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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

1980-81 CASH LIMITS AND PAY

Memorandum by the Chancellor of the Exchequer

1. I attach a note by officials in response to the request at E(79)4th Meeting for a paper on ways in which Option A might be applied in practice and with flexibility to some of the main programmes in 1980-81.
2. Although the approach in the note seems complicated, it suggests practicable ways of achieving the desirable and necessary objective of some flexibility, while also offering the prospect of the effective cash control which is vital. The alternation Option B would need at least as much refinement if it were to be effective, and at the end of the day would tend to have the dangerous quality of giving, albeit subject to reductions in the volume of expenditure, ex post facto endorsement of each and every pay settlement.

G.H.

HM Treasury
London, S.W.1
16 July 1979

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Note by Officials

1. On July 9 the Committee discussed a paper by the Chancellor outlining two options for handling pay in the 1980-81 cash limits, E(79)15. In summing up the discussion, the Prime Minister said the Chancellor "should arrange for a paper to be prepared demonstrating for some of the main programmes the way in which Option A might be applied in practise and with flexibility in 1980-81".

2. Under a strict interpretation of Option A in E(79)15 cash limits would be set before many of the relevant pay negotiations began and before any confident guess at their outcome could be made, but would impose a firm and unyielding constraint within which negotiations would have to take place. The element of inflexibility - an important and desirable feature of the approach in itself - raises the problem of holding to the limits under what could be very severe pressures.

3. Flexibility could be introduced into Option A through

- a. the way in which the overall pay and price assumptions are applied to individual cash limits;
- b. delaying the fixing of cash limits;
- c. adapting the coverage of cash limits, including the provision of a central Vote for Civil Service pay increases;
- d. using offsetting savings to keep any irresistible changes to cash limits within the agreed public expenditure totals.

These are considered in more detail below. The paper subsequently examines the flexibility that might be available in particular areas of expenditure. It does not deal with the nationalised industries; the arrangements for applying Option A to the nationalised industries are discussed in a separate paper - E(79)16.

A. Flexibility in Applying Pay and Price Assumptions

4. The prime objective in setting the cash limits would be to ensure consistency with the Government's monetary objectives. Cabinet is presently considering the Chief Secretary's proposals, C(79)26, for the volume of public expenditure in 1980-81. As the Chancellor's paper, C(79)27, made clear, these proposals are themselves based on the monetary objectives; in other words the volume of public expenditure proposed by the Chief Secretary in conjunction with the prospects for the economy described in C(79)27, which include forecast pay and price increases, produces an appropriate total of public expenditure in cash terms.
5. Cash limits could be set on the same basis. Cabinet decisions on the volume of public expenditure would be combined with the pay and price forecasts described in C(79)27 to produce cash totals. In C(79)27 it was stated that pay in the public sector was forecast to increase by 18½% in 1980-81. The same forecast indicates price average increases of some 15%.
6. Cash Limits would not be set by the mechanical application of these broad figures. They conceal some foreseen variations. The pay figure takes account of the staged implementation of certain recent pay awards, for example in the civil service. It also makes assumptions about the impact of implementing the various reports of the Clegg Commission.
7. Variations of the sort would be taken into account in setting individual cash limits with the result that the pay provision in some cash limits would be greater than the average and in others less.
8. It will be possible for the unions to identify pretty accurately the pay bill assumption in most cash limits. E(79)15 pointed out that pay and price assumptions had in the past been revealed and there would be pressure to continue to do so.

9. This is a dilemma here. Revealing the pay assumption risks creating a starting point for negotiations. In this way revealing the figure could go a long way to falsifying the initial provision and so requiring volume adjustment. On the other hand negotiators need to know the provision if it is to exert financial pressure on the negotiations.

10. Like the pay assumption, the overall figure for price increases in paragraph 5 is an average. In setting the cash limits account would be taken of price movements of different types of expenditure, for example capital and current, within that average. In this way the cash limits would be set in a way which would take account of expected variations in pay and price movements in different areas.

B. Flexibility in the Timing of Setting Cash Limits

11. On the strictest interpretation of option A, the process of calculating the cash limits would begin once Cabinet has reached decisions on volumes for 1980-81. The proposals in C(79)26 are equivalent to a current price total of public expenditure in 1980-81 of over £90 billion. This can be readily broken down into totals of the main programme. For example the figures for defence would be about £11¼ billion, for health and personal social services about £12¼ billion and trade, industry, energy and employment some £3¼ billion. The next stage would be to move from these programme totals to cash limits. This would depend on the allocation within programmes between expenditure which is subject to cash limits and expenditure which is not.

12. Setting the cash limits in this way has the advantage that the pay and price assumptions used would be consistent with those underlying the Survey decisions; and the cash figures would be known at the start of the pay round when they could be expected to have the greatest influence on negotiations.

13. It has the disadvantage that cash limits would be set for a period up to 18 months ahead and before there had been any experience of the pay round just beginning.

14. A way of providing more flexibility would be to defer setting the cash limits or most of them until the New Year, when Ministers would have a later view of the requirements of monetary policy in the financial year ahead, and experience of the early part of the pay round. Arrangements of this sort would mean that cash limits would follow a few public service pay settlements in the early part of the pay round, would take account of them but would still be in time to influence the majority.

15. A difficulty with this approach is that the later view of pay and prices when combined with the earlier decisions on the volume of public expenditure might well be incompatible with the monetary objectives. In these circumstances, it would be necessary to adjust the planned volume of activity if the taxation and monetary objectives were to be achieved.

C. Flexibility in the Coverage of Cash Limits

16. Nothing can prevent actual cost diverging from the assumptions used in setting cash limits. In principle the system requires any excess on pay or prices to be offset by volume reductions. In practice there is a better prospect of achieving this if individual cash limits cover a wide variety of expenditure. A wide coverage provides greater possibility for meeting excess costs in one area with savings in another.

17. Certain cash limits already have a varied coverage but many cover little but pay. It might be helpful to broaden the coverage by merging Votes wherever possible and where it would not conflict with Parliament's requirements. But the scope for broadening coverage needs further study and is probably limited.

18. There is a rather separate question of whether pay presently outside cash limits should be brought within the discipline of the system. The main areas involved are the general practitioners in the Health Service and certain specific grants paid to local authorities, notably that for police expenditure.

D. Flexibility in financing adjustments to Cash Limits from other Public Expenditure Savings

19. In the end it might prove impossible to avoid some adjustments to cash limits. In these circumstances the objective would remain that of ensuring consistency with the monetary objectives.

20. This could be achieved by offsetting any increases in individual cash limits by reductions in other expenditure. These savings would be sought most obviously in other expenditure of the same department, preferably in another cash limit. Failing this, savings could be sought elsewhere, including from the contingency reserve.

21. Such a procedure would not be easy. Finding offsetting savings is usually painful and the contingency reserve could quickly be exhausted by pay settlements in excess of the provision in cash limits.

The Operation of Option A in Particular Areas

22. One of the most difficult is Civil Service pay. This is contained in some 40 Votes the majority of which contain little but pay. They offer very limited flexibility as only limited changes can be made to manpower numbers in the short term.

23. The cash limits would be set taking account of the staged implementation of the 1979 pay awards. A view would also have to be taken of the 1980 awards. These awards would on past practice be based on pay research and tensions would arise if the provision built into the limits proved inadequate to meet pay research findings.

24. This problem was apparent in 1979-80. It is possible that this may have been an exceptional year. Public service pay was catching up with that in the private sector following successive pay policies. In future pay in the public services should follow that in the private sector more smoothly and predictably. This may make it possible to forecast pay research findings within a narrower margin than this year.

25. The provision would be helped by delaying setting these cash limits until nearer the start of the financial year when the preliminary findings of pay research should be available.

26. A further problem on these Votes is that, even if the overall cost of settlement were in line with the provision, the cost falling on individual cash limits might differ significantly depending on the allocation between different grades. The distributional problem could be mitigated through the use of a central cash-limited Vote for pay increases. Departmental cash limits would be drawn up on the basis of existing pay rates. The provision for the coming year's settlement would be in the central cash limit and allocated to departmental ones in the light of the settlements.

27. This device would not make it any easier to adjust to a settlement in excess of provision, except that it would be possible to delay fixing a central cash limit until nearer the start of the financial year. Apart from this the only flexibility available on Civil Service pay would be to have contingency plans well advanced for further cuts in manpower should these be necessary, or, failing that, to find other offsetting savings in public expenditure or the Contingency Reserve.

28. The defence budget is organised in five Votes of which four are cash limits. Two of these contain significant proportions of pay but, taking the four together, pay represents under 40% of the total. It is already established practise that switches can be made between these cash limits.

29. There is therefore a reasonable degree of flexibility in the defence budget if Ministers were prepared to see excess costs in one area offset by volume reductions in others. Much the same is true of the health services, where there is a single very large cash limit covering the whole of the hospital and community health services.

30. Local authority current expenditure is not directly cash limited. A cash limit is applied to the Rate Support Grant (RSG) through which the government provides finance for a certain proportion of relevant expenditure - this year the proportion is 61% for England and Wales. The remaining 39% is met from the rates over which the government has no control.

31. A provision for pay and prices is built into the RSG cash limit. Local authorities can however finance settlements in excess of this provision in setting the rates or drawing on their cash balances. The RSG therefore provides only limited discipline

32. The problem in this area is one of reducing the local authorities' flexibility rather than increasing it. This could be achieved by linking the RSG percentage to the level of pay settlements and the level of rates. For example the total of relevant expenditure could be set as in the past in the November preceding the start of the financial year. Authorities would be told at that time that if pay increases were no more than, say, 10%, the rate of grant would be, say, 60%; if pay increases were higher, the rate of grant would be lower according to a schedule set out at that time. The RSG would be linked in a similar manner with the increase in local authority rates. It would be finalised in March after rates had been set.

33. The tightness of this discipline would depend on the schedule. It would always be open to authorities to impose a supplementary rate later in the year but they are likely to strive to avoid such an unpopular move. They would continue to have the flexibility of drawing on their balance. Despite this such a system would subject them to stronger financial constraints than in the past, and would, for that reason, be useful in its own right.

34. Another problem in this area is the range of specific grants paid to local authorities. These are not subject to cash limits and in many cases cover pay costs, most notably for the police. The possibility could be explored of bringing these within the RSG cash limit and, while they might remain open-ended, it would mean that the more that was spent on, say, police, the less would be available within the RSG for other expenditure by local authorities.

Conclusion

35. It would be possible to incorporate some flexibility into Option A through the way in which the overall pay and price assumptions are applied to individual cash limits, the timing of setting them, a central cash-limited Vote for civil service pay increase and by seeking offsetting savings to match any increases that proved necessary. Different techniques may be appropriate for different parts of the public sector. If Ministers agree these ways of introducing flexibility into Option A, further work will be undertaken accordingly.