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Strategy: Pt 4

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PRIME MINISTER

Pay and Price Provisions for the 1980-81 Cash Limits

(C(79) 60)

BACKGROUND

You discussed this paper with the Chancellor of the Exchequer and others at your meeting on Friday. The Chancellor has now circulated it in a slightly amended form. The main difference is the omission of any indication of the 'volume squeeze' on different programmes.

2. There are two issues here: the effect of these proposals on the volume of public expenditure next year; and their impact on pay negotiations.

Effect on the volume of public expenditure

3. Cabinet will be discussing, later on this Agenda, the Chancellor's proposal to re-open the expenditure totals for next year. He is asking for a total reduction of £1 billion. On certain assumptions, the 'volume squeeze' implied in this paper on cash limits could add a further £450 million to this reduction. This would be true if the overall rate of inflation were 17 per cent (as the current forecasts suggest) and the Chancellor's proposals for a 14 per cent allowance in cash limits were accepted. The squeeze would be particularly tight on the Defence Budget, for two reasons:

- (i) Experience shows that the rate of increase in defence goods and services is rather faster than that in the economy as a whole (the "sophistication factor"): this is compounded by the fact that goods which would be classified as 'capital' in other programmes, for which the Chancellor proposes to allow between 15 and 16 per cent, are treated as current expenditure on the Defence Budget, and get only 14 per cent.
- (ii) The Government is committed to pay whatever increases are recommended by the Armed Forces Pay Review Body (AFPRB) whose report should be implemented on 1st April. This year's report is a straight up-dating one: but recent trends in pay settlements in the private sector suggest

CONFIDENTIAL

that the AFPRB will recommend something nearer 17 per cent than 14 per cent; this would put a further squeeze on the Defence Budget. The Secretary of State for Defence, who believed that he had done a satisfactory private deal with the Chancellor over the size of the Defence Budget, involving provision for the nuclear deterrent, will react adversely to this (see my separate note).

4. There are two ways of easing the Defence dilemma. It has already been agreed that a decision on the uplift factor to arrive at Civil Service pay cash limits for 1980-81 should be deferred until next February so that account can be taken in setting it of the indications which will be then available of the likely outcome of PRU. This arrangement will cover the Civil Service staff in Defence as well as civil servants more generally. A similar operation could be conducted for armed forces' pay relating in their case to the likely outcome of the AFPRB report. The alternative would be to set a higher number now - say 17 per cent - for armed forces' pay only, based on the best guess which can be made of the AFPRB results.

5. Similarly it would be possible, if Cabinet agreed, to set a higher price assumption for Defence expenditure on equipment - say 15 or 16 per cent - on the "capital goods" analogy referred to above. This could be continued with or calculated separately from the armed forces pay factor.

6. The impact of the squeeze on other programmes is smaller: but in the case of the Health Service could be as much as £85 million. Mr. Jenkin is prepared to consider some cuts there, but might argue that the cash limits squeeze involves double-counting. Other spending Ministers, who are affected to a rather smaller extent, might argue the same. To this, the Chancellor will reply that the proposals give a little more leeway than the cash limit applied to local authorities: but this was (as his paper admits) because the local authorities have the alternative of taking the strain of the rates, or of running down cash balances. All in all, Ministers will argue that the Cabinet decided the appropriate volume of public expenditure in the summer. If that has to be reopened, it should be done openly (in the way suggested by the Chancellor in the next paper) and not through the back-door.

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Public sector pay

7. One additional reason for settling cash limits at this stage is to put some pressure on public sector pay.

8. Ministers have already agreed the treatment of the nationalised industries and the local authorities. The approach appears to have worked, in the case of the NCB. It may not work so well with the BSC, where other factors have intruded. Negotiations in the local authorities continue: but our latest information is that there is a reasonable chance of a settlement at, or around, the 13 per cent provision built into cash limits for the RSG.

9. The picture in the Health Service is less clear: the negotiators will probably defer a settlement until they see how the local authority talks go. A cash limit for the water industry is being separately negotiated. In the past, the water workers have set the tone for local authority negotiations (and have of course considerable industrial muscle). This year, however, they seem to be biding their time, and there is a good chance that the local authority settlements would be reached without the risk of blackmail from the water workers.

10. It has already been agreed to leave over the cash limit for Civil Service until February. First indications are that the PRU evidence will point to something like 17 per cent. There is a margin for negotiation built in to the system, but even so a 14 per cent limit would be likely to impose a very considerable further volume squeeze.

11. The Government has no option on the armed forces - see above. The other two Review Body Groups (Doctors and Top Salaries) are, fortunately, small in numbers, and can be accommodated within cash limits without too much trouble.

12. Special provision has been made for the outstanding 'Clegg' awards for university teachers and nurses. That leaves the police (who are not subject to cash limits at all) and the fire service (who can probably be fitted into the Home Office overall total) and a few smaller groups like the Atomic Energy Authority (who settled earlier in the year at a figure which it may be difficult to accommodate within the proposed limits).

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13. The picture thus seems reasonably containable: but Ministers have had no comprehensive account of the way these different negotiations fit together, and of the pattern which is emerging. You might wish to ask the Chancellor to produce one for a later meeting.

HANDLING

14. You will wish the Chancellor to introduce his paper, and perhaps to ask the Chief Secretary to supplement it. You might then call for comments from some of the big spending Ministers: Social Services; Defence; Environment; Education and Science; Industry; Energy. You might suggest that Ministers distinguish between the effect on the volume of expenditure and the effect on pay negotiations (though there is of course an inter-play between the two). The Chancellor suggests no alternative to his stark 14 per cent: and I think this is what the Cabinet will eventually settle for. But compromise positions may be necessary. Those open to you include:

- (i) an extra $\frac{1}{2}$ per cent or so on the inflation allowance all round;
- (ii) special provision for the services most affected; notably the Defence Budget and the Health Service. It may be that in the special case of defence the Cabinet may be prepared to indicate a willingness to compromise on the lines suggested in paragraphs 4 and 5 above. There is less scope for compromise in Health. Details would best be left to be settled bilaterally between the Chancellor and the Ministers concerned.
- (iii) A procedural device: either postponement of publication of the estimates and cash limits (which would inevitably arouse Parliamentary curiosity if not criticism); or some additional overall and unallocated contingency margin which could be publicly identified at the time. Provided that this was not allocated to individual programmes, and remained clearly under the control of the Chancellor and the Cabinet, this need not be too damaging to confidence, though, as compared with the discipline of cash limits clearly set and announced in advance, these expedients are very much second-best.

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CONCLUSIONS

15. The outcome of the meeting will be either:

(i) to approve the pay and price provisions proposed by the Chancellor in Annex A to his paper [with any modifications agreed in discussion];

or

(ii) to invite the Chancellor to discuss with spending Ministers modified cash limits to apply to their particular programmes [in which case you will want to identify the Ministers concerned];

or

(iii) to invite the Chancellor to consider further procedural modifications of his approach (e.g. a new unallocated contingency margin - see paragraph 14(iii) above) and to bring fresh proposals to the Cabinet at a subsequent meeting;

and possibly

(iv) to invite the Chancellor to bring before the Cabinet a comprehensive paper on progress in public sector pay negotiations in the light of cash limits already set or shortly to be announced.

REA

(Robert Armstrong)

12th December, 1979