

PREM19

24

ECONOMIC POLICY

(Strategy)

(Part 1)



PART 1:

SECRET

MT

(SEPARATE BOX)

Confidential Filing

Economic Strategy. Pay and Prices.

ECONOMIC
POLICY

PART 1:
May 1979

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
8.5.79							
9.5.79							
17.5.79							
29.5.79							
31.5.79							
4.6.79							
6.6.79							

PREM 19/24

PART 2 begins:-

S/S Energy to Pm 17/6/79

PART 1 ends:-

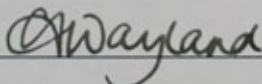
Pm to H. Sec 14/6
(MS/79T)

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
C(79) 6	15/05/79
CC(79) 2 nd Conclusions, Minute 7	17/05/79
E(79) 5	24/05/79
E(79) 2 nd Meeting, Minute 1	01/06/79
E(79) 8	04/06/79
E(EA)(79) 2 nd Meeting, Minute 1	07/06/79
E(79) 9	12/06/79

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate CAB (CABINET OFFICE) CLASSES

Signed 

Date 24 October 2009

PREM Records Team

SUBJECT



cc Mr Hoskyns FILE
Mr Hoskyns

10 DOWNING STREET

B/F 15-679
for meeting on Monday

THE PRIME MINISTER

Personal Minute

No. MS/797

SECRETARY OF STATE FOR THE HOME DEPARTMENT

We are meeting on Monday at 1100 in No. 10 to consider the framework of the economic strategy required to meet our objectives. John Hoskyns, Head of the Policy Unit at No. 10, has prepared the attached paper as a basis for our discussion. I am sending it to you so that you will have an opportunity, in consultation with Ministerial colleagues in your Department and your Permanent Secretary, to consider its implications in readiness for our discussion.

I am copying this minute, with John Hoskyns's paper, to the Chancellor of the Exchequer, the Secretaries of State for Industry, Employment, Environment, Energy, Trade and to the Lord President of the Council.

Margaret Thatcher

14 June 1979

tw

Ref: A09776

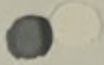
MR. LANKESTER

Monthly Economic Report (E(79) 9)

I mentioned to you that I had the strong impression during the last months of the previous Government that the Monthly Economic Report was not being read by Ministers, largely because it had become too long. For my own part, I had also stopped reading it, apart from the cover note: and I found that Sir Douglas Wass was doing the same. Accordingly, after discussion with Mr. Boreham, we are trying out a much shorter alternative version which consists only of a cover note and a lot of charts. If you get a reaction from the Prime Minister, one way or another, to E(79) 9, I should be interested to know.

John
(John Hunt)

14th June 1979



14 JUN 1979

14 JUN 1979

Faint, illegible text covering the upper half of the page, possibly bleed-through from the reverse side.

14 JUN 1979



Faint text at the bottom left of the page.

CONFIDENTIAL

sjn



file cc: Home Secretary
Foreign Sec
D/I
Ld President
D/EMPLOYMENT
MAFF CS, TSY
D/T CO
D/EN

10 DOWNING STREET

From the Private Secretary

14 June 1979

The Prime Minister would like a further discussion on pay in the Ministerial Committee on Economic Strategy soon after she returns from the Tokyo Summit.

The Chancellor of the Exchequer was invited at the E Committee meeting on 1 June to circulate a paper setting out the possibilities for a "forum" in which pay matters could be discussed with interested parties in a wider context. This is one paper which the Committee will need to discuss. But in addition, the Prime Minister has asked for two further papers to be commissioned.

The Prime Minister would like the Secretary of State for Industry to circulate a paper on the questions of pay, prices and efficiency in the nationalised industries. She would also like the Chancellor to bring forward a paper on the question of the pay element in future cash limits for central and local government and the nationalised industries, together with an indication of the timetable against which decisions must be taken.

I am sending copies of this letter to the Private Secretaries to the members of E Committee and Martin Vile (Cabinet Office).

TIM LANKESTER

Tony Battishill, Esq.,
H.M. Treasury.

CONFIDENTIAL

2/11

PRIME MINISTER

John Hoskyns has prepared the attached paper for you and the colleagues concerned to use as a basis for discussion at your Ministerial meeting on strategy on Monday at 1100. We ought to send it out in good time for them to read and I think it would be right to do this under cover of a minute from you indicating that you want Ministers in their Departments to have done their homework on it before the meeting. I attach a draft for this purpose.

Are you content for the paper to go forthwith, under cover of your minute?

Yes - but it
will take a

KRS.

whole day

do discuss it even on the
basis of the possible
Appendix.

13 June 1979

GOVERNMENT STRATEGY

1. INTRODUCTION

This paper is intended as background to our Strategy Meeting on 18 June. The purpose of that meeting is to answer the following questions:

- (1) What are the Government's main objectives?
- (2) What essential intermediate objectives - or "sub-objectives" - must be achieved, if we are to reach those main objectives?
- (3) What actions must which people put in hand, starting when, if we are to begin moving towards those sub-objectives?

The structure of the paper is as follows:

Section 2: OBJECTIVES AND STRATEGY. This Section briefly recapitulates the Stepping Stones thinking of the last two years, for those who were not involved in it.

Section 3: STABILISATION. This Section looks at some of the sub-objectives which must be achieved over the next 2-3 years, if we are to prevent our present instability from undermining all our other plans.

Section 4: REBUILDING THE REAL ECONOMY. This Section lists some of the measures needed if the long process of economic recovery is to start.

Section 5: INNOVATION. This Section briefly discusses the need for new ideas in policy, whether novel measures or familiar ones assembled in new ways.

Section 6: COMMUNICATIONS. This Section discusses the importance of communications to support policies, and as part of a programme, which starts now, to ensure that we win a second term in 1983/4.

Section 7: CONCLUSION. Summary; suggested agenda at Appendix A.

2. OBJECTIVES AND STRATEGY

2.1 The Stepping Stones Project

2.1.1 The purpose of the Stepping Stones project was to develop a coherent approach to the task of turning round the British economy. The emphasis was not on the developing of a comprehensive list of measures, but rather on ensuring that we understood the structural and systemic nature of the problem. We agreed that, if we could do this before coming to office, we would have a better chance of concentrating our limited resources of thinking time, administrative effort, political capital, money, on the root causes of Britain's malaise, rather than doing "a little bit of everything", in treating the symptoms.

2.1.2 The reason why previous Governments have had virtually no success in halting Britain's decline is that the nature of that decline has not been fully understood. In particular:

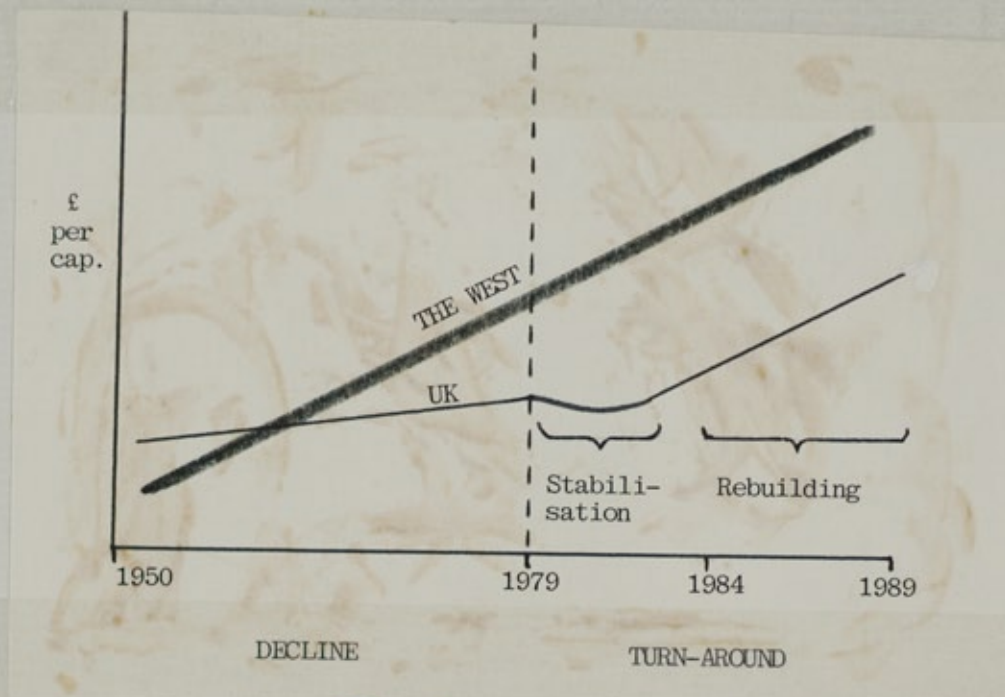
- (a) The problem is a single problem with a large number of interconnected bits and pieces. The interconnections cross departmental boundaries, and comprehending the problem in its entirety is difficult.
- (b) The decline process is a network of vicious circles, which are continually generating fresh momentum. The process is thus, at any given moment, always more powerful than it looks. Governments have found themselves vainly chasing after an accelerating decline, instead of preparing to intercept it.
- (c) We are dealing with social systems, not mechanical ones. The expectations within the system tend to be self-fulfilling. Government therefore has to persuade people to think and feel differently, before the behaviour of the system can change.

2.1.3 We found it helpful to distinguish between categories of policy. In particular:

Good Housekeeping - All those sensible economic policies (included in our Manifesto), whose gradual abandonment over the last 20 years has been responsible for most of our problems. Economic recovery will not be possible without a resolute and single-minded return to Good Housekeeping. But Good Housekeeping alone will no longer be enough to arrest the decline momentum.

Turn-Around - These are the new measures which must arrest that momentum and get the economy back to a stable state, in which Good Housekeeping policies can become effective. In this paper I have suggested that the process of Turn-Around should itself be divided into Stabilisation, and Rebuilding.

We can represent the whole process as follows:



Stabilisation is the difficult bit. It is what people mean when they say "You can't get there from here". That part of the journey is likely to take most of our first 5 years. There is likely to be a noticeable J-curve effect over the first 2 or 3 years, when economic deterioration, as judged by the traditional indicators - growth, unemployment, inflation - will all look worse than they did in 1978/9. Hence the need for careful design of the stabilisation programme and its successful communication to the electorate. The electorate, and the media commentators, have experienced 20 years of Government exhortation, new dawns, belt-tightening, all without any discernible effect on our fortunes. The resulting scepticism is now one of the main obstacles to recovery.

After Stabilisation, we will need to get back to a growth rate which is roughly similar to that of the other Western countries. The alternative is to continue to drop slowly out of the Western world in political, social, and military terms.

- 2.1.4 In reality, of course, the Stabilisation and Rebuilding policies will merge together. It is neither necessary nor desirable that measures for Rebuilding should wait until the Stabilisation process is achieved. In fact, the more credible the Stabilisation programme looks - and thus the more quickly confidence is restored - the sooner the Rebuilding process can start. But it is important, in our own minds, to separate

the two. While Stabilisation is possible, with or without subsequent Rebuilding, Rebuilding will not be possible without Stabilisation. To attempt it would be like trying to pitch a tent in the middle of a landslide. This is what Governments have tried to do in the past and have been surprised as their efforts keep getting swept away by the latest instalment of bad news.

2.1.5 In the original Stepping Stones report, we listed our Stabilisation objectives as follows:

- (a) Zero, or near-zero, inflation.
- (b) ! Zero inflationary expectations. In other words, people must be sure that there will either be no further inflation; or else that they would neither gain nor lose, if there were.
- (c) Private sector and "market" public sector pay systems. The process of pay bargaining should no longer be capable of either raising prices or reducing investment. It must instead be based on past real economic performance.
- (d) Non-market public sector pay systems. These systems must in aggregate be non-inflationary, in the same way, following real GNP growth rather than triggering monetary expansion. (There will of course be wide variations within the public sector reflecting labour supply and demand.)
- (e) Restoration of personal incentives (involving a significant reduction in Government's share of GNP).

What-

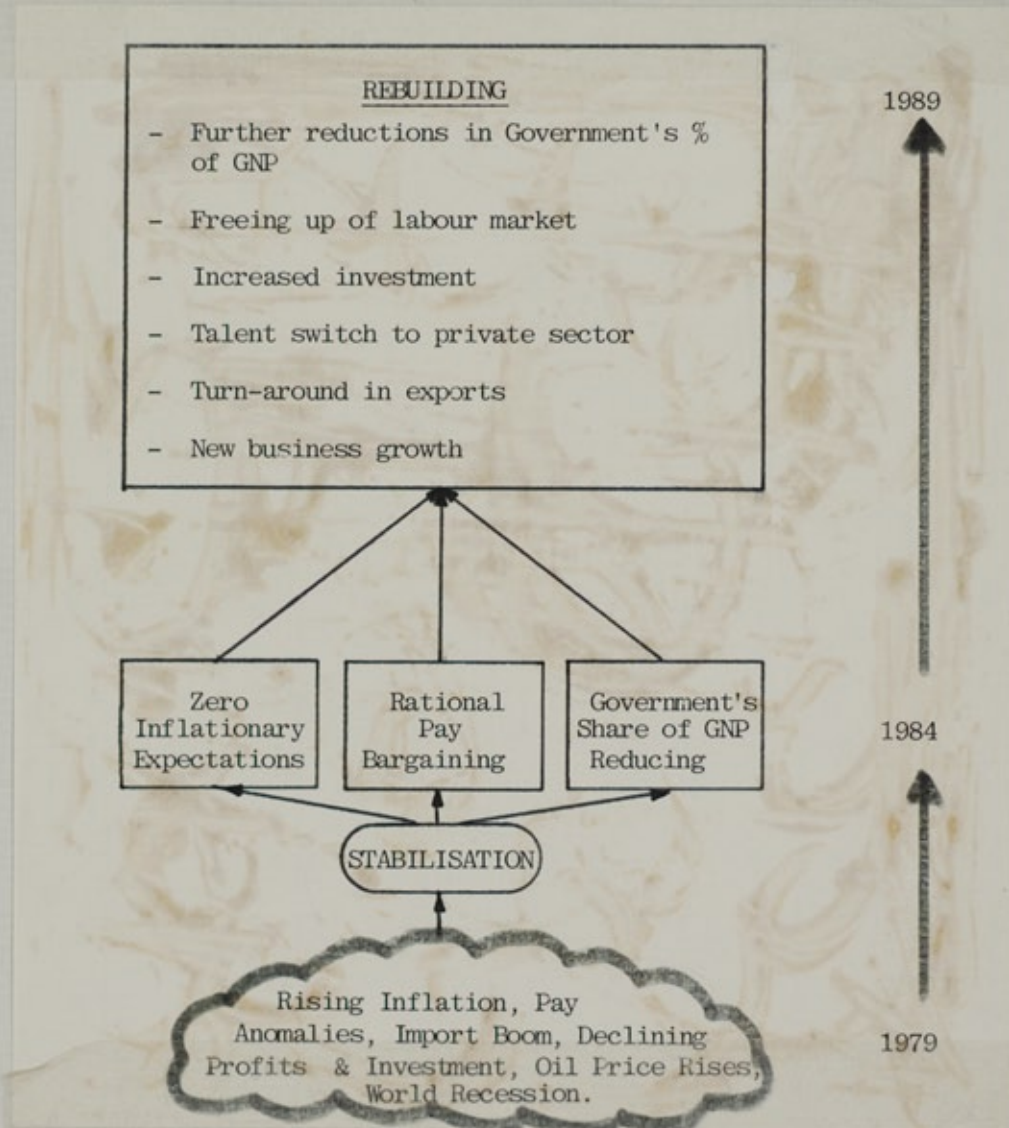
To this we should now perhaps add:

- (f) : Stabilisation of the exchange rate, if that is possible at all, at a level which allows British exporting companies to bootstrap themselves back to real international competitiveness, given other structural changes.

This is the sort of stability we should be aiming for. We have a large task of economic rebuilding to do, and we need a high degree of stability if we are to do it. But these objectives do no more than allow the process of Rebuilding to start. On their own, they will do no more than stabilise the rate at which we drop out of the Western world, in relative economic terms. For Rebuilding requires fundamental changes in both the quality and the financial arithmetic of the private sector.

Strategy requires the setting of objectives and working back from those objectives to find possible routes from the present situation.

If we now take a 10-year view of our long-term objectives, intermediate objectives and strategy, we could get a simple picture that looks like this:



3. STABILISATION

3.1 Which Comes First, Stability or Confidence?

3.1.1 Stabilisation requires "reasonable behaviour!" It is difficult for Governments to stabilise the economy while individuals or groups behave irrationally or irresponsibly. But if the economy is unstable - especially with a combination of inflation, inflationary expectations and accumulated distortions and

grievances as a result of past failure to index - everyone is forced to take action to protect himself, even though it is obvious that those actions help to perpetuate the instability. The most obvious example of destabilising behaviour is that of trade unions trying to pre-empt each other's attempts to anticipate the future inflation rate.

- 3.1.2 Reasonable behaviour depends on confidence about the future, so that people are prepared to plan ahead, and to make present sacrifices for future benefits.

Confidence will always be a relative matter. It can never be complete, because the future is uncertain. But the additional uncertainty caused by a high and rising inflation rate can be relied on to produce the "unreasonable" behaviour which will itself make that inflation much harder to eliminate.

If these circular forces are likely eventually to drive us to some sort of interim pay freeze or guideline, it is important that we see it coming and build it into our Stabilisation strategy, as a properly thought out option.

- 3.1.3 Business confidence is also a complicated matter, because a businessman only feels confident when he senses that other businessmen also feel confident. Confidence comes - as people who have worked in the United States know - from direct experience of successful operations, and from seeing many other examples of spectacular business success. It cannot come from the assurances of politicians or the increase of investment grants. It is therefore a long drawn out chicken-and-egg process. After all, most businessmen have been living, like everyone else, with economic disappointment for 15 years. (It is very much easier to recreate economic confidence in an economy which has nowhere to go but up: eg Western Europe after the war or South Korea, Singapore, Taiwan today.)

A realistic objective would be for British businessmen to begin to think like their foreign counterparts by the time Stabilisation has been achieved - in other words, about 1983 or 1984.

3.2 Where do we Start?

- 3.2.1 Past efforts to revive the economy have consisted of Government exhortation (management must be bolder, unions must be more co-operative, consumers must tighten their belts) coupled with steadily growing public expenditure, and fiscal and monetary adjustments of various kinds. In the absence of any sustained programme to restabilise the system and then repair its structure, these efforts have amounted to no more than fighting with the controls of an aeroplane that can no longer fly.

3.2.2 The present unstable situation includes:

- (a) High inflation and inflationary expectations. Further post-dated cheques in the pipeline. Still growing public expenditure.
- (b) Unresolved pay anomalies, especially in the public sector.
- (c) Import boom, with falling company profits, aggravated by an over-valued pound.
- (d) Likelihood of world recession, with further oil price rises.

3.3 Main Components of a Stabilisation Programme

3.3.1 It was suggested in Section 2.1.5 above that a successful Stabilisation programme would achieve five things: zero inflation/inflationary expectations; performance-related pay bargaining in the private sector; GNP-linked pay bargaining in the non-market public sector; the restoration of personal incentives; and a stable and appropriate exchange rate.

3.3.2 Here are some of the questions we have to ask before trying to assemble a programme to achieve such objectives:

(1) Inflation

- (a) What is our target rate of inflation? Is there an inflation rate (say 3%) which does not inhibit the economic rebuilding process, and might even lubricate it?
- (b) Given that it will take time to squeeze inflation out of the system, are there any ways in which we can reduce inflationary expectations (which will otherwise make the elimination process harder) in the meantime?
- (c) To what extent should we index in order to reduce further distortions, anomalies and injustices during the squeezing-out period?

(2) The Role of the Trade Unions

- (a) Will the changes in union law now in hand be sufficient to prevent the strong unions from gaining at the expense of the rest of society, under a regime of tight monetary discipline?

- (b) Is there any other mechanism, apart from a transitional period of pay freeze or pay restraint, by which we can prevent unions trying to get ahead of each other and repeating the 1974 disaster?
- (c) More generally, are there other ways in which we can persuade unions to bargain in ways which do not inevitably lead to some combination of lower investment/higher prices/fewer jobs?
- (d) How do we get the "union debate" started properly, as proposed in the original Stepping Stones report? We need to force union leaders to address their members in the language of the real world, so that rational debate about the role of the unions over the next vital years can begin. The predictable reactions of union leaders to the Budget could provide the opportunity.

(3) Exchange Rate

- (a) In the past, devaluations have been, faute de mieux, the only actions Government have taken to try to rescue British industry from its own failure. Attempts at real structural change, (eg tax, union reform) have either not been attempted, or have come unstuck. We now have no option but to go for structural change. Is there such a thing as an optimal exchange rate for that period of change? Is there in fact anything we can do to help bring about such an exchange rate?
- (b) What are the present predictions for the exchange rate, in the light of the Budget? If the pound remains high, to what extent can exporting companies adapt to it? What is the process by which they would do so? What is the likely effect of the relaxing of exchange controls?

(4) Reducing Unnecessary Risk

- (a) We know that macro-economic management will be extremely difficult, because the real economy is now so fragile. Even if we get all the main decisions right, turning the economy around will be a close-run thing. In every major decision, therefore, we have to be clear about what we are trying to achieve; are we trying to maximise the benefits of a correct decision, or to minimise the cost (political as well as economic) of a wrong one? They are two different objectives, usually, though not invariably, requiring different approaches. Perhaps the most obvious example of a complete lack of this sort of perspective was the introduction of museum charges in 1970/71.

- (b) Purely as examples, we may take a high-risk technical decision on nuclear power technology, which may have extremely serious consequences if we are proved wrong, and only modest benefits if we are proved right. Similarly, the political disadvantages of BNOC may be less (especially once some of its privileges are trimmed back) than its usefulness in preventing predictable future oil shortages from interrupting Britain's struggle for economic recovery. How does the pay-off from abolishing BNOC, and being proved right, compare with the penalties from abolishing it and being proved wrong? How central is that decision to Britain's recovery? There will be many such decisions.

3.3.3 Pay Freeze, Incomes Policy, etc

Previous Governments have drifted into incomes policy, either because their strategic thinking had proved wrong, or else because they had no strategy at all. There are very strong arguments for avoiding a freeze or pay policy; the irresistible challenge to militants or dissenting union leaders; the headline publicity given to any successful breach, representing a further similar challenge to other union leaders; the continued distortion of the economy and the paralysing of an already rigid labour market; growing resentment and frustration preparing the way for an explosion when the period of restraint ends.

Despite the scars of the past (and the UK has experienced the worst of all worlds; the flat-rate Jack Jones increase, together with a refusal to index tax bands) it is not impossible that we will find ourselves, once again, having to choose between three evils:

- (1) Holding fast to our monetary targets, while powerful unions (public or private sector) get their way, putting other people out of work and bankrupting small firms.
- or:
- (2) Avoiding (a) above by relaxing control of the money supply, cash limits in the public sector etc, and thus accepting a further surge of inflation which will bring the whole problem round again in 18 months' time.
- or:
- (3) Hastily putting together a pay freeze or guideline, knowing it will prove to be just another cul de sac.

As soon as possible, therefore, we should try to establish the circumstances in which we might find ourselves facing such a choice and being driven towards option (3). If we conclude that these circumstances are likely, then we should do some preliminary "design work" on a system which will help

us to get from instability to long-term stability. Its requirements would include:

- (i) It must be inflation-damping, not inflation-aggravating (as ill-conceived threshold systems have been in the past).
- (ii) It must be minimally distorting (in other words percentage-based and accompanied by appropriate indexing of tax bands etc).
- (iii) It must provide for easy exit to the type of stable system we will need for Rebuilding, rather than, as in the past, a sudden mass return to the same chaotic instability from which we were originally trying to escape.
- (iv) It must embody, as far as possible, features which will make it politically saleable.

3.4 What are the Relevant Issues or Decisions now Facing Ministers?

For example: European Monetary System; exchange rate policy and exchange controls; oil shortage (impact on unemployment, prices etc); public sector pay settlements, comparability etc; EEC contributions.

and effect on prices

4. REBUILDING THE REAL ECONOMY

- 4.1 I have suggested that the task of Stabilisation is not only urgent but, due to its Catch-22 nature, extremely difficult to perform. This is why the major part of this paper has been devoted to that part of the programme.

The task of Rebuilding is in some ways more straightforward, though it involves many different actions and a long time-scale. This Section does no more than comment briefly on its main elements.

- 4.2 There is a large number of technical measures the Government can take to make economic revival, and especially the regeneration of the private sector, quicker and easier. Many of them require no legislative changes. Most of them can start early, while the process of Stabilisation goes on.

Many of these measures are in hand or will shortly be put in hand.

4 Getting the Economic Arithmetic Right

4.3.1 Cutting Government spending and eliminating waste

This is a long-term programme. We have not yet succeeded in communicating to the public that we have no option in this matter, that the economy simply cannot fly, in its present debilitated state, unless the welfare and public services pay load can be lightened, and the private sector engines made more powerful.

4.3.2 Public Sector pay

We have already said that getting this onto some systematic basis is an essential part of the Stabilisation programme. However, we need to work in the longer-term towards more imaginative arrangements, whereby people can be positively motivated to improve value for money, as the real way to higher pay.

4.3.3 Freeing up the labour market

The first steps will soon be taken, with amendments to the Employment Protection Act. The sale of council houses should also help. There is still, however, a familiar vicious circle to unwind here: high unemployment, a low birth-rate of new businesses, skilled labour shortages in growing companies, high manning levels especially in obsolescent businesses, with strong trade union resistance to their reduction.

4.3.4 Improving company performance

Although investment levels are by no means the sole determinant of profitability, the present vicious circle is well enough known: overmanning leading to low profits and cash flow; leading to low investment and obsolescent plant; leading to low output, low pay, low profits, low investment, low growth; leading back to defensive union attitudes and over-manning.

4.4 Getting the Management and Technical Talent into the Right Places

4.4.1 This is another long-term programme, requiring a profound cultural change. Perhaps the important thing for us to recognise is that fashion follows money. As the American academic said at the end of his lecture, "Don't clap. Throw dollars!". Previous Governments have been constrained by union power in industry and by the prevailing egalitarian mood. They have therefore resorted to the commissioning of studies and the publication of papers about how to encourage more people to study engineering instead of pottery or sociology. Everyone knows that industrial management is very hard work, made harder by industrial relations problems, badly paid, highly taxed, in the wrong geographical areas. The whole package is simply unattractive.

4.4.2 The only way to change this is to make management and engineering a better way of accumulating personal capital. Prestige and social status will follow the money soon enough. There may be other things we can do to encourage movement between the Civil Service and industry, but it probably won't happen until managers are so prosperous and so lightly taxed that they begin to attract the attention of other parts of the population. The reverse is at present the case.

It may be possible to accelerate things by giving special grants to engineering students and so on, but what is really needed is 10 years of vulgarly pro-business and pro-industry policies.

4.5 Winning Export Markets

Businessmen know that, other things being equal, it is much easier to concentrate their efforts on the domestic market. It follows that in most countries (but not perhaps in Britain) there is considerable pressure and incentive, together with close Government partnership and support, for exporting companies. Similarly, foreign governments erect all sorts of unofficial barriers in the way of imports. I suspect that there are many things we could do - all relatively simple and perfectly legal - which would help us to export more and import less.

Our difficulty is, first, that Britain in the past has tended to play by Queensberry rules, without realising that everyone else is doing catch-as-catch-can wrestling; and, second, the Civil Service has concentrated on being "fair" in its dealings with British companies, preferring them all to be relatively unsuccessful, rather than that one or two should enjoy unfair good fortune. This is one area where Government can "back the winners", and should do so.

4.6 Breeding New Businesses

4.6.1 The two most important spurs to the growth of new businesses are, first, the abundant and visible evidence of entrepreneurial success (not much of that around in Britain these days) and, second, large numbers of individuals with enough surplus wealth to be able to take the very high risk of investing in a new business. Government agencies to back small companies or Government exhortation to the financial institutions to do so are not really the answers because the overheads in using highly-paid analysts to investigate tiny investment projects are disproportionate. In the United States, especially, such analysis is often done (with great care!) by business executives (often retired) risking their own money and their spare time.

4.6.2 There must be many things, however, that can be done to speed up the process. For example, allowing people to set new

venture investments against income for tax purposes. We have to make this type of risk-taking extremely attractive. Once we can get over our traditional British hang up - the lurking fear that a few individuals might make a lot of money out of it - a lot of good things will start happening.

5 THE NEED FOR INNOVATION

5.1 Complex Problems Don't Have Obvious Answers

Everyone knows that the UK economic problem is one of structural fatigue, not simply bad navigation. It follows that, as suggested earlier, feverish twiddling with control knobs - subsidies, taxes, regulations - will be ineffective. Repairing the structure is a quite different task and it will involve generating and trying out novel ideas; or assembling familiar ideas and measures into novel "configurations". That will require a blend of realism and technical and political imagination, together with a lot of patience.

5.2 Innovation is Unpopular

Innovation will run into many obstacles. People often resist new ideas because they feel they should have had them themselves. New ideas may threaten local interests, or conflict with Departmental views. Thirty years of decline have persuaded many of our political and administrative elite that nothing can really be done about anything. The British are particularly inhibited about generating new ideas, for fear of looking foolish. Innovation involves risk. People feel safer trying old remedies which may not work, but which at least fail in familiar and predictable ways. Since doing nothing is always the least stressful option, they tend to dismiss familiar ideas as unoriginal, and original ones as naive. All this must apply to innovation in Government as it does in industry.

5.3 We will not innovate successfully, unless we organise for it

5.3.1 We need to give some thought to the best way of tapping analytical and creative talent within the Departments so that (making appropriate use of the CPRS) we can start to design some prototype solutions, especially for the Stabilisation programme. As with any other entrepreneurial activity, political innovation must be an act of faith. Only when we have built something new will we be able to see how difficult it would have been to do without it.

5.3.2 Necessity is the mother of invention, and it is perhaps worth remembering that wartime produces innovation on a massive scale; an endless list of technical and logistical achievements which everybody thought were impossible. Innovation is only attempted when it is clear that the consequences of failure to solve a particular problem will be very grave indeed.

6 COMMUNICATIONS

6.1 Supporting Policy

Communications means not just the conveying of information, but persuading people to change their minds, to see things in a different light. The more carefully thought out our broad strategy is, the easier it will be to focus our communications effort on the issues that really matter, if our policies are to succeed.

Already, since the election, we have seen examples - understandable in the pressures of taking office - of obvious failures of communication. Conscious preparation and co-ordination will be necessary if we are to get it right in the more difficult months ahead. Top of this list, as already suggested, is the debate about the role of the trade unions.

6.2 Winning a Second Term

Since the next two years will be hard going, and we are not likely to be able to show the electorate a great deal for our efforts by 1983/4, we have to think now exactly how we are going to win the next General Election. I have had preliminary discussions with the Chairman of the Party and the Director of CRD on a communication programme to pave the way. Such a programme might have the following elements:

- (a) Sustained and imaginative education on the economic facts of life so that, by 1983/4, a larger percentage of the electorate is beginning to see that our policies are hard-headed, rather than hard-hearted; that the real problems have been tackled at last, and that much of the necessary pain is over.
- (b) Steady erosion of Labour's claim - virtually unchallenged until last winter - to a monopoly of all the human virtues.
- (c) Similar erosion of the stereotype Tory image so carefully maintained by Labour.
- (d) Constructive debate about political reforms (eg Bill of Rights etc) which will help to symbolise the general spirit of national renaissance and appeal to those Tory voters who might be tempted to swing Liberal after 3 years of hard slog.

7 ● CONCLUSION

7.1 This paper can be summarised as follows:

- (1) Our 10-year objective is to "rejoin the West", in terms of economic stability and growth rate.
- (2) We won't get there unless we have a well thought out strategy - a series of stepping stones - for doing so.
- (3) | There is no change in our original view that a positive role for the trade unions is a central - perhaps the central - element in that strategy.
- (4) The strategy must integrate all the major elements of policy, and their supporting communications, into a coherent whole. If it does not, (a) we'll get confused and lose our way; (b) the electorate won't let us do it anyway.
- (5) If we fail to achieve Stabilisation, as our first objective, we can forget the rest. We will simply be on the run till we're chucked out.
- (6) We can do no more than make a start in the next 5 years. A second term is essential but we will need a sea change in the electorate's grasp of economic reality and the limited real powers of the State. The count-down to the 1983/4 election has therefore already started, in communication terms.

7.2 A suggested Agenda for 18 June is at Appendix A.

A POSSIBLE AGENDA

It would be quite unrealistic to try to discuss all aspects of Strategy in a single 2-hour meeting. I therefore suggest we make a start by considering the following key questions:

1. Is the case for concentrating on Stabilisation accepted?
2. If it is, what is our position in principle on the question of pay policy, freezes etc? Should we be examining such options or do we regard them as politically (or technically) unthinkable?
3. Do we agree the other Stabilisation measures suggested on pages 7-9 of the paper? What other Stabilisation measures are called for, and what work should be put in hand to develop them?

*✓ Mr Holt for
Mr Haslegrave*

SECRET

Prime Minister 41

*Would you like me
to commission the
further papers suggested
by John Hunt in
para 9?*

Ref. A09745

PRIME MINISTER

*Yes please
and.*

Pay

TL 12/6

The discussion on Pay in the Economic Strategy Committee on 1st June was, deliberately, a 'second reading' affair. Meanwhile we have, as you asked, circulated the CPRS paper on Pay. Amongst other things, this will be useful background to the discussion of the Secretary of State for Employment's papers on Industrial Relations at E on 19th June.

*Minutes
at Flug A*

2. Meanwhile the annual pay cycle continues. Shortly after the election you took decisions on armed forces and on police pay in discharge of Manifesto commitments. Since then we have had decisions in E on teachers (a reference to Clegg) and on implementing the TSRB and DDRB reports. Last week E(EA) approved increases for probation officers (another law and order group), Stationery Office printers (following a private sector analogue) and craftsmen in the water industry (a very large increase for a group which has an effective stranglehold over water supplies). I know that the Secretary of State for Industry, who was in the chair at E(EA), was worried about all these three, but was persuaded that there was no realistic alternatives.

3. In the private sector, as you will know from your discussion last week with the Secretary of State for Employment, there are some signs of an accelerating rate of settlement. Luckily we are very near the end of the present pay round, and there are not very many private sector cases left to settle.

4. In the public services there are two key settlements still to come in this round. The local authority APTC Group is due for an increase on 1st July. Both sides are taking it very slowly. But the case will come to Ministers in the next two or three weeks. In E(EA) the general view is that the Government will find it hard to avoid making another reference to Clegg. The industrial Civil Service is also due for a settlement on 1st July. A comparability study, carried out by PRU, is in hand. The results will be known in a week or two. It seems almost inevitable that there will be large increases, introduced by stages over the next 12 months. The cost for this year will have to be dealt with under the already approved formula: the eventual wage bill less 3 per cent.

SECRET

5. Finally, there is the public sector outside the non-trading public services. Here we have the impending troubles with the Tube men in London, a long overdue settlement for postmen and telecommunications staff and, a little further ahead, settlements for administrative staff in the Gas and Water industries.

6. Although there are possibilities for trouble in the next few months, it is broadly true that we can look forward to a relative pause in pay issues during the summer. The next pay round will not really get going until November when we will have the traditionally difficult Ford and British Oxygen private sector negotiations, the opening of negotiations for local authority manuals and craftsmen and the next round in British Leyland. On the other hand it will be necessary before then to take a view on the pay assumption for 1980-81 to be built in to the RSG settlement with the local authorities and the Government's internal consideration of cash limits for 1980-81 and its discussions with the nationalised industries on their future financing will also be well advanced.

7. It is clearly essential that the Government uses this pause to set the scene for the next round. Since there will not be a pay policy with guidelines, etc. there is an urgent need to launch the campaign of public education which you discussed in E. The Council of Economic Advisers, the use to be made of NEDDY, the 'forum', etc. could all be relevant and you will be looking to the Chancellor for ideas and action as soon as the Budget is out of the way.

8. I think it would also be useful to begin quite soon the process of examining how the pay assumptions, for inclusion in the cash limits, RSG, etc., are to be formulated. There is scope here both for a more rigorous intellectual approach and for an improvement in forecasting techniques, methods and timing. You will also want to improve the quality of comparability exercises and perhaps rationalise the various parts of the comparability machine.

9. Much of the necessary work was commissioned by you at E at its meeting on 1st June - in particular the Chancellor of the Exchequer was invited to circulate a paper setting out the possibilities for a "forum" in which pay matters could be discussed with interested parties in a wider context; and a marker was put up to the effect that questions of pay, prices and efficiency in the nationalised industries would need to be considered by the Committee when the work at present in hand

SECRET

by the Secretary of State for Industry had been further advanced. This latter is an important and difficult area for which no time frame has yet been established. You might ask the Secretary of State for Industry to bring forward to E an early report which could provide the basis for a discussion. You might also find it useful to invite the Chancellor, once the Budget is out of the way, to bring forward a similar paper on the question of the pay element in future cash limits for central and local Government and the nationalised industries together with an indication of the working timetable so that an early grip can be taken on this third important leg of the total strategy.

10. Obviously you are heavily committed for the next few weeks and the Ministers concerned need time to prepare their thoughts. You may however think that you should have a further discussion in E, covering the whole field, soon after your return from the Tokyo Summit - perhaps in the first week in July - and that papers should be commissioned accordingly.

JH
(John Hunt)

11th June, 1979



[Faint, illegible text, likely bleed-through from the reverse side of the page.]



11 JUN 1979



DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB

TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

PS/ Secretary of State for Industry

7 June 1979

Tim Lankester Esq
Private Secretary to the
Prime Minister
10 Downing Street
London SW 1

Dear Tim,

R. 15/16

MINISTERIAL CORRESPONDENCE ON PAY QUESTIONS

Two of the items on the agenda for E(EA) Committee today have been the subject of previous correspondence between Ministers which was not copied to my Secretary of State.

As Chairman of E(EA) my Secretary of State needs to be aware of developments on pay questions as they arise and he would be grateful if all Ministerial correspondence on pay questions could be copied to him and to other members of E(EA). This applies in particular to pay questions which Ministers seek to resolve without formal discussions in E or E(EA) Committees.

I am copying this letter to the Private Secretaries to all members of the Cabinet, the Minister of Transport and Sir John Hunt.

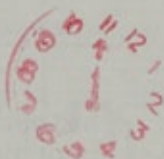
Yours sincerely,

ANDREW DUGUID
Private Secretary

DEPARTMENT OF INDUSTRY
LONDON SW1R 4DU
LONDON SW1R 4DU
LONDON SW1R 4DU



15-8 JUN 1979



STOWE

PURPOSE OF THE STRATEGY MEETING

"It is of the utmost importance that, from the outset, we are absolutely clear on the key objectives which we must achieve if we are to get the country onto the road of economic recovery. Once those objectives are clearly established, then we can agree the broad strategic framework for reaching those objectives.

The purpose of the meeting is to do these two things - establish the objectives and agree the strategic framework. Once that has been done, the Policy Unit, in conjunction with the appropriate people in your Departments and CPRS, can start on a programme of work to turn the strategy into reality.

John Hoskyns will circulate a briefing paper in the latter half of next week, outlining an approach to objectives and strategy and a framework for the meeting itself."

JH.

Is this OK?

JOHN HOSKYNS

6 June 1979

Esq. P51. vb

6 June 1979

Thank you for your note of 5 June about the meeting on 18 June and this is just to confirm that the Prime Minister is happy for the Lord President to attend between 1100 and 1200 but quite understands that he will have to leave quite punctually.

CS

Jim Buckley, Esq.,
Lord President's Office.

VLC.



Civil Service Department

Whitehall London SW1A 2AZ

01-273 4400

5 June 1979

Ms Caroline Stevens
10 Downing Street
London SW1

Dear Caroline,

No 10 POLICY UNIT

We had a word about the meeting on 18 June which you have arranged for 1100 and which is scheduled to last till 1300. The Lord President has a number of other commitments but should be available between 1100 and 1230. I will be grateful for confirmation that this will be acceptable to the Prime Minister.

*Yours sincerely,
Jim Buckley.*

J BUCKLEY
Private Secretary

Ken,

I have received
messages from you about
the briefing paper for 18th
June meeting & also about
a note concerning the
meeting.

I find that Caroline has
already done the letter
(attached). I don't propose
to circulate discussion paper
till latter half of next
week. Have we got crossed
wires?

JH

File

Econ Policy DS



cc: D/I	D/En
D/Exp	MAFF
LPO	HMT
DOE	CST
DIT	John Hoskyns

10 DOWNING STREET

From the Private Secretary

of 15.6.79.

5 June 1979

Dear John,

I am writing to confirm that the Prime Minister is holding a meeting on Monday, 18 June from 1100-1300 here at No.10. John Hoskyns will be preparing a brief and the following people have already been invited: Sir Keith Joseph, Mr. Prior, Lord Soames, Michael Heseltine, John Nott and David Howell.

Peter Walker has sent his regrets as he will be in Luxembourg, and so will either the Chancellor or John Biffen. Whichever one does not go to Luxembourg will be attending the meeting.

Yours sincerely
 Cecile Stephan

John Chilcot, Esq.,
 Home Office.

JS

PRIME MINISTER

David Wolfson asked me to set up a meeting to discuss the Government's basic economic and industrial strategy with the following people:-

Mr. Whitelaw
Sir Keith Joseph
Sir Geoffrey Howe
Lord Soames
John Nott
Michael Heseltine
Peter Walker
Jim Prior
David Howell

I am having more than a little difficulty getting them altogether. The only possible date (unless we leave it until the middle of July) seems to be Monday 18 June. The major disadvantage of this date is that Sir Geoffrey and Peter Walker will be in Luxembourg. I have had a word with John Hoskyns about this and he wonders whether you would be prepared to go ahead with this meeting without Sir Geoffrey as (a) John Hoskyns knows Sir Geoffrey's thinking, (b) he would have a meeting with him prior to this meeting and (c) he would circulate a paper in good time to receive both Sir Geoffrey's and Peter Walker's comments. John Hoskyns also suggests that John Biffen should be invited instead of Sir Geoffrey.

Handwritten signature

Handwritten initials

31 May 1979

(13)

10 DOWNING STREET

25 June

4 = Ld Soames ✓

5 = M. Wickham + lunch

2 = Sir Keith ✓ ~~no~~ No lunch (18)

1 * Sir Geoffrey Luxembourg ::

3 = John Nolt ✓ + lunch

J. G. H.

4 = Michael Hazell ✓ No lunch

5 = Peter Walker :: Luxembourg ::

2 = Jim P. O'R. ✓ No lunch

3 = David Howell ✓ No lunch

L. G. W. / 8/18/1982
Omylen, powers, d. p.
E. S. S.

policy unit: - to basic strategy & coordination
Industrial



Econ Pol

DEPARTMENT OF HEALTH & SOCIAL SECURITY

Alexander Fleming House, Elephant & Castle, London SE1 6BY

Telephone 01-407 5522

From the Secretary of State for Social Services

The Rt Hon John Biffen MP
Chief Secretary to the Treasury
Treasury Chambers
Great George Street
LONDON SW1

31 May 1979

Dear Chief Secretary,

At Cabinet this morning colleagues expressed considerable doubts as to whether it would be possible to get through the House proposals to extend from three days to six days the number of waiting days which a person has to serve before becoming entitled to sickness or unemployment benefit. The matter was to be considered further at Committee E tomorrow and I am therefore circulating this letter to colleagues in advance of the meeting.

I attach a note about this proposal: despite all the obvious difficulties, it remains my view that this is the best available option, if savings of this order have to be achieved this year on the social security side. If colleagues are not able to accept that we should go forward with this proposal, then I have to say that it will be extremely difficult for me to find substantial savings - of the order of £30m - in this financial year, if the possibility of increased NHS charges for prescriptions and dental work is also excluded. (I am assuming that Cabinet's decision not to make good the shortfall in the 1978 uprating for those on short-term benefits which will save £10m in 1979-80 counts towards my overall target of £40m).

I have nonetheless considered in detail what savings could be made and I list below propositions which, to my mind, are frankly less acceptable than going for six waiting days but which are the only alternatives I can offer:-

- (a) abolish death grant. This would save £5m in 1979/80 and £16m in 1980/81. One could argue that those in financial difficulties with funeral expenses could claim supplementary benefit, as indeed they do at the moment. But: this would be fiercely opposed in Parliament, where all the recent pressure has been to increase the grant.
- (b) hold down on the uprating of child dependency allowances. If the increases in the child dependency allowances are restricted so that child support for those on national insurance benefit goes up only by the amount needed to inflation proof the dependency allowances themselves and not by the amount needed to inflation proof the total support for each child (including the child benefit element), as is provided for in

the public expenditure programme, £10m would be saved in 1979/80 and £26m in 1980/81. If, more realistically, only the child dependency allowances paid with sickness and unemployment benefit were so restricted the savings would be about £5m and £12m respectively. But: this would be a subterfuge, yielding a much less generous level of child support. Coming on top of our decision not to uprate child benefit this November, it would be very damaging to our claim to concern for the family.

- (c) align supplementary benefit and national insurance main rates. The principal scale rates for married and single persons on supplementary benefit are slightly ahead of the principal national insurance rates (£31.55 for a married couple compared with £31.20 and £19.90 for a single householder compared with £19.50). If those rates were aligned with the new pension rates there would be a saving of £12m in 1979/80 and £30m in a full year. But: this would mean that supplementary pensioners got less than price protection in November, which would be inconsistent with our undertakings.
- (d) hold the uprating of family income supplement to the minimum. It would be possible to shave £2-£3m off the FIS uprating, final details of which have yet to be arranged. But: a "mean" FIS uprating is inconsistent with colleagues' aims to encourage people to stay in work rather than fall back on social security benefits.

Nonetheless these are the only immediate savings I can offer if colleagues do not wish to go ahead with the proposal to increase waiting days from three to six. Beyond these areas one moves into impracticable propositions such as attempting yet again to withhold unemployment benefit from occupational pensioners.

I have looked again at the possibility of making savings in the HPSS programme but the only way to secure such savings while not cutting expenditure would in fact be to increase charges. I am still ready to pursue this if colleagues so wish. I have considered but rejected the possibility of charging for family planning supplies or of curtailing the present welfare milk scheme. Reductions in health authority expenditure are ruled out by our Manifesto commitment; and the most I could do would be to make some comparatively small savings in centrally financed services, which cover for example research, training and grants to voluntary bodies. I may be able to save in all up to £5m spread over a number of sub-heads, which I am urgently reviewing.

For myself I would prefer to go ahead either with the extended waiting days or with the increased charges rather than put together a package of the kind I have outlined above, which would attract criticism on a number of fronts out of all proportion to the savings achieved.

Yours sincerely

S.H.F.H. King

11 PATRICK JERMIN
(Approved by the Secretary of State
and signed in his absence)

EXTENSION OF WAITING DAYS

Proposal

1. It is proposed that the 3 days for which unemployment, sickness and injury benefit are not paid at the beginning of a spell of unemployment or incapacity should be extended to 6 days.

Savings

	<u>Gross</u>	<u>Full year Net of Supp. Ben.</u>
2. Sickness Benefit and Injury Benefit	£63m	£60m
Unemployment Benefit	£15m	£10m

Only very rough estimates are possible. The latest available figures relating to claims for benefit show that in 1976/7 the total number of sickness benefit claims was 10 million, while the total number of unemployment benefit claims in 1978/9 was 4½ million.

Effect on claimants

3. Beneficiaries would lose 3 days flat-rate benefit: £7.88 for a single person; £12.76 for a married couple; £14.46 for a married couple with 2 children. Perhaps 70% of men would be likely to have some sick pay cover for those 6 days and a rather higher proportion of women. The unemployed would receive no continuing payments from their employers but a considerable proportion receive an extra week's payment (a week in hand) when they are discharged and a number of them would have redundancy etc payments.

Historical

4. The waiting period for receipt of unemployment benefit when the scheme commenced in 1911 was 6 days. During the 1920s the period varied between 6 and 3 days; but it has been 3 days since 1937. From 1948 waiting days became payable retrospectively after there had been 12 days of sickness, unemployment or injury during a period of interruption of

employment. In 1968 the Labour Government tried to make the 3 waiting days absolute but had to withdraw their proposals in the face of backbench pressure and Conservative opposition. In 1971, the Conservative Government made the 3 waiting days absolute in the face of very strong opposition from the Labour benches (3 mornings were spent on this subject in Committee).

In favour of the proposal

5. It would result in considerable savings (see para 2. above). It could be argued that since the period of 3 waiting days was last introduced the background has changed a great deal. Increasingly employers have provided sick pay for employees who are temporarily incapacitated. The Contracts of Employment and Redundancy Payments Scheme have increased considerably the provision made for a worker who becomes unemployed; and the number of workers who receive a week's wages in hand on the termination of their employment has also increased. The rates of national insurance benefit are now much higher than in 1948 and earnings and savings have also gone up considerably since then, and with them the ability of people to manage on their own resources during short interruptions of earnings.

Against the proposal

6. a. Many claimants would be worse off particularly those who are low-paid and those working in heavy industries such as coal mining, engineering and shipbuilding where the incidence of sick pay is not as great. Considerable opposition could therefore be expected from the Labour benches and from the TUC.

b. The fact that benefit will not be payable for the first 6 days of sickness will mean that many employers with sick pay schemes would either have to pay their employees an additional 3 days' benefit or re-negotiate the private insurance cover they have for sick pay schemes. The CBI would therefore be likely to oppose the proposals also.

c. More claimants would need to have recourse to supplementary benefit. It has been estimated that 14% of those becoming unemployed claim supplementary benefit during the first week of unemployment and 26% during the second week. A change to six absolute waiting days would mean an increase in these numbers.

d. Increasing the number of waiting days would be contrary to the ILO conventions on sickness and unemployment benefit. There could be difficulties for us in relation to the EEC, as none of the EEC countries has more than three waiting days for sickness benefit and only one (Italy) has more than three waiting days for unemployment benefit.

Administrative implications

7. The payment of unemployment benefit is mainly computerised and, because of the need to re-programme the computers, the change could not be made until January 1980. The sickness benefit rules could however be changed with effect from September 1979, assuming legislation is through before the summer recess. This would mean an awkward 4 months' period during which two benefits which have run in close parallel for 30 years had different rules and would be a complication which would be unwelcome to staff and beneficiaries alike. But it would not be operationally impossible to begin the new arrangements on different dates. On this basis the benefit saving in 1979/80 would be £40 million net.

CONFIDENTIAL

PRIME MINISTERPAY
E(79)5 and C(79)6

BACKGROUND

Mr Prior's Paper on pay - C(79)6 - was originally intended for Cabinet but you diverted it to E and asked for a parallel paper by the Chancellor. This is now available to the Committee as E(79)5.

2. I do not think either paper sufficiently comes to grips with some difficult problems so this brief is inevitably rather longer than usual. I realise however that you may want to confine tomorrow to a "second reading" discussion.

3. This discussion will set the framework for the Government's approach to pay especially in the next pay round which begins in August. The broad lines of your strategy are established and your administration is likely to be far less involved in the detail of individual pay negotiations than were your predecessors. In particular you will be relieved of involvement in private sector pay settlements other than through maintaining the proper level of external financial discipline. But you will need to monitor carefully what is going on - if only because private sector settlements set the pace for public sector ambitions. And you will also find that some private sector settlements - like Fords next year - have a substantial influence on union negotiators in other private sector cases, especially where the mass unions run across firms and industries and where matching the "going rate" becomes a virility symbol for the negotiators concerned. This does not mean that the Government need interfere in detail. It does, however, place a good deal of importance both on maintaining the necessary financial discipline and on efforts to create the right climate of expectations in which bargaining takes place.

4. The real problems for Government arise in the public sector. The Government needs to set cash limits for next year in advance of knowing the outcome of pay negotiations and, in some of the nationalised industries, faces the additional problem that, because of their monopoly or quasi-monopoly position, management and men can jointly bleed the consumer. In addition the same problem

arises in the public sector as in the private where large unions bargain with a number of public sector employers in circumstances where the results of one negotiation read across to the others (the classic chain being gas, electricity, water but there are a number of others). And this year the unions co-ordinated their approach over the whole NHS/ Local Authority field.

5. The hardest problems are likely to revolve around cash limits. In the short run it is perfectly possible to set the limits on the basis of an expected outturn and to correct for any under-estimation by reducing staff numbers and services. But in the longer run this process, especially when accompanied, as it will be, by a separate and specific drive for economies, risks facing the Government with the choice of breaking its cash limits or accepting reductions in services below the levels which it wants to provide. This is an area where a good deal more thought is required, I suggest, before a fully workable and acceptable system can be devised. Clearly little can be done for next year. Cash limits will have to be set in the normal way and at whatever figure the Government feels to be justified, and the consequences accepted. But we really ought soon to begin to examine whether there are ways, eg by a better co-ordination of the timing of public service pay negotiations with the processes of setting cash limits, the Rate Support Grant and so on, which would enable a better fit to be made between forecast and achievement. It may also be that the uncertainties are such that we should be thinking of budgeting for a larger Contingency Reserve, especially to cover pay based on comparability, in order more readily to accommodate financial control with the bargains actually struck in the market place. (This would mean, on a technicality, putting the Contingency Reserve on a cash as opposed to a resource basis.) And in all this you will find your problems reduced as the size of the public sector shrinks and as the identification of options for cuts in functions creates a hidden "Contingency Reserve".

6. But for this year - the year of transition - I suspect you will have to improvise.

HANDLING

7. I have bracketed these two papers together on the Agenda, and I think the discussion will best be handled as a single item. You might start by asking the Chancellor to introduce his paper, which I suggest is a better framework for discussion, and then ask the Secretary of State for Employment to supplement it. The other main speakers at this stage will probably be

Secretaries of State for Industry and the Environment. Then I think you might take the Committee through the main headings of the Chancellor's paper (which incidentally covers most of the same ground as Mr Prior's) and pick up the remaining points from Mr Prior's paper at the end. In that case, the main topics are these:

- (a) the remainder of this round. The real risk is of 're-opening' past settlements. Now that you have decided to maintain the Clegg Commission, at least for the existing reference, the danger is reduced. Most probably the remaining public sector claims can be fitted into the pattern already established. There are a few difficult ones. Much the worst is the local authority APTC grades (covered by NALGO). The issue will be whether to refer them to Clegg. You will not want a snap decision at this meeting. You might therefore ask Mr Heseltine to put a paper to E(EA). The same procedure should apply to any other difficult cases - for example probation officers whose pay problems are already the subject of Ministerial correspondence.
- (b) Rate Support Grant - 1980-81. The Chancellor suggests that the autumn negotiations should take their tone from the Clegg findings. It will not be quite so simple as this (Clegg will not tell us what next year's pay outcome will be) and the RSG will have to include an estimate which will also in part determine the pattern of next year's wage round. Ministers cannot therefore wholly avoid taking a view about a desirable rate for settlements in the following pay round and they may want to take a preliminary look at this problem before the summer recess (there will be a relatively little time at the end of September to do so before the negotiations begin in earnest).
- (c) Public Services. You will also need to take a preliminary view on the desirable level of settlements, eg in the NHS, as well as the Civil Service, well before setting cash limits for next financial year - and this means taking a view not much later than Christmas. If the Chancellor agrees to this timetable, you might ask him to bring forward proposals towards the end of the year.
- (d) Nationalised Industries. The Chancellor proposes a general review of pay, prices, financial targets and efficiency. I note from Mr Lankester's letter of 29 May that you want to reserve judgement on how to organise the review which the Chancellor proposes. This needs to be related in some way to the general review of nationalised industry policy which Sir Keith Joseph has set in hand, and on which you have promised to arrange a general discussion in E when he has produced a revised paper. At this

stage - with no major industry pay settlements outstanding in the present round - you might simply note the problem, and say that you will write to the Ministers concerned when you have decided how this is to be resolved. I can then let you have ^{some} suggestions.

- (e) The Longer Term and the 'Forum'. The Chancellor floats a number of suggestions here, which are also touched on in Mr Prior's paper. You yourself have floated the idea of a 'Council of Economic Advisers', but I understand that by this you only mean some relatively informal and infrequent gathering. You may have a clearer idea, from your talks with Mr Murray, of the sort of reception you might expect from the TUC to such proposals.
- (f) Comparability. You asked the Chancellor to include more specific conclusions on this point (para 13 (iv) and (v) do this). May I suggest that any review of comparability should cover not only PRU and the review bodies, but also the future of schedule 11 of the Employment Protection Act and of the Central Arbitration Committee? These last can have quite an important effect on the public sector where there are direct analogies with the private sector (Road Haulages a good example) and make it very difficult to avoid extending 'the going rate' into parts of the nationalised industries.

8. Turning now to the remaining points in Mr Prior's paper which have not been covered above:-

- (g) Procedural changes. Mr Prior plans to bring forward his proposals on industrial relations reform to E in about three weeks. It will be important not to rely too much on these changes to influence the next pay round in the private sector. Even if legislation could be introduced and acted in time, the changes proposed are relatively modest, and will not of themselves greatly influence unions' attitudes. They may have some part to play in weakening the strike weapon, but the more they are seen to be designed for this purpose, the more bitterly they will be resisted by the unions.
- (h) Monitoring and information. Mr Prior suggests that sponsoring Ministers should keep in fairly close touch with the course of public sector negotiations, and that his own Department should continue to monitor pay movements in the private sector. While you will want to avoid any impression of intervention or structured pay policies, I'm sure that both of these proposals are sensible.

CONCLUSIONS

9. Subject to the course of the discussion, I think you may be able to guide the ~~Committee~~ to agree to the five conclusions set out at the end of the Chancellor's paper, and in addition -

- (vi) to invite the Secretary of State for Employment to come forward with his proposals for industrial relations reform as soon as possible;
- (vii) to agree that sponsored departments should maintain close liaison with public corporations on pay negotiations;
- (viii) to agree that the Department of Employment should continue informal monitoring of private sectors. You may also care to suggest that thought be given to the technical problem of improving the pay forecasts on which cash limits have to be set; and of any changes, eg in the timing of negotiations which would enable greater realism to be achieved.

[Handwritten signature]

J JOHN HUNT

31 May 1979

CONFIDENTIAL

Qa04128

To: MR STOWE

From: SIR KENNETH BERRILL

PAY

1. Cabinet Committee E is due to discuss pay policy against the background of papers by the Chancellor of the Exchequer(E(79)5) and the Secretary of State for Employment (C(79)6). I understand that the discussion will only be a short one but the Prime Minister might like to read the attached note by the CPRS. It does not address itself directly to all the points raised in E(79)5 and C(79)6 but attempts to look fairly generally at the fundamental issues in the pay area now confronting the Government.
2. I am sending a copy of this minute and attachment to Sir John Hunt.

KB

31 May 1979

Att

CONFIDENTIAL

PAY

A Note by the Central Policy Review Staff

This note looks at the actions which need to be taken by the Government in the pay area in the period between now and the end of 1979. It attempts to set these short-term requirements in a longer-term, strategic context.

It goes without saying that containment of inflation is at the heart of the Government economic policy. Failure in that field would mean not only rising social discontent (and defeat at the polls) but continued low industrial investment and increased unemployment.

Strict fiscal and monetary policies are essential ingredients - and the ingredients most readily under Government control. The Government intends to be strict both in the general and in the particular (less help for lame ducks, less employment support schemes). But in the circumstances of the UK this will not be enough; basically because the forces in our labour markets are unbalanced and incapable of providing "responsible free collective bargaining" (in the sense of achieving wage settlements at levels which are reasonably related to prospective increases in output). And there is every evidence that things have been getting worse rather than better - with the balance of forces in the labour market becoming even more one-sided.

The Government will go into the pay round next autumn against a background of an increased rate of inflation (15%), and large awards for particular (public sector) groups. The traditional trade union approach will be to get compensation for the past year's inflation plus something on "special case" grounds. Can anything be done apart from fiscal and monetary discipline?

What should be the Government's objectives in the pay field? Possibilities include the following:

- i. The aim is not pay restraint, but higher pay for higher effort. This is a more positive message. ~~_____~~
- ii. The object should be to try to make the labour market work better. This is easier said than done. We have got used to national wage rates and existing relativities, irrespective of supply and demand or differences of performance.
- iii. Change will have to come gradually. There is no way of imposing change except by public consent to what is regarded as reasonable. Some measures can be taken to redress the balance over powers and immunities of the unions but a policy of widespread direct confrontation will not succeed.
- iv. Public opinion must be mobilised. Wherever possible the consequences of "excessive" pay settlements should feed directly and obviously through to prices and/or unemployment.

CONFIDENTIAL

- v. Preparations should be made to withstand strikes. If a change of attitude is to be achieved, there must be some successes. This may need contingency planning, support for employers etc. One cannot rule out a state of emergency and the use of troops. Even a statutory pay policy should be kept in reserve. (It is likely that, to achieve a sharp reduction in the rate of inflation, there will need to be at least one year in which earnings rise less than prices; and it is certainly not clear that this can be achieved by voluntary means).

There is little scope for a change of direction during the remainder of the current pay round. The most difficult outstanding cases have been referred to the Clegg Commission and this reduces the likelihood of industrial action. There is a lot to be said for treating this as a "clearing-up" operation, which should remove the main outstanding sources of grievance - after which it would be legitimate to change the rules of the game. This would suggest honouring inherited commitments in the public sector, but without prejudice to future treatment of the groups concerned. Nationalised industries and local authorities who have still to settle should be encouraged to follow the pattern which has already been set for the round.

Private Sector

Strict monetary policy is a necessary, but not a sufficient, ingredient. The message has to get across that the logic of free collective bargaining will be pursued. This means that some companies will be able to afford big increases: others in the same industry will not. Rewards will depend on profitability. National wage rates and maintenance of existing relativities are irrelevant to this approach. It is the policy the unions have asked for but they must be prepared to live with the consequences.

So far as Government is concerned the policy requires that there should be no bailing out of companies which get into difficulties by paying wages they cannot afford. It is worth considering whether employers can be mobilised to withstand strikes. Employers will need to take their workers into their confidence about the effects of pay settlements on the future of the company. This implies some form of worker participation, though almost certainly not at Board level. It will be necessary to persuade the work force that resources are required for adequate investment; and that there may well be a trade-off between pay and employment.

In the light of all this what can be done between now and the end of 1979 to improve the operation of our labour market; to begin to restore the balance of forces - or at least make people think that the balance is shifting.

Possible Improvements

The first possibility is a (tripartite) "forum" to help educate trade unionists and the public generally on the realities of the increase in resources likely to be forthcoming in the year ahead and the level of wage increases likely to be compatible with containing inflation.

CONFIDENTIAL

Education is always important because what people know and believe has a major influence on the way they act. And even unpalatable realities finally sink in. There is increasing public awareness of the parlous British performance, - especially in manufacturing industry and increasing acceptance of the fact that if productivity is likely to go up by 2% a 10% wage round will mean both price increases and unemployment (probably more of the former than of the latter).

But it would be a mistake to expect a great deal from a forum - especially in the short run. People can accept general propositions about inflationary wage claims while feeling, understandably, that whatever the going rate is they should get it and if a "pay anomaly" has developed that should be rectified too - no matter what the consequences for inflation and employment. (Even if over time employment in their own industry falls the chance of them personally being made compulsorily redundant is small.)

Facts about a Dispute

A measure of public education in addition to the "forum" which might be useful is for the Government (or some independent group of institutes) to publicise the basic facts at issue early in an industrial dispute. Extremely misleading 'facts' are put out by both sides in a dispute and the media give prominence to the most extreme figures. Independent publicity of basic facts such as average weekly earnings (and fringe benefits) of those involved, how much is at issue between the two sides, how long it would take a striker to get back the money he is losing by being on strike etc. could help.

Trades Union Organisation

It is perhaps a paradox that redressing the balance of forces in the labour market and restoring conditions for responsible free collective bargaining could mean in some respects strengthening Trades Unions. That is to say strengthening the power of the trades union leadership at the centre to discipline local irresponsibles.

The inadequacies of our trades union structure have long been recognised: - the fragmentation of unions; the competition for membership which limits the ability of the centre to discipline local wildcats; the weaknesses in the selection, training and tenure of their officials etc.

Some improvements have been made - the number of unions has fallen, more money is spent on research, and full-time officials have a better pay and career structure and better qualified people are being attracted to the job. But much more needs to be done. One line of approach is to provide money - money for secret ballots (for election of officers, for calling strikes) money for training and research (as is provided now for courses on the new Health and Safety at Work Act).

Another line of approach is to require change as a qualification for being a recognised trades union with the legal privilege enjoyed by trades unions. The requirements might cover (i) that the union constitutions covers certain broad elements - including secret ballots and the power to discipline local members for acting without the authority of the union. (ii) withdrawal of recognition if the trades union failed to honour contracts and procedures it had entered into or failed to discipline any of the members who so acted.

CONFIDENTIAL

Such changes in the law would meet very strong resistance from the trades union movement and there would be real difficulties of definition and enforcement. A quick look at material on the practice and experience in other countries in this field could be useful.

Picketing

Many cases of industrial action do not involve picketing to be effective - the go-slow, the work to rule (teachers' 5-hour day), the small but crucial group (computer operators, Leyland toolmakers), the 'solid' big group (Engine Drivers). But last winter's experience has concentrated attention on the picketing issue and it is one which must be tackled.

What has happened in picketing in the UK is not so much that the law has become more favourable to the picket but that the practice has moved in his favour and his weapons of intimidation have been strengthened. The practice has changed in that increasingly he has come to be granted the right to obstruct. (to put barriers across the entrance to plants or hospitals, to put braziers on the footpath to keep warm.) And the police seem to have adopted the policy of regarding their main objective as keeping the peace rather than keeping the road and footpaths clear.

But perhaps the main problem is the increased fear of the closed shop; of the black-leg label. There always was, and always will be, genuine reluctance to cross picket lines for a whole mixture of motives - many admirable. But the fear of the possible consequences seems recently to have increased quite sharply. A world in which a camera became the picket's main weapon of intimidation poses great difficulties for the police and the law, and makes it all the more important that the unions' own disciplines also be directed to members who act contrary to agreements and directives. Changes in the law have a part to play but what is needed is less a change in the law than a change in the practice. Employers, government, the police, have become so afraid of 'confrontation' or 'provocation' at the local level that they have allowed practices and attitudes to industrial disputes slowly to shift. It will not be easy to push the tide back and change the attitudes and practices but it must be done.

Taxation and Supplementary Benefits for Strikers

Another instrument which might be used to help shift the balance of forces in the labour market is to make it financially more painful to strike by taxing short-term supplementary benefits (as are long-term benefits) and in the calculation of the supplementary benefits making an assumption that reasonable strike pay is being received.

The logic of this is clear enough. Short-term benefit should in equity be taxed like long-term. The question at issue is "is it worth doing now"? Is it worth it in terms of the large number of civil servants which, until PAYE is computerised, it would take to deduct tax? Is it worth it in terms of the number of workers it will deter? The evidence is that when a strike is called most strikers do not anticipate a long strike, and most (over three-quarters) do not in the event claim supplementary benefit but make do inside the total family budget and by being late with rent, rates, hire-purchase, etc.

Industrial Democracy

It is sometimes argued that industrial democracy or profit sharing would make trades unionists more responsible in their collective bargaining. This must remain an open question and a long-term one. At the moment profits in British industry are so low in relation to the wages bill that an offer to share in them would in the short run be very small compensation for a low wage claim. Industrial democracy of the "workers on the board" type seems to excite little interest. Something on the scale of the individual plant and office to which the worker can relate (the workers' council) might be more promising - at least the German experience would suggest so. But these are long-term questions and not something which the Government need make rapid moves on before the end of 1979.

All the above has been concerned with what might be done between now and the end of 1979 to begin improving the UK pay bargaining position across the board. But the public sector has its very particular problems and consideration of what to do there is no less urgent and no less difficult.

The Public Sector

a. Public Services: Comparability

The Chancellor recommends in his paper that the whole question of comparability (including the future of the PRU and the review bodies) should be examined with particular reference to its effect on inflation. This is clearly unexceptionable, though there is a much greater need for urgency in conducting any such review than his paper implies. But it should not be imagined that a review would reveal any easy alternative. There has been a good deal of heart searching by successive Governments over this question, and the present system has survived a fair amount of hostility. Some of the considerations are as follows:

- i. For certain groups (eg armed forces, civil service, National Health doctors and dentists) there is no market-determined rate. The Government, as paymaster, is not subject to the constraint of profitability. There is no measurable "output".
- ii. The Government's objective must be to pay rates adequate to maintain the services at the level they require, but certainly no more. This can be regarded as "fair" both to their employees and to the taxpayers.
- iii. There is much to be said for a system which seeks to attract a reasonable share of talent for the public sector by paying rates comparable to those which might be earned elsewhere - taking full account of conditions of service, job security, pension rights and so on. And it is very doubtful whether the system could be jettisoned without a degree of disruption which could be very damaging indeed.

CONFIDENTIAL

- iv. But this still leaves very important questions to be answered. Are the comparisons sufficiently rigorous; and whether the machinery is sufficiently independent. It would also be legitimate to consider whether the price for this system should be no-strike agreements.
- v. What needs to be checked is (a) that comparability is genuine (job-for-job comparisons, wherever possible) and that the review bodies should not suffer from client-orientation. This is less likely to be a problem with a single Commission than with ad hoc enquiries, and (b) that the system allows for market forces - labour shortages or surpluses - to be taken into account. In many cases this will be reflected in the pay scales of private sector comparators - but not always, particularly if there is a conscious decision to reduce the public sector.
- vi. The question of coverage also needs to be examined. Should comparability be restricted to the groups traditionally covered in this way or is it sensible to offer it to the public services generally? Should the traditional "linkages" be sacrosanct. Should more allowance be made for regional variations in labour market conditions and private sector earnings.

b. Local Authorities/NHS

It would be unrealistic to assume that the Government will stand aside from pay bargaining by the local and health authorities. As the main Paymaster it will have to take a view on what can be afforded in determining cash limits. And it cannot ignore the likely repercussions on other groups.

All past experience suggests that where the Government has influence - as it does in these areas - it will want to use it to the full to reinforce its general stance on public services pay.

This may well be an argument for including these groups under the umbrella of disciplined comparability *faute de mieux*. But this needs further and rapid examination.

c. Nationalised Industries

The public trading sector presents perhaps the most difficult and undiscussed problems of all. Here, there is a great deal of industrial muscle capable of wreaking havoc in the rest of industry. There is a measurable output, but no free market. Most nationalised industries enjoy a degree of monopoly which cannot easily or rapidly be reduced. Many are highly capital intensive and a high pay settlement is much cheaper than suffering industrial action. The techniques for influencing pay bargaining are clear enough - financial targets, cash limits, some control over investment and prices. But there is still the problem of how much to build in for pay settlements, and on what principle. This needs considering in the context of the discussions on the future relations with nationalised industries which Sir Keith Joseph is leading.

CONFIDENTIAL

Conclusion

To sum up the Government's strategy in the pay area across the board should be to restore the conditions under which "responsible free collective bargaining" within a framework of fiscal and monetary discipline can result in low inflation and rising investment and employment. This means beginning to shift balance in the labour market. But when the next wage round begins the fiscal and monetary discipline can be in place but other background conditions will be adverse - especially the rate of inflation. What can be done by then to make people believe that the balance has begun to shift back. The areas to look for are: (i) the forum (ii) publicising the facts on objectives (iii) the legal prerogative of trades unions (iv) the law and practice of picketing. In the public sector the most urgent needs are for a study on (i) whether there is any alternative in practice, to comparability, or if we are stuck with comparability, how it can be improved (ii) how do we deal with nationalised industries?

31 May 1979

CONFIDENTIAL

13 MAY 1979

11 12 1
9 7 2
8 6 3
5 4



PRIME MINISTER

PAY IN THE NATIONALISED INDUSTRIES

I am afraid that I shall be unable to attend the Economic Strategy Committee tomorrow. May I however express my broad agreement with the Chancellor's paper on pay. I think the conclusions recommend a sensible and cautious step-by-step approach.

I particularly welcome the Chancellor's conclusion in 13.2 that a detailed study should be set up to consider how to handle pay/price questions in the nationalised industries particularly those which have a monopoly power. Paragraph 5(e) may slightly exaggerate what can be achieved through our new competition policy. As you know we intend to reform the Monopolies Commission but its impact on these pay/price questions is likely to be limited. Whilst it may be possible for it to be used to examine efficiency in the nationalised industries, it will need to build up experience in this field. We foresee that in the early days it will primarily be concerned with examining specific anti-competitive practices which are brought to its attention. It is not intended, of course, that it should involve itself in the wider questions of financial objectives and cash limits.

I am copying this minute to members of E Committee and to Sir John Hunt.

SN.

J. N.

Department of Trade
31 May 1979



6261 AM 1979

[Faint, illegible text, possibly a signature or title]



Secretary of State for Industry

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB

TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

Econ Pol.

Martin Hall Esq
Private Secretary to
The Chancellor of the
Exchequer,
Treasury Chambers,
Parliament Street,
London SW1P 3AG

R
mys
29 May 1979

Dear Martin,

PAY: PAPER FOR E COMMITTEE.

My Secretary of State has now seen the draft paper for E Committee which you copied to Andrew Duguid and a copy of your letter of 24 May to Tim Lancaster.

My Secretary of State is broadly content with the paper but would like to suggest one amendment to paragraph 8. At the beginning of paragraph 8 he would like to delete the words "The question is " and replace it by "The questions are whether such a process is not so likely to throw up a figure which will be considered a norm that it is too dangerous to launch and, on the other hand,".

I am copying this letter to Tim Lancaster and Ian Fair.

Yours sincerely,
Pete.

Peter Stredder
Private Secretary

29 MAY 1978
10 11 12 1
13 14 15 16
17 18 19 20
21 22 23 24
25 26 27 28



cc D/EMP
D/I
CO

Ecan PD

bcc Hoskyn
Wolfson

10 DOWNING STREET

From the Private Secretary

29 May 1979

Pay: Paper for E Committee

The Prime Minister has now considered the draft paper for E Committee which Martin Hall sent under cover of his letter of 24 May.

In the Prime Minister's view, the draft does not provide an adequate basis for Ministers to advance their thinking on pay matters very far. She therefore feels that the E Committee discussion next Friday can only be brief. The Prime Minister has the following specific comments:

(i) She does not think that paragraphs 1-3 contain sufficient "principles" to warrant conclusion i in paragraph 13; she suggests that this conclusion be deleted.

(ii) Likewise, she considers there is insufficient substance in paragraph 5 to warrant conclusion ii in paragraph 13, and she would like this deleted also. Furthermore, she has questioned the statement in paragraph 5 (c) that "the local authorities would themselves be left to negotiate without interference". The Prime Minister's view is that the Government must bring some influence to bear upon local authority negotiators since it is the Government which pays much of the local authority wage bill.

(iii) As regards conclusion iii, the Prime Minister does not doubt that a study of how pay/price questions in the nationalised industries should be handled is needed. However, she would like to consider further the question of who should co-ordinate the preparation of this study; and therefore this should be left open in the paper. She has also commented that before the study gets under way, Ministers will need to have more details of what it is proposed the study should look at.

(iv) As regards conclusion v, the Prime Minister does not think that it is possible to await completion of the current round of references to the Clegg Commission before the whole question of comparability is considered. She understands that the reference on teachers pay will not be completed until early 1980; in her view, it will be necessary to take a view on the future of Clegg well before that. She also thinks that Ministers will need to take a view on the future of PRU and the review bodies

before they start working on next year's pay round; and that this consideration will need to take into account the possibility that - at some stage - PRU, the review bodies and the Clegg Commission should be brought together. The Prime Minister has therefore suggested that conclusion v should be amended to read as follows:-

"To agree that further action on the Clegg Commission be reserved until the first five references have been completed".

She has also suggested that this should be followed by two additional conclusions:-

"That any consideration of public sector pay policy must include consideration of the future of PRU and the review bodies".

"That comparability be considered in relation to its effect on inflation".

The Chancellor will wish to be aware that, to help Ministers in their thinking on pay and other economic issues, the Prime Minister has it in mind to set up a Council of Economic Advisers as soon as possible after the Budget; she will of course wish to discuss this with the Chancellor. The Prime Minister also intends that the CPRS should contribute to the further work which is needed on policy in relation to pay.

I am sending a copy of this letter to Ian Fair (Department of Employment), Andrew Duguid (Department of Industry) and Martin Vile (Cabinet Office).

T. P. LANKESTER

Tony Battishill, Esq.,
H.M. Treasury.

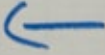
ce: W. A. Ashby

PRIME MINISTER

Chancellor's Paper on Pay

I attach the draft of the Chancellor's paper on pay which you wanted to see before it is circulated.

On the whole, this paper seems sensible. However, I do not think conclusion v. on the question of comparability is satisfactory. It recommends that "the whole question of comparability for the public services as a permanent feature should be left open pending the outcome of the present round of references to the Clegg Commission". This won't do because the present round of references, culminating in the teachers, will not be completed until early 1980. And yet, there may be suggestions well before then that additional groups should be put to the Commission. In my view, it should be possible to reach at least a provisional decision on the long term future of Clegg when the first five references have been completed (by the early autumn). A further argument for looking at the long term future of comparability in the autumn is that the Government will have to take a view on the PRU and the review bodies ^{before they} ~~who~~ operate in the next pay round. A case can very well be made that PRU, the review bodies and Clegg should - at least at some stage - be brought together, so that the same comparability principles are used throughout the public services. By putting off the review of comparability until next year, any such bringing together is effectively ruled out until then. (Indeed, it is rather odd that there is no mention of PRU and the review bodies in the paper.)



Clegg
Rev.
PRU

Tim: This is a very poor paper and we can only

charitably assume that the Treasury is "otherwise occupied" at the present.

25 May 1979

But next their proposals (over the horizon) are a holding operation - and we certainly can't wait until Clegg has finished all his work. It is important that (i) we set up a Council of Economic Advisors in 1980 or so after the P.T.O.

budget and

(ii) as far as C.P.R. related out (any job

(item) and an effective economic action

then to consider this whole question - including
monopoly power.

You can witness stand - especially the need
reference to other 'competitively' bodies, and
therefore the discussion will need to be brief
I suggest that - conclusion (iv) stands (distressed
or forum) and that -

(v) be amended

that. Further action on the Clegg Commission
be reserved until the first 'five' references
have been completed.

could (vi) that - any new consideration of public utility
may claim must also include PRU &
other review bodies.

(vii) that 'competitively' be considered in relation
to its effective action.

See no need - for (i) (ii) & (iii) in view of
concerns on a C.E.P. & C.P.R.

010
CONFIDENTIAL

E. M. Hasky



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

24 May, 1979

Dear Tim,

PAY : PAPER FOR E COMMITTEE

.... I attach a draft paper on Pay for E Committee, which the Chancellor has approved. I should be grateful if you could let me know whether the Prime Minister is content by mid-day on Tuesday 29th May.

I am copying this letter to Ian Fair and Andrew Duguid. The Chancellor would also be grateful to know if their Secretaries of State are content.

Yours ever,

MA

(M. A. HALL)

Tim Lankester Esq,

CONFIDENTIAL

24 MAY 1964

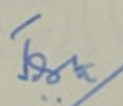
11 3
7 6 5 4
8 9

Ref: A09581

PRIME MINISTER

The Way Forward on Pay

When you get to Item 7 I suggest you say something like -
"I want to postpone discussion of the Secretary of State for
Employment's paper until Cabinet next week. This is partly
because we have a very long agenda today: but also the
Chancellor of the Exchequer has the main responsibility for
incomes policy and ought therefore to have a chance to put
his own views forward. "


John Hunt

17th May 1979

Taken off agenda
for Cabinet 17/5

CONFIDENTIAL

Ref. A09571

PRIME MINISTER

The Way Forward on Pay

(C(79) 6)

BACKGROUND

In C(79) 6 Mr. Prior points out that the level of settlements is now around 13 per cent and rising and that nearly half the settlements for this round are yet to come. He says his recommendations are aimed at creating a climate for responsible collective bargaining through a variety of ways which he considers are compatible with the Government's general approach on management of the economy and pay. They relate not only to the rest of the current round but also the round starting this August. However some of his proposals, if they find favour, raise sensitive questions of handling and presentation which are likely to require further consideration and discussion.

HANDLING

2. You will wish to invite Mr. Prior to introduce his paper and then seek general comments from Sir Geoffrey Howe, Sir Keith Joseph and other colleagues.

3. Thereafter it would probably be most convenient to work through Mr. Prior's specific recommendations in paragraph 7 of his paper.

4. Paragraphs 7a., b. and c. build on the Manifesto Commitment to "open and informed discussion of the Government's economic objectives . . . so that there is wider understanding of the consequences of unrealistic bargaining and industrial action"; and on the TUC agreement with the previous Administration on a target of reducing inflation by 1982 to below 5 per cent. They would require discussions with the CBI and the TUC but also a more broadly aimed educational effort. Mr. Prior specifically envisages "development of the economic forum approach". Clearly further thought needs to be given to the mechanics of any such operation. The nature of the forum? Who takes part? etc. How will the talks be presented publicly? Who should conduct them? And how should the proposed wider educative campaign be orchestrated? It would be desirable to clarify issues of this kind before any final commitment. The simplest

CONFIDENTIAL

solution would be to ask Mr. Prior and the Chancellor to put a more detailed paper on these matters to the Ministerial Committee on Economic Strategy (E) for circulation at an early meeting.

5. The recommendations in paragraph 7d. on monetary targets and cash limits are the subject of other items on the agenda and no separate conclusion is needed.

6. The recommendation in paragraph 7e. on the Comparability Commission falls to be considered separately in the meeting in the context of the joint paper on the Commission's future (C(79) 3). As to the continuation of Civil Service Pay Research and the Review Bodies you will want particularly the views of Lord Soames and the Secretaries of State for Social Services and Defence. But all of these Bodies have a long history and for the moment you may prefer to leave them in place and concentrate on detailed improvements. You could, if you wished, commission a review by officials of the mechanics of these bodies to provide a basis for later discussion (in E or E(EA)).

7. The recommendations in paragraph 7f. concern mechanics but also raise some important questions of principle. The previous Administration required the nationalised industries to clear all pay offers with them before they were made. But this was in the context of a tight pay policy norm. Your Manifesto stated that "in the great public corporations pay bargaining should be governed by what each can afford". But the public utilities are, by and large, able to set prices at whatever level is necessary to achieve profitability. The decisions taken by E on Monday to strengthen the investigative powers of the Office of Fair Trading and provide for it to make references to the Monopolies Commission as part of a more active competition policy will obviously help to impose a price - and hence a pay - discipline on the nationalised industries. But will it suffice? This again might provide the opportunity to commission a review by officials on the complex problems of seeking efficiency in the nationalised industries - with a future report to E or E(EA).

8. The question of repercussive effects raised by Mr. Prior in paragraph 7f. is also important. Apart from the more generalised concept of the "going rate" to which many trade unions have regard in their negotiations, there are also long established relativities e.g. between electricity, gas and water manuals (where

CONFIDENTIAL

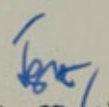
the unions overlap even if the employers don't). It is desirable that these are taken into account by management in making offers. You do not want to continue the interventionist approach of the last Administration but you may nevertheless want colleagues to consider whether there should be arrangements under which the Government is notified by the nationalised industries of major pay offers before they are made and to be given the chance to comment on them.

9. The recommendation in paragraph 7g. (that the Department of Employment should monitor private sector settlements on a voluntary basis and co-ordinate information for Ministers on the pay situation) is sensible and would provide Ministers with a guide not only to what was happening and pay settlements generally but also important settlements ahead. The previous Administration received a monthly report and Mr. Prior might be asked to continue this in less detailed form and to circulate it to the Ministerial Sub-Committee (E(EA)), of the Ministerial Committee on Economic Strategy.

CONCLUSIONS

10. You will want to record the Cabinet's conclusions in each of the recommendations set out in paragraph 7 of C(79) 6; and, subject to the discussion (especially on (b) and (d) below) to commission -

- (a) A joint paper from Mr. Prior and Sir Geoffrey Howe for consideration by E amplifying the proposal for early talks with the TUC and CBI to influence the pay climate; and the options for other long term steps which might be taken to the same end.
- (b) A report by officials (to E or E(EA)) on the scope for improvement in the present arrangements for determining Civil Service Pay through the Pay Research Unit and the pay of doctors and dentists, the armed forces, and top salary groups through the Review Body system.
- (c) A paper from Sir Geoffrey Howe for consideration in E (or E(EA)) on arrangements for enabling the Government to comment on pay offers in the nationalised industries before they are made.
- (d) A monthly report from Mr. Prior to E(EA) on pay settlements.


(John Hunt)

16th May, 1979

File *hw*

MR. HOSKYNS

We spoke about the proposal for a future Cabinet discussion of the Government's overall strategy, and the need to focus on key issues of policy which cut across the whole Administration.

You agreed to draft, in consultation with Sir Kenneth Berrill, a minute from the Prime Minister to members of the Cabinet, in which she would ask for a more considered note about the major issues falling on each of them. We envisaged the circulation of this minute on Thursday of this week, with a request for replies by, say, 1 June. You and the CPRS would then be able to finalise a strategy paper, to which the Departmental Ministers' minutes could be attached, in the following week, and this could be considered by Cabinet around 11 June.

I attach a copy of Ken Stowe's minute to the Prime Minister about this, with copies of the short replies prepared by each Cabinet Minister for the Prime Minister last week.

KAP

15 May 1979

CONFIDENTIAL



10 DOWNING STREET

From the Private Secretary

MR. VILE
CABINET OFFICE

PAY AND CASH LIMITS

Sir John Hunt sent the Prime Minister with his minute of 11 May a draft "annotated agenda" for her to circulate to Cabinet.

The Prime Minister has considered the draft, and has now decided that she does not want an "annotated agenda" of the kind which Sir John had in mind, discussed in Cabinet.

Her comment on the draft is as follows:

"Discussion on this paper in Cabinet would be futile - and on any other paper which raises such enormous questions and supplies so few answers. It would weaken our hand - not strengthen it."

T. P. LANKESTER

14 May 1979

CONFIDENTIAL

A handwritten signature in the bottom right corner of the page.

CONFIDENTIAL

Copied to:
Econ Pol: May 79 1:

Prime Minister Public Exp.
Are you content with
the attached draft to
be circulated to
Cabinet under your
name? No not
R 11/5

Ref. A09536

PRIME MINISTER

Pay and Cash Limits

In my introductory brief on this subject, I suggested that you might want to have a general discussion in Cabinet, for which purpose we could produce an "annotated agenda" for you to circulate to your colleagues. You agreed to this suggestion. We have therefore prepared the attached draft, which you may care to consider. If you approve this, or any amended version you prefer, it might then serve as the basis for a general discussion in Cabinet next week to precede discussion on related subjects (e.g. cash limits in 1979-80, the Standing Commission) which your colleagues will be bringing forward for decision. It may also be a useful background to subsequent discussion in the relevant Committees on particular cases.

X The Chancellor will be putting in a paper on cash limits. He and Mr Prior have already circulated a paper on the

J. Hunt
JOHN HUNT

11th May, 1979

Standing Commission (included in your folder on Teachers Pay for E Committee).

R

11/5

Discussion on this paper would be fruitful - and on any other paper which raises such enormous questions & requires so few answers! It would need our best - not strengthen it. John's 11/5

CONFIDENTIAL

PAY AND CASH LIMITS

Memorandum by the Prime Minister

We face a series of decisions over the coming months on pay and related cash limit problems. It may help if we first have a more general discussion. This note is intended to focus such a discussion, not as a vehicle for decisions about individual cases.

The Private Sector

2. We aim to leave this to the companies and workers concerned. As the Manifesto put it, 'no one should or can protect them from the results of the agreements they make'. But:

a. the attitude of both sides and particularly of management, will be influenced by our monetary policy and in the short term by the state of company liquidity (which is not particularly tight at present). We cannot yet forecast how companies will act in the next wage round. It will depend on the general situation at the time as well as on the circumstances of individual employers. But we can generate a climate through our policies and actions and through informed public debate. The case for enlightened self-interest in pay matters should not go by default. In this connection we will need to carry forward our Manifesto proposal for "more open and informed discussion of the Government's economic objectives". I return to this below.

b. Our policy depends on 'striking a fair balance between the rights and duties of the trade union movement'. We are committed to three immediate changes in trade union law, after discussions with the unions. If this is to affect the 1979-80 pay round, the legislation must be introduced this summer. Can this be done? Are there other aspects of trade union reform which we should be considering on a contingent basis?

CONFIDENTIAL

c. We must withstand demands for Government funding from companies which run into difficulty by granting excessive pay increases. How best can we make this clear in advance - if possible before the first case hits us? And do we need a working definition of 'excessive'?

The Public Sector

3. Our policy is for pay bargaining in the public corporations to "be governed by what each can afford" and in central and local government to "take place within the limits of what the tax payer and rate payer can afford". However in our first year of office:-

a. We have inherited cash limits (set out in Cmnd 7515) which make insufficient allowance for the promises our predecessors made but which we have to honour. Frequently these promises relate to the 'catching-up' of pay in the public sector which follows inevitably from three years of rigid pay restraint. To this extent they represent a temporary rather than a permanent problem. Do we accept that we must act within the limits of the possible this year and consider each case on its merits and subject to our prior commitments?

b. The most important of these commitments relate to the armed forces and police where we have already taken our decisions which require expenditure going beyond the provision made by our predecessors.

c. During the election campaign we deliberately exempted certain parts of the public sector (eg the National Health Service) from major cuts. We must nevertheless seek vigorously for sensible economies.

4. Within this general framework we will need to consider several different categories of public sector cases:-

a. Nationalised industries: The circumstances of individual public corporations vary widely and different considerations and issues arise on each. Thus the "public utility" corporations (electricity, water, gas and the Post Office) are able, within limits, to set their prices at whatever level is necessary to achieve profitability. Are we prepared to leave them this freedom? If so, what steps are open to us to impose other disciplines which will provide the necessary incentives for efficient operation? Then there are industries such as British Rail where it is unrealistic to expect their charges ever to cover their costs. Obviously cash limits impose a useful discipline but our decisions on BR financing will effectively set the limit of pay increases they can grant or the volume of services they can provide. The problem of unprofitable railways which nevertheless provide an essential service (eg for the London commuters) is common throughout the world. How far are we prepared to leave decisions of this kind to the Railway Board alone? The heavy basic industries, such as steel and shipbuilding, form yet another group. They face, in common with their overseas competitors, very depressed markets and are inevitably passing through an expensive phase of contraction. Here, too, we will need to strike the right balance between the long term and the short. Next, in a category of its own, comes the National Coal Board, which ought to be profitable - the rising price of oil benefits it as much as OPEC - and whose product is of considerable long-term importance to our energy supplies and the balance of payments, but which appears to be heading for serious deficits. Do we ask them to take the whole strain on prices, investment and pit closures? Or do we seek some intermediate position knowing that this will inevitably draw us into the industries' management decisions? Finally there are the mainly manufacturing public industries ranging from British Aerospace to British Leyland where our basic cash limits doctrine can probably be applied without very great difficulty. Ministers concerned must investigate the situation in the industries and corporations for which they are responsible. Our basic aim should be to minimise the outflow of central Government funds to the nationalised industries and, where appropriate, to maximise the inflow.

CONFIDENTIAL

b. Local Government: The last Government made various promises about pay and Rate Support Grant which will take expenditure this year beyond the published levels. We cannot go back on these and we have added our own promises on police pay. But many local authorities seem to have budgeted for quite large cash balances, and we should not accept that any further pay settlements should automatically attract RSG support. If necessary they can draw their balances down, or trim their services: and they must be made to take responsibility for the consequences of their decisions. Looking ahead, we may well want to trim the level of RSG support we offer for next and subsequent years in order to encourage the authorities to exercise restraint in their expenditure. We will also need to consider what other means are available to us to promote economy and efficiency in local government services, some of which are extravagant and wasteful.

c. The National Health Service: The Government finances virtually the whole cost of the NHS. The Health Authorities were told by the last Government that their cash limit would be increased to finance this year's pay settlements for nurses, NHS ancillaries and ambulancemen (and some other related groups): and we confirmed in the election campaign that it was not our intention to look for major cuts in NHS services. We need nevertheless to find ways of improving the cost-effectiveness of the NHS where we are likely shortly to face even bigger wage bills following the Report of the Doctors and Dentists Review Body.

d. Central Government: The main settlement for the non-industrial Civil Service, based on pay research, was reached just before the election. The existing cash limit covers only about one-third of the cost. A research-based settlement for the industrial Civil Service is due in July; it is likely to put further pressure on cash limits. Other settlements to come - for the Prison Officers and the TSRB grades - are likely to be of less significance in cash terms. None of us is fully satisfied with the operation of pay research, and we will need

CONFIDENTIAL

to look at it again. But detailed improvements in the pay determination mechanism are not enough. We will need substantial savings to offset at least part of the cost. Of course the 'catching-up' element in present pay settlements poses a once for all problem this year of exceptional magnitude. Once we are back to a cycle of annual settlements the scale of our task will be reduced. Nevertheless, it is clear that we need a sustained and continuing effort to cut out waste, find more cost-effective means of carrying out our policies and a strong operation of priorities in Government expenditure. Departmental Ministers must give this effort the impetus it needs.

5. Comparability: We inherited a growing system for determining pay in the public services on the basis of comparability. For the non-industrial Civil Service the system has its origins in the Priestley Royal Commission of 1953-1955 and has evolved into a structured arrangement with the Pay Research Unit (PRU) to provide data; a Pay Research Unit Board (of which Sir Derek Rayner is Deputy Chairman) to provide independent supervision of the PRU's activities; and complex pay agreements between the Civil Service unions and management governing the pay negotiations which are based on the PRU evidence. Do colleagues agree that, whatever view we take on the subsequent spread of comparability beyond the non-industrial Civil Service, we should not overturn this structure: and that our efforts must be concentrated on improving it on the lines set out in our Manifesto?

6. Similarly would it be counter-productive to seek to change the three Review Bodies (Armed Forces, Doctors and Dentists and Top Salaries) which have existed for some time and which have gained a wide measure of acceptance? In the longer term we may need to consider some rationalisation but it is of great value to have authoritative and independent means for determining salaries in these areas - including of course the salaries of MPs and Ministers.

The first part of the report deals with the general situation of the country and the progress of the work done during the year. It is followed by a detailed account of the various projects undertaken and the results achieved. The report concludes with a summary of the work done and a list of the names of the staff members who have been engaged in the work.

The second part of the report deals with the financial position of the organization. It gives a detailed account of the income and expenditure for the year and shows how the funds have been used. It also gives a list of the names of the donors who have contributed to the work of the organization.

The third part of the report deals with the work done in the various departments of the organization. It gives a detailed account of the work done in each department and shows how the funds have been used. It also gives a list of the names of the staff members who have been engaged in the work.

CONFIDENTIAL

7. Extending the comparability system through the Standing Commission on Pay Comparability is however a different matter. It can of course be argued that comparability provides a useful tool for determining the proper 'rate for the job' in the public services (not the trading corporations) and applying it by a means which minimises the possibility of industrial disputes. And clearly there are a number of groups - nurses for example - where independent assessment of pay is necessary and an experienced Standing Commission may have advantages for this purpose over ad hoc inquiries. The danger however is that like will not be compared with like and that a system, apparently fair, will in fact become an engine for inflation. We will need to consider our attitude to the Standing Commission separately on the basis of a paper which the Chancellor of the Exchequer is circulating.

8. The Bargaining Climate: Our counter-inflation policy rests heavily on the restoration of firm monetary policies, including cash limits, and on a new approach to trade union power. But we want to encourage responsible collective bargaining, and our Manifesto therefore provides for 'open and informed discussion of the Government's economic objectives ... so that there is wider understanding of the consequences of unrealistic bargaining and industrial action'. This will require a resumed dialogue with both sides of industry as well as in Parliament and more widely. In the case of the unions should we seek to hold them to the target they accepted jointly with the last Government of reducing inflation below 5 per cent by 1982? Or do we have a different approach?

Conclusion

9. We do not want to run an interventionist pay policy but we have general responsibilities for the health of the economy and specific responsibilities in the public sector. The main lines of our policies are already clear. We must now work to apply them in detail so as to achieve our common objective. I hope that the general discussion we are to have in Cabinet will help us all in this task.

PRIME MINISTER

ECONOMIC STRATEGY

1. I attended this morning the Chancellor's first discussion on economic strategy with his colleagues and senior officials. A number of interesting points emerged in the subsequent discussion, of which the most important are noted below.

2. Public Expenditure and the PSBR

The PSBR, as you know, is presently reckoned to be around £10bn. However, it is not entirely clear whether this figure makes full allowance for recent revisions in the estimated cost of existing policies or for the consequences of public sector pay settlements likely to arise from the activities of the Comparability Commission. The Treasury are investigating urgently to see how fully these factors have been allowed for in their estimate, and we shall no doubt know the answer beforelong. I am not myself satisfied yet that the £10bn figure reflects accurately the true present position.

3. Timing of Income Tax Changes

There was some discussion of the very important issue of whether one could in some sense bring reductions in income tax into force part of the way through the present financial year. The Inland Revenue stressed, as might be expected, the difficulties of doing this. They are, no doubt, very considerable, but it will be interesting to see what they amount to. I understood the meeting to conclude that the Revenue would be producing a submission on this matter, which I believe Tim Lankester has already been investigating at your request. From a policy point of view, there seemed to be enormous advantages in starting the cuts half-way through the year, if it can be undertaken without undue technical difficulties.

4. Charges

You will remember that the Chancellor was inclined not to push too hard with increases in school meal or prescription charges if there was to be a substantial increase in VAT. Clearly, this is a matter on which it is not essential to make an instant decision. My impression from the discussion is that there is a very strong case for moving on both fronts. After all, the previous Secretary of State for Education had proposed a

10p increase in school meal charges last autumn, and prescription charges have not been increased for many years. When the exemptions are taken into account, the impact on the needy does not emerge as the serious issue which many feel it to be.

5. Capital Gains Tax

As I intimated to you the other day, there are a number of very serious problems involved in indexing or tapering Capital Gains Tax. In terms of the burden on what should be a short Finance Bill, dealing with CGT could well turn out to be unjustifiably onerous unless a simple method can be found for the time being. This the Chancellor is keen to do.

6. The RPI

There was some discussion of the possibility of supplementing the RPI with an index which takes into account cuts in direct taxes. Such an index could, as you know, come very close to being an index of the standard of living. The Treasury pointed out that to compile such an index accurately is not likely to be easy at the moment, since the present index of the RPDI is produced quarterly and in arrears. The Treasury will shortly be given some papers which we did on this issue while in Opposition. My own instinct is that we shall not get very far with this in the short run, and that the best way to proceed in presenting the effects of the budget to the public will be to prepare tables for specimen families showing the overall impact of price and income tax changes attributable to the budget.

7. Taxation of Short-Term Benefits

There was insufficient time to discuss this issue more than in passing. The initial judgment was that it would be a matter for year two. The technical complexities involved in this operation are, by any standards, very considerable and Lord Cockfield will be examining them with the Revenue in the near future.

8. General Observation

Some quick jottings on the back of an envelope suggest to me that, even if the £10bn PSBR forecast proves to be correct, the greatest difficulties will arise on the expenditure side. For that reason, I would advise extreme caution in the very short run before taking any decisions which involve increased expenditure over and above what we have committed ourselves to in the Manifesto. In particular, we should be cautious

SECRET

in establishing the preliminary guidelines for the revision of Cash Limits to deal with pay and price increases. I understand that you and the Chancellor felt yesterday that it would be appropriate to "squeeze" Cash Limits by about 2%. I would recommend that, if it is not too late, no final decision be made on this until the basic budgetary arithmetic is a little clearer than at present. It may well turn out that, almost regardless of the apparent practical difficulties, a slightly tighter rein may be needed.

MR

ADAM RIDLEY
9 May 1979

*Adam. Thawson - this is
most helpful
ant*

SECRET

b.c.: Mr. Stowe
Mr. Wolfson
Mr. Ridley
Mr. Ryder



10 DOWNING STREET

File
280
2
Economic Policy

From the Private Secretary

MR. VILE

PAY AND CASH LIMITS

The Prime Minister has now read Sir John Hunt's brief of 4 May on the above subject. She has made the following comments:

- (i) On teachers' pay, she thinks the previous Administration were quite right to oppose the teachers' request that their comparability study should be no more than an up-date of Houghton. She thinks the previous Administration were quite right to insist on "an honest comparability study done with full weight given to the non-pay terms and conditions of teachers service".
- (ii) On PAR, she has commented that the PAR studies were well nigh useless and took up a lot of time.
- (iii) On paragraph 7, the Prime Minister agrees that it would be highly desirable to conduct early reviews of local authority expenditure and NHS expenditure with a view to identifying - and getting rid of - waste. I will be commissioning reports from DOE and DHSS respectively on these; but no doubt Sir Derek Rayner will also have an important role to play here.
- (iv) On comparability, the Prime Minister cannot confirm that comparability is the key to establishing public service pay. (She has of course already commented on this - see my note of 6 May.)

See separate files under Local Govt & Nat Health.

SECRET

/The Prime Minister
APB

SECRET

- 2 -

The Prime Minister agrees with Sir John Hunt's conclusion - that Ministers or Ministerial Committees will need to be asked at an early stage to produce papers and proposals on the various issues touched on in the brief, but she would first like to have a general discussion in Cabinet, and with this in mind she would be grateful for an annotated agenda which could be circulated to colleagues.

7.

P.S.

As regards the reports from DOE and DHSS ((iii) above) I would be grateful if you would let me have drafts of the commissioning letters for me to send.

8 May 1979

SECRET

1a

SECRET

Ref. A09456

PRIME MINISTER

Summary and Timetable of Urgent Economic Issues

This brief summarises the most urgent economic issues which the Government will need to tackle in the next few months. They are:-

- (a) The Budget. The last week of May and the first week of June are not available because of the Bank Holiday and the recess for the European elections. Present Treasury thinking is that the best date is 12th June. A Budget before the European elections would be too soon for the new Chancellor to prepare and for colleagues to take any related decisions. But to leave matters much after 12th June would leave too little time for the passage of the Finance Bill. I am giving you a separate brief on the broad issues which will arise on the Budget.
- (b) The CAP Price-Fixing. Negotiations will reopen in May. The outcome is important, among many other reasons because it affects the net payments we will make to the Community Budget over the next 12 months.
- (c) The Public Expenditure Review. Decisions on the current year will presumably be taken in the Budget context. You have more time in which to re-examine the inherited expenditure plans for later years. The annual PESC review of expenditure from 1980-81 onwards has already begun at official level. But this is a policy-neutral exercise, confined to three questions: what can be afforded within the already published totals: what adjustments are inevitable for demographic reasons; and what options are available for increases or reductions. You will clearly want to set new guidelines for this operation, and I know that Treasury officials will have draft proposals ready for the Chancellor to put to Cabinet very quickly.

12th June ✓
G H Green.

SECRET

If the spending agencies are to adjust their policies in good time for 1980-81, you will need final Cabinet decisions in the autumn - and perhaps before then. The PESC exercise is carried out in 'constant price' terms and there will be a separate and difficult job of setting cash limits for 1980-81. This will be particularly important in the local authority field - see below.

- (d) Rate Support Grant. The annual fixing of Rate Support Grant for local authorities takes place in the autumn. The grant (over £9 billion in 1978-79 always has to be based on assumptions about local authority pay and has important implications for both central and local authority expenditure. Because you will be relying on cash limits as an important element in controlling public sector pay, you may want to give an earlier indication than usual this year of the sort of pay increases to be ^{assumed,} ~~announced~~. This points to a decision on the level of RSG for 1980-81 before the summer recess.
- (e) Pay. The "current pay round" ends on 31st July. The original White Paper governing the round ("Winning the Battle against Inflation - Cmnd 7293) is presumably no longer operative but 31st July nevertheless represents a watershed. A number of key problems will arise before that date. In particular:-
- (i) you will want to consider how the Manifesto idea of "more open and informed discussion of the Government's economic objectives" is to be pursued. The previous Government had made a start on similar lines through bilateral talks with the TUC and CBI but had not got very far when the Election intervened.
- || If any new exercise is to have an influence on pay bargaining after 1st August a very early start will be necessary;
- (ii) your Manifesto had a clear line on pay bargaining in the public corporations but still leaves detailed application to be worked out, e.g. some public corporations, such as British Gas, are highly profitable and can "afford" substantial pay increases and

SECRET

others, e.g. British Rail, are permanent public pensioners and cannot, in a strict sense, "afford" to pay wages at all. Moreover pay settlements in some nationalised industries inevitably read across to others, e.g. for manual workers in the gas, electricity and water industries where there are close historical links stemming from their common 'municipal' past. Luckily most of the public corporations' pay bargaining this year has been completed. (The main outstanding case is the Post Office where the offer made has just been rejected by a ballot of the employees.) The reflection of these issues in the Government's financial arrangements with the nationalised industries will require quick examination if a coherent and disciplined framework is to be embodied in the Government's public expenditure plans;

- (iii) Similarly your own approach to pay bargaining in the public services will have to be worked out in detail before cash limits for next year are set.

A fuller brief on public sector pay and cash limits is being submitted separately.

- (f) Immediate public service pay issues. You will be faced almost immediately with the need for decisions on five public sector pay issues: the pay of MPs and Ministers (on which the Boyle Report should be available very shortly); the pay of doctors and dentists (where the Report of their Review Body is to hand); the pay of other "top salary groups" (covering e.g. judges, nationalised industry chairmen, generals and senior Civil Servants) where the TSRB Report is just available; teachers, where negotiations were postponed because of the intervention of the Election (and where the Government has a direct interest through RSG); and the broad mass of local authority white-collar employees whose settlement date is 1st July.

SECRET

- (g) Energy. I have sent you a separate brief covering the energy sector where a number of difficult issues are outstanding. Among the most urgent of these are:-
- (i) Measures to cut oil consumption next winter in order to meet our IEA and EEC obligations. Decisions are needed before the summer recess.
 - (ii) Linked with this is the question of coal. The NCB is heading for a major loss this year and carries a fringe of heavy loss-making pits in politically sensitive areas like Wales and Scotland. Early decisions on these could help reduce losses - next year if not this. You will also need to consider how far you are prepared to pay for extra British coal next winter to replace oil or whether we should import more coal.
 - (iii) The reorganisation of the nuclear supply industry. By common consent the present system will no longer serve and reorganisation is long overdue. Delay will mean setting back completion of the next batch of stations.
- (h) Industrial Issues. There are a number of difficult industrial issues which are bound to come up in the next few weeks. You may care to note the following check-list of the more sensitive of them:-
- (i) The future of the shipbuilding industry (badly hit by the world shipbuilding slump and very expensive to maintain).
 - (ii) The equally expensive problem of the steel industry.
 - (iii) The almost certain early financial collapse of the Port of London Authority.
 - (iv) Possibly the financial problems of Dunlop.
 - (v) Constraints on industrial development caused by planning procedures (the CPRS are conducting a study) - with Moss Morran as the current leading case.

SECRET

- (vi) Regional development with heavy expenditure, doubts about the cost effectiveness of some of the techniques, but continuing pressure for more money. This links with the future of Government support for industry in general and in particular the operation of the Industry Act 1972.
- (i) The European Council. The next regular meeting of the EEC Heads of State and Government is at Strasbourg on 21st-22nd June. The quality of these meetings and the importance of the decisions to be taken varies. But this will be your first appearance and the proceedings are likely significantly to influence at least the atmosphere, and possibly the direction, of EEC policy over the years ahead. We are now the Community's largest paymaster but its third poorest member. There is a lot to play for in terms of redressing this imbalance. I am sending you a separate brief about European matters.
- (j) The Economic Summit. This is scheduled to take place in Tokyo on 28th-29th June. The attenders will be President Carter, President Giscard, Chancellor Schmidt, the Prime Ministers of Japan Italy and Canada, Mr. Jenkins as President of the EEC and yourself. The Summit will be particularly important this year because the international financial situation is still shaky (and has not been helped by the larger than expected rise in oil prices). The Summit provides a good opportunity to urge our partners to react in a sensible manner.
- (k) UNCTAD V. This triennial meeting starts in Manilla on 7th May and may go on until early June. With the MTNs more or less under control and the framework of the Common Fund already agreed, UNCTAD V could create less of a trauma for North/South relations than did UNCTAD IV in Nairobi in 1976. But representation in the final stages is normally at Ministerial level and there will be a good deal of interest in the attitude of the United Kingdom Administration to North/South issues in general and to aid in particular.

SECRET

CONCLUSION

2. There is a great deal to be done in a short time on these issues (and inevitably others will arise in the normal course of business). The most immediately pressing is the shape of the Budget and associated matters like the money supply target. On these you will no doubt wish to await the Chancellor's specific proposals. But close behind in terms of time, and ahead in terms both of intrinsic importance and inherent difficulty, is the development over the months ahead of a strategy for public expenditure. And such a strategy will take you and your colleagues deep into a complex of related issues such as relations with the nationalised industries, the finance of local government and the difficult realities which lie behind the adoption of cash limits for central Government. One essential concern of the Cabinet Office is of course to ensure that the work which clearly needs to be done, and which Ministers wish to be done, is tackled in an orderly fashion and in good time so that the Ministers have a sound basis for decision-taking. This in turn relates to the structure of Ministerial Committees on which I will let you have recommendations when you have made your main Ministerial appointments.

J.H. 4/5

John Hunt

SECRET

Ref. A09457

PRIME MINISTER

PAY AND CASH LIMITS

This note seeks briefly to summarise the main features of the pay scene and prospects at the outset of your Administration. In the light of your Manifesto it is largely concerned with pay in the public sector.

Pay determination machinery

2. You have inherited five formal pieces of pay determination machinery.

They are:-

- (a) The Civil Service Pay Research Unit and Pay Research Board.
- (b) The new Standing Commission on Pay Comparability.
- (c) The Armed Forces Review Body.
- (d) The Doctors and Dentists Review Body.
- (e) The Top Salaries Review Body.

3. The first three of these base their recommendations on "comparability" (i. e. the systematic assessment of the going 'rate for the job'). The last two are influenced by comparability but their recommendations, e. g. on doctors or Members of Parliament, also have a judgmental content. The PRU and the three Review Bodies have a long history and well-established procedures and techniques. The Standing Commission is new and reflected a decision by the previous Government to allow a substantial extension of the comparability principle into pay determination in the public service in its widest sense, i. e. in all of the public sector excluding only trading bodies like the nationalised industries. Although new, the Standing Commission already has a number of remits to fulfil extending from local authority manual workers to nurses. You will wish to consider at an early stage whether to accept the continuation of these various pieces of machinery and in particular whether to seek to cut back on the Standing Commission or to continue to leave it available to any public service group in the non-trading public sector where both sides agree to call on its services.

SECRET

4. The previous Government had already begun the process of seeking to establish an annual economic assessment with the TUC and the CBI to inform future wage bargaining. You are committed to a rather similar idea in your Manifesto. If progress is to be made an early start is needed. The idea has long been advocated by the CBI and you should find a ready acceptance by them. The TUC, on the other hand, may seek to claim that the understandings they had reached with the previous Government were specific to that Government and that all bets are off. Such an attitude is however more likely in relation to their commitment to achieve a reduction in the rate of inflation to below 5 per cent by 1981 (where the TUC would in practice have found it very difficult to agree on the specific implications of honouring that commitment) than to taking part in a joint assessment of the economic outlook. The trouble of course is that no economic assessment can be divorced from policy on taxation and public expenditure, where views are influenced more by political judgment than by cold analysis, so that a tripartite agreed analysis is probably not attainable. Nevertheless the process of education is valuable in itself as is the impact of discussion on expectations. German experience is particularly relevant here. You will need to arrange for early thought to be given on the best way of proceeding.

Early public sector cases which will require Government decision

5. Large parts of the public services and the nationalised industries have already concluded their pay negotiations for this year but there are a number of outstanding issues and negotiations still to be settled. The most important of these are likely to be:-

- (a) Armed Forces. You are committed to increase the pay of the Armed Forces. The Review Body's recent report giving their recommended full rates of pay for 1st April 1979 is available and its implementation need cause no difficulty in itself. There would however be some problems of overlap given that the pay of senior serving officers is handled by the TSRB rather than the AFRB. Without special action for them inverse pay differentials would result from the full and immediate implementation of AFRB report, e. g. Brigadiers would be paid more than Major Generals.

SECRET

- (b) Doctors and Dentists. Like the Armed Forces the Doctors and Dentists Review Body (DDRB) produced a report last year which showed that very substantial pay increases were needed to bring the Doctors' and Dentists' pay up to date following the period of pay restraint. The then Government agreed that these increases should be paid in stages - 10 per cent last year, half the balance on 1st April this year and the remainder on 1st April next year - with both this year's and next year's stages being updated to current levels. The DDRB report on what those current levels should be on 1st April 1979 is now to hand. The presentation is complicated because the report also deals with the new contract for senior medical staff. Early decisions will also be needed on:-
- (i) Whether this year's updating is acceptable to the Government.
 - (ii) Whether the cost of introducing the new contracts is acceptable to the Government.
 - (iii) Whether, like the Armed Forces, the outstanding payment due next year should be brought forward to this so that the acknowledged anomaly is fully corrected at the outset of this Parliament. So far as I am aware, the doctors have not yet argued for this but it would be surprising if they did not press for parity of treatment.
- (c) The "top salaries" groups. The Top Salaries Review Body covers a wide range of senior public appointments ranging from Members of Parliament and Ministers to senior civil servants, senior officers in the Armed Forces, judges and the Chairmen and Board members of nationalised industries. These groups, too (with the exception of MPs and Ministers), had a report last year recommending substantial increases in pay as a catching up operation. The then Government accepted the proposals in principle subject to staging over this year and next but with an important difference as compared with doctors and soldiers. This was that the Government expressly deferred a decision on whether the recommended

SECRET

pay rates should be updated in 1979 and 1980 to take account of developments since the main report was produced in early 1978. The TSRB has however now reported on what it believes the updating should be for 1979. The Government therefore needs to decide whether it will accept the proposals for updating included in the latest TSRB report. You may also care to note that, as with the Armed Forces, there can be problems in Civil Service pay structures arising from the fact that grades up to Assistant Secretary are handled through PRU and more senior officials through the TSRB. The particular problem here is that the TSRB's latest report recommends salaries for Under Secretaries below those which PRU evidence suggests for Assistant Secretaries. This has happened before and has been met by cutting back on Assistant Secretaries' pay. But a conscious decision will be needed.

- (d) Members of Parliament and Ministers. The TSRB report on the pay of MPs and Ministers is in a different category because it is the first report on their pay for many years. The Government will therefore need to decide ab initio:-
- (i) Whether it accepts the recommendations of the report.
 - (ii) Whether it is prepared to implement them at once or to provide some form of staging for implementation over a future period.

In handling all of these cases, other than the Armed Forces, you and your colleagues will need to balance the case for getting rid of old anomalies quickly (including the political case that any increase for the higher paid arouses opposition and that staging therefore prolongs the presentational agony) against the immediate cost of full implementation and the repercussions on other groups, e.g. the police, the nurses, the non-industrial Civil Service, who have accepted varying degrees of staging for their outstanding claims.

- (e) Local Authority non-manual employees. The local authorities' white-collar (APTCS) grades, largely represented by NALGO, are due for a pay settlement on 1st July. Although they have traditionally sought to strike their own bargains without reference to "comparability" (and may have done rather better from this than they would on a strict "fair

SECRET

comparisons" basis) they may well this time press for "comparability" and a reference to the Standing Commission. The problem with local authority pay settlements is of course that they involve an underlying battle between Government and local authorities about who should pay the cost. On recent form the local authorities will only make an offer when they have a Government assurance that Rate Support Grant will be forthcoming because otherwise the cost of any settlement above what is already allowed in RSG falls on the rates. This question is part of the wider issue of the control of public expenditure by local authorities and the drain on central Government resources represented by the RSG to which your Government may want to give a good deal of attention in the public expenditure review.

- (f) Teachers. Negotiations on teachers' pay continued up to a late stage in the election campaign and were then deferred at the Government's request until the election was out of the way. The basic issue dividing the two sides was that of the terms of reference for any comparability study.

Mej
Speed
The teachers saw the purpose of a new study as up-dating the Houghton report (which was particularly generous to teachers) and wanted terms of reference framed accordingly. The management side (including the Government) wanted an honest comparability study done with full weight given to the non-pay terms and conditions of teachers' service. If the negotiations do not lead to agreement the teachers enjoy a statutory fall-back right to arbitration which they have so far been reluctant to exercise. Negotiations will have to be resumed very quickly now that the election is over.

- (g) Post Office. At a very late stage in the election campaign Post Office employees rejected by ballot the terms of a pay offer made to them in negotiation. The negotiations must therefore be resumed at an early date. The Government will need to decide what guidance if any should be given to the Post Office.

SECRET

Cash limits

6. Cash limits are central to your approach to the control of public expenditure, and indirectly of pay levels in the public sector. There are however two points to be made:-

- (a) The degree of control exerciseable through cash limits varies depending on the particular part of the public sector in question. The key distinction is whether the Government itself is the sole paymaster or one among several. In central Government and the NHS the Government is the sole source of finance. If you set cash limits here, and stick to them, excessive pay increases (over and above those for which you have allowed in setting the cash limits in the first place) will inevitably and necessarily result in a reduction in the number of staff employed or the volume of goods and services bought. In the case of the local authorities, 61 per cent of expenditure in England and Wales is met by the RSG and 68½ per cent in Scotland. A decision to set a cash limit on the amount of RSG provided, therefore, puts the burden of adjustment, whether through rates, charges, alterations in balances or the volume and quality of service provided, on the local authority concerned. In the case of the nationalised industries, the proportion of Government finance provided to them varies from industry to industry. The balancing factors are prices, employment, investment and the quality of service. Moreover, with the nationalised industries, the nature of the "cash limit" varies. In some it will be a limit on their borrowing from the National Loan Fund. (Though the British Gas Corporation, for example, is a net repayer of Government borrowing.) In others it will relate to specific subsidies (e.g. those to British Rail and some of the payments to the National Coal Board). In yet others it will relate to deficit financing, whether described as borrowing or not (e.g. British Steel). This does not mean to say that the concept of cash limits is inappropriate to these industries. But it does mean that the financial arrangements with each will need to be tailored to its particular circumstances.

SECRET

(b) Cash limits are not a painless instrument of financial control. In central Government, for example, the application of a cash limit to a Department can have three quite separate and distinct effects:-

(i) It intensifies the search to cut out waste in administration. And it must be true that in any organisation as large as the Civil Service there will be waste in some areas. The real problem is to carry through the detailed and searching enquiries needed to bring waste to light. There is of course already a substantial apparatus of staff inspectors etc. who carry out detailed surveys but the real problem is to motivate the line managers. Many are cost-conscious and do their not inconsiderable best to economise. But top management is generally too involved with policy and the needs of Ministers to get deeply involved and it is, unfortunately, very rare indeed to find a Minister who takes a personal interest or is willing to devote time to the detailed, and in personal political terms unrewarding, work required. You have I know your own ideas about how the 'war on waste' should be conducted.

(ii) It intensifies the search to find ways in which the objectives of policy could be achieved by less expensive means (the Treasury have expenditure on housing in their sights as an example here). Success here depends on a lively and imaginative input by

No - because they were well rep. with list & took for list of items

Ministers (the Programmes, Analysis and Review arrangements - PAR - have tended to wither precisely because Ministers react against the disturbance and interference with their own parishes which can result). The possibilities are nonetheless worth systematic identification.

(iii) Finally, it causes Departmental Ministers to rethink their priorities so as to identify the functions they are prepared to drop in the interests of economy. Politically this is the hardest of all. (Every expenditure and every policy has its own lobby.) And of course it is here that Departmental Ministers most hesitate

SECRET

to act because they are at the receiving end of the pressure groups' attentions. But no serious programme of cuts in public expenditure and no serious intent to hold to cash limits can succeed without a realistic assessment of priorities. Again you will need to decide whether some external 'input' would help Departmental Ministers.

7. Of course central Government expenditure is most subject to your control.

But many substantial sums of public money are spent through the local authorities and the NHS in both of which, by common consent, there is a good deal of 'waste'. Local authority expenditure is particularly difficult to control - and attempts to do so will lead into very difficult areas of relationships with independent-minded and elected authorities. The prize however could be substantial. The NHS is in an intermediate position. It is wholly funded by Government but enjoys a good deal of autonomy and is riddled with difficult characters (especially the professionals) besides being a political minefield. You will want the responsible Ministers to turn in quick and thoughtful reports on the possibilities.

Looking ahead

8. Given your Manifesto commitments, your administration will escape the treadmill of private sector cases which took up so much of the time of your predecessors. You will however still have an inescapable responsibility for pay in the public services. The main issues to which you may wish to direct attention are:-

(a) Do you confirm that 'comparability' (properly carried out) is the key to establishing public service pay?

(b) If so can improvements be made in the machinery and techniques for carrying it out? In particular do you want to work towards the merging of the present five Boards, Commissions, etc? And what can be done to improve the methods used to determine true comparisons? This is an area in which you might like to commission an early report by officials to serve as the basis for Ministerial discussions.

Yes -
to the
importance

No - have
already commented
on this

SECRET

Conclusion

9. There are a number of specific decisions which you will have to take quickly, mainly relating to specific pay cases; you will need to launch quickly a national debate on the economic outlook and this involves deciding how, where and with whom the debate is to be conducted; you will need to begin the process of settling cash limits for 1980-81 and to settle the level of RSG, before the summer Recess; and you will need to begin quickly a searching examination of public expenditure, including in that examination a search for areas where, and the techniques whereby, waste can be eliminated, new and cheaper ways found of achieving agreed objectives, and priorities established so that functions can be jettisoned to lighten the ship. In all of this you will inevitably get drawn into questions of pricing, investment and employment policies for the nationalised industries, the whole difficult area of local authority expenditure, efficiency and finance, and the question of charges for services at present free or higher charges for services at present provided too cheaply. At the same time you will be concerned with redressing the balance in pay bargaining by the various means outlined in your Manifesto and you may find that you have to go on to consider more fundamental questions like the structure and organisation of the British trade union movement. And you will want to think through the machinery for public service pay determination.

10. The handling of these issues within Government will depend partly on the decisions you have yet to take about the Committee structure and possibly wider machinery of Government issues. Nevertheless it is clear that at an early stage you will want to give a series of remits to Ministers or Ministerial Committees to produce papers and proposals on the sorts of issues touched on in this note.

You may also want to precede the issuing of specific remits by a general discussion in Cabinet. If you wish we could readily produce an annotated agenda for you to circulate to your colleagues.

Yes please
on.

John
4/5
(John Hunt)



PERSONAL & CONFIDENTIAL

HM Treasury

Parliament Street London SW1P 3AG

Direct Line 01-233 3016

Switchboard 01-233 3000

J B Unwin

Under Secretary

4 May 1979

T P Lankester Esq
10 Downing Street
LONDON SW1

Dear Sir,

I enclose on a personal basis copies of the two general briefs on the economic outlook and the Budget that we are giving the new Chancellor.

2. If you have any queries, please give me a ring (or Margaret O'Mara if I am not available).

*Yours
faithfully*

J B UNWIN

PERSONAL & CONFIDENTIAL

OVERALL ECONOMIC OUTLOOK

Note by the Central Unit

This note summarises the economic prospect facing the UK over both the short and medium term. It does not make any policy recommendations but is intended to set the general background to the major policy decisions the Chancellor will need to take in the next few months, especially those which concern his Budget (see brief A2). Separate briefs and submissions will be available on individual subjects and policy issues.

THE SHORT-TERM PROSPECT

2. The forecasts on which the assessment below is based contain a number of policy assumptions which broadly reflect the position from which the Chancellor is starting and imply no judgement about the policies he may himself wish to adopt. On taxation they assume the indexation of the main personal allowances provided for in the recent Finance Act but no increases in the specific indirect tax rates. On public expenditure they assume the plans of the previous administration broadly as set out in the last Public Expenditure White Paper (Cmnd 7439), together with the Chief Secretary's Statement of 23 February on the operation of cash limits in 1979-80. The forecasts are necessarily uncertain and subject to significant margins of error but will provide some indication of the likely development of the economy during 1979-80. Revised and more detailed forecasts will be submitted in 2-3 weeks.

(i) Earnings and prices

3. Pay settlements in the year ending July 1979 are likely to lead to earnings increases averaging 13-14 per cent with the public and private sectors faring about equally. In the absence of major policy initiatives pay increases in the economy as a whole may well remain at about the same level in the 1979-80 pay round. This assumes that comparability agreements are extended to some further public sector groups and that as a result earnings in the public services rise by 18% which is significantly more than in the rest of the economy. This represents a bunching together in 1979-80 of a "catching up" process covering large parts of the public services. Prices will probably be rising faster this year than last. Even with no increase in indirect taxation, the RPI will probably rise by around 10-11 per cent during 1979 and by a similar rate during 1980.

(ii) Growth

4. Although the economy grew by around 3% in 1978, growth is likely to be around only 1½ per cent in both 1979 and 1980 and will probably be insufficient to prevent some rise in unemployment. The main problem is the failure of domestic industry to match growth in demand by increased production - in 1978 consumer spending rose by 5½ per cent while manufacturing output grew by less than 1 per cent. Company profits are likely to remain low, reflecting a depressed domestic economy and an uncompetitive level of labour costs, but because of a low rate of stockbuilding and a downturn in the level of investment no widespread liquidity problems are foreseen.

(iii) Balance of payments

5. The current account of the balance of payments should remain in approximate balance in 1979 though it seems likely to move into deficit in 1980, largely as a result of the loss of competitiveness. In addition the capital account is likely to be weakened by a reduction in inflows by foreign oil companies to finance North Sea oil development.

(iv) PSBR

6. On unchanged policies, the Public Sector Borrowing Requirement (PSBR) is expected to rise from just over 5 per cent of GDP (£8½ billion) in 1978-79 to some 5.3 per cent of GDP (£10 billion) in 1979-80.

(v) Domestic and External Monetary Policy

7. Continuation of the 8-12 per cent target range for the growth of M3 has been assumed for 1979-80. Achievement of that target with existing fiscal policies would almost certainly require a rise in interest rates from the current levels. The recent upward movement of the exchange rate is likely to continue throughout most of the current quarter but then to be reversed in line with the deterioration in the balance of payments referred to above and the prospects for the money supply and inflation in the UK compared with other countries. The consequence of this would be an effective rate of around 60-62 by the end of 1979-80.

8. From this summary of the short-term prospect, it is clear that the economy faces two major and inter-related problems: a rising rate of inflation and slow growth.

9. The projected rise in the rate of inflation this year is largely due to high growth of earnings in the 1977-78 and 1978-79 pay rounds. Control over the rate of inflation is a precondition for sustained economic expansion and higher growth. Higher rates of inflation tend also to be unstable. They create uncertainty and reduce the willingness of companies to invest, particularly as they are inevitably accompanied by high nominal interest rates. The value of personal savings is eroded and this makes consumers less willing to spend. The effects of domestically generated inflation also tend to be reinforced from the external side. The balance of trade and output will be adversely affected insofar as there is a loss of competitiveness through the exchange rate failing to respond on the lines described above.

THE MEDIUM-TERM PROSPECT

10. Attempts to predict the course of the economy further into the future are even less certain and also subject to large margins of error. Recent trends in the international environment and in the UK's performance give no grounds for expecting a rise in the sustainable rate of growth in the early 1980s or an autonomous decline in the rate of inflation. Only a substantial improvement on the supply side of the economy is likely to warrant expectation of a significantly better outcome.

(i) Productivity and Growth

11. The underlying growth of productivity has declined in recent years and on present prospects there is no reason to expect any early improvement. The fall in productivity has more or less offset the contribution that the rise in North Sea oil output and the faster growth of the labour supply have made to the economy's productive potential. In time, faster growth of output could lead to a recovery in the growth of productivity but until inflation is contained and competitiveness improved there is little prospect of achieving a sustained increase in growth. Lying behind these trends is a long history of industrial inertia, inefficiency and lack of innovation, and on present prospects it may well be difficult for the economy to sustain growth much above a rate of 1-2 per cent over the next few years. Since about half of this would represent an increase in North Sea oil output, the prospects for the rest of the economy, particularly manufacturing, are extremely worrying. Such slow growth may well lead to a continued rise in unemployment but it is difficult to predict the increase with any accuracy.

(ii) Competitiveness and trade performance

12. The adverse trends in Britain's trading performance in manufactures have also been a major factor depressing the economy's growth. Exports of manufactures have risen at less than the growth rate of world trade (though there has been some improvement

in performance in recent years) and imports of finished manufactures have risen much faster than the growth of the domestic economy. UK labour costs have risen at a much faster pace than our main competitors' and this has been compounded recently by the appreciation in the effective sterling exchange rate, reflecting in part the direct and indirect effects of North Sea oil and of domestic monetary policy. As a result large parts of British industry have become uncompetitive - over the past two years, UK labour cost competitiveness has probably worsened by about 10 per cent. The benefit that North Sea oil has brought to the balance of payments has been largely offset by a deterioration in non-oil items. Though the current account has been close to balance in the past two years, and may not be far from balance in the years ahead, this has to be seen against the background of a generally depressed economy and a major contribution from North Sea oil.

(iii) The PSBR and Monetary Prospects

13. An important implication of the poor growth prospect is that, on present public expenditure plans (which assume a 2% annual growth path, which is higher than the prospect for the growth of the economy as a whole) and unchanged tax rates, the PSBR would increase both in absolute amount and as a percentage of GDP. In consequence, even to contain the growth of the money supply, substantially higher nominal interest rates could well be required. A reduction in the PSBR would reduce the growth prospect even further, at any rate for the first year or two.

WORLD ENVIRONMENT

14. The problems of high inflation and low growth are common to the majority of industrialised countries, although the UK suffers more than most. They are likely to be intensified in the short-term as a result of the loss of a substantial proportion of Iranian oil exports. Over the medium-term too there is little sign of a return to the trend rates of growth in world trade experienced in the 1960's and early 1970's and on average, GNP in the industrialised countries will probably rise by only 3 per cent a year, compared with an average growth of 5-5½ per cent in the decade to 1973. We cannot therefore rely on the expansion of other economies to extricate us from our own difficulties. In a number of international fora - IMF, OECD, EEC and the seven power summits - a lot of effort has gone into the negotiation of international programmes of concerted action. These are helpful as an assurance against a major world recession; but they should not be expected to improve more than marginally the outlook for the UK, as described in this brief.

15. Most outside forecasters share the above gloomy assessment of the problems in the medium-term. There is little consensus, however, about the effects on the economy of major policy changes. The main issue for macro-economic policy, in the immediate future, is how far to press anti-inflationary policies, such as strict fiscal and monetary policies, with their probable damaging effects on profits, output and employment in the short-term at least. The major problems in the economy may be helped by successful macro-economic policies to some extent - for example, lower inflation and reduced expectations of future inflation would encourage investment. But these major problems seem to stem from deep-seated attitudes and rigidities in both management and the work-force and require fundamental improvements on the supply side of the economy.

General Government Account and public sector borrowing requirement

(Positive sign = receipt)

	£ million	
	1978-79	1979-80
<u>General Government receipts</u>		
Taxes on income	22555	27511
Taxes on expenditure	18713	21160
National Insurance contributions	10080	11430
Local authority rates	5996	7076
Gross trading surpluses	219	230
Rent dividends and interest	6421	7144
<hr/>		
Total current receipts	63984	74551
<hr/>		
<u>General Government Expenditure</u>		
Final consumption	-33505	-38667
Current grants	-20345	-24387
Subsidies	-3714	-4211
Debt interest	-7655	-8720
<hr/>		
Total current expenditure	-65219	-75985
<hr/>		
Current surplus	-1235	-1434
<hr/>		
Investment and stockbuilding	-4630	-5411
Capital grants	-1861	-1973
Taxes on capital	938	1015
<hr/>		
Net acquisition of financial assets	-6788	-7803
<hr/>		
Net lending to public corporations	-1513	-2899
Other net lending	-396	-47
Other adjustments	-9	-366
<hr/>		
General Government borrowing requirement	-8706	-11021
<hr/>		
Public corporations' borrowing other than from general government (Positive sign = repayment)	+248	+912
<hr/>		
Public Sector Borrowing requirement	-8458	-10109

Note: Showing figures to the nearest £1 million does not imply accuracy of this order. Error margins for PSBR forecasts are normally considered to be in the region of £2000 - 3000 million.

BUDGET

Note by the Central Unit

This note assumes that the Chancellor will wish to introduce an early substantive Budget (a separate submission will recommend 12 June as the appropriate and earliest feasible date) and its purpose is to draw attention to the main policy issues on which urgent decisions will be required. It is to be read in the context of Brief A1 which summarises the overall economic outlook; and more detailed briefs on the specific tax and other policy issues referred to will be available to the Chancellor separately as he requires them.

Money Supply and PSBR

2. As we understand it, the Prime Minister and the Chancellor will regard a progressive reduction in the rate of growth of the money supply as the main priority in the task of mastering inflation. The Budget, and the fiscal policies contained in it, will therefore be structured to give effect to this intention.
3. In the Budget the Chancellor will be expected to announce the monetary guidelines for the 12 months to mid-April 1980 and he will therefore need to consider the desired growth of the money supply over this period. At present the growth of the money supply is expressed as a target range for the growth of £M3, which has been rolled forward for a 12 month period at six monthly intervals. The current 8-12 per cent range applies to the year ending mid-October 1979.
4. In setting a new target a judgement will have to be made on two closely related questions: the main influences on £M3, and the effect on the economy of different target ranges for the growth of the money supply. The main policy decisions that affect the growth of £M3 include - the size and structure of the PSBR; external policy, in particular the possibility of any substantial intervention to influence the exchange rate; the acceptability of the prospective level and pattern of interest rates; and direct controls on the banking system (eg, through the use of the SSD scheme).
5. On existing policies (which include the indexation of the main personal allowances as in the April Finance Act at a full year revenue cost of about £1 billion and the implementation of the petroleum revenue tax increases estimated last August as worth about £140 million in 1979-80) the PSBR in the current year is forecast at around 5.3 per cent of GDP (about £10 billion). Attached at Annex is a table showing the main revenue and expenditure com-

pon... On any view of its composition, some reduction will be required to keep the money supply within the existing 8-12 per cent range during 1979-80 and to allow some further reduction in interest rates, let alone achieve growth within a lower target range should the Chancellor decide on this for this year.

6. The PSBR is thus one of several factors to be taken into account in assessing how to achieve a desired growth of £M3, but it has assumed a special importance in view of its direct effect on market expectations. The previous Chancellor was committed to keep it to around £8.5 billion in the current year. However, its composition is in many respects as important as its size both in terms of its direct monetary effects (eg, the extent to which there are offsetting changes in bank lending) and in its effect on market confidence. For example, increases in the PSBR resulting from income tax reductions are likely to be more acceptable to the market than increases resulting from public expenditure changes.

Fiscal Options

7. To give the Chancellor a preliminary view of the implications of the main options he is likely to want to consider, a rough guide to the effect of some different possible tax changes is provided in paragraphs 10 and 11 below. More details are given in the separate tax briefs. It will also be possible to provide "ready reckoner" estimates of the effects of these and other tax changes on output, prices, the PSBR and other economic variables. (In relation to these it will be important to bear in mind that the PSBR effects of individual changes are not strictly additive; and that they do not bear a constant relation to the full year revenue effects, some being more PSBR 'rich' than others.) However, a full analysis, taking account of all the interactions, will require a more complete forecast. This will enable us to provide the Chancellor with some indication of the change in interest rates that could be necessary to keep the money supply within the desired range given the other elements of policy referred to above. We shall also be able to give an indication of the likely effects on the economy, including the short-term effects on demand and employment, of PSBRs of different size and composition, in combination with different interest rates, within the monetary limits on which the Chancellor decides.

8. In addition to the achievement of his monetary objectives, the Chancellor will also want to make an immediate start on the manifesto commitment to reduce direct taxation. In order to pay for this, both public expenditure cuts and increases in indirect taxation will be necessary.

(i) Public Expenditure

9. Decisions on public expenditure, including cash limits policy and this year's social security uprating, will need to be discussed with the Ministers concerned and will therefore

have to be pursued very quickly if they are to be announced in the Budget. The Government will in any case want to hold a major review of the medium-term public expenditure plans, but for the Budget it will be necessary to concentrate on those things which will have an immediate impact in the current year. This limits the field, but a significant contribution from public expenditure cuts is desirable, both to avoid putting undue weight on increases in indirect taxation, and as a first step towards the desired shift in the share of the public sector in national resources. The possible candidates for early cuts, including possible sales of assets, are described in brief.

(ii) Indirect Taxes

10. In considering indirect tax increases the Chancellor will wish to take account of the effects on the RPI. As a very broad rule of thumb, each £1 billion in additional full-year revenue raised from indirect taxes will add about 1% to the RPI. For example, raising the standard rate of VAT to 12½% to bring it into line with the higher rate would add about 2.1% to the RPI while bringing in about £2,250 million in a full year. (Because of the late date of the Budget, however, and the time lag in collection of VAT receipts the revenue in 1979-80 would be only about £1,200 million.) Increases in the specific excise duties would be likely to add rather more to the RPI than an increase in VAT yielding the same revenue, depending on the composition of the package.

(iii) Direct Taxation

11. The scope for making a start on the manifesto commitment to reduce income tax at all levels will depend on the size of the income tax package which the Chancellor judges would be compatible with his other objectives, including the possible increases in the indirect taxes referred to above and the resultant level and composition of the PSBR. The best means of dealing with the poverty trap through the income tax system is to raise tax thresholds. Each £10 added to the single allowance and £20 added to the married allowance cost together rather over £100 million in a full year. At the top of the scale, to cut the top rate of tax on earnings to, say, 60 per cent and to restore the value of the bands to their level at April 1973 would cost about £1 billion in a full year. If in addition the Chancellor wished to make any substantial reduction for those on middle incomes this could be done only by a reduction in the basic rate: the revenue cost of this in a full year would be about £½ billion for each penny taken off.

END

Filmed at the National
Archives (TNA) in London

February 2010