Econ Pol

Original on:-
Public Exp: Pt 7

CONFIDENTIAL

Ref. A0939

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 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. <u>The impact of the squeeze on other programmes</u> is smaller: but in the case of the <u>Health Service</u> 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 <u>the proposals give a little more leeway than the cash limit applied to local authorities</u>: 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.

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).

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 ½ 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 4and 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.

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];

<u>or</u>

(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];

<u>or</u>

(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 <u>possibly</u>

(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.

ROBERT ARMSTRONG

(Robert Armstrong)

<u>12th December, 1979</u>

Ref: A0937

Original on:- Public Exp: Pt 7

CONFIDENTIAL

PRIME MINISTER

The Economic Outlook and Public Expenditure
(C(79) 61)

BACKGROUND

The Chancellor of the Exchequer has now circulated the paper which he discussed informally with you and others on Friday. At that meeting there was general support for the Chancellor's proposals, although Mr. Prior (who left before the end) is not wholly reconciled, and can be expected, I think, to voice his reservations in Cabinet. The Chancellor has not yet had the separate talks with Mr. Pym (who only gets back on Wednesday night) and Mr. Heseltine envisaged last Friday. Nor have any further approaches been made, so far as I know, to other members of the Cabinet. But the Chancellor's intentions have been well-trailed in the Press, and his move will come as no surprise. His paper contains the £1 billion target for 1980-81 and a £2 billion target for later years. But, at your request, it does not contain detailed proposals for individual programmes.

HANDLING

2. I imagine you will want the Chancellor to introduce his paper briefly. You might thereafter like to take advantage of Friday's softening-up meeting by inviting some of the participants to speak. A possible sequence would be: Sir Keith Joseph or Mr. Nott (broadly allies); Mr. Prior (likely to be opposed); Mr. Jenkin or Mr. Whitelaw (supporters again). But after that, you will want to throw the discussion open, and give most members of Cabinet a chance to join in.

3. To judge by Friday's discussion, these are the points which may come up:-

(i) The uncertainty of forecasting the PSBR. This is not an argument for inaction because the penalties of guessing wrong are too high. Most commentators now believe - with the Chancellor - that the

PSBR is likely to be unacceptably high next year, and are expecting corrective action. It will be easier to compensate later for overkill now, than to fail to do enough now and have to cut expenditure or increase taxes by more later.

(ii) In a depression, the Government will still be able to finance a PSBR of this kind at reasonable interest rates, and/or without adding to the money supply. The same arguments hold: the Government cannot afford to take a risk. Although there are some slight signs that the rise in interest rates is working through to bank lending, the Government borrowing requirement remains disturbingly high.

(iii) In a recession, the appropriate response is to allow the PSBR to increase somewhat. This argument would be stronger if the PSBR was not already uncomfortably high. But the Chancellor has to finance the real PSBR, and not some hypothetical constant-employment PSBR, in the markets.

(iv) If the PSBR must be reduced, the answer is to increase taxation not to cut expenditure. The scope for increasing direct taxation is severely limited, particularly if the Chancellor decides not to reverse the 'Rooker-Wise' amendments and increases would in any case be quite contrary to the Government's broad strategy Because of the big VAT increases this year, there is no scope here - though the yield will rise with inflation. Petrol, alcohol and tobacco are the traditional remedies. A respectable case can be made for an increase in petrol duty, on energy saving grounds; the duties on alcohol ought at least to keep pace with inflation. But all indirect taxation affects the RPI, and it may seem odd to seek to counter inflation by deliberately - and again - increasing consumer prices. Other remedies - PRT, NIS, or increased Employee Contributions, are worth considering. But all except PRT feed through to industrial costs.

(v) If expenditure must take the strain, we should take credit for a reduction in the EEC Budget. Mr. Walker is bound to revert to this point but the only sensible answer is 'not until we are sure of it'.

(vi) The Defence Budget should take its share. I have sent you a separate minute about the minefields in this area, through which you will need to step very carefully. You will need to bear in mind that the Cabinet does not yet know of the earlier deal between the Chancellor and the Secretary of State for Defence.

(vii) Law and Order. Mr. Whitelaw has offered to find his share somewhere - possibly on the Fire Service. You may wish to ask him if that can be done without unacceptable damage to standards of fire cover. Cabinet will probably accept that the main Law and Order programme must be preserved.

(viii) Social Security. The discussion on Friday of 'indexation' will help here - and there may be a little more to come when E has come to conclusions on the taxation of social security benefits. The Secretary of State for Social Services will, I think, argue on the latter point that the right course is to wait until benefits can be taxed. He will probably resist any attempt to cobble together an interim scheme for reduction of benefits meanwhile. Any action on indexation of course will require further and contentious legislation.

(ix) Costs of Administration. The Cabinet's most recent discussion of Civil Service numbers was disappointing, and some may wish to reopen the question. The separate proposals on cash limits in C(79) 60 will impose their own general squeeze. Cabinet has decided against another general manpower exercise. Further pressure on this front is best brought to bear in the course of public expenditure reviews, and the right course is probably to pursue extra savings case-by-case, in the course of bilaterals with spending Ministers. You might invite the Chancellor to associate CSD Ministers with his studies where appropriate (leaving it to the CSD to suggest the appropriate cases).

(x) Offsets. Mr. Heseltine made it clear, in an earlier discussion, that he would be more inclined to offer further savings in the housing and rents programme, if some part of the proceeds were recycled to 'accelerator' proposals. The discussion in E on Wednesday will have illuminated this problem. It seems unlikely that the two Heseltine schemes would work, and the Chancellor has grave reservations about finding room for any sweetners of this kind at all. In the event, therefore, Mr. Heseltine may have to be told rather than asked to find more. He will be the less likely to be co-operative if he foresees the prospect of losing part of the Local Government Bill.

(xi) Procedure hereafter. You were anxious to avoid any further negotiation in full Cabinet. Friday's meeting was not keen on reviving the idea of a 'star chamber' group on the lines of MISC 11 in the summer. I believe that on this occasion it is preferable for the discussions to be conducted bilaterally, extended as necessary on the lines I suggested in my earlier minute. You yourself should keep out of that stage of the exercise, so as to preserve your own freedom of action until final decisions come to be taken in Cabinet.

(xii) Public Expenditure White Paper. If Cabinet approves these proposals, the publication of the 'later years' White Paper will have to be postponed from January until nearer the Budget. The discussion in Cabinet provisionally planned for 20th December would be correspondingly set back.

CONCLUSIONS

4. If the discussion goes the way you want, the conclusions might be:-

(i) to recognise that the prospects for the PSBR next year and in subsequent years require further savings of the broad order of £1 billion in 1980-81 and of £2 billion a year in 1981-82 and subsequent years - without any final commitment to exact numbers at this stage.

(ii) To invite the Chancellor of the Exchequer and the Chief Secretary to open discussions with spending Ministers and to bring proposals, and options, to the Cabinet in January.

(iii) To agree to postponement of the Public Expenditure White Paper until March.

ROBERT ARMSTRONG

(Robert Armstrong)

12th December, 1979