

Prime Minister ①



Agree to the circulation
of these three papers?

Treasury Chambers, Parliament Street, SW1P 3AG
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Would you prefer
the end-year flexibility

6 July 1982 paper to be discussed

some time after

July 15?

MUS 6/7

Yes ~~not~~

Michael Scholar, Esq.,
10, Downing Street

Dear Michael,

CABINET : 15 JULY

..... I enclose copies of three draft Cabinet papers, i.e.

- (a) The Chancellor's paper on the economic background
- (b) The Chief Secretary's paper on the objectives for the 1982 Survey
- (c) A short paper by the Chief Secretary covering an interdepartmental report on "End-year flexibility".

The Chancellor envisages that the first two would be circulated this week for discussion on 15 July.

His own paper sets the scene, along lines which will be familiar to the Prime Minister from their recent discussions. Its scope is wider than the public expenditure issues, and the Chancellor in fact believes that it would be useful for the discussion on 15 July to be fairly wide-ranging. But it also points to the importance of holding the public expenditure planning totals.

This is the Chief Secretary's aim in the survey, as set out in his paper. The Prime Minister will remember that the totals were increased, by £5 billion for 1983-84, and £7 billion for 1984-85, in the last Survey. The reasons for opposing any further increase are set out in both papers. But the Chief Secretary is not seeking a cut in the overall level of public expenditure: the objective is to maintain the present planning totals, offsetting increases in one programme against reductions in another.

The Chief Secretary has yet to decide whether to circulate the third paper this week. It presents a report commissioned originally by OD in February, and (by mutual consent) postponed until the public expenditure round. It sets out the arguments for and /against

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against various schemes of end-year flexibility. The Chief Secretary's covering paper comes down against such schemes, particularly for this year. There is no doctrinaire objection to end-year flexibility (and indeed something to commend it). But schemes of this kind are not strictly necessary: if Ministers collectively decided to take note of an underspend in one year, and add a corresponding amount to a particular public expenditure programme in the following year, the usual mechanisms (Supplementary Estimates and a call on the Contingency Reserve) are already there. The proponents of end-year flexibility want a completely automatic system. Treasury Ministers are reluctant to concede full automaticity, and point out that the costs are likely to be high.

The Chancellor feels that it would be a pity to waste much time on the third paper in Cabinet on 15 July. It could perhaps be taken fairly summarily at a later Cabinet this month. But if the officials' report had not been circulated by 15 July Cabinet colleagues might then enquire about its fate. The Chancellor would welcome advice on how the Prime Minister would like this to be handled.

A copy of this letter goes to David Wright in the Cabinet Office.

Yours ever,

J. O. Kerr.

J.O. KERR

ECONOMIC PROSPECTS

The economic situation has not changed dramatically since the Budget, though the outlook for US, and so world-wide, growth has worsened, while the prospect for inflation here has improved.

Prospects

2. Over the next two years the prospects seem to be:-

- (a) World Outlook. The fall in US output stopped in the second quarter, and there should be some resumed world-wide growth in the rest of this year and throughout 1983; but the level of world activity is likely to remain lower than we had earlier hoped. Oil prices are higher than we had assumed at Budget time: this improves our revenue take, though the effect on inflation is of course adverse.
- (b) Output. Our recovery has shown some hesitation in recent months, due to weaker trading conditions in many industrial countries and the temporary rise in interest rates at the end of last year. But the forward indicators point to a perceptible, though perhaps uneven, rise in output over the next year. The latest forecast is for 2 per cent growth in 1983.
- (c) Unemployment. The growth in output is unlikely to be fast enough to reverse the rising tide of unemployment, but may be sufficient to arrest it. We have to reckon on unemployment, on the wide definition, remaining around 3 million. Levels are rising steeply in our competitor countries.
- (d) Interest rates have fallen by about 3½ points since last autumn, but further falls may depend on what happens in the United States, where rates, both nominal and real, are well above ours; and on our maintaining confidence at home.

(e) Prices. Inflation has declined more rapidly than expected. The Budget forecast was for 9 per cent by the end of this year and 7½ per cent by the middle of next year. In fact we now expect to hit 8 per cent by the end of this year, and about 7 per cent by the middle of next year. On past experience there must of course be a risk that, as the economy picks up, so too will the inflation rate. We need to do all we can to prevent this: continuing success on the pay front will be one key element.

3. These indicators from the latest Treasury forecast are summarised ... in the attached table. As we approach the next election we should be able to point to an economy which is again growing (though with unemployment still very high); to major progress on inflation; to substantial achievements in productivity and competitiveness; and to considerable success in insulating ourselves from the pressures caused by high US interest rates. In short, our attack on the fundamental malaise of the British economy is making progress and deserves to be sustained.

Hazards

4. This scenario is however at risk in a number of areas.

5. First, developments abroad. There remains a strong risk that US interest rates will remain high - and could indeed go higher. And we cannot rule out the possibilities of international financial disorder deriving from major loan defaults, private banking failures, or exchange rate volatility.

6. Second, the domestic pay scene. E Committee is discussing this: the key point is that another pay explosion could blow away much that we have achieved, on inflation, productivity and competitiveness. We need settlements in the coming pay round substantially lower than those in the one now ending.

7. Thirdly, and perhaps most important, we could, by omission or commission, lose the confidence of the markets, domestically and abroad. This could result from a bad pay round, but equally it

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could spring from any suggestion that we were relaxing our grip on public expenditure, or that we were prepared to reverse engines on the drive to reduce borrowing, or through failure to carry conviction about our determination to maintain non-inflationary monetary conditions. Loss of confidence for any of these reasons would affect the recovery through the exchange rate, and interest rates, and more generally.

The Budget Prospect

8. At the time of the last Budget we saw room for tax reductions (over revalorisation) of only some £0.5 billion in the financial year 1983-84, assuming that the spending totals were held. This would be significantly less than we were able to concede in the last Budget; and the latest forecast does not materially change the position. Yet the case for assisting recovery by further tax reductions, for industry and if possible by raising personal tax thresholds, remains very strong.

9. To adopt the ostensibly "easy" course of borrowing more in order to permit tax reductions would be fatal to confidence. We must hold to the plans for reductions in the PSBR as a proportion of GDP which we have announced and so far delivered. The US example demonstrates all too clearly the consequences of failure in this respect.

10. The 1981-82 PSBR was £1½ billion below forecast. Analysis however suggests that this shortfall will not be carried through into subsequent years. It has been taken into account in the latest forecast; which shows the PSBR this year and beyond remaining very close to the figures published at Budget time.

Parliamentary
11. But this depends on holding, as the Chief Secretary proposes (C(82)), to the present spending plans, published only 4 months ago. If we were seen to be revising them upward, the effect on market confidence would be substantial and adverse.

12. Moreover, to increase the planning totals would mean a real possibility of tax increases next year. And to maintain market

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confidence, we would have to make it plain that we would not shrink from such increases. Yet the fact is that they would be wholly inconsistent with what the economy needs, and what we have in the past promised.

13. Far better to avoid all this. As para 2 and 3 above show, our monetary and fiscal policies are now starting to bring success, to change course would risk throwing away all that we have achieved, particularly on inflation.

Positive Action

14. But, though I am confident that we are on the right course, and must stick to it, we shall want to consider if there is anything we can do to improve the pace.

15. I am clear that we must be seen to do more to counter unemployment. This does not mean a change of macro-economic policy, for today's dole queue is not the result of our efforts to reduce inflation, but rather that of others' past failures to do so. To drop our efforts would merely store up new problems for the future, and would have a confidence back-lash. But we need a drive to make sure that what is now being spent, e.g. by the MSC, or what has already been made available, is being deployed to maximum effect, and attracts maximum attention. And we need to keep the political initiative in overcoming, or at least exposing, trade union resistance to sensible low-cost schemes for getting people off the register and into useful work.

16. Nor have we yet done enough to publicise and effectively promote all the changes we have made in order to encourage enterprise. A new publicity campaign has been agreed, but the search for ways of eliminating obstacles to enterprise must also be stepped up. There are major economic and political prizes to be won here.

17. Thirdly, on industry's costs, our role is two-fold. As well as working to secure further interest rates reductions (by ensuring that monetary conditions remain appropriate, seeking further to

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insulate our markets from the threat of another US interest rate crisis, and helping to improve industry's access to medium-term finance), we need to encourage the further reduction of unit costs. This is not merely a matter of encouraging restraint in pay: industry must also be encouraged to go on improving efficiency, through investment and the necessary changes in working practices. This entails our supporting those whose efforts to secure higher productivity lead to industrial action, and stepping-up our efforts to secure the removal of institutional and other obstacles to changes in working practices.

Conclusion

18. The economic prospects as we approach the last part of this Parliament are not unpromising (paras 2 and 3), but there are risks (paras 5 to 7). The greatest, and the one most within our power to avoid, is that of allowing ourselves to be sucked into a spiral of higher expenditure, and therefore higher tax (paras 8 to 13). We must maintain our fiscal and monetary policies, so as to be able to go on bringing interest rates down, and this means maintaining our grip on public expenditure. Consistent with that, we can and must do more (paras 14 to 17) to combat unemployment, unleash enterprise, and help industry improve its competitiveness.

PUBLIC EXPENDITURE: OBJECTIVES FOR 1982 SURVEY

We now need to start considering the public expenditure programmes for 1983-84 and the two following years. The Report of the Public Expenditure Survey Committee (PESC) which gives the material is available in Departments.

The Aim

2. The aim which I propose is to hold to the present planning totals, that is, for 1983-84 and 1984-85 the cash totals for the aggregate of programmes plus contingency reserve which we agreed last November and published in the March White Paper, as modified by the decisions announced in the Budget and with some minor estimating changes. For 1985-86 there is no cash programme yet. In discussion of colleagues' programmes for that year, consistently with the aim I am suggesting for the previous years, I propose to aim for the total currently shown in the PESC baseline.

3. The present planning totals for 1983-84 and 1984-85 stand at £120.3 billion and £127.6 billion. These totals include the additions of £7 billion and £5 billion respectively which we agreed last year on top of the previous plans which had been converted to cash using general inflation factors of 6% and 5%. For 1985-86, the PESC baseline is £133.3 billion.

4. To hold to these plans should leave room for modest tax reductions next year, which could benefit industry and aid economic recovery. The economic prospects are discussed in the separate paper C(82).. by the Chancellor of the Exchequer. We must beware of new commitments which would add to our problems after the next Election.

The problem in 1983-84

5. To achieve the aim of holding the planning totals will be difficult. We can accommodate some limited additions to certain programmes by committing now some of the contingency reserves of £4 billion for 1983-84 and £6 billion for 1984-85. But we must keep an adequate reserve for unforeseen contingencies. The need to do this has of course been particularly vividly demonstrated by the Falklands experience. At the beginning of the current year 1982-83 we had a reserve of £2.4 billion, and already it is clear that we shall find it hard to live within this.

6 For 1983-84 we have to recognise the probability of a substantial increase in local authority current spending, simply because, even with a very tough RSG settlement, we have no means of preventing some increased spending occurring, however much we may deplore it. In addition it looks as if our statutory social security commitments will cost £0.6 billion more than is allowed for in current plans. Including these amounts, the proposals put forward so far during the preparatory work for the Survey already amount to about £6 billion extra for 1983-84 and about £7½ billion for 1984-85; a summary of the main item is at Annex A. The Falklands will require certain additions to present programmes. So holding the planning totals will mean offsetting savings in some programmes.

Inflation

7. This year's Survey is the first to be carried out in cash at all stages. As I have indicated, the baseline figures originally incorporated an overall provision for inflation (pay and other prices together) of 6% in 1983-84 and 5% in 1984-85. The latest forecast for overall inflation, not just in the public sector, is about 7% for 1983-84, but I shall report any revision in September. No precise forecast can usefully be made for later years, but it will remain our firm objective that the rate of inflation should continue to decline. In these circumstances I propose no general revaluation of the cash programmes. In the case of public services pay, which we have discussed separately, we shall certainly want to aim at very much lower figures, and if later in the year our decision is to allow for less than the present implicit 6% for pay increases next year, it may then be necessary to make appropriate adjustments in the relevant programme figures.

Civil Service Manpower

8. The PESC Report this year sets out the approved and proposed manpower figures for each department. We are on course to achieve and hold the 1984 target of 630,000 civil servants. The position is tight. Any significant increases above what is now proposed would frustrate achievement of the 1984 target. There is no room for any new initiatives with sizeable manpower implications in the lifetime of this Parliament.

9. I propose that we now regard the figures in the Report for 1 April 1984 as firm limits in the next stages of the Survey. Within these limits, I will take up points with colleagues where some further reduction seems possible by April 1984 or where their figures for April 1983 seem too high to leave a feasible last step to their target for April 1984.

Conclusion

10. I invite the Cabinet:

- (1) to agree that our aim should be to hold to the present planning totals for expenditure in 1983-84 and 1984-85;

- (2) to note that this means only the minimum inescapable additions to programmes in the course of the current Survey, and requires reductions in certain programmes in order to leave room for these inescapable additions;
- (3) to agree that the civil service manpower totals for 1 April 1984 proposed in the report should now be regarded as firm limits;
- (4) to agree that within the general framework of (1) & (2), I should hold bilateral discussions with spending Ministers about additions and reductions to their programmes and report back to Cabinet in October.

BIDS FOR ADDITIONS TO PROGRAMMES IN 1983-84 AND 1984-85

The main bids received so far are as follows.

	1983-84		£m 1984-85
Defence	526	Including Armed Forces Pay, 3% real growth and relative prices	1200
	[250+]	Falklands consequences excluding garrisoning+	[250+]
Industry	272	Mainly regional development grants and launch aid for civil aircraft/engine.	400
ECGD	218	Effect of higher interest rate assumptions on export subsidies.	-
Housing	980	To maintain capital at 1982-83 level assuming rent increases in line with RPI.	825
Health	397	Inflation, relative prices, demography, health authority capital and some improvement in service.	532
Social Security	810	of which £560 million in 1983-84 and £661 million in 1984-85 for existing statutory obligation.	1233
Nationalised industry	1136	Increased external financing	1130
Local authority current	1100	Guess at likely expenditure over plan.	1250
Other	560		180
	<u>6250</u>		<u>8000</u>

+Provisional and partial estimate - not in PESC report

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C(82)

COPY NO.

CABINET

END-YEAR FLEXIBILITY FOR PUBLIC EXPENDITURE PROGRAMMES

Memorandum by the Chief Secretary

I was asked by the Defence and Overseas Policy Committee on 27 January to arrange for proposals for a scheme of flexibility between years for public expenditure. The invitation arose in the context of difficulties which were then anticipated with the defence programme, but the issue affects other departments too. The Secretary of State for the Environment subsequently suggested that we should consider end-year flexibility as a way of encouraging the construction industry.

2. I now attach a report by officials. As it reminds us, we have considered these questions before.
3. End-year flexibility would allow departments to carry-over any underspending into a subsequent year, or to overspend a cash limit in anticipation of a subsequent year's provision, or both.
4. Allowing overspending would be utterly inconsistent with our established policy that cash limits are a firm and effective control. I do not see how we could possibly support an arrangement which would appear to encourage or condone overspending of cash limits.
5. Allowing the carry-forward of underspending might be helpful to good management (though I think it is possible to exaggerate this). But it would also add to total public expenditure. The Treasury view is that the cost of the limited scheme described in paragraphs 19-20 of the paper would be of the order of £300 to £450 million a year starting in 1984-85. More ambitious schemes would cost more.
6. In the context of the situation described in my other paper C(82) , I do not think that we can at present afford any such scheme.

END-YEAR FLEXIBILITY FOR PUBLIC EXPENDITURE PROGRAMMES

Note by officials

The Defence and Overseas Policy Committee invited the Chief Secretary on 27 January to arrange for proposals to be submitted for a scheme of flexibility between years for public expenditure programmes, in time for possible introduction in 1982-83. Subsequently, the Secretary of State for the Environment suggested that consideration should be given to a similar scheme as a way of encouraging the construction industry. This paper, which has been agreed by an interdepartmental group under Treasury chairmanship, responds to both remits. It discusses the main issues and outlines the main points for decision should Ministers decide that they wish to implement a scheme of this kind.

History

2. End-year flexibility has been discussed several times in the recent past. In July 1980, the then Chief Secretary circulated a paper outlining a scheme which would have permitted carry-forward into a subsequent year of underspending on capital or equivalent programmes of up to 5 per cent. The scheme was discussed with the PAC, who indicated that they favoured a controlled experiment to provide evidence of its effectiveness (14th Report, Session 1980-81). In February last year, however, Ministers decided not to implement the scheme either in 1981-82 or 1982-83 because the potential cost in terms of additional public expenditure - £300 million in the first year and £450 million in later years in 1982-83 prices - could not be afforded. A description of the 1980 scheme, and its costing, is provided at Annex 1.

3. The Chief Secretary's scheme was a general one. Arrangements for certain types of end-year flexibility already exist within some programmes. In particular, individual local authorities already enjoy considerable flexibility for most of their capital expenditure, and individual health authorities for both current and capital expenditure, within the framework of overall national cash limits subject to the same discipline as any other cash limit. Flexibility arrangements of different kinds also exist for overseas aid and for nationalised industries' borrowing. A brief description of each of these schemes is provided at Annex 2.

Why end-year flexibility?

4. The objectives of end-year flexibility schemes are related to managerial efficiency problems associated with the strict application of annual cash limits. In brief they are intended:

- (i) to reduce the underspending which tends to result from programme managers' actions to reduce the risk of overspending, especially in situations where the pattern of expenditure or receipts cannot be controlled precisely.

Persistent and significant underspending may be regarded by Parliament as symptomatic of bad management. It cannot, however, be avoided if annual cash limits for some of the programmes most difficult to control are to be strictly obeyed. The gap between declared plans and performance, particularly for capital programmes which the Government has stated it wishes to preserve, confused Parliament and the private sector industries concerned. The respect for controls of programme managers set impossible targets is also undermined. On the other hand, although not always made explicit a general allowance for underspending is built into the Treasury's assessments of public expenditure and expected by informed commentators. If this were reduced, planned expenditure on programmes would, other things being equal, have to be lower to keep within the same planning total.

- (ii) to reduce the risk of waste at the end of the year. As the possibility of underspending becomes apparent, low priority expenditure with a short lead-time may be brought forward to reduce it.

The extent to which waste of this kind does take place is a matter for debate. The evidence is mainly anecdotal. It certainly does happen. But it does not necessarily follow that items brought forward because of short lead-times are not desirable in their own right.

- (iii) to reduce the risk of waste throughout the year, but especially at the end, if managers have to reduce expenditure quickly in whatever way they then can so as to avoid or reduce a threatened overspend.

Waste of this kind undoubtedly occurs from time to time, particularly in programmes where short-term cash flow can neither be controlled nor forecast within fine limits. This is true of the roads programme and complex programmes, like defence, where it may be impossible to adjust efficiently within an annual timescale. The problem is made worse where systems of forecasting, monitoring and control are inadequate.

5. Against these objectives have to be set the difficulty of cost, which could be very substantial depending on the precise nature of the scheme adopted, and the possibility of undermining the basic disciplines of cash planning, particularly if the scheme adopted covered overspending as well as underspending.

All these considerations have to be set in the context of the financial management initiative. Many departments believe that the drive to improve financial management and efficiency could increase the need for some kind of end-year flexibility if freedom and authority over their costs and expenditure is to be increasingly delegated to line managers. The right to accumulate savings in current expenditure to defray future cost-saving purchases, for example, could create difficulties if there was no corresponding freedom to carry voted funds forward into a future year. The Treasury do not, however, accept this. They believe that it is possible to exaggerate the extent to which strict observance of an overall cash limit is inconsistent with greater delegation of responsibility. It is already open to individual departments to provide flexibility between years for individual cost centres within their programmes (following the analogy of the health authorities and local authorities), provided the results can be contained within their total budgets. The introduction of better financial planning and control systems ought to make arrangements of this kind easier.

7. The following paragraphs briefly discuss the main issues which need to be decided if a scheme is to be implemented - whether it should cover over as well as underspending, whether it should include current as well as capital expenditure, which spending authorities should be included and the mechanics of the scheme.

Over and underspending

8. Most spending departments believe that end-year flexibility ought to apply to over as well as underspending. That is, they believe that spending managers ought to have the ability to anticipate up to a given proportion of a subsequent year's allocation, as well as to carry forward underspending into a subsequent year. They argue that only a symmetrical approach of this kind would fully meet the objectives set out in paragraph 4. The Treasury and Sir Derek Rayner's office take a different view. Considerations of cost apart, they accept that there may be case in principle for allowing the carry-forward of underspend. But they believe that to allow overspending in anticipation of next year's provision would seriously undermine the discipline of cash limits and cash planning. There would also be a problem of credibility, as to whether overspending would in practice be fully clawed back. A symmetrical scheme could be significantly more expensive in a given year than one confined to underspending.

9. It is already established policy that overspends on a cash limit in one year are automatically deduced from the cash limit for the following year.

10. The PAC did not recommend in favour of a scheme which allowed overspending. But they did suggest that the Government should consider whether in certain circumstances a 'less censorious' attitude towards occasional breaches in cash limits might be appropriate,

where this occurred beyond the control of departments. In their reply, the Treasury firmly rejected this idea.

Capital and current expenditure

11. The problems described in paragraph 4 apply mainly to certain capital and procurement programmes such as roads, defence procurement and prison building where much of the expenditure in a particular year may be on projects already under contract and where the timing of work and of payments for it may be uncertain. The problems of defence procurement were described in the memorandum by the Secretary of State for Defence circulated as OD(82)3. The difficulties of the roads programme are described in Annex 3.

12. Similar problems could, however, occur with certain types of current expenditure, particularly in areas where capital and current expenditure (as presently defined) are close substitutes for one another, or with R & D. The generality of current expenditure ought however, to be forecastable and controllable within much tighter limits than most capital expenditure.

13. Implementing a scheme to cover current as well as capital expenditure would add considerably to the cost. Total current expenditure by central government on goods and services in 1982-83 is planned to be £36 billion.

14. In practice, if a scheme was to be confined to 'capital and equivalent expenditure' this may need to be done in a way which meets the spirit of the proposals, even if it violates current accounting practice. The details of the expenditure to be covered on each programme would need to be discussed bilaterally once the decision as to principle had been taken.

Spending authorities to be covered

15. It was left open whether the 1980 scheme should apply to capital expenditure by local authorities and health authorities as well as by central government departments. It would be for consideration whether any scheme introduced now should do so. Individual health authorities and local authorities already have a great deal of flexibility within the national cash limits.

16. The arrangements for health authorities predate the introduction of cash limits. These appear to have worked well and to have given the health authorities the kind of managerial advantages now sought for central government departments.

17. The scheme for local authorities was only introduced in 1981-82. In that year the overall cash limit was underspent by around £600 million. The DOE believe that

underspending was partly caused by deliberate caution on the part of the local authorities, in turn partly caused by fear that the flexibility allowed them could lead to aggregate overspending, followed by a moratorium, as proved necessary for housing investment in 1980-81. Fears of this kind could be eased by a scheme which allowed for carry-forward at national level, particularly if it covered overspending.

Mechanics

18. There are a number of different ways in which a scheme for end-year flexibility could be operated.

19. The 1980 scheme was an administrative one. A similar scheme instituted now, and confined to underspending, might have the following features:-

- (i) carry-forward to the following year of underspends, subject to a minimum (necessary to avoid an unmanageable multiplicity of small amounts; the nature of the minimum to be considered further but possibly a combination of a percentage and an absolute amount) and subject to a maximum percentage of the original capital programme: the 1980 had a ^{maximum} of 5 per cent. The Secretary of State for the Environment has suggested that it should be as high as 20 per cent.
- (ii) the amount carried forward to be added to the programme previously settled for the following year and to be charged to the Contingency Reserve in that year, the Reserve being debited as soon as the amount carried forward is identified and agreed.
- (iii) Supply estimates increased when required by way of supplementaries.
- (iv) The system would probably only be workable if applied to whole cash limits. However, many cash limits contain a mixture of current and capital expenditure. It would be necessary to consider further the implications of this, including for the defence block budget.

20. A more detailed illustration of how such a scheme might operate is given in Annex 4. It could be introduced in 1982-83, with no credit being allowed for underspending in 1981-82 because by the time the scheme was launched it would be too late for it to produce any managerial advantages in that year.

21. An analogous arrangement could be devised to deal with overspending, though there could be problems of Parliamentary authorisation in relation to the overspending, in that it

ould increase the number of Excess Votes unless it emerged early enough for Spring Supplementaries to be taken. There could also be difficulties in managing the Contingency Reserve, since the possibilities of overspend may not emerge until very late in the year.

22. The MOD are concerned that an administrative scheme of this kind would not guarantee that flexibility would be allowed, since it would open to Ministers in any year to decide to refuse to agree to the necessary supplementaries (if, for example, they took the view that the Contingency Reserve could not accommodate them). The MOD have therefore suggested that, now cash limits are now mainly accommodated to votes, flexibility could also be voted if Parliament voted funds for a longer period than twelve months. Underspending could be catered for by allowing funds unspent at the end of March to be utilised during April. Overspending could be dealt with by allowing funds voted for the subsequent financial year through the vote on account to be utilised at the end of the previous financial year, e.g. from 1 March. In short, Parliament would vote funds for 14 months rather than 12. Underspent funds would automatically be carried forward for one month without creating a need for Supplementary Estimates in the following year. Overspending would automatically eat up the following year's funds and the cash limit discipline would be seen to be biting effectively. It would be for consideration whether a limit of some kind should be applied to the facility.

23. A fuller description of this alternative, as it might apply to MOD, is at Annex 5. It would probably require legislation, and could not therefore be introduced in 1982-83. It could involve a number of practical difficulties. Parliament could be expected to argue that Supply Procedure is already sufficiently flexible to allow the transfer of expenditure from one year to another without the need for devices which weaken their control over expenditure; and that the problem is one of public expenditure control, not Parliamentary authority for the issue of the necessary funds.

24. A third possibility would be to enable the payment of bills to be delayed or advanced to meet developing overspends or underspends. The superficial attraction of shifting payments in this way is that the cash limits of each respective financial year would remain unaltered; a potential underspend, for example, would be avoided by accelerating payments rather than adding to the following year's cash limit. Manipulation of bill payment would be in line with much private sector practice, and might be presented as a means of allowing more administrative discretion than the present situation allows.

25. Such a scheme would, however, require a change in the long-established principle that the Government pays its bills as soon as they are presented and the necessary formalities completed. They are good reasons for the convention. Deferring payments penalises firms and contractors - possibly unevenly - and would inevitably attract criticism. The Exchequer

ould effectively be borrowing from the contractor. This would normally in some way entail an additional cost. Making payments in advance of due dates in order to avoid an underspend might be unobjectionable from the contractors' point of view, but would involve an additional borrowing cost to the Exchequer.

26. A change of this kind, would also raise practical difficulties. In particular, there would be uncertainty about the extent to which payments should be advanced or retarded. The problem of making outturn conform to cash limits would therefore not be resolved, though it would be reduced.

Cost of the schemes

27. The potential cost of introducing a scheme of end-year flexibility is very uncertain and would depend upon the detail of the scheme adopted. Two effects need to be considered - the effect on public expenditure totals and the improvement in efficiency which might result. The latter is very difficult to evaluate.

28. The potential future expenditure cost of the 'basic' scheme described in paragraph 19 is roughly estimated to be similar to that of the 1980 scheme, about £300 million to £450 million a year in 1982-83 prices, starting in 1983-84, if the maximum carry-forward is limited to 5 per cent. The cost in any one year depends on the balance of expenditure brought forward from the previous year and carried forward to the following year. There would be no cost, and possibly some saving, in 1982-83. A fuller explanation of the costing is provided in Annex 1.

29. Extending the scheme to cover current as well as capital expenditure or over as well as underspending could add substantially to the potential cost and to the variability of the effect on public expenditure in any one year. So would any increase in the margin of flexibility to be allowed.

Conclusion

30. Ministers are invited to consider whether they accept the arguments in principle for some form of end-year flexibility, whether they are prepared to accept the potential addition to public expenditure in 1983-84 and later years when measured against other competing priorities and, in the light of this, whether they wish officials to undertake further work in designing a scheme either for general application or a more limited experiment.

31. If further work is to be done, it would be helpful to have a guidance on:

- (i) whether the scheme should be addressed only to underspending or should cover overspending as well.

- (ii) whether it should extend to current as well as capital and equivalent expenditure.
- (iii) whether it should cover the expenditure of health authorities and the capital expenditure of local authorities as well as the expenditure of central government.
- (iv) which of the approaches outlined in paragraphs 18 to 26 they favour.

ANNEX 1: COSTING OF THE 1980 SCHEME FOR CARRYING-FORWARD OF UNDERSPEND

The scheme was limited to expenditure for which there is a managerial case for flexibility, principally capital expenditure. The carry-forward was subject to a maximum of 5 per cent of eligible expenditure and a minimum of 1 per cent, the minimum threshold being intended to prevent a large number of Supplementary Estimates for small amounts. Departments were asked to give their views on the scheme at official level and to give the total value of expenditure that would be eligible in 1981-82. It was explained that it was for consideration with the relevant departments whether it would extend to the capital programmes of the local authorities or the health authorities. The scheme would not apply to the external finance of the nationalised industries about which separate discussions were in progress. It was envisaged that the additional expenditure needed for the scheme would be charged to the Contingency Reserve and in evidence to the PAC the Treasury said that the carry-forward could be authorised in summer Supplementary Estimates.

2. Under this scheme the total of eligible expenditure was about £10 billion in 1980 survey prices, this figure including some allowance for local authority and health authority expenditure. Of this, almost £5 billion was on defence procurement and capital expenditure. In evidence to the PAC, the Treasury said that 'On a five per cent basis, the maximum potential carry-forward would be of the order of £500 million, but because departmental requirements would be uneven the actual carry-over should be less than that'. It was estimated that the actual carry-forward might be only about £300 million in 1980 survey prices. However, it was expected that the scheme would cause Departments to underspend slightly more because they would not be so anxious to spend their full allocations before the year-end and a figure for this effect of £100 million or so, in 1980 survey prices, was suggested.

3. The net overall cost of the scheme in the first year of operation would therefore be the £300 million likely carry-forward less the estimated £100 million additional underspend ie £200 million in 1980 survey prices. The scheme would have started with a carry-forward from 1980-81 to 1981-82, the net cost being about £250 million in 1980-81 prices, the rough equivalent of £200 million in 1980 survey prices. In later years the cost of the scheme would be higher since the higher underspend would be offset by the higher carry-forward, so the cost would be about £300 million in 1980 survey prices. In 1982-83 prices the cost would be £300 million in the first year and £450 million in later years.

4. The scheme considered in this paper is slightly different from the 1980 scheme in that departments would be given notice of its introduction; ie they would be told in 1982-83 that a carry-forward would be allowed from 1982-83 to 1983-84. So in 1982-83 there would be a

ing of about £150 million and in future years the cost would average about £450 million in 1982-83 prices with the cost being higher in some years, lower in others. The effect on the Contingency Reserve would depend on when the debits take place. If the carry-forward was authorised in summer Supplementary Estimates, the cost to the Contingency Reserve when the scheme is in operation would be £600 million in 1982-83 prices, which would be offset by an underspend of £150 million. However, if the debits only take place when departments need the money then the cost to the Contingency Reserve would be smaller, in the range £450 million to £600 million, say £500 million, with the underspend being correspondingly smaller.

5. Since this costing was made in 1980, departments have gained greater expertise in living within cash limits. So the estimated costs given above may be on the high side, the cost might be a third less than the estimates given above ie about £300 million in 1982-83 prices, so the effect on the Contingency Reserve would be between £300 million and £450 million, depending on when the debits for carry-forward are made.

ANNEX 2: EXISTING END YEAR FLEXIBILITY SCHEMES

The only case where a department is allowed to carry over expenditure is the overseas aid programme. Most of this programme is cash limited, but there is a proportion which consists of non-voted expenditure not subject to cash limits. Under a long-standing arrangement, an underspend of up to £15million (about 1.5 per cent of the total) may be carried forward to be added to the aid programme in the next year but one, subject to Treasury consent. Similarly, any overspend is carried forward and deducted from the next year but one. In practice, these arrangements are held in reserve. ODA is expected to make all possible efforts not to overspend its programme. In particular, the roll-over provisions do not give ODA any excuse for breaching its cash limits.

2. Since 1981-82, nationalised industries have been allowed increases in short term borrowing from the NLF at the end of the year in excess of that year's EFL, within one per cent of forecast turnover and fixed investment expenditure and on condition that the amount of the excess is deducted from the following year's EFL. Maintaining the discipline for carry-forward of overspends depends on the additional cash not being available until the following year's EFL has been set. Thus the EFLs are set during the third quarter and the carry-forward scheme is only available in the final quarter. To date there is little practical experience of the scheme's operation.

3. Flexibility schemes exist within programmes. For example, within the framework of an overall cash limit which is subject to the same discipline as any other cash limit, the DHSS have for some years allowed individual regional health authorities to carry over underspending of up to 1 per cent of their revenue allocations into the subsequent year. Any overspending is deducted from its allocation in the next year. Health authorities are also allowed to carry over underspending of up to 10 per cent of their capital expenditure allocation, with the adjustment being made in the next year but one. They also have some freedom to shift resources between capital and current expenditure. These arrangements appear to have worked well for several years. DHSS believe that the arrangements for revenue carry-over, while not eliminating underspending, have enabled them to reduce it below what it would otherwise have been and that it also helps to reduce wasteful expenditure at the end of the year.

4. An analogous arrangement has been introduced with effect from 1981-82 for local authorities' capital expenditure. Within a national cash limit for the bulk of local authority capital expenditure, individual authorities may carry forward an unspent allocation up to 10 per cent of the total to a subsequent year, anticipate a subsequent years' allocation by the same amount, or both. Other features of the scheme give further flexibility. It is too early to judge whether the scheme is compatible with maintenance of strict control on the national cash limit.

ANNEX 3: THE ROAD PROGRAMME

Note by the Department of Transport

This note sets out the particular problems in the application of an annual cash limit to the Roads etc. England vote. These arise from the problems of reconciling expenditure on the roads programme which comprises about 98 per cent of the Vote, and in the short run is inherently volatile, with an inflexible annual limit.

2. About three-quarters of the vote is for new construction and improvement schemes, including preparation and supervision. Two-thirds of the rest is on structural maintenance, which although classed as current expenditure is akin to capital expenditure. Road construction is necessarily a long-lead programme. Schemes making up the programme commonly take four years to complete with most of the expenditure concentrated in the second and third years. Up to 90 per cent of prospective expenditure in any individual financial year is committed before the year starts, and most of the rest is generally committed in the first half of the year. The scope for adjusting cash flow to meet fluctuations during the year in which they occur is therefore limited. As the rest of the cash block is small, it gives no significant scope for balancing uncontrollable deviations in the main programme.

3. Problems first arise because the indices used to establish the cash limit for the vote are extremely volatile. Assumptions made when the cash plans are agreed can be overtaken even before the year begins, as was the case this year (1982-83). Not only are future trends unpredictable, but partly because of problems of analysis, reliable information on past movements is not available until up to a year after the event. The interdepartmental Working Group on Roads Revaluation set up in 1981 found no way of remedying this situation. Without a reliable method of predicting price movements, the Department must therefore plan against a background of considerable uncertainty.

4. Various factors add to the uncertainties. As with other construction programmes, when the construction industry is short of work, tenders can be particularly keen. If, on the other hand, contractors are in a stronger position, tenders may be higher than expected. The road construction industry moreover is specially vulnerable to certain cost changes: the cost of oil, for example, affects the cost of bituminous surfacing as well as transport costs and those of operating plant on site. These are substantial elements in their costs. The industry's annual wage settlement generally takes place in July. This is early enough in the financial year significantly to disturb costs if an unexpectedly high increase is agreed, but too late to allow significant changes to commitments for the year.

The Department constantly refines its techniques for predicting the pattern of payment on contracts and relating these to commitments. There remains, however, a substantial random element which can cause major deviations from the projections on any one scheme.

6. The weather is a major cause of these random changes. Large-scale road building entails moving large volumes of earth, in some cases to clear the way for a road, in nearly all cases to use after compaction as the base for the carriageway. Weather conditions will have a marked effect on such operations, and can cause substantial variations in spending. Other operations are delayed by unseasonably cold weather. In unusually favourable conditions contractors can improve on expected progress and become entitled to larger progress payments than forecast. In poor conditions work can be delayed, even brought to a halt, and the projected scale of payments then becomes an overestimate.

7. Another uncertainty arises from the timing of claims arising from variations in contract or unforeseeable difficulties of terrain. Sometimes contractors are unpredictably slow in submitting claims: at other times, claims are prompt or applications are made for them to be made more frequently than is usual. Problems can also arise with the programming of large construction schemes where local or even national opposition can cause postponement at short notice. This can radically alter prospects in a very short time and, if it occurs well into the year, there is no prospect of offsetting delays by adjusting the programme. Large schemes especially cannot be replaced or rescheduled quickly.

8. Within the constraint of an inflexible annual cash limit, the Department cannot run the risk of deliberately aiming high in its plans, because it could not accommodate the possibility of an overspend. The scope for then using up the headroom later in the year should it not be required is however very restricted: contracts cannot be released to reduce it as they would not generate significant expenditure in time - and they would tend to over-commit the programme for the following year.

9. Flexibility between years would provide a way of smoothing out the effect of all these unpredictable short-run variations in the cost and rate of road building and thus improve the efficiency of management of the programme.

ANNEX 4: EXAMPLE OF HOW END YEAR FLEXIBILITY SCHEME MIGHT OPERATE

The following simple example illustrates how the scheme might work. The essential features are carry-forward of underspending up to a maximum, starting in 1982-83, but with no credit allowed for underspending in 1981-82. The scheme is compared with the situation where there is no end year flexibility ie the "do nothing" situation. In the example "surge" is used as shorthand to describe low priority expenditure which may be brought forward at the end of the year to reduce underspending on a cash limit. The numbers in the example are merely illustrative and are not intended to show the possible cost of the scheme.

	<u>1982-83</u>	<u>1983-84</u>	<u>£million</u> <u>1984-85</u>
<u>A. Do nothing</u>			
Provision	1000	1000	1000
Expenditure	990	990	990
Shortfall	10	10	10
<u>B. End year flexibility</u>			
Basic provision	1000	1000	1000
Augmented provision	1000	1020	1020
Normal shortfall	10	- 20	10
Lack of surge	10		
Expenditure	980	1000	1010
Total underspend = carry forward	20	20	10
<u>Cost of scheme</u>			
ie additional expenditure compared to do nothing situation.	-10	+10	+20

2. In 1982-83, the example assumes that total underspend is £10m more than in the "do nothing" situation. This is attributed to the lack of end year surge, as the department knows that it can transfer its underspending to 1983-84. The cost in 1982-83 is therefore -£10m.

3. In 1983-84, the example assumes that actual spending is £1000m, and that carry-forward to 1984-85 exactly balances what was brought forward from 1982-83, at £20m. The cost of the scheme is therefore £10m, the amount of the normal shortfall. In

nciple, there would be no need for the department to claim on the contingency reserve, since its actual spending equals its basic provision. But in practice, the department might think part way through the year that it will spend the £20m it had brought forward from 1982-83, and claim it from the reserve. In this case the £10m costs of the scheme would be made up of £20m from the reserve offset by an additional £10m underspend (£20m instead of £10m in the "do nothing" situation).

4. In 1984-85, the example assumes that actual spending is £1010m, ie that carry-forward to 1985-86 is £10m less than the underspend brought forward from 1983-84. The cost of the scheme is therefore £20m. Again, the department might claim the full £20m from the reserve part way through the year; in this case the £20m cost exactly matches the drawing from the reserve, because total underspend is the same as in the "do nothing" situation.

5. The example shows that the cost of the scheme in any one year (after 1982-83) depends on two elements.

- (i) the amount of normal shortfall without flexibility
- (ii) the balance between the amount of underspend brought forward, and the amount carried forward.

The second element can be positive or negative, and might be expected to balance out over time. The two elements are not independent, however: if a department plans to use up all the underspend it has brought forward from the previous year, it will probably not be able to eliminate all its normal shortfall, as the augmented provision will act as an absolute constraint in the same way as cash limits in the current system.

6. An optional feature of the scheme might be that any second year carry-forward would not be automatic, but would be reserved for Ministerial discussion and agreement. In the example, in 1983-84, there would be no automatic carry-forward of £20m to 1984-85, since actual spending matches basic provision. This £20m carry-forward would be reviewed before being added to the basic provision for 1984-85.

ANNEX 5: HOW A 'VOTED' FLEXIBILITY SCHEME MIGHT OPERATE IN MOD

Note by the MOD

The capital etc. expenditures and receipts which are difficult to estimate and control with precision are spread throughout MOD cash limited votes. Subheads covering expenditures of about £7,500m and receipts of nearly £1,200m might be included within a flexibility scheme.

2. On the assumption that expenditure would in normal circumstances be evenly spread throughout the year, a 14 month year would allow about £500m of funds to be moved in either direction across the 31 March barrier. As far as MOD is concerned this would not have produced any increase in total expenditure over the last 5 years, because outturn has been very close to the cash limit over that period. The practical problem is that when a trend to either overspending or underspending is identified there is inadequate time to take smooth corrective action to the programme in-year, and the knock-on effect of such corrective action in future years needs to be taken into account.

Illustration A. Overspending.

Assume a continuing annual budget of £1,200m ie £100m per month.

By end-July the trend is 10 per cent too high. There is a 3 month lag in payments. Hence, action cannot effectively influence cash flow before end-October. By that time expenditure = £770m, leaving £430m to be spent in the remaining 5 months. Effective corrective action within the year would imply monthly expenditure by March running at about £80m ie well below the monthly level required for the following year.

If an overspend of up to £100m were permissible, it would be possible to limit the reduction of average monthly expenditure in the last five months of the year to a level consistent with a budget of about £1,100m in the subject year. If restraint were too effective the underspend facility would operate at the end of the second year.

Illustration B. Underspending.

Again, assume a budget of £1,200m ie £100m per month. By end-July the trend is 10 per cent too low. By end-October, total expenditure = £630m leaving £570m to be spent in 5 months. Effective corrective action within year would imply a level of monthly expenditure in excess of £120m by March, with consequent problems in following year.

If the facility existed to carry forward £100m, a long term monthly expenditure rate of about £100m could be arrived at ie consistent with a budget of £1,300m, in the second year.

If the expansion were overdone, the overspend facility would operate at the end of the second year.

3. The defence cash limit is treated in practice as a single, overall cash limit. If flexibility is to be limited to defined categories of capital expenditure, there might need to be some modification of this concept. The question of virement between subheads would also need to be examined.

4. An important feature of this scheme is that overspends and underspends would be carried forward automatically. This would facilitate the delegation of authority and responsibility for cash flow to managers without the fear that this would inevitably create large underspending. Taut estimating necessarily involves a symmetrical risk of overspending/underspending.

5. Under a 'voted' flexibility scheme it would perhaps not be necessary to surrender excess receipts at 31 March (as cfers).

6. Current accounting procedures might be reviewed. At present a great deal of attention is directed to determining the exact sums to be booked to vote in a particular year and long after a year has ended there is uncertainty, within £50m in either direction, what the total will be. Precision may be less necessary if succeeding financial years overlapped.

JUL 1982

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10 DOWNING STREET

From the Private Secretary

8 July 1982

CABINET, 15 JULY

Thank you for your letter of 6 July, to which were attached three draft Cabinet papers: the Chancellor's on the economic background, the Chief Secretary's on the objectives for the 1982 Survey, and another by the Chief Secretary on "End-year flexibility".

As you know, the Prime Minister and the Chancellor discussed these en route for Rome. The Prime Minister has agreed that the three papers should be circulated, and that the first two should be discussed at Cabinet on 15 July; on the flexibility paper, she would prefer no discussion either on 15 July or before the recess.

I am sending a copy of this letter to David Wright (Cabinet Office).

M. C. SCHOLAR

John Kerr, Esq.,
HM Treasury

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