percentage in the 1984 Green Paper on long term spending and is now the measure of expenditure used in Government publications.

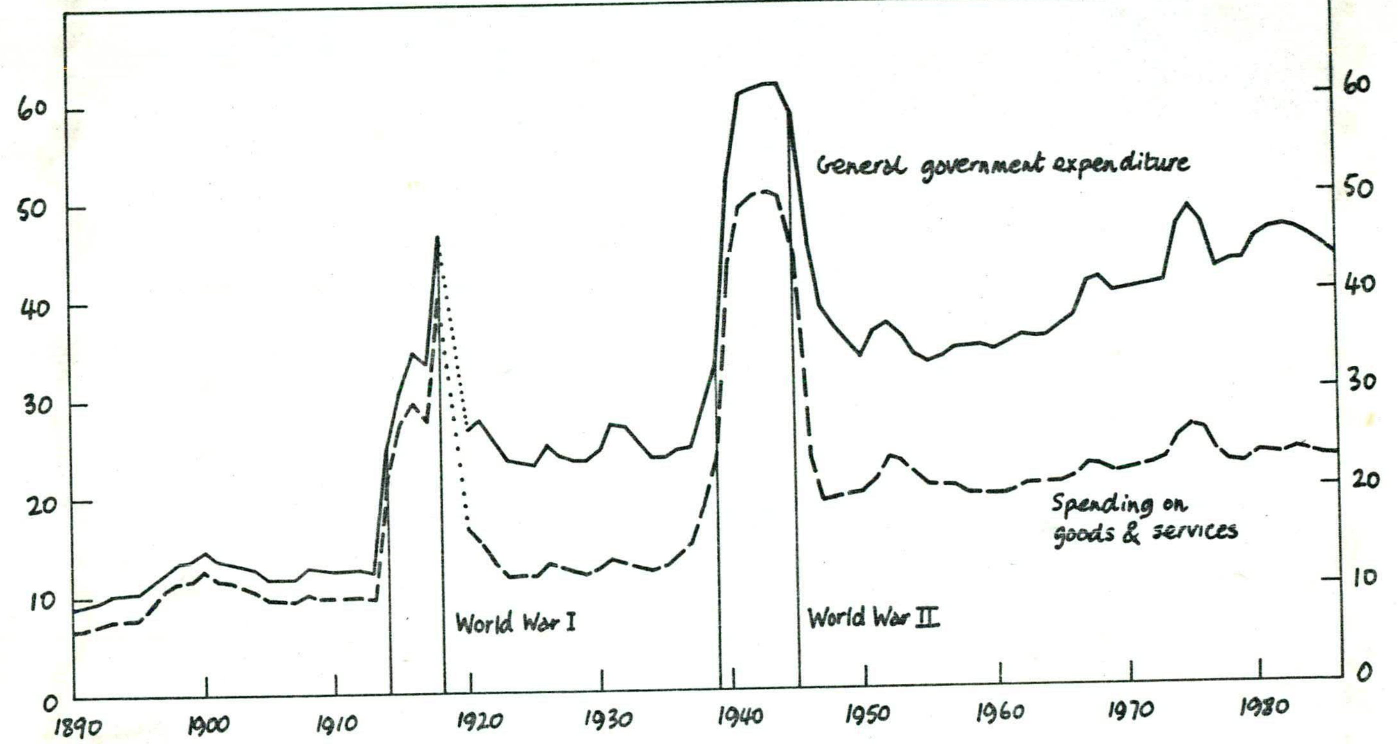
10. There are also alternative measures of GDP available for use in the calculation of the percentage and in fact in the past GNP has often been used, by both the Treasury and outside commentators, rather than GDP. Whether GNP or GDP is adopted there are a number of alternative measures. For example, GDP can be measured in three ways, the expenditure based measure, GDP(E), the income based measure, GDP(I), and the output based measure, GDP(O), and both GNP and GDP can be measured either at factor cost or at market prices. The three measures of GDP are combined to give an average measure, GDP(A), which is the preferred measure for assessing medium and long term changes. The current practice, introduced in the 1984 Autumn Statement, is to use GDP(A) at market prices in the calculation of the percentage. **Appendix 1** gives more detail about the different ways of measuring GDP and GNP.

11. **Chart 2** compares general government expenditure with GDP over the period 1890 to 1986. It also compares general government expenditure on goods and services with GDP. The expenditure figures for the early years (1890 to 1920) are necessarily approximate and some extrapolation has been necessary to derive figures for individual years. Up to 1947 the expenditure data has been extracted from "The growth of public expenditure in the United Kingdom" (A.T. Peacock and J. Wiseman) and the GDP data from "National income, expenditure and output of the United Kigdom, 1855 to 1965." (C.H.Feinstein). Thereafter the figures are taken from data held by the CSO. GDP(A) at market prices is available from the CSO data and has been used as the denominator from 1948 onwards. However for the years prior to 1948 only GDP(E) at market prices is available. The difference between GDP(A) and GDP(E), and the use of alternative

sources for the expenditure data, are likely to result in relatively small differences and these should not effect the overall trends illustrated in **Chart 2**.

12. The figures in **Chart 2** show that many of the peaks coincide with years of war – in particular, the two World Wars (1914 to 1918 and 1939 to 1945). Smaller peaks can be seen at the time of the Boer War (1899 to 1902) and the Korean War (1951 to 1952). The chart shows that government expenditure was less than 15 per cent of GDP before World War I, rising to just under 50 per cent of GDP during the War. Afterwards, the percentage fell but not to its earlier level and between World Wars I and II the percentage fluctuated around 25 per cent. In the slump of the 1930s, it took rearmament to restore the rising trend in government expenditure and eventually the percentage reached its peak during the Second World War rising to around 60 per cent. Again the percentage dropped immediately after the War and has not reached that level since. During the early 1950s the percentage rose a little at the time of the Korean War and there were small peaks in 1966 and the mid 1970s. In 1982 the percentage reached its highest level since the mid 1970s but since then has been continuously falling.

Chart 2 General government expenditure as a percentage of GDP, 1890 to 1986



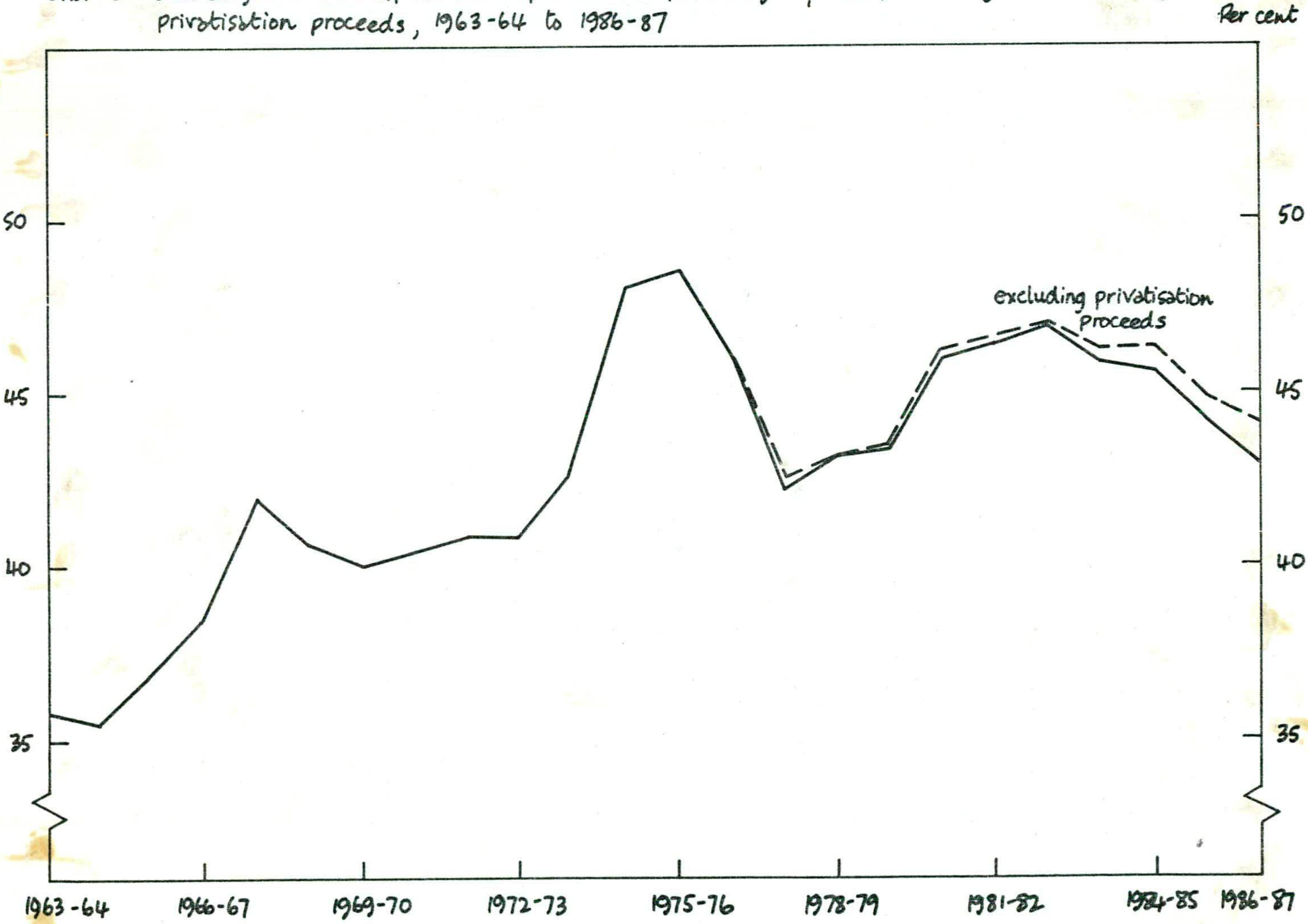
General government expenditure excluding privatisation proceeds as a percentage of GDP

13. Privatisation proceeds have been increasing in recent years and currently amount to about £5 billion. **Chart 3** illustrates the effect of excluding privatisation proceeds from general government expenditure as a percentage of GDP. It shows that even after allowing for increased receipts from privatisation proceeds general

government expenditure excluding privatisation proceeds has been falling as a pecentage of GDP, with a decline of almost 3 percentage points between 1982-83 and 1986-87.

14. The data used to produce the charts in this article are shown in **Tables 1, 2** and **3** in **Appendix 2**. Figures in **Tables 1** and **2** (and hence **Charts 1** and **2**) are based on calender years and those in **Table 3** (and **Chart 3**) are based on financial years.

Chart 3 General government expenditure ~~expressed~~ as a percentage of GDP, including and excluding privatisation proceeds, 1963-64 to 1986-87



Appendix 1

The measures of GDP and GNP used in the calculation of public spending as a percentage of GDP.

1. Public expenditure is often presented as a percentage of GNP as well as GDP. GNP includes the income of United Kingdom residents from economic activity abroad and from property held abroad and excludes the corresponding income in the United Kingdom of non-residents. In practice it is generally more appropriate to compare government spending with domestic output rather than GNP, because GDP is the aggregate more commonly used in macroeconomic management.

2. In addition the definition of GDP used in the calculation of public spending as a percentage of GDP has changed over the years. GDP can be measured in three ways:

i. GDP(E) - the expenditure method sums the current expenditure by UK consumers and government and the additions to fixed capital and stocks and adds on exports minus imports.

ii. GDP(I) - the income method sums income from employment and self-employment and adds on company profits and other trading surpluses.

iii. GDP(O) - the output method sums the value of output of all industries and services.

3. In theory the three measures of GDP are equal but in practice discrepancies occur when producing large estimates by different measures. The average of all three measures is called GDP(A).

4. Up until 1984 GDP(E) was used as the denominator but this was then replaced by GDP(A). GDP(A) was introduced in the 1984 Autumn Statement as the denominator of the percentage to overcome the measuring discrepancies between the three measures and also because the forecasts of GDP used in the Government's Medium Term Financial Strategy are based on GDP(A).

5. GDP can also be measured either at factor cost or at market prices. Market prices are the prices which purchasers pay for the goods and services they acquire or use. Factor cost is market prices less taxes plus subsidies.

6. During the earlier part of the 1970s GDP at factor cost formed the denominator of the percentage. It was argued that if government expenditure is expressed as a percentage of GDP at market prices, rather than at factor cost, year to year comparisons of the resulting percentages could be distorted by changes in indirect taxation. This is because the impact of indirect taxation on government expenditure is small compared to its impact on expenditure by the private consumer and thus on the total expenditure in GDP. This difficulty could be overcome if both government expenditure and GDP were expressed at factor cost. However information is not available on indirect taxes less subsidies for all economic categories of government expenditure, so government expenditure can only be expressed at market prices. Midway through the 1970s the denominator was changed to GDP at market prices.

7. The percentage using GDP is higher than the percentage using GNP, by about half a percentage point. However, there is a larger difference as a result of measuring GDP or GNP at factor cost rather than at market prices where the difference in recent years amounts to about 7 or 8 percentage points.

Appendix 2

Table 1 General government expenditure, 1950 to 1986

£ billion

	Cash	Real terms(1)
1950	4.5	54.8
1951	5.4	59.6
1952	6.0	61.5
1953	6.2	61.8
1954	6.1	60.7
1955	6.5	61.4
1956	7.0	62.7
1957	7.6	65.6
1958	8.0	65.7
1959	8.5	69.0
1960	8.9	72.1
1961	9.8	76.1
1962	10.4	78.2
1963	11.0	81.2
1964	12.0	87.1
1965	13.3	90.3
1966	14.5	93.7
1967	16.7	104.7
1968	18.3	110.5
1969	19.0	109.0
1970	20.9	111.4
1971	23.5	114.7
1972	26.4	119.2
1973	30.5	128.4
1974	39.2	144.0
1975	51.5	148.6
1976	58.5	146.8
1977	61.9	136.3
1978	72.2	143.0
1979	85.5	147.8
1980	104.1	150.2
1981	117.0	151.4
1982	128.6	154.8
1983	138.5	158.5
1984	146.9	161.1
1985	157.6	163.2
1986	162.2	162.2

(1) Cash figures adjusted to 1986 price levels by excluding the effect of general inflation as measured by the GDP deflator.

Source: Central Statistical Office

Table 2. General government expenditure as a percentage of GDP, 1890 to 1986

per cent

	General government expenditure	Spending on goods and services only		General government expenditure	Spending on goods and services only		General government expenditure	Spending on goods and services only
1890	9.0	6.7	1910	12.2	9.7	1930	24.4	12.3
1891	9.1	6.7	1911	12.2	9.8	1931	26.9	13.3
1892	9.6	7.1	1912	12.4	9.9	1932	26.6	12.7
1893	10.0	7.6	1913	12.1	9.8	1933	25.0	12.4
1894	10.0	7.6	1914	24.6	21.8	1934	23.5	12.0
1895	10.2	7.7	1915	30.5	27.6	1935	23.7	12.6
1896	11.3	8.9	1916	34.4	29.7	1936	24.2	13.7
1897	12.6	10.4	1917	33.4	27.9	1937	24.6	14.9
1898	13.3	11.2	1918	46.3	40.4	1938	28.5	18.7
1899	13.8	11.8	1919	*	*	1939	32.9	23.8
1900	14.4	12.6	1920	26.6	16.6	1940	51.9	43.3
1901	13.5	11.6	1921	27.8	15.4	1941	60.4	49.4
1902	13.2	11.2	1922	25.7	13.2	1942	61.1	50.3
1903	12.9	10.8	1923	23.4	11.6	1943	61.4	50.4
1904	12.4	10.3	1924	23.2	11.8	1944	61.4	50.2
1905	11.8	9.6	1925	23.1	11.9	1945	58.8	44.3
1906	11.7	9.5	1926	25.2	13.0	1946	45.5	23.6
1907	11.8	9.5	1927	24.0	12.5	1947	38.8	19.1
1908	12.5	10.0	1928	23.5	12.0	1948	36.3	19.2
1909	12.4	9.9	1929	23.4	12.0	1949	34.8	20.0

	General government expenditure	Spending on goods and services only		General government expenditure	Spending on goods and services only
1950	33.8	20.1	1970	40.1	22.0
1951	36.1	21.2	1971	40.5	22.2
1952	37.2	23.4	1972	40.8	22.4
1953	35.9	23.0	1973	41.1	23.0
1954	33.8	21.8	1974	46.8	25.2
1955	33.0	20.5	1975	48.8	26.6
1956	33.4	20.5	1976	46.9	26.0
1957	34.3	20.2	1977	42.5	23.6
1958	34.4	19.6	1978	43.0	22.7
1959	34.5	19.7	1979	43.3	22.3
1960	34.1	19.4	1980	45.1	23.7
1961	35.1	19.8	1981	46.0	23.6
1962	35.7	20.3	1982	46.4	23.4
1963	35.6	20.3	1983	45.9	23.9
1964	36.0	20.6	1984	45.5	23.7
1965	36.6	20.6	1985	44.5	22.9
1966	37.4	21.2	1986	42.8	22.9
1967	40.9	22.6			
1968	41.4	22.3			
1969	40.0	21.6			

Sources: 1890 to 1947 A.T. Peacock and J. Wiseman - The growth of public expenditure in the United Kingdom.

C.H. Feinstein - National income, expenditure and output of the United Kingdom 1855 to 1965.

1948 to 1986 Central Statistical Office

* Not available

Table 3 General government expenditure as a percentage of GDP, including and excluding privatisation proceeds, 1963-64 to 1986-87

	General government expenditure			General government expenditure excluding privatisation proceeds		
	£ billion			£ billion		
	Cash	Real terms (1)	% of GDP	Cash	Real terms (1)	% of GDP
1963-64	11.3	84.3	35.9	11.3	84.3	35.9
1964-65	12.3	88.1	35.8	12.3	88.1	35.8
1965-66	13.6	91.7	36.8	13.6	91.7	36.8
1966-67	15.1	97.2	38.4	15.1	97.2	38.4
1967-68	17.5	109.7	42.0	17.5	109.7	42.0
1968-69	18.2	109.1	40.5	18.2	109.1	40.5
1969-70	19.3	110.0	40.0	19.3	110.0	40.0
1970-71	21.6	113.6	40.4	21.6	113.6	40.4
1971-72	24.4	117.2	40.9	24.4	117.2	40.9
1972-73	27.6	123.2	40.7	27.6	123.2	40.7
1973-74	31.9	132.9	42.6	31.9	132.9	42.6
1974-75	42.8	149.4	48.0	42.8	149.4	48.0
1975-76	53.7	149.1	48.5	53.7	149.1	48.5
1976-77	59.5	145.8	45.9	59.5	145.8	45.9
1977-78	63.7	137.2	42.2	64.2	138.4	42.6
1978-79	74.8	145.5	43.2	74.8	145.5	43.2
1979-80	89.8	149.4	43.3	90.1	150.1	43.4
1980-81	108.4	152.2	45.9	108.8	152.8	46.0
1981-82	120.5	154.1	46.3	121.0	154.7	46.5
1982-83	132.5	158.1	46.7	133.0	158.6	46.8
1983-84	140.1	159.7	45.6	141.2	161.0	46.0
1984-85	150.1	164.0	45.6	152.2	166.3	46.2
1985-86	158.3	163.0	43.8	161.0	165.8	44.6
1986-87	165.1	165.1	42.9	169.5	169.5	44.0

(1) Cash figures adjusted to 1986-87 price levels by excluding the effect of general inflation as measured by the GDP deflator.

Source: Central Statistical Office

FROM: R B SAUNDERS

DATE: 5 October 1987

PPS

cc PS/Chief Secretary
PS/Managerial Secretary
PS/Paymaster General
PS/Economic Secretary
F E R Butler
A Wilson
Mr Anson
Mr Scholar
Mr Turnbull
Mr Spackman
Mr Odling-Smee
Mr Culpin
Mr Gieve
Mrs R J Butler
Mr Pratt
G C White
Miss Walker
Mr Towers
Miss Chapman
Mrs Sigler
Mr Tyrie
Mr Kenny-CSO

This article has clearly been AS/FSBR thorough-goings. But I will be attracted to PPS's suggested improvements. There is always scope for improvement. See also paper below.

LONG TERM TRENDS IN PUBLIC EXPENDITURE

Sir Peter Middleton has seen Mr White's minute of 2 October. He thinks the terms "including privatisation proceeds" and "excluding privatisation proceeds" in the charts are confusing. Something more precise is needed.

RBS

R B SAUNDERS

MR 2/20

cc: Sir P Middleton
Mr R Griffiths
Mr Butler
Ms Boys
Mr Meadows

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

LORD PRIVY SEAL

TRANSFER OF RESPONSIBILITY FOR THE CHEQUERS TRUST

I am writing to you in your role as Chairman of the Board of Administrative Trustees to seek your agreement to the transfer of responsibility for the Trust from the Treasury to the Minister for the Civil Service.

The grant in aid to the Chequers Trust is currently provided from the Treasury Vote. The other costs of the Prime Minister's residences and her office are currently met by the Management and Personnel Office and will be transferred to the new Office of the Minister for the Civil Service. I think that responsibility for the Prime Minister's office and residences should be concentrated on the one Vote.

I propose therefore that, when the new Office is created, responsibility for the Trust should be transferred to the Minister for the Civil Service.

This change will not affect the status or running of the Trust and I hope you can agree that I should invite the Prime Minister to concur.

I am sending a copy of this to Richard Luce.

NL

N.L.

5 October 1987

Ch/

Minute to PM below.

JT

15/10

Ch/Minister

CH/EXCHEQUER
REC. 13 OCT 1987 13/10
~~ACTION~~ Sir P Middleton
COPIES TO Mr R Griffiths
Mr Butler
Ms Boys
Mr Meadows

CHANCELLOR OF THE EXCHEQUER

TRANSFER OF RESPONSIBILITY FOR THE CHEQUERS TRUST

Thank you for your minute of 5 October about transferring responsibility for the Trust from the Treasury to the Minister for the Civil Service. I am content with your proposal and agree that you should invite the Prime Minister to concur with it.

I am sending a copy of this to Richard Luce.

JW

12 October 1987

2130/2

SECRET & PERSONAL

SCORECARD
Copy No 3 of 16 Copies

FROM: A TURNBULL
DATE: 16 OCTOBER 1987

CHIEF SECRETARY +1

cc Chancellor
Sir P Middleton
Mr F E R Butler
Mr Anson
Mr Monck
Mr Luce
Mr Gieve
Mr Sedgwick
Mr Mowl
Mr Hansford
Mr Tyrie
Miss Walker

Mr X, pse [illegible] me of comparable 20s for 1978-79, 1977-78, 1973-74, 1972-73, 1971-72, 1970-71.
[illegible]

THE SURVEY SCORECARD

I attach our latest Scorecard at Annex A and at Annex B a table showing the changes since the version Mr Gieve sent up on Wednesday. It is in much the same format as the tables for Star Chamber but includes the forecast outcomes on Aid and the programmes still being considered bilaterally.

2. The overall increases to programmes are £4.7/6.3/8.1 billion, increases of £0.1/0.5/0.5 billion on the last report. These increases reflect principally:

i. revised economic assumptions on interest rates and the RPI (now assumed to be 4¾ for the year to September 1988) adding £60/395/440;

ii. the health settlement which was £30/40/50 over the previous Scorecard outcome - a better outcome that it looks as this is despite a higher GDP deflator and it requires Mr Moore to earmark £50 million more a year for future pay, money we may well have had to concede anyway;

iii. the settlement on the Wales industry programme where an extra £8/9/12 million was conceded;

iv. higher estimates of the LAPR/MIRAS of £10/20/30 million.

Implications for the planning totals

3. On the basis of reserves of 4/7/10 (we are due to put a submission to you and the Chancellor on this for decisions next week) the Scorecard would point to increases in the published planning totals of £3.2 billion in 1988-89 and £5.8 billion in 1989-90 before taking account of any changes in privatisation proceeds (or £2.7 billion and £5.3 billion if privatisation proceeds were projected at £5½ billion a year - see below).

Real growth rates and ratios to GDP

4. In order to illustrate the implications for growth rates and ratios we need to make assumptions about:

a. **Privatisation proceeds.** The Chancellor has a meeting next week to discuss Mr Moore's submission of 8 October; we have assumed below a figure of £5½ billion in each year;

b. **Debt interest and national accounts adjustments.** The forecast is being reworked to take account of the decisions the Chancellor has made on interest rates, inflation and the PSBR. GEP will be discussing the outcome with the forecasters on Tuesday. The Chancellor has indicated that we should follow the same course as in the last Autumn Statement and not identify debt interest and the adjustment separately. We have assumed below £25.5 billion in 1987-88 and £26 billion in each of the next three years.

c. **GDP deflator.** The Chancellor has now decided to publish increases of 4¼ per cent in 1987-88 and 4½ per cent in 1988-89.

d. **Money GDP.** The forecasters are likely to recommend increases of 8¾ per cent in 1987-88 and 8 per cent in 1988-89.

e. **Outturn in 1987-88.** The Chancellor has decided to publish a shortfall on the planning total of £1¼ billion, of which £¼ billion corresponds to higher privatisation receipts and £1 billion to higher local authority and new towns receipts.

5. On these assumptions, the published growth rates in public expenditure and the ratios to GDP would be as follows:

		87-88	88-89	89-90	90-91	87-88 to 90-91
PT (inc pp)	- percentage real growth	1.4	1.9	2.7	2.2	2.3
GGE (exc pp)	- percentage real growth	1.4	1.2	1.7	1.4	1.4
X	- percentage of GDP	42½	41¾	41¼	41	
	[PEWP 1987	44	42¾	42¼	-]	

6. A number of features of this outlook are worth nothing. On the basis of the assumptions above (a number of which may change):

i. the real terms growth rate in the published planning total looks like being 2¼ per cent a year;

ii. the real terms increase in GGE (excluding privatisation proceeds) about 1½ per cent a year - and there is now no longer any significant difference between the figures based on 1986-87 and 1987-88;

iii. the ratios decline by ¾ percentage points between 1987-88 and 1988-89, ½ percentage point in the next year and ¼ percentage point in the final year;

iv. the path for the ratios is below that in the PEWP by 1½ percentage points in 1987-88 and 1 per cent in the two succeeding years.

AT

A TURNBULL

ANNEX

SECRET
SUMMARY SCORECARD

Date of last update: 16/10/87

(£million)

	1988-89 BASELINE	1988-89 DEPT POSITION	1988-89 OUTCOME	1988-89 HMT POSITION	1989-90 BASELINE	1989-90 DEPT POSITION	1989-90 OUTCOME	1989-90 HMT POSITION	1990-91 BASELINE	1990-91 DEPT POSITION	1990-91 OUTCOME	1990-91 HMT POSITION
TOTAL ALREADY AGREED	147,739.3	4,509.5	4,509.5	4,509.5	152,868.1	6,049.6	6,049.6	6,049.6	156,637.9	7,779.1	7,779.1	7,779.1
BEING CONSIDERED BY GROUP												
FCO - Overseas Development Administration	1,399.0	76.8	31.2	16.0	1,441.0	152.1	51.6	21.3	1,477.0	232.2	71.7	28.4
STILL IN BILATERAL DISCUSSIONS												
Ministry of Agriculture, Fisheries and Food	747.0	34.2	31.3	28.3	749.0	38.7	36.5	33.5	768.0	30.1	30.1	30.1
Other Departments	604.0	35.5	29.8	9.1	620.0	63.8	41.9	20.8	636.0	117.2	91.1	61.5
Chancellor's Departments (excl LAPR/MIRAS)	2,069.0	137.6	94.5	80.7	2,149.0	185.9	93.6	76.2	2,203.0	220.5	99.2	76.8
TOTAL ADDITIONS TO PROGRAMMES	152,558.8	4,793.6	4,696.3	4,643.6	157,827.1	6,490.1	6,273.2	6,201.4	161,721.9	8,379.1	8,071.2	7,975.9

ANNEX B

SECRET 16/10/87

SUMMARY OF CHANGES IN FORECAST OUTCOME SINCE LAST SCORECARD

	1988-89 CHANGE IN FORECAST OUTCOME	1989-90 CHANGE IN FORECAST OUTCOME	1990-91 CHANGE IN FORECAST OUTCOME
Ministry of Defence	0.0	0.0	0.0
FCO - Overseas Development Administration	0.0	0.0	0.0
FCO - Diplomatic, Information, Culture	0.0	0.0	0.0
European Communities	0.0	0.0	0.0
Intervention Board for Agricultural Produce	0.0	0.0	0.0
Ministry of Agriculture, Fisheries and Food	0.0	0.0	0.0
Forestry Commission	0.0	0.0	0.0
Department of Trade and Industry	0.0	0.0	0.0
Export Credits Guarantee Department	60.0	-10.0	15.0
Department of Energy	0.0	0.0	0.0
Department of Employment	0.0	0.0	0.0
Department of Transport	0.0	0.0	0.0
DOE - Housing	0.0	0.0	0.0
DOE - Other Environmental Services	0.0	0.0	0.0
DOE - Property Services Agency	0.0	0.0	0.0
Home Office	0.0	0.0	0.0
Lord Chancellor's Department	0.0	0.0	0.0
Department of Education and Science	0.0	0.0	0.0
Office of Arts and Libraries	0.0	0.0	0.0
DHSS - Health and Personal Social Services	30.0	40.0	50.0
DHSS - Social Security	0.0	405.0	425.0
Scotland	3.5	4.7	5.9
Wales	9.8	11.1	12.6
Northern Ireland	-1.0	1.2	1.6
Chancellor's Departments	0.0	0.0	0.0
LAPR/MIRAS	10.0	20.0	30.0
Other Departments	0.0	0.0	0.0
Nationalised Industries	0.0	0.0	0.0
Local Authority Relevant	0.0	0.0	0.0
TOTAL ADDITIONS TO PROGRAMMES	112.3	472.0	540.1

BF 19/10

MINISTER OF STATE, PRIVY COUNCIL OFFICE

CH/EXCHEQUER	16/10
REC.	16 OCT 1987
ACTION	MR C.D. BUTLER
COPIES TO	SIR P MIDDLETON
	MR L. GRIFFITHS
	MS BOYS
	MR MEADOWS

C87/4246

CHANCELLOR OF THE EXCHEQUER

TRANSFER OF RESPONSIBILITY FOR THE CHEQUERS TRUST

Thank you for sending me a copy of your minute of 5 October. I am content with your proposal, on the understanding that the change of responsibility would be accompanied by an appropriate transfer of PES provision from the Treasury to the OMCS Vote.

I am sending a copy of this to John Wakeham.

Richard Luce

RICHARD LUCE

16 October 1987

RC6.33

SECRET AND PERSONAL ?

FROM: CATHY RYDING
DATE: 19 October 1987

MR TURNBULL

cc PS/Chief Secretary

THE SURVEY SCORECARD

The Chancellor has seen your minute to the Chief Secretary of 16 October.

2. The Chancellor has noted the figures for public expenditure as a percent of GDP given in paragraph 5, and would be grateful to be reminded of comparable percentages for 1978-79, 1977-78, 1973-74, 1972-73, 1971-72 and 1970-71.

CR

CATHY RYDING

cc PS/CST

Mrs Ryding.

The figures the Chancellor wants (and more) are contained in the draft article for Economic Trends attached, in particular = Table 3. — At X

AT
19/10

Thanks.

MOM: 2. So 1987-88 ~~[illegible]~~ is ~~[illegible]~~ clearly the lowest since 1977-78, & perhaps since 1972-73.

3. And I take it that this is the 1st govt for a v. long time under which the ratio has fallen. How low? N.

815

Long term trends in public expenditure

Graham White and Helen Chapman, HM Treasury

Introduction

There are a number of different measures of public spending. A key measure is general government expenditure (the combined spending of central and local government including both capital and current spending plus net lending). This is useful for analysing overall trends in public spending, and in the formulation of macro-economic policy. It is broadly a measure of the amount which the Government has to raise by taxation and borrowing and is the key public spending aggregate used in the Medium Term Financial Strategy.

2. General government expenditure differs in a number of respects from the public expenditure planning total, the other key public spending aggregate which is used by the Government in its annual review of detailed public expenditure plans and forms the basis of the control totals set each year. The main differences in coverage are the inclusion in general government expenditure of gross debt interest and the finance which public corporations raise direct from the market rather than from Government. Other differences are explained in more detail in an Annex to Part 2 of the 1987 public expenditure White Paper (Cm 56-II) and in the Financial Statistics Explanatory Handbook.

3. This article discusses long term trends in public expenditure and concentrates on general government expenditure. The national accounts include detailed figures of government spending, which comprises a number of different elements. General government expenditure on goods and services is the government's direct contribution to the expenditure measure of GDP; total current and capital expenditure also includes interest payments and transfer payments such as subsidies and grants; and general government expenditure in total also includes net lending. Figures for general government expenditure are published in the Blue Book (United Kingdom National Accounts) and Financial Statistics.

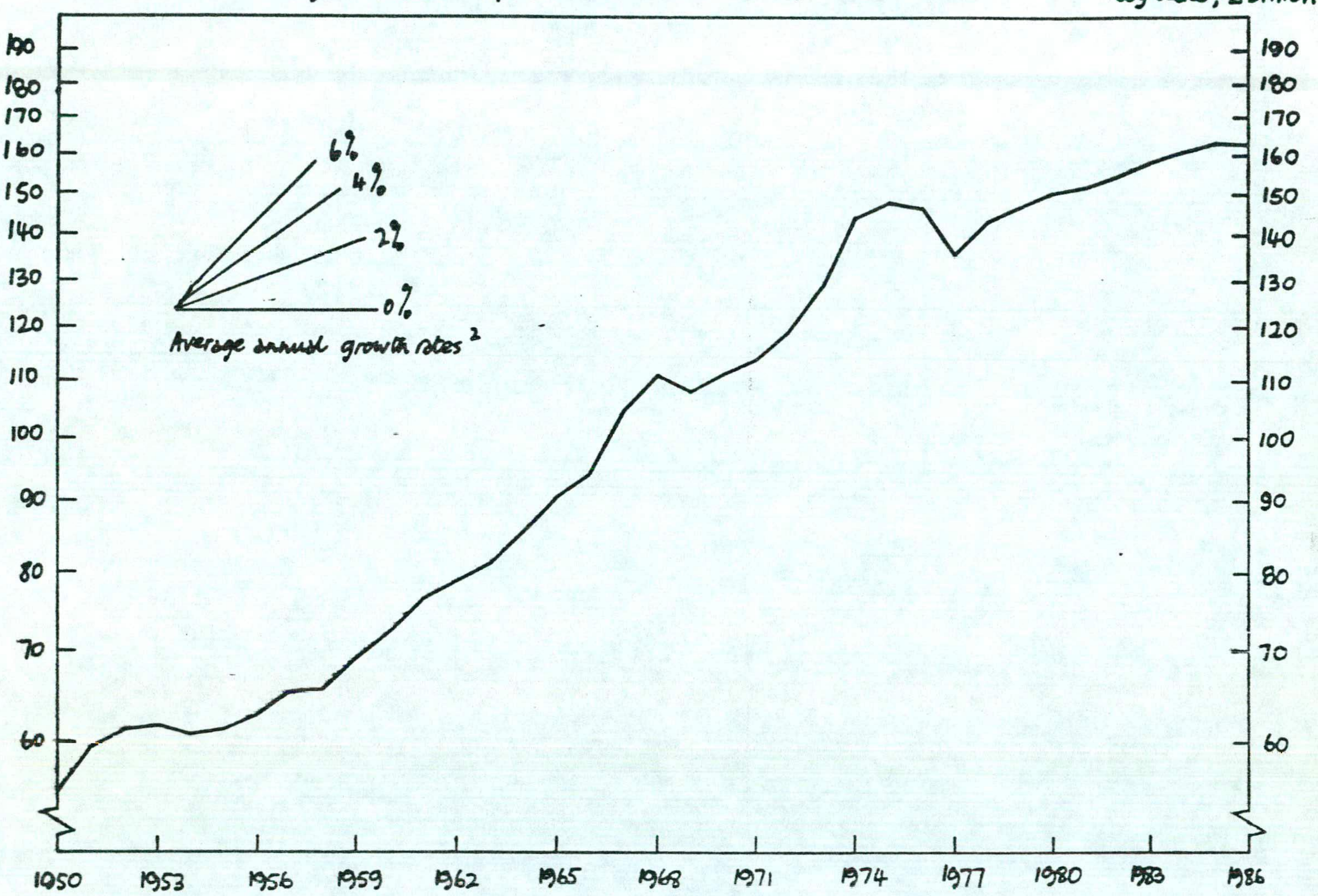
General government expenditure since 1950

4. The Central Statistical Office (CSO) has a consistent series of general government expenditure figures back to the late 1940s. **Chart 1** shows general government expenditure from 1950 to 1986 in real terms. Real terms figures are the cash figures adjusted to 1986 price levels by excluding the effect of general inflation as measured by the GDP deflator.

5. General government expenditure has increased in real terms over the years, showing a small peak in 1968 and a much larger peak in the mid-1970s. After the peak in 1968 efforts were made to reduce government expenditure in 1969, mainly by the acceleration of the withdrawal of British forces east of Suez, a postponement of the general increase in social security benefits, and deferment by two years of the raising of the school leaving age. As a result government expenditure fell in real terms, but soon started to follow

an upward trend again to reach the peak of the mid-1970s. Following negotiations with the International Monetary Fund (IMF) in the latter half of 1976, public expenditure plans for 1977-78 were revised downwards by £1 billion and it was announced that £500 million of government-owned shares in the British Petroleum Company were to be sold in 1977-78. (The proceeds from the sale counted as negative expenditure). The planned reductions were spread across most public expenditure programmes but actual expenditure in 1977-78 was even lower than expected - about £4 billion below the revised plans set in January 1977. Much of this was due to underspending which was difficult to forecast in advance. This reduction in spending coincided with the introduction of cash limits in 1976.

Chart 1 General government expenditure in real terms[1], 1950 to 1986 log scale, £ billion



[1] Real terms figures are the cash figures adjusted to 1986 price levels by excluding the effect of general inflation as measured by the GDP deflator.

[2] The different slopes of the lines represent different rates of annual growth. The steeper the gradient the greater the growth rate. By comparing the slopes with particular sections of the graph the reader can determine the appropriate rate of annual growth over that period.

6. Since the reduction in the late 1970s general government expenditure continued to increase in real terms, but at a slower rate. Over this period the main increases have been on employment measures, defence, social security, law and order and the health service. In other areas there have been reductions. Spending on public sector housing and subsidies to trade, industry and energy have fallen substantially. This is a reflection of Government policies for sales of publicly owned houses and for a greater share of housing needs to be provided by the private sector, and for support

to both private and public sector industry to be reduced as profitability increases.

7. During the 1950s general government expenditure rose in real terms by about 2¾ per cent a year. This increased to 4½ per cent a year in the 1960s and 3 per cent a year in the 1970s but has now fallen to 1¼ per cent a year since 1980. Since 1982-83 the average annual growth rate has been about 1¼ per cent a year and even after excluding privatisation proceeds, in order to show the underlying trend, the rate has been 1¾ per cent a year, lower than the corresponding rates in the 1950s, 1960s and 1970s.

General government expenditure as a percentage of GDP since 1890

8. General government expenditure is often expressed as a percentage of GDP. This compares growth in government spending with growth in the economy. It does not represent the share of GDP "consumed" by government, as public spending includes transfer payments, such as grants and loans, which transfer spending power to the private sector. The government's own consumption is measured by public spending on goods and services only. However, the larger measure shows the extent to which the government has to raise taxation and borrow on financial markets to finance its activities and is the statistic most widely used in discussion of public spending comparisions with GDP.

9. The definition of public expenditure used in the comparison with GDP has varied over the years. The different definitions which have been used in Treasury documents are discussed in an article in the August 1985 edition of Economic Trends. General government expenditure was introduced as the numerator of the GDP percentage in the 1984 Green Paper on long term spending and is now the measure of expenditure used in Government publications.

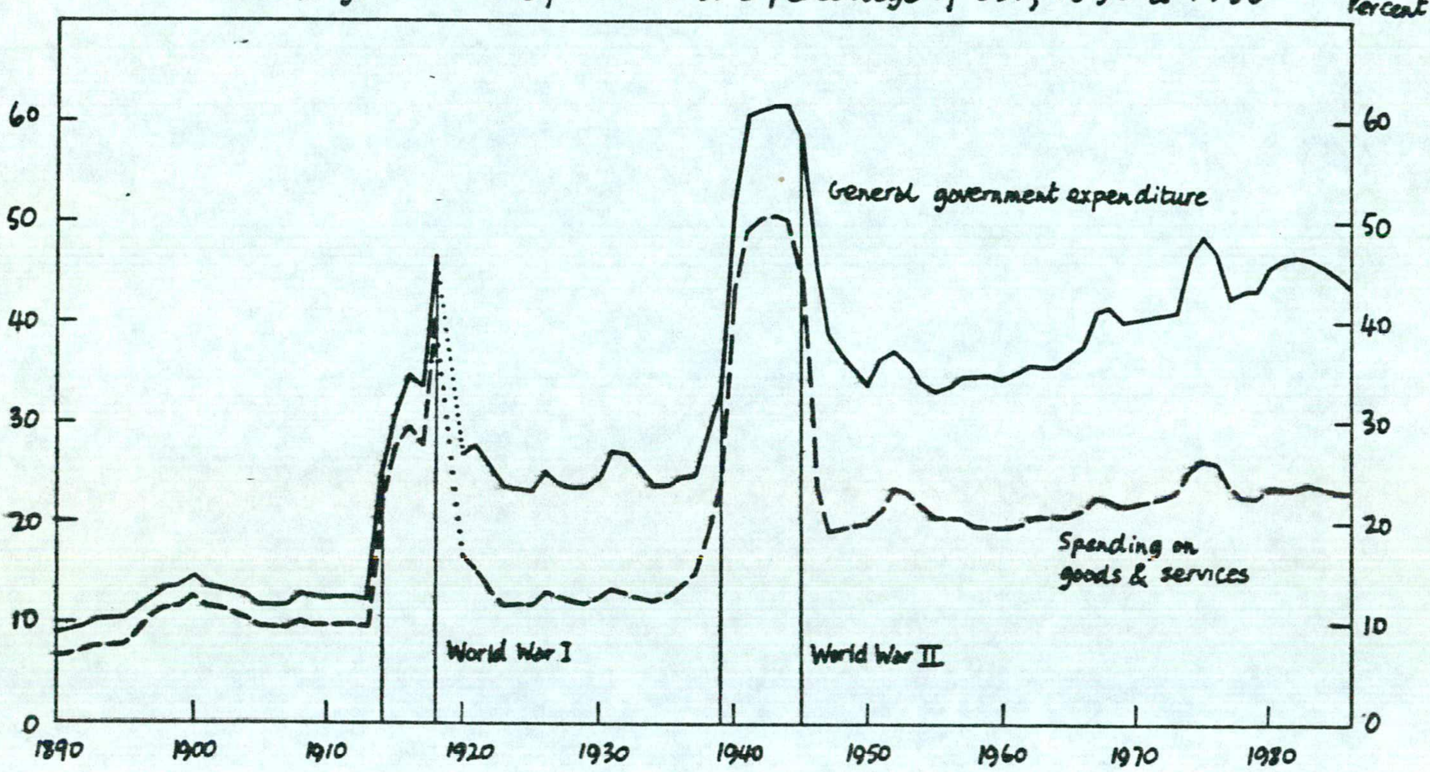
10. There are also alternative measures of GDP available for use in the calculation of the percentage and in fact in the past GNP has often been used, by both the Treasury and outside commentators, rather than GDP. Whether GNP or GDP is adopted there are a number of alternative measures. For example, GDP can be measured in three ways, the expenditure based measure, GDP(E), the income based measure, GDP(I), and the output based measure, GDP(O), and both GNP and GDP can be measured either at factor cost or at market prices. The three measures of GDP are combined to give an average measure, GDP(A), which is the preferred measure for assessing medium and long term changes. The current practice, introduced in the 1984 Autumn Statement, is to use GDP(A) at market prices in the calculation of the percentage. **Appendix 1** gives more detail about the different ways of measuring GDP and GNP.

11. **Chart 2** compares general government expenditure with GDP over the period 1890 to 1986. It also compares general government expenditure on goods and services with GDP. The expenditure figures for the early years (1890 to 1920) are necessarily approximate and some interpolation has been necessary to derive figures for individual years. Up to 1947 the expenditure data have been extracted from "The growth of public expenditure in the United Kingdom" (A.T. Peacock and J. Wiseman) and the GDP data from "National income, expenditure and output of the United Kingdom, 1855 to 1965." (C.H.Feinstein). Thereafter the figures are taken from data held by the CSO. GDP(A) at market prices is available from the CSO and has been used as the denominator from 1948 onwards. However for the years prior to 1948 only GDP(E) at market prices is available. The difference between GDP(A) and GDP(E), and the use of alternative sources for the expenditure data, are likely to result in relatively small differences and these should not affect the overall

trends illustrated in **Chart 2.**

12. **Chart 2** shows that many of the peaks coincide with years of war – in particular, the two World Wars (1914 to 1918 and 1939 to 1945). Smaller peaks can be seen at the time of the Boer War (1899 to 1902) and the Korean War (1951 to 1952). The chart shows that government expenditure was less than 15 per cent of GDP before World War I, rising to just under 50,per cent of GDP during the War. Afterwards, the percentage fell but not to its earlier level and between World Wars I and II the percentage fluctuated around 25 per cent. In the slump of the 1930s, it took rearmament to restore the rising trend in government expenditure and eventually the percentage reached its peak during the Second World War rising to around 60 per cent. Again the percentage dropped immediately after the War and has not reached that level since. During the early 1950s the percentage rose a little at the time of the Korean War and there were small peaks in 1966 and the mid 1970s. In 1982 the percentage reached its highest level since the mid 1970s but since then has been continuously falling.

Chart 2 General government expenditure as a percentage of GDP, 1890 to 1986



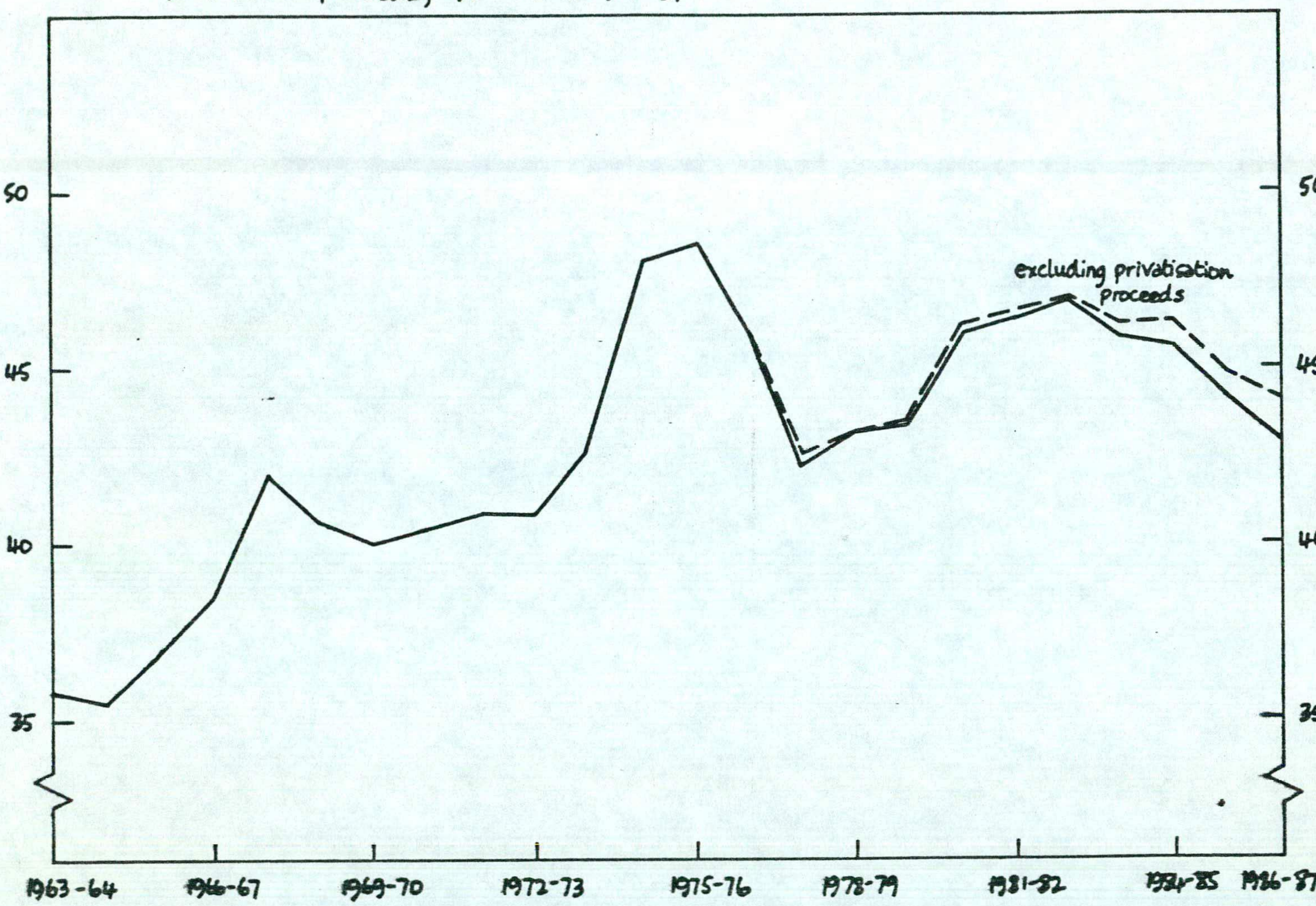
Effect of privatisation proceeds on general government expenditure as a percentage of GDP

13. Receipts from the privatisation programme, which reduce general government expenditure, have been increasing in recent years and currently amount to about £5 billion a year. **Chart 3** shows that even after taking them out of the figures general government expenditure has been falling as a pecentage of GDP, with a decline of almost 3 percentage points between 1982–83 and 1986–87.

14. The data used to produce the charts in this article are shown in **Tables 1, 2 and 3** in **Appendix 2**. Figures in **Tables 1 and 2** (and hence **Charts 1 and 2**) are based on calendar years and those in **Table 3** (and **Chart 3**) are based on financial years.

Chart 3 General government expenditure ~~expressed~~ as a percentage of GDP, ~~including and excluding privatisation proceeds~~ 1963-64 to 1986-87

Per cent



Appendix 1

The measures of GDP and GNP used in the calculation of public spending as a percentage of GDP.

1. Public expenditure is often presented as a percentage of GNP instead of GDP. GNP includes the income of United Kingdom residents from economic activity abroad and from property held abroad and excludes the corresponding income in the United Kingdom of non-residents. In practice it is generally more appropriate to compare government spending with domestic output rather than GNP, because GDP is the aggregate more commonly used in macroeconomic management.

2. In addition the definition of GDP used in the calculation of public spending as a percentage of GDP has changed over the years. GDP can be measured in three ways:

i. GDP(E) – the expenditure method – sums the current expenditure by UK consumers and government and the additions to fixed capital and stocks and adds on exports minus imports.

ii. GDP(I) – the income method – sums income from employment and self-employment and adds on company profits and other trading surpluses.

iii. GDP(O) – the output method – sums the value of output of all industr and services.

3. In theory the three measures of GDP are equal but in practice discrepancies occur. The average of all three measures is called GDP(A).

4. Until 1984 GDP(E) was used as the denominator but this was then replaced by GDP(A). GDP(A) was introduced in the 1984 Autumn Statement as the denominator of the percentage to overcome the discrepancies between the three measures and also because the forecasts of GDP used in the Government's Medium Term Financial Strategy are based on GDP(A).

5. GDP can also be measured either at factor cost or at market prices. Market prices are the prices which purchasers pay for the goods and services they acquire or use. Factor cost is market prices less taxes on expenditure plus subsidies.

6. During the earlier part of the 1970s GDP at factor cost formed the denominator of the percentage. It was argued that if government expenditure is expressed as a percentage of GDP at market prices, rather than at factor cost, year to year comparisons of the resulting percentages could be distorted by changes in indirect taxation. This is because the impact of indirect taxation on government expenditure is small compared to its impact on expenditure by the private consumer and thus on the total expenditure in GDP. This difficulty could be overcome if both government expenditure and GDP were expressed at factor cost. However information is not available on indirect taxes less subsidies for all economic categories of government expenditure, so government expenditure can only be expressed at market prices. Midway through the 1970s the denominator was changed to GDP at market prices.

7. The percentage using GDP is higher than the percentage using GNP, by about half a percentage point. However, there is a larger difference as a result of measuring GDP or GNP at factor cost rather than at market prices where the difference in recent years amounts to about 7 or 8 percentage points.

Appendix 2

Table 1. General government expenditure, 1950 to 1986

£ billion

	Cash	Real terms(1)
1950	4.5	54.8
1951	5.4	59.6
1952	6.0	61.5
1953	6.2	61.8
1954	6.1	60.7
1955	6.5	61.4
1956	7.0	62.7
1957	7.6	65.6
1958	8.0	65.7
1959	8.5	69.0
1960	8.9	72.1
1961	9.8	76.1
1962	10.4	78.2
1963	11.0	81.2
1964	12.0	87.1
1965	13.3	90.3
1966	14.5	93.7
1967	16.7	104.7
1968	18.3	110.5
1969	19.0	109.0
1970	20.9	111.4
1971	23.5	114.7
1972	26.4	119.2
1973	30.5	128.4
1974	39.2	144.0
1975	51.5	148.6
1976	58.5	146.8
1977	61.9	136.3
1978	72.2	143.0
1979	85.5	147.8
1980	104.1	150.2
1981	117.0	151.4
1982	128.6	154.8
1983	138.5	158.5
1984	146.9	161.1
1985	157.6	163.2
1986	162.2	162.2

(1) Cash figures adjusted to 1986 price levels by excluding the effect of general inflation as measured by the GDP deflator.

Source: Central Statistical Office

Table 2. General government expenditure as a percentage of GDP, 1890 to 1986

per cent

	General government expenditure	Spending on goods and services only		General government expenditure	Spending on goods and services only		General government expenditure	Spending on goods and services only
1890	9.0	6.7	1910	12.2	9.7	1930	24.4	12.3
1891	9.1	6.7	1911	12.2	9.8	1931	26.9	13.3
1892	9.6	7.1	1912	12.4	9.9	1932	26.6	12.7
1893	10.0	7.6	1913	12.1	9.8	1933	25.0	12.4
1894	10.0	7.6	1914	24.6	21.8	1934	23.5	12.0
1895	10.2	7.7	1915	30.5	27.7	1935	23.7	12.6
1896	11.3	8.9	1916	34.4	29.7	1936	24.2	13.7
1897	12.6	10.3	1917	33.4	27.9	1937	24.7	14.9
1898	13.3	11.2	1918	46.3	40.4	1938	28.5	18.7
1899	13.8	11.8	1919	*	*	1939	32.9	23.8
1900	14.4	12.6	1920	26.6	16.6	1940	51.9	43.3
1901	13.5	11.6	1921	27.9	15.4	1941	60.4	49.4
1902	13.2	11.2	1922	25.7	13.2	1942	61.1	50.3
1903	12.9	10.8	1923	23.4	11.6	1943	61.4	50.4
1904	12.4	10.3	1924	23.2	11.8	1944	61.4	50.3
1905	11.8	9.6	1925	23.1	11.9	1945	58.8	44.3
1906	11.7	9.5	1926	25.2	13.0	1946	45.5	23.6
1907	11.8	9.5	1927	24.0	12.5	1947	38.8	19.1
1908	12.5	10.1	1928	23.5	12.0	1948	36.3	19.2
1909	12.4	9.9	1929	23.4	12.0	1949	34.8	20.0

	General government expenditure	Spending on goods and services only		General government expenditure	Spending on goods and services only
1950	33.8	20.1	1970	40.1	22.0
1951	36.1	21.2	1971	40.5	22.2
1952	37.2	23.4	1972	40.8	22.4
1953	35.9	23.0	1973	41.1	23.0
1954	33.8	21.8	1974	46.8	25.2
1955	33.0	20.5	1975	48.8	26.6
1956	33.4	20.5	1976	46.9	26.0
1957	34.3	20.2	1977	42.5	23.6
1958	34.4	19.6	1978	43.0	22.7
1959	34.5	19.7	1979	43.3	22.3
1960	34.1	19.4	1980	45.1	23.7
1961	35.1	19.8	1981	46.0	23.6
1962	35.7	20.3	1982	46.4	23.4
1963	35.6	20.3	1983	45.9	23.9
1964	36.0	20.6	1984	45.5	23.7
1965	36.6	20.6	1985	44.5	22.9
1966	37.4	21.2	1986	42.8	22.9
1967	40.9	22.6			
1968	41.4	22.3			
1969	40.0	21.6			

Sources: 1890 to 1947 A.T. Peacock and J. Wiseman - The growth of public expenditure in the United Kingdom.

C.H. Feinstein - National income, expenditure and output of the United Kingdom 1855 to 1965.

1948 to 1986 Central Statistical Office

* Not available

able 3. General government expenditure as a percentage of GDP, 1963-64 to 1986-87

	General government expenditure			General government expenditure excluding privatisation proceeds		
	£ billion			£ billion		
	Cash	Real terms (1)	% of GDP	Cash	Real terms (1)	% of GDP
1963-64	11.3	84.3	35.9	11.3	84.3	35.9
1964-65	12.3	88.1	35.8	12.3	88.1	35.8
1965-66	13.6	91.7	36.8	13.6	91.7	36.8
1966-67	15.1	97.2	38.4	15.1	97.2	38.4
1967-68	17.5	109.7	42.0	17.5	109.7	42.0
1968-69	18.2	109.1	40.5	18.2	109.1	40.5
1969-70	19.3	110.0	40.0	19.3	110.0	40.0
1970-71	21.6	113.6	40.4	21.6	113.6	40.4
1971-72	24.4	117.2	40.9	24.4	117.2	40.9
1972-73	27.6	123.2	40.7	27.6	123.2	40.7
1973-74	31.9	132.9	42.6	31.9	132.9	42.6
1974-75	42.8	149.4	48.0	42.8	149.4	48.0
1975-76	53.7	149.1	48.5	53.7	149.1	48.5
1976-77	59.5	145.8	45.9	59.5	145.8	45.9
1977-78	63.7	137.2	42.2	64.2	138.4	42.6
1978-79	74.8	145.5	43.2	74.8	145.5	43.2
1979-80	89.8	149.4	43.3	90.1	150.1	43.4
1980-81	108.4	152.2	45.9	108.8	152.8	46.0
1981-82	120.5	154.1	46.3	121.0	154.7	46.5
1982-83	132.5	158.1	46.7	133.0	158.6	46.8
1983-84	140.1	159.7	45.6	141.2	161.0	46.0
1984-85	150.1	164.0	45.6	152.2	166.3	46.2
1985-86	158.3	163.0	43.8	161.0	165.8	44.6
1986-87	165.1	165.1	42.9	169.5	169.5	44.0
1987-88				178.4		42.5

(1) Cash figures adjusted to 1986-87 price levels by excluding the effect of general inflation as measured by the GDP deflator.

Source: Central Statistical Office

RJ8.94

PM

cc Sir P Middleton
Mr Griffiths
Ms Boys
Mr Meadows
Mr C D Butler

19/10/87.

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

PRIME MINISTER

TRANSFER OF RESPONSIBILITY FOR THE CHEQUERS TRUST

Financial responsibility for the grant in aid to the Chequers Trust currently rests with the Treasury. With his agreement, I suggest that it should be transferred to the Office of the Minister for the Civil Service.

The grant in aid to the Chequers trust meets the deficiency between income from the Chequers Trust and the total maintenance costs of Chequers. The grant currently accounts for 79 per cent of the cost.

The existing Management and Personnel Office is already responsible for the other costs of your office and official residences. When its title changes to the Office of the Minister for the Civil Service certain functions will be transferred to the Treasury. I should like to use that occasion to transfer responsibility for the Chequers Trust. This will concentrate expenditure and accountability on one Vote. The Lord Privy Seal, as Chairman of the Trustees, is content with this proposal.

This change will require no transfer of staff or public announcement. A Transfer of Functions Order is needed to transfer the powers in Section 2 of the Chequers Estate Act 1958 from the Treasury to the Minister for the Civil Service. But this can be included in the Order which is needed to transfer functions from the Minister for the Civil Service to the Treasury.

I should be grateful for your authority to proceed with this transfer, to take effect at the same time as the other changes. I am sending a copy of this minute to the Lord Privy Seal, the Secretary of State for the Environment, who appoints one trustee, the Minister of State, Privy Council Office and Sir Robert Armstrong.

NL

N.L.

19 October 1987

2130/10

Papers Pse

Thanks. Possible AS, for use in Mansion House/ Budget speech.

FROM: A TURNBULL
DATE: 21 OCTOBER 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Miss O'Mara
Mr Gieve
Mr G C White

PUBLIC EXPENDITURE AS A SHARE OF GDP

You asked when was the last government which left office with public spending at a lower share of national income than when it came in. The answer can be derived from tables 2 and 3 of the White/Chapman article for Economic Trends.

2. In the inter war period, GGE as a proportion of GDP showed no trend fluctuating in the range of 23-27 per cent of GDP until rearmament started around 1937.

3. After the war, the proportion fell under the Labour Government as the wartime economy was wound down. They left office in October 1951, just after the start of the Korean War. The share for 1951 was 36.1 per cent. Under the Conservatives the share fell to 33 per cent in 1955 and then rose to 36 per cent by 1964.

4. Using the more familiar financial year figures which are available since 1963-64 the position is:

Labour	1963-64 to 1969-70	up from 35.9 to 40.0%
Conservatives	1964-70 to 1973-74	up from 40.0 to 42.6%
Labour	1973-74 to 1978-79	up from 42.6 to 43.2%
Conservatives	1978-79 to 1987-88	down from 43.2 to 42½%

5. Thus it can be argued that the Churchill/Eden/Macmillan government held the share constant from the level they inherited, but this was inflated by the Korean War. Once the effect of this had disappeared they allowed the share to rise. The best way to express the point might be:

> "the first Government for over 30 years to reduce the share during its time in office."

AT

A TURNBULL

IN CONFIDENCE

pmp

10 DOWNING STREET

LONDON SW1A 2AA

From the Secretary for Appointments

CHEXCHEQUER
REC. 23 OCT 1987
ACTION MR CD BUTLER
COPIES TO SIR P. MIDDLETON
MR R. GRIFFITHS
MS BOYS
MR MEADOWS

✓23/10 22 October 1987

Dear Alex,

Transfer of Responsibility for the Chequers Trust

The Chancellor minuted the Prime Minister about transferring the financial responsibility for the grant in aid to the Chequers Trust from the Treasury to the Office of the Minister for the Civil Service.

The Prime Minister is content, and it is noted that provision for the transfer will be included in the Transfer of Functions Order which is needed to transfer functions from the Minister for the Civil Service to the Treasury.

Yours ever,

Robin Catford

A C S Allan Esq

prep
6/10

CH/EXCHEQUER
REC. 26 OCT 1987
ACTION SIR P MIDDLETON
COPIES TO MR C D BUTLER
MR GRIFFITHS
Mr BOYS
MR MEADOWS

10 DOWNING STREET
LONDON SW1A 2AA
From the Secretary for Appointments

Mr Woolley

Transfer of Responsibility for Grants to the Chequers Trust

Thank you for your minute of 26 October conveying Sir Robert Armstrong's advice on the proposal by the Chancellor that financial responsibility for the Chequers Trust should move from the Treasury to OMCS.

The Prime Minister is content for the transfer to proceed and this has been conveyed urgently to the Treasury to meet their deadline on preparing a Transfer of Functions Order.

I am copying this to the offices of the other recipients of the Chancellor's minute of 19 October.

ROBIN CATFORD

26 October 1987

UNCLASSIFIED

Ch/ Content to approve this supp estimate, and the draft PQ?

FROM: D E G GRIFFITHS
27 October 1987

1. MR C D BUTLER — not seen
2. MR F E R BUTLER
3. SIR PETER MIDDLETON
4. CHANCELLOR

Content with the cash limit increase. FERB 28.10

OK

cc - Chief Secretary

Mr Parry - OMCS
Mr Meadows

WINTER SUPPLEMENTARY ESTIMATE 1987-88
ECONOMIC AND FINANCIAL ADMINISTRATION (HM TREASURY) VOTE: CLASS XIX VOTE 11

This submission seeks approval for a Winter Supplementary Estimate for the above Vote and for the terms of a Parliamentary statement announcing changes to the Treasury's running costs limit.

2. A Winter Supplementary Estimate is necessary:

i. to transfer provision from the Office of the Minister for the Civil Service (OMCS) to reflect:

a. the changes in the distribution of functions between the OMCS and the Treasury announced by the Prime Minister on 7 August 1987; and

b. the transfer of responsibility for payment of annuities to UK civilian holders of the George Cross; and

ii. to transfer provision from Treasury to the OMCS for the payment of grant in aid to the Chequers Trust.

3. As a result of the Supplementary Estimate, the cash limit will change by only a token £1,000, but the running costs limits for the three Treasury Votes will increase by £803,000 from £65,561,000 to £66,364,000. This increase will be offset by a corresponding decrease in the running costs limits for the OMCS.

4. These changes have been agreed by LG2 and Mr F E R Butler is asked to approve the increase in the Treasury's running costs limit.

5. If you are content, it will be necessary to announce the running costs changes to Parliament in advance of the ~~Spring~~ Winter Supplementary Estimates. I enclose a draft Parliamentary Question and Answer for your approval. If you are content, it should be tabled at the first opportunity.

B Woodall p.p.
D E G GRIFFITHS

78

EOG3

DRAFT PARLIAMENTARY QUESTION

Q - To ask the Chancellor of the Exchequer whether there will be any changes to the Treasury's running costs limit.

A - Subject to Parliamentary approval of the necessary Supplementary Estimate, the Treasury's running costs limit will be increased by £803,000 from £65,561,000 to £66,364,000. This increase will be offset by a corresponding decrease on the running costs limit for the Central Management of the Civil Service etc - Office of the Minister for the Civil Service (Cabinet Office) Vote (Class XX, Vote 1) and results from the changes in the distribution of functions between the Office of the Minister of the Civil Service and the Treasury announced by the Prime Minister on 7 August 1987.

The cash limit for the Economic and Financial Administration (HM Treasury) Vote (Class XIX, Vote 11) will be increased by only a token £1,000.

DEPARTMENT OF HEALTH AND SOCIAL SECURITY
Alexander Fleming House, Elephant & Castle, London SE1 6BY
Telephone 01-407 5522
From the Secretary of State for Social Services

I w. tr. X! ✓

The Rt Hon John Major MP
Chief Secretary to the Treasury
HM Treasury
Parliament Street
LONDON
SW1P 3AG

2 July 1987

Ms Boys
CX Sir Peter Middleton
Mr Butler Mr Anson
Mr Luce Miss Peirson Mr Turnbull
Mr Gieve Mr McIntyre
Mr Cropper Mr Tyrie

Dear John

PUBLIC EXPENDITURE SURVEY 1987

In this letter and the others enclosed I make expenditure proposals for the survey period for all my programmes.

The sheer size of these programmes, both absolutely and in relation to public expenditure totals, is much in my mind. I am deeply committed to the Government's objectives in controlling public spending and have carefully considered my proposals against that background. I have in particular sought to keep to the absolute minimum bids which reflect decisions on choices between competing priorities, meaning those which are not driven by demographic or economic forces but rest on judgements about public expectations or service quality.

As you will see, I am recommending substantial increases on both health and social security. But by far the greater proportion of these increases is a response to ineluctable pressures rooted in demography and in assumptions - by the Treasury and others - about the economy, the take-up of benefits, and similar factors. This is, of course, especially true of the big increases proposed for 1990/91, where the baseline admits only a conventional increase.

All my programmes present major problems of service delivery, as you are well aware. So far as the NHS in all its aspects is concerned, I shall want to work for a change in public attitudes and expectations which now so far outstrip what is possible, given the other demands on the economy, and consider other ways of reducing that gap. As for social security, I am in the short term constrained by the overriding need to deliver, and sustain public acceptance of, the reformed system. Some of my bids, including

DHSS

E.R.

some for administration, are directed to that end. I shall want to consider further how best to deliver benefits, an area where we shall have more scope as our major computer developments come on line. Meanwhile, the administration bids reflect inter alia my intention to carry through the Cabinet's commitment that Government should be a good employer.

There are certain areas within my responsibilities where I think we would all recognise problems with major political, as well as practical, dimensions. I have in mind, in particular, hospital waiting lists, the recruitment and retention of nurses in the NHS, the management of NHS staff who are not covered by Review Bodies, and the position of the poorer pensioners. These are matters which require much more thought and effort than I have been able to give them so far. I shall be seeing that they get them, in ways which define consistent policy aims across all the services and identify the necessary measures and their financial implications. So although I am not now able to say whether appropriate policies will have expenditure consequences, and if so what, I cannot rule out the possibility that I may have to return to you on some or all of these. But I assure you that I shall frame my approach to them with the need to be prudent with resources very much to the fore.

We have already corresponded about some of the forward savings commitments that I inherited. You and I understand how I have accepted, and shall honour, them. But I shall need time to adjust my programmes so as to combine savings with appropriate improvements in service delivery. I have set studies in hand accordingly.

You will see that my priority programme bids have been kept to the minimum and are marginal in terms of the underlying programmes. As I have said, this is a deliberate attempt to limit the difficulties which I know these programmes present for you. I hope that we should be able to avoid argument about the minutiae, and that as in the past our officials will be able to clear the way for the discussions we must have about the broader objectives and policies, and the pace at which they should be pursued.

I am copying this letter to the Prime Minister, the Lord President, the Secretaries of State for Scotland, Wales and Northern Ireland and to Sir Robert Armstrong.

Yours ever

John

JOHN MOORE

Pup

SECRET

CHIEF SECRETARY TO THE TREASURY

NOTE OF A MEETING HELD IN THE CHANCELLOR'S ROOM

H M TREASURY AT 9.45AM ON FRIDAY 10 JULY 1987

Present:

Chancellor
Chief Secretary
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr Anson
Mr Monck
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mr Gieve
Mr Hawtin
Mr Cropper
Mr Tyrie

PUBLIC EXPENDITURE: SURVEY TACTICS AND PRESENTATION

Papers:

Mr F E R Butler of 30 June
Mr Turnbull of 8 July
Mr Culpin of 8 July
Sir Peter Middleton of 9 July to Mr Culpin

The Chancellor said he would like to start by looking at the questions raised in Sir Peter Middleton's minute to Mr Culpin. He agreed that the questions identified by Sir Peter on page one of his note were indeed ones to which we needed answers. The most fundamental point however was that raised in paragaph 3. He was concerned that the formulation downgraded the GDP ratio for the first year of the Survey and was therefore an apparent weakening. He was very anxious to present the GDP ratio in a strong form i.e linking it to the decline set out in the Public Expenditure White Paper. Mr F E R Butler thought that the two positions were reconcilable by establishing a framework in which the percentages set out in the White Paper were not exceeded.

2 Discussion then turned to the background briefing following

preferable to use the White Paper ratio. Commentators would no doubt draw their own conclusion about the scope for increases in the planning total, but we should refuse to be drawn. It was important to avoid any suggestion that we might be using higher privatisation proceeds to fund extra spending. It had to be made clear that we were focussing on GGE excluding privatisation proceeds.

5 Summing up this part of the discussion, <u>the Chancellor</u> said that he was attracted to the formulation set out by Mr F E R Butler. It should be made clear that the Chief Secretary's aim was to get as close as possible to the cash totals, but the possibility - not the certainty - of an increase in the planning total should be confirmed within the context of the Government's complete adherence to its strategy of reducing GGE as a proportion of GDP. It should be made clear that that meant doing at least as well the path set out in the Public Expenditure White Paper. <u>The Chancellor</u> asked Mr Culpin and Mr Turnbull to produce on a revise of the Ingham communique and the background briefing on that basis.

6 Turning to the Cabinet paper, (Mr Turnbull's minute of 8 July,) <u>the Chancellor</u> said that there were some substantive points on the tactics. <u>Mr F E R Butler</u> identified these as:

(i) what should be said about the RSG settlement;

(ii) whether specific programmes which were targets for reduction should be identified;

(iii) what should be said about the envelope for public expenditure.

All these could enhance the toughness of the message conveyed by the Cabinet paper, but at the same time they ran the risk of provoking a substantive discussion. The problem still remained that we had no decent answer to the question of why we could not say how much public spending and the economy could afford. <u>The Chancellor</u> said that we should say that our intention was percentage from 61 to 46.4per cent, with the clear implication cuts could go no further. Moreover the Secretary of State for Education, backed by other colleagues had said that any cut in the grant percentage would make the position of the Secretary of State for the Environment intolerable. The Chief Secretary said he reserved his position both on provision - where the actual scale of disagreement was much more limited - and grant. The only help in prospect was the Secretary of State for the Environment's offer to reduce the estimate of financing items etc which scored as relevant expenditure and thus produce a lower grant quantum consistent with the stable percentage. But that would not remove the unfortunate signal. And it still left the grant quantum over £300 million away from our final negotiating objective.

10 The Chancellor acknowledged that there would be a feeling among colleagues that, with local government legislation going through, it was difficult to expose Environment ministers yet again. But the case against a fixed grant percentage was extremely strong. To keep the same percentage for the third year running would all butset it in concrete. It was therefore extremely important to reduce it this year. He would wish to discuss this with the Lord President - and then possibly the Prime Minister - before the Chief Secretary's meeting with the Lord President. He noted that were colleagues to offer a grant quantum we could accept, but based on much lower - and therefore unrealistic - provision figuresto give the appearance of a stable grant percentage, this was not something we could legitimately refuse although it was very much a second best option. The overriding objective had to be to constrain the cash increase in AEG. The Chancellor would try to speak to the Prime Minister about this on Sunday night.

Jill Rutter

JILL RUTTER
Private Secretary

Distribution:
Those present
Mr Hawtin (paras 7 - 9 only)

005/4202

SECRET

NOTE OF A MEETING HELD IN THE CHANCELLOR'S ROOM

H M TREASURY AT 9.00AM ON THURSDAY, 9 JULY

Present:

Chancellor
Chief Secretary
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr Anson
Mr Monck
Mr Sedgwick
Mr Turnbull
Mr Culpin
Mr Gieve
Mr Cropper
Mr Tyrie

PUBLIC EXPENDITURE: SURVEY TACTICS AND PRESENTATION

Papers:

Mr F E R Butler of 30 June
Mr Turnbull of 8 July
Mr Culpin of 8 July

The Chancellor said that the first issue to be considered was how to handle the later years - this subject had not been considered at the previous meeting on 7 July. There was a choice offered in Mr F E R Butler's paper of setting a tight but realistic figure which would give a large enough increase to enable the Treasury to hold the cash plans next year; or putting in the lowest figure negotiable with departments - that would create less alarm outside, but would mean that we were faced with a similar decision on increasing the planning totals this time next year.

2 Mr F E R Butler said that his preference would be for a realistic figure which the Government could hold. But he felt that would be difficult to reconcile with the MTFS path. He

the lowest possible figures for programmes in the later years of the Survey. At the end of the process a reserve would be added, which would if possible be larger than in the past. The actual size would be a matter for judgment at the time; it would have to be consistent with the critical constraint that GGE as a proportion of GDP should conform to the pre-set path. Mr F E R Butler pointed to a problem with the figures for the later years where a new GDP forecast was not provided at the time of the Autumn Statement. The Chancellor noted that it had been a key point that the MTFS was only revised once a year. Nonetheless he would be grateful if Sir Terence Burns could produce a note considering the pros and cons of extending the forecast in the Autumn Statement to the later years.

5 Turning to the draft paper for Cabinet and Mr Culpin's press line , the Chancellor said he thought that the Cabinet paper was along broadly the right lines. But there were two questions which had to be addressed:

(a) what precisely did we mean by a declining proportion of GDP, and

(b) why had the planning totals been increased?

6 On the first point, it was imperative to make clear that we were talking about the gradient in the PEWP. To let colleagues have the impression that the Treasury would be satisfied by anything that could be rationalised as a decline in the proportion of GDP taken by public spending would give them far too much scope for bids. Mr Turnbull's paper referred in his paragraph 5 to the decline "as envisaged in the PEWP". However this was not strong enough - it should be redrafted "as set out in the PEWP" and should be picked up in the conclusions which Cabinet were invited to endorse.

7 Mr Turnbull agreed. He pointed out that allowing all the bids for 1990-91 would still allow GGE to be the same proportion as in 1987-88. That indicated the margin. He asked whether

to its planning totals. The arguments in Mr Culpin's paper would cut little ice in justifying why we did not know how much extra public expenditure the economy could afford. That was the question we were unable to answer.

9 It was pointed out that whatever the line to take after the July Cabinet the markets and outside commentators would take their immediate signal from the announcement of the Rate Support Grant settlement, which on present assumptions would be that afternoon.

10 The Chancellor said that these issues, including the interaction with the RSG announcement, would need to be discussed further.

Jill Rutter

JILL RUTTER
Private Secretary

Distribution:

Those present
Mr Scholar

DRAFT PAPER FOR PUBLIC EXPENDITURE CABINET

21

SECRET

Copy No 1 of 15 Copies

FROM: A TURNBULL
DATE: 8 JULY 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Anson
Mr Monck
Mr Scholar
Mr Luce
Mr Sedgwick
Mr Culpin
Mr Gieve
Mr Tyrie

LATER YEARS → FERB 30/6 para 7 (MP X)

DRAFT PAPER FOR PUBLIC EXPENDITURE CABINET

Following your meeting on objectives and tactics for the July Cabinet, you asked Mr Culpin and myself to consider the post Cabinet form of words and answers to the immediate questions. Mr Culpin is submitting material on this tonight. — below

2. We thought it would also be helpful if, before your meeting tomorrow, you were able to consider a draft of the Chief Secretary's Cabinet paper. A version is attached which embodies the approach you suggested at Tuesday's meeting.

3. This will need to be refined over the course of the next few days so that it can be sent to the Prime Minister at the end of next week. We envisage it would be circulated on the Tuesday before Cabinet.

possibly for PM bilateral next Wednesday.

4. The paper does not say explicitly that no decision is being sought on the planning total, still less than an increase might be made. It is likely, however, that this question will be put in which case you could draw on the line suggested in Mr Culpin's note; and even if no questions are raised, the issue will come up when agreement is sought on the post Cabinet form of words. This will make it clear that the totals are subject to review.

(not arrived. Will get copy first thing in morning / in time for you to see well before meeting

5. The paper does not yet cover local authority spending. LG group are minuting the Chief Secretary tonight on the way forward following E(LA)'s firm adherence to maintaining the grant

percentage at 46.4 per cent. One possibility considered would be to withhold Treasury agreement, and force a delay in announcing the settlement until the autumn.

6. In terms of tactics for the July Cabinet, GEP see advantages in this:

i. failure to announce details of the RSG settlement in July would make it easier to explain failure to set firm figures for the planning totals;

ii. Treasury obduracy on the grant percentage would help get across the message that we mean business on the other tough policy decisions.

7. On the other policy changes listed in paragraph 7, you will want to consider whether the text strikes the right balance between getting across the Treasury message while not provoking a revolt from the individual Ministers whose programmes are identified.

AT

A TURNBULL

MEETING RECORD
7.7.87

005/4202

SECRET

For meeting folder

CHIEF SECRETARY TO THE TREASURY

NOTE OF A MEETING

HELD IN THE CHANCELLOR'S ROOM - H M TREASURY

AT 9.00AM ON TUESDAY, 7 JULY 1987

Present:

Chancellor
Chief Secretary
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr Anson
Mr Monck
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mr Culpin
Mr Gieve
Mr Cropper
Mr Tyrie

PUBLIC EXPENDITURE: OBJECTIVES, TACTICS AND PRESENTATION

Paper: - Mr F E R Butler 30 June

The Chancellor said that on reflection, and after reading Mr Butler's note, he had concluded that the provisional conclusion reached at the meeting on 18 June, that Cabinet should be asked to endorse increased planning totals on July 23rd, which would then be followed by a Parliamentary announcement was not the right approach. He now thought it would be the wrong tactics to reveal cash figures at this stage. The real objection was the scale of the increases required - which were completely out of line with public expectations. He therefore thought that the approach would need to be based on a variant of option (iii) in Mr F E R Butler's paper. He did not however think that that formula mentioned there would suffice. It had to be buttressed by the iron constraint of public expenditure as a declining share of GDP. That immediately begged the questions of what path for the share of GDP - whether it should be based on the percentages in the White Paper or the FSBR and whether the path should be based on GGE including or excluding privatisation proceeds? It was unfortunate that the presentation of the text of the White Paper had been based on GGE including privatisation proceeds, although the graphs had shown GGE ex privatisation proceeds. The option (iii) approach would obviate the need for a post-Cabinet statement since there would be no new figures. Mr Ingham would need to be briefed to refer to the Government reaffirming its commitment to see public expenditure declining as a percentage of share of GDP. The Chancellor thought that option (vi) - estabilishing an envelope for the Survey - was not an appropriate tactic for the July Cabinet. But he thought that an approach based on option (vi) would be needed for the second phase of the Survey with the move to Star Chamber.

2 Mr F E R Butler thought there might be difficulties in drafting the Cabinet paper to present option (iii) in a sufficiently strong way. If spending Ministers took the Survey to be open-ended they would be reluctant to settle in the bilaterals. That was what had attracted him to option (vi),which had the advantage of establishing a total to work against. He thought that there had to be some meat in the Cabinet Paper - either a cash figure or some radical options. The Chancellor doubted whether the envelope had any operational significance in advance of the Star Chamber discussions. He was not aware that colleagues were influenced by overall amount available when negotiating with the Chief Secretary. Stressing the declining percentage share would provide a constraint.

3 Sir Peter Middleton was concerned about the stress on the GDP share as "iron constraint". He thought that it was very unlikely to prove effective. In his experience such a formulation tended to sow the seeds of its own destruction - the Government was tempted to overstate GDP and understate public expenditure. Moreover it was an approach that implicitly accommodated inflation. He was therefore attracted to asking Cabinet to re-affirm the objective of holding to the planning totals. The Chancellor said that he felt that the problem

with this formulation - which he agreed would be preferable if it were feasible - was that after last year it lacked credibility. Holding to the path for public expenditure as a percentage of GDP would allow the Government to give the message that it was sticking to its existing policy.

4 Sir Terence Burns pointed out that there were potential problems in the profile of GGE to GDP ratios. For example, the current forecast of money GDP suggested that the ratio would be lower than in the White Paper or FSBR for 1987-88. He believed that the stress should be on sticking to a path which declined at least as steeply as in earlier plans.

5 Mr Scholar said he still saw attractions in option (ii). He believed that the public presentation would be easier than imagined, because outside commentators were unaware of the present position they would see the large reserve, and would exaggerate the public expenditure savings arising from falling unemployment. He did not think as radical a departure from previous practice as was implied by option (iii) was necessary. The Government might instead however say that the aim was to stick to the existing numbers, while giving some indication that this might not be achieved.

6 The Chancellor doubted whether it was actually in the interest of the Treasury to declare a target and fail by a wide margin to achieve it for the second year running. The Chief Secretary agreed. Supplementary estimates had already been picked up as being higher than last year. Added to that was the £1 billion local authority over spending, the pledges made before the Election, and the costs of Manifesto proposals. He did not believe it would be credible to say that the planning totals would be held. He wanted to avoid the impression of a major Treasury defeat in the Autumn Statement. Mr Anson pointed out that we lost presentational advantage if we initially hooked ourselves on to a non-credible stance. Mr Monck supported option (iii); he agreed with Sir Terence Burns that it would be important to underline the Government's commitment on public expenditure by saying that the decline should be at

least as fast as set out in the previous plans. This would preserve the option of a more rapid decline if inflation came out higher. He believed that the Cabinet paper should contain some tough options.

7 There was some discussion about whether presentation should be based on GGE excluding privatisation proceeds or whether the issue should be fudged. The Chancellor thought that ideally the issue should be fudged, but if pressed we would point to GGE ex-privatisation proceeds.

8 Summing up this part of the discussion the Chancellor said that he did not believe that option (ii) was feasible this year. He therefore would like to look at the presentation of option (iii). He asked Mr Culpin and Mr Turnbull to produce a formulation along the lines of that suggested by Sir Terence Burns. Mr Culpin and Mr Turnbull's note should also set out answers to possible supplementaries. In the light of that note there would be a further discussion which would also look at the handling of the later years.

9 Mr Turnbull asked whether the Chancellor favoured including some specific options eg on electricity prices, social security, illustrative rates, employment programme and Scotland in the Cabinet Paper. The Chancellor said that his preliminary view was that such a presentation would not be helpful. He thought we were more likely to gain Cabinet assent if the presentation was that the bids were absurd and could not possibly be accommodated. It was clear that there would have to be reductions. The areas for reduction would then have to be named, but not in a precise way. He thought this approach was more likely to get Cabinet's backing. Sir Peter Middleton agreed. On the substance the Chancellor saw scope for substantial reductions on employment programmes - and Mr Fowler was on record saying that the fall in unemployment was a product of the strength of the economy. On defence, Chancellor said that there would

clearly have to be an increase but the bids put in by Mr Younger would have to be cut back. He would look to the Chief Secretary for advice on social security. He believed that was scope for significant cuts on regional policy, first because the economy was doing better and many areas no longer needed Government help, and secondly because there should be diversions from regional aid the inner cities. He believed the Government would have to concede something on science, but there should be scope for reductions in education. He would also want to see a tough settlement on electricity.

Jill Rutter

JILL RUTTER
Private Secretary

Distribution:

Those present

TACTICS AND PRESENTATION

PEO

SECRET

FROM: F. E. R. BUTLER
3rd July, 1987.

CHANCELLOR OF THE EXCHEQUER

c.c. Chief Secretary
Sir P. Middleton
Sir G. Littler
Sir T. Burns
Mr. Anson
Mr. Monck
Mr. Cassell
Mr. Turnbull
Mr. Scholar
Mr. Sedgwick
Mr. Gieve
Mr. Mowl
Miss Walker

PUBLIC EXPENDITURE OBJECTIVES, TACTICS AND PRESENTATION

As requested in Mr. Allan's minute of 1st July, I attach a table showing annual real growth rates of public expenditure on the various bases illustrated in my minute of 30th June. I also attach a revised version of the table attached to that submission, which has been altered to reflect the CSO's latest estimate of GGE in 1986-87. Since this is rather lower than the previous estimate, the growth rate between 1986-87 and 1987-88 and the average growth rate over the three years to 1989-90 are marginally higher.

F.E.R.B.

F. E. R. BUTLER

FERB to CH/EX 3/7

REAL GROWTH IN PUBLIC EXPENDITURE

	87-88	88-89	89-90	Annual averages 78-89/ 82-83	82-83/ 86-87	86-87/ 89-90
White Paper plans						
Planning Total	2.1	0.3	1.7	1.4	1.0	1.35
GGE	1.8	-0.1	1.5	2.1	1.1	1.1
GGE exc. priv	1.8	-0.2	1.4	2.2	1.7	1.0
GEP forecast of negotiable Survey outcome on MTFS base						
Planning Total	2.0	2.1	2.2	1.4	0.9	2.1
GGE	1.1	1.8	1.7	2.1	1.0	1.5
GGE exc priv	1.3	1.6	1.6	2.2	1.6	1.5
Forecasters' forecast on MTFS base						
Planning Total	1.9	3.0	4.4	1.4	0.9	3.1
GGE	0.9	2.5	3.6	2.1	1.0	2.4
GGE exc priv	1.3	2.3	3.4	2.2	1.6	2.3
Forecasters' forecast on June forecast base						
Planning Total	1.4	1.3	2.9	1.4	0.9	1.9
GGE	0.5	0.9	2.0	2.1	1.0	1.1
GGE exc priv	0.8	0.6	1.8	2.2	1.6	1.1

SECRET

£ billion (% of GDP in brackets)

White Paper Plans	1986-87	1987-88	1988-89	1989-90	Average Real terms growth 1986-87 to 1989-90
Planning total	140.4	148.6	154.2	161.5	1.35%
GGE incl privatisation proceeds	164.4 (43¼)	173.7 (42¾)	179.6 (41¾)	187.8 (41¼)	1.1%
GGE excl privatisation proceeds	169.2 (44½)	178.7 (44)	184.6 (42¾)	192.8 (42¼)	1.0%
GEP forecast of negotiable Survey outturn as % of GDP in MTFS					
Planning total	139.8	149	158.2	167.5	2.1%
GGE incl privatisation proceeds	164.3 (43)	173.5 (42¼)	183.7 (42)	193.4 (41¾)	1.5%
GGE excl privatisation proceeds	168.7 (44)	178.5 (43½)	188.7 (43¼)	198.4 (42¾)	1.5%
Forecasters' forecast of actual outturn as % of GDP in MTFS					
Planning total	139.8	148.8	159.4	172.3	3.1%
GGE incl privatisation proceeds	164.3 (43)	173.3 (42¼)	184.9 (42¼)	198.2 (42¾)	2.4%
GGE excl privatisation proceeds	168.7 (44)	178.5 (43½)	189.9 (43½)	203.2 (43¾)	2.3%
Forecasters' forecast of actual outturn as % of GDP in June Forecast					
Planning total	139.8	148.8	159.4	172.3	1.9%
GGE incl privatisation proceeds	164.3 (43)	173.3 (41½)	184.9 (41¼)	198.2 (41¼)	1.1%
GGE excl privatisation proceeds	168.7 (44)	178.5 (43)	189.9 (42¼)	203.2 (42¼)	1.1%

RA7.3

SECRET

pup

FROM: A C S ALLAN

DATE: 1 July 1987

MR F E R BUTLER

cc PS/Chief Secretary
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Anson
Mr Monck
Mr Cassell
Mr Turnbull
Mr Scholar
Mr Sedgwick
Mr Gieve
Mr Mowl
Miss Walker

PUBLIC EXPENDITURE OBJECTIVES, TACTICS AND PRESENTATION

The Chancellor was most grateful for your minute of 30 June. We shall be fixing up a meeting next week to discuss it.

2. Before that meeting, he would be grateful for year-by-year figures for the real growth in public expenditure on the various bases in the Annex to your minute (which gave average real terms growth over the period 1986-87 to 1989-90).

ACSA

A C S ALLAN

ACSA to FERB 1/7

Tac

FERB TO CH/EX 30/6

SECRET

Mr Anson. ~~Arrangements~~ For I will hold a mtg with to discuss this.

FROM: F. E. R. BUTLER
30th June, 1987.

CHANCELLOR OF THE EXCHEQUER

Ch
We'll set up a further meeting next week.
(& I'll get figures for % real-terms increases year by year - aggregate figures in Annex @ back)
AA

c.c. Chief Secretary
Sir P. Middleton
Sir G. Littler
Sir T. Burns
Mr. Anson
Mr. Monck
Mr. Cassell
Mr. Turnbull
Mr. Scholar
Mr. Sedgwick
Mr. Gieve
Mr. Mowl
Miss Walker

PUBLIC EXPENDITURE OBJECTIVES, TACTICS AND PRESENTATION

At your meeting on 18th June it was agreed that our objectives should be:-

i. Public expenditure plans taking a steadily smaller share of national income, as in the last PEWP.

ii. Cash totals which we could hold, and which we would not have to increase again in next year's Survey for 1989-90 and 1990-91.

iii. Increases which, if announced in July, we would not have to increase again in the autumn.

We recognised that it would be dangerous for the Government to get too tightly hooked on linking its public expenditure plans to proportions of nominal GDP but also that increases in the cash totals would have to be justified in terms of the Government's policy of reducing public expenditure's share of GDP.

2. This submission discusses the choice of our objectives and, in the light of that, the tactics and presentation

real terms increases in GGE (with or without priv. procs) no higher than in PEWP.

to follow

in July. I am making a parallel submission on the options for reducing the public totals by policy changes. To the extent that we can achieve these, they present an alternative way of easing the problem.

The dilemma

3. The dilemma is easily described. The public expenditure groups' assessment (before receiving Departments' bids) is that, to give us a chance of delivering the cash plans, the planning totals would have to be increased by £4 billion in 1988-89 and £8-10 billion plus in 1989-90. The forecasters put the figures even higher at £5 billion and £11 billion. Yet even the latter figures are consistent, in the forecast, with the ratio of GGE to GDP falling closely in line with the ratios in the PEWP (slightly faster in 1987-88 and 1988-89).

4. The reason is, of course, that the forecasters' latest assessment of the course of nominal GDP is higher than in the MTFS published in the Budget. (The arithmetical relationship of the various outcomes of the Survey to the projections of nominal GDP in the MTFS and the latest forecast is set out in the Annex.) This is mainly because inflation does not fall progressively as projected in the MTFS, which puts cumulative upward pressure on public expenditure as it does on nominal GDP. These figures show one measure of it:-

GDP deflator - % movement on previous financial year

	1987-88	1988-89	1989-90
PEWP	3¾	3½	3
Latest Treasury forecast	5	5¾	5
Cumulative difference	1¼	3½	5½

By 1989-90, ~~inflation~~ the price level is 5½% higher than assumed in our published plans: this is equivalent to nearly £9 billion on the planning total.

5. The forecasters' expectations about inflation are, of course, not necessarily right and the upward pressure on public expenditure is not all inflation. There are major pressures for real increases in volume - eg increases in local authority employment, electricity investment and, most important of all, take-up of social security benefits. Moreover, one of the Treasury's most important instruments in containing expenditure is to obstruct increases for inflation and thus squeeze back the volume (though the fact that we are in a weaker position in relation to some programmes than others skews the effect of this tactic). But if we were to provide fully for our expectations of inflation - even by having much higher reserves - the real total of public expenditure would probably finish higher.

When? presumably Autumn.

6. So the dilemma is this. Do we publish cash figures for public expenditure which we really think we can hold, not only in 1988-89 but also for 1989-90, when this will not only involve publishing horrific cash increases in the planning totals but the objective of a declining GGE/GDP proportion would involve publishing higher figures of nominal GDP than in the MTFS? Or do we publish the smaller increases in the cash totals which we can think we can negotiate with Departments - put provisionally at £4 billion for 1988-89 and £6 billion in 1989-90 (before seeing the additional bids) - but with the expectation that in next year's Survey we would have to increase the cash planning totals again, for the third year running?

7. My conclusion is that for 1988-89 we must concede as small an increase to the planning total as we believe can be delivered. This will involve going for some tough options for reductions but, if we are reasonably successful,

it should enable us to publish a figure in the autumn which will show a continuing fall in GGE's share of GDP, though it will probably also be a substantial cash increase in the planning total. For the later years it will not be possible to publish cash totals we really think we can achieve and make them consistent with MTFS projections you will find acceptable - unless there are really dramatic public expenditure policy changes.

Tactics for July

8. Against this background, what should be the approach to the July Cabinet?

9. The purpose of the July Cabinet from the Treasury's point of view is to set an overall "envelope" which will strengthen the Chief Secretary's hand in the negotiations. The difficulty this year is that, unless major reductions are to be made, whether the objective for the whole exercise is realism or negotiability, the "envelope" will involve increases in the planning total which are difficult to defend and justify.

10. Against that background we have considered the following options:-

i. Not holding the July Cabinet. The slippage of the timetable as a result of the Election provides some pretext. But there would be no good reason for not holding the Cabinet in September if not in July when the same dilemma would present itself; and there would be increasing speculation over the summer on our plans and no Cabinet agreement on the line to take in response to it. So we do not consider that option further.

ii. Last year's tactics, ie not acknowledging that any increases are needed in the planning totals and thus imply that only some £2 billion a year is available from the Reserves for additions to programmes. We believe that this approach would be "rumbled" by the rest of Whitehall and the press. It is probably necessary therefore to go a bit further in the direction of openness.

iii. Acknowledge that some increases in the planning totals will probably be needed, but give the Chief Secretary the remit of minimising them. This avoids a statement to Parliament in July but leaves the Chief Secretary without a firm ceiling within which to negotiate. Spending Ministers would probably be more inclined to press bids in the bilaterals. + higher than [illegible]. (PEWP on FSBR ex [illegible])

iv. Acknowledge that the planning totals will be increased but set lower figures in July than we expect to concede in the autumn to justify a tough approach to the bilaterals. This transgresses one of the objectives agreed at the Chancellor's previous meeting. Although it might help to achieve the best available result the Treasury would be faced with announcing two "defeats". It also probably involves an announcemnent in July, which would be difficult in itself and would put the further "defeat" in the autumn in greater prominence.

v. Agree in July target planning totals which we would hold in the autumn. This is the most straightforward option. The presentational difficulty might be eased by restricting the agreement to 1988-89. For that year it could be pointed out that an increase in the planning total is justified by the higher GDP forecast in the FSBR. Even so, such an increase would require a major announcement in July which it would be difficult to make convincing, at any rate on the basis of figures so far published.

vi. "Uncouple" the Survey by proposing to Cabinet increases not for the planning totals or GGE but for the total of programmes or some subset (eg programmes excluding local authorities, or even EC contributions and social security). This could set a tight but reasonably realistic envelope for the Chief Secretary's negotiations in terms of figures which would not be too alarming to the outside world, eg £3 billion for increases in programmes other than local authority current in 1988-89 or £2.5 billion for "new" additional bids. This would not require an external announcement since it could be represented as just a working stage in the Survey, not involving any final decision on the planning total or GGE. But since others in Whitehall, and informed press commentators, will be able and probably ready to calculate that even this is not compatible with the present planning totals it might be wise to acknowledge - as in option iii - that some increase in the cash planning totals is likely to be necessary but that the object is to keep it to a minimum.

Star Chamber stage

Conclusion

11. Our feeling is that the choice lies between option iii and option vi. Both options avoid a Parliamentary announcement in July. The choice between them probably turns on whether the advantage to the Chief Secretary of having a ceiling within which to conduct his negotiations is outweighed by the difficulty of naming any figure at all. A possible compromise is to choose option iii for July and move to option vi at a further Cabinet in September or October when the Star Chamber is set up. In any event, we should press for as many of the options for reductions in my separate submission as you think practicable and

arrange for the Prime Minister to read a lecture to the Cabinet in July about the extravagance of the additional bids. But even with all this I do not pretend that the prospect is satisfactory, since we look like having to make a further increase in the cash planning totals for 1989-90 and 1990-91 this time next year.

F.E.R.B.

F. E. R. BUTLER

SECRET

£ billion (% of GDP in brackets)

White Paper Plans	1986-87	1987-88	1988-89	1989-90	Average Real terms growth 1986-87 to 1989-90
Planning total	140.4	148.6	154.2	161.5	1.35%
GGE incl privatisation proceeds	164.4 (43¼)	173.7 (42¾)	179.6 (41¾)	187.8 (41¼)	1.1%
GGE excl privatisation proceeds	169.2 (44½)	178.7 (44)	184.6 (42¾)	192.8 (42¼)	1.0%
GEP forecast of negotiable Survey outturn as % of GDP in MTFS					
Planning total	139.8	149	158.2	167.5	2.1%
GGE incl privatisation proceeds	164.8 (43)	173.5 (42¼)	183.7 (42)	193.4 (41¾)	1.4%
GGE excl privatisation proceeds	169.2 (44¼)	178.5 (43½)	188.7 (43¼)	198.4 (42¾)	1.4%
Forecasters' forecast of actual outturn as % of GDP in MTFS					
Planning total	139.8	148.8	159.4	172.3	3.1%
GGE incl privatisation proceeds	164.8 (43)	173.3 (42¼)	184.9 (42¼)	198.2 (42¾)	2.25%
GGE excl privatisation proceeds	169.2 (44¼)	178.3 (43½)	189.9 (43½)	203.2 (43¾)	2.20%
Forecasters' forecast of actual outturn as % of GDP in June Forecast					
Planning total	139.8	148.8	159.4	172.3	1.9%
GGE incl privatisation proceeds	164.8 (43)	173.3 (41½)	184.9 (41¼)	198.2 (41¼)	1%
GGE excl privatisation proceeds	169.2 (44¼)	178.3 (43)	189.9 (42¼)	203.2 (42¼)	1%

	GGE	Planning Total	Privat Proceeds	GDP	Deflator	GGE/GDP	REAL PT	GGE excl priv proc	Plan tot PT exc p.proc	PT exc p.p real	GGE ex p.p /GDP	GGE REAL	GGE ex p.p REAL	
1963-64	11336	9899		31590	0.13448	35.88	73609	11336	9899	73609	35.88	84,295	84,295	
1964-65	12254	10806		34230	0.13916	35.80	77652	12254	10806	77652	35.80	88,057	88,057	
1965-66	13599	12034		36964	0.14823	36.79	81185	13599	12034	81185	36.79	91,743	91,743	
1966-67	15052	13320		39221	0.15492	38.38	85980	15052	13320	85980	38.38	97,160	97,160	
1967-68	17451	15532		41569	0.15909	41.98	97630	17451	15532	97630	41.98	109,693	109,693	
1968-69	18240	16136		45012	0.16720	40.52	96507	18240	16136	96507	40.52	109,091	109,091	
1969-70	19326	17026		48311	0.17574	40.00	96882	19326	17026	96882	40.00	109,969	109,969	
1970-71	21600	19059		53469	0.19014	40.40	100237	21600	19059	100237	40.40	113,601	113,601	
1971-72	24356	21446		59554	0.20783	40.90	103190	24356	21446	103190	40.90	117,192	117,192	
1972-73	27615	24795		67791	0.22423	40.74	110578	27615	24795	110578	40.74	123,155	123,155	
1973-74	31942	29269		75065	0.24026	42.55	121822	31942	29269	121822	42.55	132,948	132,948	2.9
1974-75	42811	39340		89168	0.28663	48.01	137250	42811	39340	137250	48.01	149,360	149,360	
1975-76	53716	48838		110808	0.36017	48.48	135597	53716	48838	135597	48.48	149,141	149,141	
1976-77	59455	54442		129590	0.40766	45.88	133548	59455	54442	133548	45.88	145,845	145,845	
1977-78	63691	56818	548	150836	0.46431	42.23	122371	64239	57366	123551	42.59	137,173	138,354	
1978-79	74800	65733		173120	0.51399	43.21	127888	74800	65733	127888	43.21	145,528	145,528	
1979-80	89769	77560	377	207526	0.60073	43.26	129110	90146	77937	129737	43.44	149,433	150,061	
1980-81	108433	92639	405	236420	0.71221	45.86	130073	108838	93044	130641	46.04	152,249	152,817	2.17
1981-82	120503	103987	493	260154	0.78201	46.32	132974	120996	104480	133604	46.51	154,094	154,724	
1982-83	132496	113469	488	283972	0.83830	46.66	135356	132984	113957	135938	46.83	158,053	158,635	
1983-84	140065	120319	1142	306992	0.87685	45.62	137217	141207	121461	138520	46.00	159,737	161,039	
1984-85	150117	129777	2132	329263	0.91546	45.59	141762	152249	131909	144090	46.24	163,980	166,309	1.67
1985-86	158257	133622	2707	361248	0.97075	43.81	137648	160964	136329	140437	44.56	163,025	165,814	
1986-87	165120	140332	4403	385257	1.00000	42.86	140332	169523	144735	144735	44.00	165,120	169,523	
1987-88	173446	148625	5000	411540	1.07944	42.15	137687	178446	153625	142319	43.36	160,681	165,313	
1988-89	180424	154220	5000	438408	1.12262	41.15	137375	185424	159220	141829	42.29	160,717	165,171	
1989-90	188567	161533	5000	465114	1.16191	40.54	139024	193567	166533	143327	41.62	162,291	166,594	
1990-91	195691	168135	5000	490984	1.19677	39.86	140491	200691	173135	144669	40.88	163,516	167,694	

97 ?

figures underlying Table 3.

trends\gger

Last updated 17 September 1987

HISTORIC TRENDS -GENERAL GOVERNMENT EXPENDITURE IN REAL TERMS

	GGE	1980 Deflators	1986 Deflators	GGE/Deflator
1948	4,381	11.5	0.07970	54,972
1949	4,459	11.8	0.08177	54,528
1950	4,522	11.9	0.08247	54,834
1951	5,371	13.0	0.09009	59,618
1952	5,962	14.0	0.09702	61,451
1953	6,172	14.4	0.09979	61,849
1954	6,145	14.6	0.10118	60,734
1955	6,466	15.2	0.10534	61,384
1956	7,041	16.2	0.11227	62,717
1957	7,633	16.8	0.11642	65,562
1958	7,971	17.5	0.12128	65,727
1959	8,461	17.7	0.12266	68,979
1960	8,944	17.9	0.12405	72,102
1961	9,756	18.5	0.12821	76,097
1962	10,401	19.2	0.13306	78,170
1963	10,979	19.5	0.13514	81,245
1964	12,007	19.9	0.13791	87,066
1965	13,322	21.3	0.14761	90,252
1966	14,474	22.3	0.15454	93,659
1967	16,684	23.0	0.15939	104,674
1968	18,307	23.9	0.16563	110,531
1969	19,030	25.2	0.17464	108,969
1970	20,913	27.1	0.18780	111,356
1971	23,522	29.6	0.20513	114,670
1972	26,436	32.0	0.22176	119,210
1973	30,517	34.3	0.23770	128,385
1974	39,212	39.3	0.27235	143,977
1975	51,475	50.0	0.34650	148,557
1976	58,516	57.5	0.39848	146,850
1977	61,864	65.5	0.45392	136,290
1978	72,226	72.9	0.50520	142,966
1979	85,505	83.5	0.57866	147,765
1980	104,076	100.0	0.69300	150,182
1981	116,999	111.5	0.77270	151,417
1982	128,622	119.9	0.83091	154,797
1983	138,509	126.1	0.87387	158,500
1984	146,854	131.5	0.91130	161,149
1985	157,574	139.3	0.96535	163,230
1986	162,191	144.3	1.00000	162,191

figures underlying Table 1.

1945				5779.00	9831.00	58.78	4354.00	44.29		
1946	4584.00			4530.00	9959.00	45.49	2349.00	23.59		
1947	4330.00			4130.00	10655.00	38.76	2038.00	19.13		
1948	4381.00	12077.00	36.28	4215.00	11724.00	35.95	2206.00	18.82	2321.00	19.22
1949	4459.00	12815.00	34.80	4423.00	12384.00	35.72	2418.00	19.53	2558.00	19.96
1950	4522.00	13363.00	33.84	4539.00	12932.00	35.10	2508.00	19.39	2681.00	20.06
1951	5371.00	14878.00	36.10	5208.00	14419.00	36.12	3238.00	22.46	3152.00	21.19
1952	5962.00	16044.00	37.16	5777.00	15632.00	36.96	3689.00	23.60	3753.00	23.39
1953	6172.00	17194.00	35.90	6048.00	16836.00	35.92	3891.00	23.11	3961.00	23.04
1954	6145.00	18191.00	33.78	5976.00	17755.00	33.66	3765.00	21.21	3972.00	21.83
1955	6466.00	19621.00	32.95	6143.00	19105.00	32.15	3810.00	19.94	4028.00	20.53
1956	7041.00	21083.00	33.40						4319.00	20.49
1957	7633.00	22240.00	34.32						4495.00	20.21
1958	7971.00	23186.00	34.38						4540.00	19.58
1959	8461.00	24554.00	34.46						4834.00	19.69
1960	8944.00	26230.00	34.10						5096.00	19.43
1961	9756.00	27774.00	35.13						5491.00	19.77
1962	10401.00	29157.00	35.67						5926.00	20.32
1963	10979.00	30868.00	35.57						6265.00	20.30
1964	12007.00	33397.00	35.95						6881.00	20.60
1965	13322.00	36390.00	36.61						7504.00	20.62
1966	14474.00	38750.00	37.35						8230.00	21.24
1967	16684.00	40758.00	40.93						9202.00	22.58
1968	18307.00	44192.00	41.43						9863.00	22.32
1969	19030.00	47533.00	40.04						10279.00	21.62
1970	20913.00	52103.00	40.14						11480.00	22.03
1971	23522.00	58019.00	40.54						12883.00	22.20
1972	26436.00	64873.00	40.75						14502.00	22.35
1973	30517.00	74311.00	41.07						17093.00	23.00
1974	39212.00	83756.00	46.82						21116.00	25.21
1975	51475.00	105534.00	48.78						28104.00	26.63
1976	58516.00	124776.00	46.90						32466.00	26.02
1977	61864.00	145507.00	42.52						34342.00	23.60
1978	72226.00	167850.00	43.03						38093.00	22.69
1979	85505.00	197449.00	43.30						44002.00	22.29
1980	104076.00	230630.00	45.13						54577.00	23.66
1981	116999.00	254052.00	46.05						59956.00	23.60
1982	128622.00	277504.00	46.35						64884.00	23.38
1983	138509.00	301533.00	45.93						72013.00	23.88
1984	146854.00	322690.00	45.51						76336.00	23.66
1985	157574.00	354280.00	44.48						81253.00	22.93
1986	162191.00	378712.00	42.83						86823.00	22.93

SOURCE:

(1) CSO database
(2) CSO database
(3) A.T. Peacock and J. Wiseman - The growth of public expenditure in the United Kingdom.
(4)C.H. Feinstein - National Income Expenditure and Output of the United Kingdom 1855 to 1965
(5) Note that these percentages are calculated from data from two different sources. It was not possible to obtain GGE and GDP figures from the same source.