E(79)35
17 September 1979

COPY No. 56

CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

NATIONALISED INDUSTRIES' CASH LIMITS & PERFORMANCE TARGETS FOR 1980/81

Memorandum by the Chancellor of the Exchequer

1. E Committee decided on 17 July that the proposals set out in the Secretary of State for Industry's paper (E(79)16) should be pursued. I was asked to bring forward proposals for implementing the general principles set out in that paper.

2. One of the main proposals was that cash limits on nationalised industries' external finance in 1980/81 should be set before the start of their pay negotiations: this means setting them in October or November instead of at the usual time - just before the 1980 Budget. The intention was that fixing the industries' cash limits early would exert pressure for responsible pay bargaining. The level of the cash limit - which should clearly not exceed the financing figures we settled in Survey price terms during July - would inevitably reflect a view about the increase in each industry's pay bill. That increase should reflect not a "norm-like" uniform assumption about pay increases but rather the particular commercial circumstances of each industry.

3. The attached paper by officials gives some illustrative estimates of what the effect might be of uprating the financing figures agreed for the industries in July (see para 7 & Table A). It discusses the considerations which will have to be taken into account when the decisions about cash limits are made. These are: the industries' own revised forecasts, the Treasury forecast for the economy as a whole (available next month), and the Government's views about the increase to be provided for in each industry's pay bill. The paper also summarises (in para 14) the advice of sponsor departments on the position of the major industries. I shall not bring forward specific proposals for the 1980/81 cash limits until next month. Before that can be done we shall need to decide rather more precisely how the cash limits are to be fixed, which is the most awkward issue raised in the officials' paper. There is no simple or mechanistic way of producing cash limits which will exercise an adequate discipline.





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4. The industries are extremely diverse and my own first reaction would be that pay increases and our own approach to them should also vary. It would certainly be preferable if the Government could avoid taking any view on the change in the pay bill which should be provided for in different industries, and could instead leave the management to reach settlements reflecting their commercial circumstances, provided they kept within the cash limit and that the cash limit was set at a level that imposed a discipline. In some cases this may be possible and we may be able to avoid taking a view on the pay bill. For one thing some of the industries are likely to forecast higher financing requirements as a result of the change in the economic prospect (slower growth, higher inflation and a higher exchange rate than they had expected) so that the cash equivalent of the figures we settled in July may impose a sufficient discipline. In the case of the steel industry which has been given a clear and ambitious financial target for next year, and operates in a highly competitive international market, we may not need to take any explicit view on the increase in the pay bill.

5. But at the other end of the spectrum, in a case like British Rail where the level of fares is a matter of considerable concern, where the labour costs are 60% of total costs and the Government meets 40% of that total, it will be much more difficult for us to avoid taking a view about costs. Other industries occupy intermediate positions. But in most cases it will be hard to decide what level of cash limit will provide an adequate and defensible constraint without taking a view on the increase in the pay bill which should be provided for. In doing this departments and the industries concerned will have to assess how pay in each of them is likely to move in relation to the national average. This is not likely to be at all easy. Not only is this approach a novel one but it is complicated by 3 distinct issues: there are firm traditional links between pay movements both between different industries and between the industries and the economy as a whole; there is a well argued presumption that in the immediate future pay in the nationalised industries, as in the private sector generally, should grow by a good deal less than in central and local government, where exceptional catching-up settlements have been made as a result of Clegg and other awards; and we do not, in any case, have or wish to formulate a view about what the likely rate of increase in average earnings is likely to be.

6. As a starting point for determining what the judgment should be officials suggest the rule of thumb that labour costs per unit of output in the industries should be assumed to rise by rather less than the expected increase in retail prices

(and therefore costs) generally. That initial figure would then be modified in the light of each industry's special circumstances, particularly where substantial losses are being made.

7. Whatever the shortcomings of this approach nothing better has been identified so far, and we cannot afford to wait longer. I therefore ask colleagues to agree that this approach should be pursued in discussions with the industries. Though rough and ready, it should offer us a useful start with a prospect of improvement. Despite the imprecision of cash limits for the nationalised industries and their vulnerability to industrial action they should without producing a uniform result, exercise some downward pressure on pay bargaining. If in the final count, the industries fail to negotiate settlements consistent with the cash limit or with performance targets for costs, they will have to put up prices or make savings in capital or current expenditure.

8. To meet the time-table proposed in E(79)16, discussions with the industries about their revised estimates need to start now. As well as covering the application of the rule of thumb to the pay bill, the discussions will need to eliminate 'fat' in the estimates and if necessary to identify what needs to be done by the industries to keep to our July decisions.

9. As E Committee asked, the paper also covers the arrangements for monitoring nationalised industries' cash flow; and it discusses how we should monitor pay developments in nationalised industries (see paras 9-11 of the paper by officials and para 7(iv) & (v) below).

10. I now invite my colleagues to:

i) Endorse for the purpose of discussions with the industries the rule of thumb and the broad approach to setting the allowance for pay bill increases in fixing the cash limits (para 5 above & para 19 of the officials' paper). This would mean that the industries would be expected to achieve some reduction in their real unit labour costs.

ii) Agree that sponsoring departments and the Treasury should now begin discussions with the industries on the make-up of the 1980/81 cash limits, as proposed in paragraphs 22 & 23 of the officials' paper.

iii) Note that I shall be bringing proposals for the limits to be set for each industry before the Committee, in the light of discussions with the industries and of the prospects for the economy as they emerge from the forecast now in course of preparation. I envisage further Ministerial discussion in the course of next month prior to publication of the limits in November.

iv) Agree that nationalised industry Chairmen should be asked to ensure that sponsoring departments are consulted before commitments are entered into in any major pay negotiation.



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v) Note that, while the present arrangements for the monitoring of nationalised industries' cash flow should in principle be adequate, the support of sponsor Ministers may be needed to ensure that the industries cooperate effectively in working those arrangements and also to oblige them to take effective steps to counter threatened breaches in their cash limits.

(G.H).

H.M.TREASURY

17 September 1979

NATIONALISED INDUSTRY CASH LIMITS & PERFORMANCE TARGETS FOR 1980/81

Note by Officials

Introduction

1. At E Committee on 17 July the Chancellor was asked to bring forward specific proposals as to how the general principles set out in the Secretary of State's paper on Pay, Prices & Efficiency in Nationalised Industries (E(79)16) and in the detailed note by officials attached to it might be applied in each of the main nationalised industries. He was also asked to examine the desirability of obtaining improved information on the cash flow in these industries.

2. In previous years cash limits have been set just before the Budget by updating the external financing figures agreed by Ministers the previous summer by reference among other things to the Government pay policy as currently interpreted. Where the annual pay settlements have already been concluded, allowance has been made for these; and in other cases a good deal of relevant information has been available by the time of decision about the "tone" of the pay round before the cash limits have been set. The approach envisaged by Ministers for 1980/81 differs in two important respects: the proposal in E(79)16 was that the cash limits will now be set before all but a few major pay settlements in the current round have been reached, and the assumptions to be made about each industry's pay bill will reflect the specific circumstances of that industry rather than any sort of general pay norm.

3. This paper is not intended to reach decisions on what next year's cash limits would be. Rather it discusses how and when cash limits might be set for each of the major industries*; how effective they might be in containing the size of wage claims; how far they could be bolstered by the enforcement of performance targets; and whether adequate information is available from the industries for effective monitoring. It does not deal with the financial targets to be applied in each case; these are the subject of separate discussions involving the industries, the

*These are defined as: coal, gas, electricity, railways, steel, Posts & telecommunications, and British Airways.

sponsoring Departments and the Treasury. The paper begins with a general discussion of the role of cash limits before moving on to a discussion of the detailed circumstances of the major industries. It concludes with proposals for further action.

The Role of Cash Limits for Nationalised Industries

4. As was noted in the paper by officials which accompanied E(79)16, individual cash limits apply to each industry's external financing (its total financing requirement net of internal resources) and hence to its contribution to the PSBR. The limits, when set, incorporate a view not only about each industry's investment, but about its costs, including wage costs, and its prices as well. Departments have sought to reduce any "headroom" the industries have tried to build into their cash limits, and the limits have been taken increasingly seriously by the industries as a basic financial discipline. Although external financing needs may on occasion increase in a way beyond an industry's control, in general the risk of a breach in the limits is recognised as calling for every effort by the industry to achieve an improvement in its cash flow sufficient to stay within them.

5. But at the same time the effectiveness of the cash limits as discipline on costs varies with the circumstances of different nationalised industries, so that cash limits are at best a very imprecise instrument of control. An industry's external financing needs are the difference between two very much larger flows of receipts and expenditure, and both may vary markedly as a result of all sorts of random factors - changes in market conditions, unusual weather patterns, the timing of payments, including progress payments, by customers - without any decisions by the industry affecting investment, prices or wage costs. Cash limits exert the strongest leverage over the financial results of those industries which have the greatest degree of monopoly power; but the industries' ability to vary prices in these cases restricts the extent to which the limits can influence the development of labour costs. Equally cash limits are likely to be more effective in influencing pay in non-monopoly industries where wage costs are a high proportion of total costs; but the ability of such industries (steel is the most notable example) to stay within the limits is less than that of industries which have monopoly power over prices.

6. Action to keep within a cash limit during the current year may not always be the correct response to a threatened breach. The

short-term discipline should not frustrate sensible longer-term planning. Although in some instances holding back investment may be the best course of action to counter a breach, cutting investment in response to a deterioration in trading conditions might do more harm than an increase in redundancies at an outdated plant, even though the initial costs of the redundancies would be such as to increase the size of the immeidate breach in the limit. Equally it may be in an industry's long-term interest to hold out against industrial action even if the costs of so doing mean a greater breach in the cash limit than would result from further concessions.

## Some Illustrative Figures

7. For purposes of illustration annexed Table A shows effect of uprating* Survey prices' external financing figures as settled by Ministers in July to outturn prices in 1980/81. Table B shows figures by industry for capital requirements, internal resources, and illustrative cash limits; and the effect in £ of a 1% change in pay bill, turnover and investment, and in numbers of 1% change in employment. The fact that external financing requirements are small in relation to turnover in most industries illustrates the risk that random factors may result in substantial deviations from the path of cash flow expected when the limits were set. The relationships between pay bill, investment programmes and total costs give an indication how much flexibility an industry may have in meeting a threatened breach in cash limits, notably by restrictions on investment.

8. Decisions on nationalised industry cash limits are not a matter of mechanical manipulation of figures - least of all applying a uniform earnings assumption - but an act of informed judgment. Apart from the Survey price figures in Table A, this judgment will need to take into account:

a) Updated forecasts from industries. Their pre-Budget forecasts which formed the basis

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*The uprating factor covers 2 years since Survey prices are 1978/79 prices. It is consistent with earlier projections, including a rise in earnings between 1979/80 and 1980/81, of 18½% in the public services and 14% in the private sector and nationalised industries, with the RPI rising at 13½%. The uprating factor is on average about 10% higher than the industries themselves assumed in their Investment and Financing Review submissions. It will probably need to be changed when the new economic forecast is available, but the pattern of a lower average figure for the private sector and nationalised industries than for the public services sector is unlikely to change.

of this summer's Investment and Financing Review have been outdated by 3 general changes since February:

- a faster increase in the general price level
- the impact of recent Ministerial decisions on prices, investment and financing
- the prospect of slower economic growth, and a higher exchange rate for the £ rather than previously expected.

The industries will also want to make other changes related to their specific circumstances. Sponsoring Departments will need to examine their revised forecasts carefully, and to consider whether the industries' underlying assumptions eg, on pay, employment and output are acceptable.

b) Prescriptive assumptions chosen by Government to exert pressure for efficiency and responsible pay bargaining, by setting limits, tailored to the circumstances of each industry, to the overall increase in the pay bill.

c) New Government economic forecasts including forecasts of earnings and prices (which would provide the basis for the next Industry Act forecast) in the autumn; the judgments about the likely increases in the private sector and in the economy generally will be particularly important.

Sponsoring Departments and the Treasury will need to undertake preliminary discussions with the industries in the next few weeks on the first two points. The Chancellor will then put specific proposals to the Committee around the end of October, incorporating the results of the discussions and the new economic forecast due early in October.

<u>Enforcement of Cash Limits</u>

9. If cash limits are to be successfully enforced, and are to serve as an effective brake on increases in unit wage costs in nationalised industries, the Government must have:

i) the earliest possible warning of the likelihood of a breach, so that the appropriate remedial action can be discussed with the industry in question;

ii) information about pay offers the industries are contemplating before any such offers are made, if implementation of the offers would result in a breach in the cash limits which could only be avoided by price increases or investment cuts.

10. Present arrangements for monitoring the financial performance of nationalised industries are set out in Annex I. In the view of sponsoring Departments and Treasury officials, the need now is to make this system work better, rather than to change it. On occasions sponsor Departments may need active support from their Ministers in persuading theindustries to improve the quality and timeliness of their regular financial returns, and to provide in advance some indication of the expected profile of cash flow through the year against which the outcome month by month can be judged. More fundamentally, active involvement of Ministers is bound to be required if the industries are to be brought to take effective and timely remedial action to prevent threatened breaches. Even then, the scope for adjustment or employment levels to keep within a cash limit may prove in the short run to be very restricted.

11. Where pay is concerned the problem is to reconcile the need for effective enforcement of cash limits and performance targets throughout nationalised industries with the Government's determination to avoid setting pay norms and to leave the industries to make their own decisions on pay and prices. These problems have been discussed in letters from the Secretaries of State for Industry (13 August) and Employment (30 August). The balance of the arguments for alternative courses of action is further considered in Annex II. In the view of Treasury officials it would be so difficult for nationalised industries to determine whether or not a particular pay settlement implied any risk to the cash limit that the Government's policy would be better served if the industries were asked to consult sponsoring departments before entering into any commitments on major wage negotiations, including productivity bargaining. This arises from the potential impact of such settlements on cash limits and performance targets, including those relating to other nationalised industries where a particular settlement - however unjustifiably - traditionally has repercussions. It does not imply any intention on the part of the Government to express a view about the appropriate earnings level for any particular group of employees.

## Performance Targets

Performance targets are particularly important in the regime to be applied to the monopoly industries. In the absence of such targets - which need to be clearly understood by everyone working in the industries, and to be set in a way which will attract as wide a measure as possible of support from public opinion - it is inescapable that insistence on cash limits and financial targets may mean more burdens on the consumer. The new powers for references to be made to the Monopolies & Mergers Commission of the efficiency with which particular monopoly activities are carried out by nationalised industries should provide a means to increase public understanding of and support for Government policies. It is clearly desirable that performance targets (which now apply only to posts and telecommunications) should be extended as soon as possible to cover the energy industries and perhaps certain rail services as well. But Ministers need to be aware that in the short run the restraining power of such targets over organised labour is likely to be very limited.

## Possible Restraints on the Diversion of Investment Funds into Pay Packets

13. Once an excessive pay settlement has been conceded in a nationalised industry, there is no escape from covering its costs through higher prices. The intention of performance targets is to restrain the monopoly industries from conceding such settlements in the first place. The question has also been raised whether steps should be taken to prevent industries from prejudicing their own futures by cutting investment in order to meet the cost of pay increases. In principle it would be possible to envisage separate cash limits for investment and the remainder of an industry's activities; but this would involve very detailed interference with the way each industry was run, even if the formidable accounting problems it would imply could be solved satisfactorily. Furthermore trying to protect investment in every case would be inconsistent with the Government's policy of bringing home to employees generally the point that excessive pay demands will put at risk their own or other people's jobs.

## The Application of Cash Limits to the Major Industries

14. Although major pay negotiations involving nationalised industries are not due in the current annual pay "round" (which began in August) for several weeks, Departments need to let the Chairmen

know as soon as possible about the overall approach, and to begin discussing with the industries the appropriate assumptions to be made about increases in their pay bills and in the prices they charge. Sponsoring epartments have provided more detailed analyses of the timing and fixing of the limits for the major industries, and the specific problems in enforcing them; this material may conveniently be summarised as follows:

a) Coal

Discussions on action to reduce uneconomic capacity, following the recent review of the industry, have not yet advanced very far, so that the projections of future investment, output and financing are very tentative. The annual pay bill next year (about £1.8 billion) accounts for over 50% of total costs, and corresponds to about 3 times the investment programme. The NCB expect miners' real wages to increase by 3% a year (with their productivity improving by 2% a year). The miners are seeking to have their settlement date brought forward from March to November, which would give them more leverage to put pressure on electricity supply at the time when that industry's need for coal is at its greatest. This is a demand which the NCB must resist; there should be no question of substantive negotiations until towards the end of the year, which would be consistent with nationalised industry cash limits being set in November, as currently envisaged. The miners are a powerful and self-confident group, and the fact that the industry is wholly dependent on Government for its investment funds has apparently imposed little restraint on their behaviour. It might be difficult to cut investment sufficiently to recoup the cost of a higher settlement than the cash limit allowed for, and it is questionable - given the need to develop new lower cost coal sources - whether restricting investment would be an appropriate response. The availability of imported coal or of alternative fuels at lower prices serves as a partial restraint on price increases, but limitations on port and transport facilities still leave the industry with a good deal of monopoly power, particularly that exercised through electricity supply.

b) Electricity

Wage costs represent only about 20% of total costs, and the effectiveness of cash limits as a discipline is reduced both by the position of the industry as a monopoly utility and by its apparent profitability. The pay bill and investment spending are roughly the same size. Pay settlements are due in February (engineers) and March (manuals), so that there is perhaps less urgency about setting the cash limit than in the case of coal. The industry expect pay increases at least in line with inflation; this, together with the carry-over from the delayed 1979 settlements would mean an increase of well over 20% in the pay bill between 1979/80 and 1980/81. The output and financial performance of the industry can be significantly affected by random fluctuations in the weather, and this has implications for the setting of precise cost objectives for relatively short periods. The 75% improvement in real output per employee over the last 20 years as new and larger generating sets have been installed limits the scope for further productivity improvements.

c) Gas
Wage costs represent only 20% of total costs, and there is ample scope for price increases without any risk of gas becoming uncompetitive with other fuels. The industry is contemplating a performance target of a 2½% a year reduction in real unit costs (other than gas, interest and depreciation); this would be a challenging target, particularly given the BGC expectation that real wage increases of 3-5% will have to be conceded, given the Corporation's high profits and rapid and continuing productivity growth. The main pay settlement is due in January, so that the cash limit would in any event need to be set well before Christmas.

d) Railways
Wage costs represent just under 60% of railways' total costs. However revenue from customers covers only about 60% of passenger costs, so that if grant is fixed fares rise steeply to cover cost increases; a 1.7% increase in fares would be needed to offset a 1% increase in passenger costs, before any allowance for the effect of price increases in reducing traffic volume. It takes some three months to bring in a fares increase; rises are implemented in January on decisions taken in early October. The extent to which unforeseen increases in costs can be offset by further fare rises within the year is correspondingly limited. The main pay settlement is due in April. The unions may well seek above average increases to recover some of the distance they have fallen behind other groups in recent pay rounds. While the Board will undoubtedly press for productivity increases, falling traffics of the order perhaps of 2-3% due to economic conditions would provide an unfavourable basis for a productivity agreement. Investment corresponds to about 35% of the pay bill, and the scope for cutting it to offset excess labour costs is very limited. The decision on the cash limit will not be taken early enough to permit any alteration in the January fare increase, though the Board will already be taking account of what they know about public expenditure constraints in 1980/81 in fixing the level of that increase. A cash limit fixed before Christmas would predate the main pay negotiations.

e) Steel
Wage costs represent about a third of total costs; investment corresponds to about a third of the pay bill. The British Steel Corporation are already on notice from the Secretary of State for Industry that their cash limit for 1980/81 will be fixed on the basis that the Government will not fund operating losses; they have been told that up to £450 million (at outturn prices) will be availabe to finance investment and redundancy costs. The pay settlements are due in February. Since BSC operate entirely in a competitive world market, they have no scope for recouping excessive pay settlements through higher prices. Further restriction of investment could be an appropriate response to such a situation; alternatively closure of plants whose productivity was insufficient to support the higher wage levels might be the better course, although the immediate effect would probably be to intensify rather than correct the breach of cash limit.

f) Posts & Telecommunications
The position of the Post Office is covered in more detail in Annex II, and has been the subject of correspondence between Ministerial Private Offices. Pay settlements of different Groups are due in January, April and July, and this year's

experience indicates the the January settlement (postmen) cannot be regarded as final until the engineers' negotiations have been completed in July. This year's negotiations have restored the 1975/76 real wage levels in telecommunications so that there should be less of a "catching-up" problem putting upward pressure on settlements in the 1979/80 pay round. The monopoly position of the Post Office businesses enables wage costs to be passed forward in prices; but the frictional costs and consultative procedures greatly limit the flexibility with which prices can be increased. Plainly the Post Office must be given every encouragement to achieve the performance targets they have already set themselves - no increase in real unit postal costs despite the declining volume of the business, and a 5% a year reduction in telecommunications costs. It is surely important that both businesses should be in no doubt about the cash flow they have to achieve, which points to the cash limits being set in the autumn before the pricing decisions for 1 January are finalised.

g) British Airways
With the Corporation operating in a competitive world market, with many fares set by international agreement, and with demand for air travel significantly price-elastic, the management have had a fair measure of success in securing productivity agreements in return for money wage increases. This in 1979 6% of the overall increase of 11% depended on productivity. The employees are under notice that excessive wage increases (settlements are due in January (most employments) and April (pilots and engineering officers)) would result in reductions in investment. A cash limit fixed in the autumn seems appropriate for British Airways.

Setting the Pay Element in Cash Limits

15. Ministers have made clear that they are not in the "norm" business, and that there is no question of the Government giving any general guidance about the acceptable rate of increase in money wages. This being so, the best solution would be one where the industries themselves made proposals about the increases to be assumed in their pay bills, on the basis of their own particular circumstances. The difficulty is that the nationalised industries cannot stand aside from developments in the rest of the economy; and they cannot just be given carte blanche to assume whatever earnings increases will assure a quiet life for management, with the Government picking up the bill. In practice, therefore, some sort of starting point will need to be set for the discussions with the industries.

16. The problem is to reconcile the Government's determination to avoid giving any normative guidance about pay increases with the need for the limits on increases in pay bills to be clearly recognised and understood by the negotiating groups concerned. The Government may be able to deflect attention for a time from the specific figures used for a particular industry with the argument

that these represent a judgment agreed with each industry about the relevant commercial situation; but it seems inescapable that the Government will in the end be obliged to give a more coherent explanation of the figures used in particular cases, if these are to carry conviction with negotiators and the general public (who will be bearing the main burden in the event of serious industrial disputes).

17. In setting the pay bill assumption for each industry it will be necessary to take into account trends in output and numbers employed, "structural" influences on productivity (eg, rationalisation schemes involving the closure of obsolescent plants and the replacement of their output by new capacity requiring less manpower), and the scope for "classical" productivity improvements through better working practices etc at continuing plants. However, although factors of this kind can be used to explain divergences from some kind of average, they do not remove the need to set that average in the first place.

18. One approach might be to determine the underlying average by reference to, say, the mid-point of the monetary target range; the resulting figure would then be adjusted (downwards) by varying amounts in each case by reference to the expected reduction in real unit labour costs. (Increases in real output would justify an upward variation.) However, the signs are that this would imply increases in earnings several percentage points below the rate of inflation, unless this element of real loss could be made good by exceptionally rapid productivity growth. Deriving other objectives from that for money has the further disadvantage that the relationship between GDP and any particular definition of money is imprecise and variable.

19. A more promising approach, provided the forecast does not suggest that prices will be increasing markedly faster than money earnings, might be to take a realistic forecast of the increase in the general price level between 1979/80 and 1980/81 and then set the starting point assumption for determining the overall increase in the pay bill somewhat below that figure. This approach would be consistent with the industries' existing or new performance targets to reduce their real unit costs, and would imply that some of the benefit of improving productivity in the nationalised industries would go to the consumer and/or the taxpayer. In this way we should be asking the industries to contribute to a

reduction in the inflationary pressures in the economy. Setting a starting point in this way would be a challenge to those industries where there has been a tendency of real unit labour costs to rise (ie, real earnings have increased faster than productivity). The starting point figure would then be translated into a figure for each industry's pay bill by reference to output trends and to other industry-specific factors (including structual productivity gains through rationalisation/ and loss-making). This approach is frankly arbitrary, and the position of organised labour in some of the industries is so strong that it may be hard to make the approach stick; but we have not found any better alternative, and this course does avoid deriving a figure for aggregate earnings in nationalised industries directly from some measure of earnings elsewhere in the economy.

20. In putting forward total assumptions about pay bill figures the Government would emphasise that they were not taking any view about the appropriate rate of increase in earnings per head of any group of employees. If employees are willing to improve productivity and to accept the implications for numbers employed, there need be no restriction on increases in each individual's earnings.

Practical Steps

21. If the general approach to cash limits set out in this paper is agreed by Ministers, it will be necessary for sponsoring Departments and the Treasury to begin discussions with the nationalised industries as soon as possible. The first step will be to ask the industries for their latest forecasts of turnover, investment, internal resources and external financing needs for 1980/81, and to explore with them the assumptions used in compiling the forecasts with a view to eliminating any "fat" from the estimates of their need for external funds.

22. At the next stage, the figures so produced would be adjusted consistently with the October economic forecasts, with the amount assumed for labour costs derived as suggested in paragraph 19 above. The eventual cash limit proposals, on which the Chancellor will be putting forward a further paper in a few weeks' time for collective Ministerial discussion, will, however, have to take into account not only the circumstances of the industries, but also

- as the Chancellor has noted in paragraph 6 of his paper on cash limits and pay (E(79) ) - the July public expenditure decisions, the Government's fiscal and monetary objectives, and the outlook for the economy in the light of the October forecasts.

H M TREASURY
PE(2) Division
13 September 1979

| | Survey Prices | | | Outturn prices - using GDP deflator - 1.3225 | | |
|---|---|---|---|---|---|---|
| | Borrowing | Grants | Total | Borrowing | Grants | Total |
| National Coal Board | 598 | (1) | 598 | 791 | (1) | 791 |
| Electricity Council & Boards | - 33[2] | 8 | - 25 | - 44[2] | 11 | - 33 |
| North of Scotland Hydro-Electric Board | 18[2] | 14 | 32 | 24[2] | 18 | 42 |
| South of Scotland Electricity Board | 54[2] | - | 54 | 71[2] | - | 71 |
| British Gas Corporation | -427[2] | - | -427 | -565[2] | - | -565 |
| British National Oil Corporation | 100 | - | 100 | 132 | - | 132 |
| British Steel Corporation | 340 [4] | - | 340[4] | 450[5] | - | 450[4] |
| Post Office | - 15 | - | - 15 | - 20 | - | - 20 |
| British Airways Board | 155 | - | 155 | 205 | - | 205 |
| British Airports Authority | 15 | - | 15 | 20 | - | 20 |
| British Railways Board | 34 | 536 | 570 | 45 | 709 | 754 |
| British Transport Docks Board | - 8 | - | - 8 | - 11 | - | - 11 |
| British Waterways Board | 3 | 19[3] | 22 | 4 | 25[3] | 29 |
| National Freight Corporation | 15 | 7 | 22 | 20 | 9 | 29 |
| National Bus Company | 9 | 46 | 55 | 12 | 61 | 73 |
| Scottish Transport Group | - 3 | 10 | 7 | - 4 | 13 | 9 |
| British Aerospace | 35 | - | 35[5] | 46 | - | 46[5] |
| British Shipbuilders | 69 | 32 | 101 | 91 | 42 | 133 |
| TOTAL | 959 | 672 | 1631 | 1267 | 888 | 2155 |

(1) Split between borrowing and grants uncertain

(2) Proportions of cuts not yet decided - allocated as follows: £50m gas and electricity as £25m each, £5m Scottish Boards as £3m SSEB and £2m NSHEB

(3) Allocation of cuts in grants to transport industries not finally decided

(4) The figure of £450m at outturn prices is the proposed cash limit - the survey price figure is derived from this

(5) Figures assume cancellation of BA 146

ILLUSTRATIVE CASH LIMITS AND EFFECTS OF CUTS[1] (outturn prices)

| | Capital Requirement | Internal Resources | Cash Limit | Effects of 1% cut in: Pay | Turnover | Investment | Numbers employed |
|---|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m | |
| National Coal Board | 637 | (71) | 708 | 18 | 30-35 | 6 | 2500 |
| Electricity (England and Wales) | 1172 | 1202 | (30) | 9 | 59 | 8 | 1614 |
| British Gas Corporation | 700 | 1150 | (450) | 9 | 44 | 6 | 1000 |
| British Steel Corporation | 472 | 22 | 450 | 13 | 36 | 4 | 1780 |
| Post Office | 1459 | 1479 | (20) | 27 | 65 | 15 | 4314 |
| British Airways Board | 477 | 272 | 205 | 4 | 19 | 4 | 573 |
| British Railways Board | 251 | (580) | 831 | 13 | 22 | 5 | 2400 |
| British Aerospace | 152[2] | 62 | 90[2] | 3 | 10 | 1 | 700 |
| British Shipbuilders | 20 | (114) | 133 | 4 | 13 | 0.4 | 700 |

[1] Latest illustrative figures (for major industries) provided by Departments. Where the cash limit figures differ from those in Table A, this reflects Departments' attempts to forecast turnover investment and cash flow on the basis of revised assumptions. The resulting figures represent the best view currently available of turnover and investment. The cash limit figures should not be seen as revised bids by Departments; nor have they been accepted by the Treasury.

[2] These figures would be lower if the BA 146 were cancelled.

# ARRANGEMENTS FOR MONITORING NATIONALISED INDUSTRIES' FINANCIAL RESULTS

The arrangements for monitoring nationalised industries' investment and cash flow against the original budgets are broadly as follows. Most of the industries provide monthly statements of their flows of funds, and quarterly returns of their profits and losses. (Some of the smaller industries provide only quarterly statements of their funds flows). These statements include an indication how far the actual outcome differs from the original "budget". In principle, these statements should make it possible for sponsoring Departments and the Treasury to detect prospective breaches in the cash limit at the earliest moment, and then press the industries in question to make proposals for appropriate remedial action. It should be emphasised that, although a procedure of this kind is an essential discipline for all concerned, it needs to be complemented by good working relationships at all levels between sponsoring Departments and their industries.

2. In practice, of course, the position is less satisfactory than might appear, for a number of reasons:

(i) there are/a number of cases long delays before the required figures are submitted to Government Departments. For example, the business of the Post Office is so complex (particularly because of the need to disentangle posts, telecommunitcations and Giro) and widely distributed that the returns do not come in until 3 months after the end of the relevant period; efforts are now under way to reduce this time to six weeks. These delays greatly restrict the scope for effective action to keep within cash limits - and this problem becomes more severe the further into the financial year the prospective breach emerges;

(ii) in other cases the industries either provide no information about possible deviations from budget, or else they simply assume, in completing the returns, that they will somehow keep within the budget despite what is actually happening. As a result Departments have no solid basis on which to judge whether there is a problem or not;

(iii) in only a few cases do Departments have a profile at the beginning of the year of the expected monthly/quarterly path of financial flows and profit/loss (the steel industry is an honourable exception here). Cash flow in a number of industries (notably gas and electricity on account of the winter peak in consumption) shows a marked seasonal variation, while in all industries the short-term results can be influenced by cyclical and seasonal variations in economic activity in the UK and elsewhere. These factors make any simple extrapolation of monthly figures almost inevitably misleading; and even in those cases where cash flow is normally fairly even, or where the seasonal patterns are very well identified, random short-term fluctuations may make it impossible to draw conclusions from figures relating to a short period of weeks.

3. Sponsoring Departments have been pressing the industries to improve the content and timeliness of the financial returns, and slow progress is being made. But it may be necessary, particularly in those cases where the industries are inclined to regard a requirement to provide this essential information as an unwarrantable intrusion by bureaucratic Government, for Ministers to make clear to the Chairmen concerned that cooperation in a satisfactory system of financial monitoring is a necessary part of the bargain with the Government, if they are to enjoy as wide a discretion as possible in running their own businesses.

# FUTURE ARRANGEMENTS FOR MONITORING PAY DEVELOPMENTS IN NATIONALISED INDUSTRIES

Pay developments present special problems, in that there may be a conflict of objectives. On the one hand

(i) the Government's policy is to leave nationalised industry managements as much freedom as possible, within the overall financial framework set by Ministers, to settle their own pay and price decisions; and

(ii) as the Chancellor made clear to the nationalised industry Chairmen, when he and sponsor Ministers met them on 23 July, the Government are not in the "norm" business.

However, despite these considerations the Government cannot adopt an attitude of complete indifference to nationalised industries' pay, because of the possible damage to the economy in various ways as a result of excessive pay settlements:

(iii) in some instances it may be impossible for an industry, having made such a settlement, to keep within its cash limit, thus putting the Government's overall financial and monetary objectives at risk;

(iv) in other cases action to keep within the cash limit may mean investment cut-backs which reduce the future competitiveness of the UK economy, or price increases inconsistent with performance targets;

(v) even in cases where there is no direct threat to the cash limits, the repercussions in other nationalised industries from a particular settlement could cause the Government serious concern.

2. More generally, the Government may not be able to escape involvement in the consequences of industrial disputes in major nationalised industries. It is an inevitable weakness of the

Government's position that trade union leaders, particularly in the essential "utility" industries, know that the country cannot do without the output of their industries, and that the Government cannot avoid standing financially behind those industries. This may inevitably mean that the Government will be dragged into taking some of the responsibility for whatever action has to be taken to deal with such disputes. In other industries (notably those engaged in manufacturing ) closure of those parts of the operations which cannot support the excessive pay levels demanded may be the right response, even at some additional short-term cost in terms of redundancy payments; but this sanction is not available in the cases of the energy or water utilities, and the scope for its application is probably rather limited in the case of the railways.

3. Recent experience with the Post Office provides a clear illustration of the problems pay developments may imply for the enforcement of cash limits. The computer billing dispute means that telecommunications will inevitably fall substantially short of meeting the current year's limit, although the shortfall should in principle be made up next year as the arrears of receipts are collected. In the case of the postal services, however, it appears that there may be great difficulty in avoiding a shortfall of £100 million or more during the current year as a result of pay settlements far in excess of those contemplated when the limits were set; and here the prospects of recouping the loss seem markedly less favourable. Further action on the substance of this issue will, of course, depend on the discussions the Secretary of State for Industry is having with Sir William Barlow; but the course of events so far does call for some more general guidance from / Ministers to the nationalised industry chairmen, as the Secretary of State's letter to the Chancellor of 13 August recognised.

4. In that letter he suggested that Ministers should ask the Chairmen

(i) to keep sponsoring Departments informed of pay settlements after the event, and to provide sufficient information for sponsoring Departments to ascertain whether they are taking fully into account the implications of the settlements for financial and performance targets, and cash limits;

(ii) to consult sponsoring Departments in advance of pay negotiations which were likely to lead to breaches of cash limits or financial targets, and to let Departments know what action they proposed to recover the situation;

(iii) to provide early warning of possible industrial disputes; and

(iv) - in the case of loss making industries - to provide detailed ex post facto justifications of productivity deals, together with period information thereafter enabling the actual outcome to be monitored.

A copy of the Secretary of State's letter is attached.

5. The Secretary of State's desire to limit the requirement for information in this way derives from the Government's policy of distancing themselves from nationalised industry management decisions. It is questionable, however, whether restricting the information to be provided in this way would help the Chairmen very much; and it could leave the Government in ignorance of developments which had an important effect on other nationalised industries, or substantial implications for public finance. It may in the end be preferable to ask the industries to consult sponsoring Departments in advance of all major pay negotiations for the following reasons:

(i) it will often be a matter of nice judgement whether or not a particular pay settlement puts a cash limit at risk. For example a settlement early in the year for a small group of employees may have little direct impact on costs, but have unacceptable repercussions on later settlements. Moreover action to recover the costs of any particular settlement could well involve setting aside the performance targets which seek to protect the consumer against the abuse of monopoly power.

(ii) where pay settlements seem likely to have repercussions in other nationalised industries(notwithstanding the Government's view that such links between groups in different industries are not justified),it is important that information should be available about what is proposed before any commitments are entered into. Better communications between nationalised industries have a part to play, but they cannot be expected to take responsibility for each other's performance, and the risks - not least to public finance - are such that some Government involvement may on occasion be inevitable.

(iii) From the point of view of public sector cash flow and monetary control, a shortfall in receipts from profitable industries (eg, as a result of unsatisfactory productivity deals) is just as awkward as a requirement for increased financial support for loss-makers.

The need for the Government to be consulted in advance of all major pay settlements was endorsed by the Secretary of State for Employment in his letter of 30 August to the Secretary of State for Industry. A copy of this letter is attached.

SECRETARY OF STATE FOR EMPLOYMENT

Caxton House Tothill Street London SW1H

Telephone Direct Line 01-213 6400

Switchboard 01-213 3000

Rt Hon Sir Keith Joseph Bt MP
Secretary of State for Industry
Department of Industry
Ashdown House
123 Victoria Street
LONDON SW1

Dear Secretary of State.

NATIONALISED INDUSTRY PAY QUESTIONS

You sent me a copy of your letter of 13 August have also seen a copy of Nigel Lawson's reply.

I too feel that this problem is not an easy one, and consider it might be best for it to be discussed at E Committee on 11 September.

I am sure you are right that we shall need to ask the nationalised industries to consult us in advance if pay negotiations are likely to lead to settlements which breach cash limits or financial targets, and also to give us clear early warning of possible industrial disputes. It could be that many of the major claims in this sector will fall into one or other category. But your proposal that in other cases a nationalised industry should inform us of its pay settlements only after they are reached will give us no room for manoeuvre in seeking to avert undesirable repercussions on other nationalised industries. I recognise the force of the arguments about not interfering unnecessarily in their affairs. But the fact is that workers in many of these industries have long been accustomed to keep a very close eye on each others' pay negotiations, and to expect similar treatment. Our objective must be to inculcate more reasonable expections, based on what the particular industry can afford. But there can be no doubt that this is going to be a long and difficult task, and I think we may handicap ourselves unnecessarily if we do not seek to provide ourselves with the full range of relevant information - which includes advance information about, and the opportunity to comment on, possible repercussions.

I am sending copies of this letter to the recipients of yours.

Yours sincerely

John Anderson



Approved by the Secretary of

Secretary of State for Industry

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13 August 1979

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Whitehall
London SW1

Dear Chancellor,

NATIONALISED INDUSTRY PAY QUESTIONS

We discussed on 17 July (E(79)5th, item 2) our general approach to questions of pay, prices and efficiency in the nationalised industries on the basis of the proposals of the interdepartmental Committee on Nationalised Industry Policy (E(79)16). You outlined this approach when we met the nationalised industry Chairmen on 23 July but we have not so far explained to them how we wish to deal with individual pay negotiations.

Although the industries Chairmen undertook to develop their ideas on pay in a paper in September, I do not think that should preclude our taking an early opportunity to explain our position to them, particularly since 1 August represents the start of the new 'pay round'. Although different circumstances exist in different industries, it is important in my view that early steps are taken to ensure at least that the approach by Ministers to industries for which they are responsible is not inconsistent.

But before we can approach the Chairmen, we need to clarify our own thinking since it seems to me that there is a danger that we may be facing in two contradictory directions. On the one hand our main objective is clear; nationalised industry managements are to be free to run their own businesses and to decide on pay and pricing questions within the constraints laid down by their financial targets, cash limits and, where appropriate performance targets (and subject to the controls on anti-competitive practices being introduced under the Competition Bill). This means that pay and prices will be decided by the Boards concerned without reference to, or prior approval by, Government.

On the other hand, we have a legitimate interest in knowing how pay negotiations are progressing; we need to be warned of major disputes which can inflict harm on the economy as a whole so that we can prepare contingency plans; we need to have advance warning if nationalised industries are not going to remain within their targets and cash limits; and in loss-making industries we need to be particularly careful that public money is not used

/to increase.....

to increase pay without offsetting improvements in efficiency. These considerations led us to decide on 1 June (E(79)2nd, item 1) that those of us who are responsible for nationalised industries should keep each other informed of pay developments in their industries which might have repercussive effects in other areas.

In deciding whether to monitor pay and how intensively, we need to reconcile the desire to obtain information with our general policy of leaving nationalised industries to manage their own affairs. Whatever system we adopt will need to be consistent with economy in manpower: we should avoid resurrecting the apparatus of pay control within Government established by our predecessors.

In my view it would be wrong to ask the nationalised industries to clear pay offers with us or to give us details of pay offers before they are made except if they would - but for remedial action which we would expect any industry with such a prospect to take and explain to us - take them over their cash limits; this would be incompatible with our wish that they should manage their own affairs, would complicate and delay pay negotiations (which are already complex enough) and would introduce the risk of the unions thinking that we were operating some form of pay policy. Besides which the Chairmen would be rightly resentful of the interference and delays which prior notification would involve. On the other hand I think we have every reason to ask the nationalised industries to furnish us with details of pay settlements, productivity deals and productivity trends after agreements have been reached. We shall need this information to monitor each industry's success in adhering to its targets and cash limits and to enable us to seek explanations and assurances if it appears that pay settlements may lead to cash limits being breached or to performance targets not being met. This last consideration is particularly important in monopoly industries to prevent the customer being milked. I also think we need to ask the industries to let us have good warning if a pay dispute looks like escalating into major industrial action.

Special considerations apply to loss-making industries where the taxpayers' money is being used to meet the pay bill of workers who would be redundant in comparable private sector employments. Our cash limits and targets impose constraints but I think we shall need to take additional steps to ensure that money earmarked for investment is not diverted into pay packets or into bogus productivity deals. I am not in favour of our seeking to vet productivity deals proposed in these industries prior to their impolementation but I think we should require the loss making industries to justify productivity deals immediately after they are made and at proper intervals thereafter.

More generally, it would be necessary to make it clear that the primary purpose of requiring information was not to absolve the industries from their management responsibilities but to bring before the industries themselves the stark facts about the implications of cash limits on any actions they proposed taking,

/as well.....

as well as enabling the Government to be aware of the need for any contingent action. Subject to that point, nationalised industries would be entirely free to discuss with Departments any pay questions before negotiations got under way or whilst they were taking place - particularly in cases where difficulties arose. It would also, in my view, be necessary to recognise that the situation in each industry varies, as indeed does the effectiveness of each industry's internal monitoring, and the precise form in which information is extent and sought and provided will need to be determined in the light of these general principles.

With those provisos I would like to propose that, subject to any comments from the other recipients of this letter, you should take an early opportunity to write to each of the nationalised industry chairmen:

- outlining our intention to apply financial targets and cash limits to each industry (plus performance targets for monopoly industries) details of which (including assumptions about total pay costs) will be discussed with them early in autumn;

- inviting them to keep us informed of pay settlements after they are reached and to provide officials with sufficient information to ensure that the industries are taking fully into account the implications of the settlements for financial targets, cash limits and performance targets;

- inviting them to consult us in advance of pay negotiations which were likely to lead to a settlement causing financial targets or cash limits to be breached together with details of the action planned to recover the position;

- inviting them to give us clear early warning of possible industrial disputes; and

- inviting loss-making nationalised industries to provide details of productivity deals after they have been negotiated and at intervals thereafter for monitoring purposes (making it clear that, if they so wish, there is no objection to their discussing proposed productivity deals with Departments before negotiations get under way). The intensity of monitoring would be for each Department to agree with its industry and for some it may be sufficient to monitor only the general trends of productivity.

Such a letter might provide a good opportunity to draw the Chairmen's attention to Peter Rees's remarks in the House on 9

/July.....

July about executive perks. The Prime Minister's private secretary wrote to Departments about this on 16 July, making the point that the public sector should not get out of line with the private sector in this area.

I am copying this letter to the Prime Minister, members of E Committee, to the Secretaries of State for Scotland, Northern Ireland and Wales, to the Minister of Transport and to Sir John Hunt.

Yours sincerely,
Peter Snedden

pp KEITH JOSEPH
(Approved by the Secretary of State and signed in his absence