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MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

CASH LIMITS FOR 1980-81 AND PUBLIC SECTOR PAY

Memorandum by the Chancellor of the Exchequer

This paper considers the handling of cash limits for 1980-81 with reference to public sector pay.

General approach

2. It is a prime objective of Government policy to squeeze inflation out of our economy. The Government's approach is to establish, by firm monetary targets, a framework of financial discipline within which pay bargaining can proceed with responsibility, negotiators on both sides being constrained by the knowledge of the consequences which the financial framework will impose if settlements are excessive. The objective is to establish, by the use of cash limits for the public sector, a financial discipline analogous to that set for the private sector.

The public trading sector

3. In the public trading sector - mainly the nationalised industries the link between cash limits and pay is indirect. Cash limits, which apply to the industries' requirement for external finance, exert a discipline not unlike that of overdraft limits set by banks on their business customers in the private sector. Those limits

are likely to be tightly drawn in the strict monetary environment which we intend to operate. In setting cash limits for the trading public sector account can be taken of the likely, or the desired trend of pay settlements, but if settlements exceed the level assumed, most of the industries can adjust their pricing or investment plans to keep within the limits. Indeed, for some industries which are monopolies or highly capital-intensive, cash limits may be relatively ineffective in preventing them from entering into high settlements. Ways in which the Government might deal with the nationalised industries are discussed in a separate paper E(79)16.

The public services

4. Within the public services the link between cash limits and pay is more direct. About half the central Government's expenditure covered by cash limits relates to the pay of what are in effect its own employees. Cash limits cover central Government expenditure on the civil service, the armed forces and health service (including hospital doctors, nurses and ancillaries), and also universities and fringe bodies.

5. The pay of local authority employees - manuals, teachers, administrative workers, firemen - is covered indirectly and partially by the cash limits on the Rate Support Grant (R.S.G.). The R.S.G. can thus be made to act as something of a constraint upon local authority pay negotiations, though as the authorities have an independent revenue-raising power (the rates) and as many of them at present have substantial cash balances this constraint is not as strong as cash limits are, potentially, on central Government negotiations. It is upon the latter that two possible approaches to cash limits in the future are principally discussed in the remainder of this paper. But the choices underlying these approaches apply also to local authorities and even, with modification, to the nationalised industries. A timetable for the main decisions on the cash limits and pay settlements is annexed.

Course A

6. Course A would consist in effect in setting the cash limits well

before the relevant pay negotiations began and imposing, a priori, a firm and unyielding constraint within which negotiations would have to take place, This course has never been pursued during the three years that cash limits have operated. Cash limits have in effect (with some squeeze in the present year) been fixed after it became reasonably clear what pay increases would be. This was of course easy during the previous Government's period of rigid incomes policy (1975-1978). For the current year we have relaxed the cash limits on pay somewhat, though we have not done this on the non-pay limits.

7. To follow Course A would involve making a judgement of what element of inflation the Government was going to think acceptable. The starting point in the calculation of cash limits would be the volume programmes laid down by Cabinet in the Survey. These would be increased by an inflation factor (which would not be the same for all programmes since relative prices, of goods, services and pay, would not be wholly independent of the rate of inflation). The Government would presumably fix the inflation factor by reference to a number of considerations, e.g. what the monetary targets were, what the price outlook was, what the climate of expectations was and possibly what the exercise of comparability, fair comparison etc. would be likely to realise in the public services. There could be a considerable element of arbitrariness about the figure (as there is, at least to some extent, about the determination of other financial figures, e.g. the monetary targets, the PSBR etc.).

8. The cash limits so established would then be held, come what may. If pay or prices advanced faster than provided for, the cash limits constraint would reduce the volume of expenditure appropriately. Exceptions could be made if desired, preferably specified from the start: but exceptions breed exceptions.

9. For the RSG negotiations the cash limit has been fixed in the last few years not later than November. This enables the local authorities to know the totality of grant they will receive before they make their rates. There is a case for publishing the basis of the cash provision for all programmes in November so that all know where they stand well in advance of pay negotiations.

10. But this means rigid cash limits are fixed for 18 months. This puts them under great pressure. It also means that local authorities can still make excess settlements between November and March and maintain the volume of their expenditure through levying higher rates. A way of mitigating those disadvantages would be by a variant of course A which would be to delay fixing final cash limits for RSG until after authorities had fixed their rates but to fix in November a provisional schedule progressively reducing the percentage Exchequer contribution towards the cost of pay increases the higher settlements went. This provisional schedule would be replaced by a frim RSG cash limit after the rates had been fixed. The firm cash limit would therefore take into account not only settlements reached but also the resources available to local authorities to finance other settlements.

11. Such a device would do much to constrain local authorities making settlements early in the round which would prove repercussive on other settlements; it would also provide a means whereby their ability to maintain the volume of expenditure if settlements had been excessive would be much reduced. It would also enable the cash limits for such blocks to be fixed later than November (although they need not wait until March if it were desirable to fix them earlier)

12. Course A would go a long way to reproduce in the public services sector something like the monetary pressures intended for the private sector. But problems would arise, especially in the field of central Government, where Ministers are directly responsible for, and in control of, pay negotiations

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Problems

13. First, as stated above, cash limits would be fixed for a period up to eighteen, and not less than twelve, months ahead. By comparison, monetary targets have not been set more than twelve months ahead and have been revised at six-monthly intervals. By the time the relevant pay negotiations were in progress, some of the factors which governed the determination of the inflation factor might have changed, and the monetary targets might also have been altered. This would invite the argument that the negotiations were being constrained within an out-dated and unrealistic financial framework. Moreover the cash limits applying to the financial year would, for some groups, have to cover settlements in two pay rounds.

14. Some problems arise also from the fact that the inflation provision, and hence the pay and prices assumptions used in constructing the cash limits, would quickly become public. There would be pressure to publish them anyway, even if it were not easy for outsiders to calculate them. This is already done under the present system of presenting the Parliamentary Estimates, and the former General Sub-Committee of the Expenditure Committee was pressing for a new presentation of Estimates which would make the distinction between volume and pay/price changes even more explicit. In any event, if the cash limits are to exercise the intended financial pressure on pay negotiations, pay negotiators would need to know what scale of settlement would be compatible with the provision available and what would be excessive, so as to force an unwelcome volume cut.

15. The fact that the pay assumption, used in fixing the cash limits, thus became known to the union negotiators, would weaken

the Government's, and the local authorities', negotiating position. It might be regarded by union negotiators as an entitlement, or possible as a minimum which it was their aim to exceed. It is arguable that the result might be a series of settlements higher than would otherwise have been achieved. On the other hand the negotiators would know that if they exceeded the amount provided there would be cutbacks on services and this would affect the employment of their members. There would also be a presentational problem: if the Government held firm to the limits, they would be accused in effect of operating a pay policy with a rigid norm.

16. Further difficulties could arise if settlements in the event exceeded the provision made, so that volume cuts were necessary to offset them. While it is logical and right that volume plans should be modified if they turn out more expensive than intended, Ministers with responsibilities for the provision of public services might find difficulty in accepting further cuts on top of those already decided on in the public expenditure Survey and civil service review. This difficulty could be greater for the Government than for the unions; and be increased by the fact that negotiations about civil service pay are conducted centrally, while the impact of cuts on individual services would vary according to the importance of the pay element in them.

17. This difficulty over cuts would not be so serious if the policy succeeded, i.e. settlements were within, or not much in excess of, the provision made. But this year's experience has shown that it is very difficult to make compensating savings to cover even a relatively small excess in the pay bill. It could well prove impossible, in the short term, to compensate for any substantial excess, especially after the volume cuts which may be expected to be applied as a result of the survey discussions now beginning.

18. It is inherent in the general approach of course A that the factors determining the cash limits should be derived, not from pay research, comparability or arbitration, but from the financial objectives of the Government. This will constitute a major change in the agreement governing the determination of public service pay and it would be bound to be resisted by the public service unions. But it would be starting from a recognition of one of the facts of life - the fact that money is always in short supply.

Course B

19. Course B would approach the matter from a different angle. It would avoid some of the difficulties just mentioned, but at the price of moving away from the analogy with the financial pressures intended for the private sector.

20. Course B would follow a pattern similar to that which in practice was followed in the current year. Cash limits would be fixed when they needed to be fixed and not earlier, and would incorporate provision for price changes compatible with the Government's financial policies, thus exerting a desired pressure on the volume of programmes if prices move ahead faster than intended. But no provision would be made in them initially for public sector pay settlements. Thus there would be no assumption for unions to seize upon as a norm or minimum to be exceeded, or to use as ground for seeking to negotiate about the fixing of cash limits.

21. The Government would however state that the cash provision, and hence the volume of expenditure, would be reconsidered in the light

of pay settlements made, and that any subsequent adjustment of cash limits on account of pay settlements would not be fully accommodating if pay settlements were excessive. It would be open to the Government thus to impose whatever offsetting economies it thought feasible and right. Knowledge of this option would be a factor for the unions to consider in deciding how vigorously to press their claims. It would be for decision in the course of the negotiations how precisely to indicate what would be regarded as an excessive settlement entailing subsequent volume cuts and what degree of volume squeeze to impose if there were an excessive settlement. (Should this squeeze be proportional to the excessiveness?)

22. This course would move away from the idea of automatic financial pressure in the negotiations. It would be necessary to find other criteria for the conduct of the pay negotiations, and probably to lean on the idea of comparability - perhaps more heavily than we should like. If the general policy were going well and settlements generally were moderate, this would not be damaging; but if they were not this system of fixing cash limits would not be much of a restraining factor.

23. In the local authority negotiations it might still be possible to tell the employers in advance the maximum extent, if any, to which the Government would be prepared to adjust the RSG cash limit.

Conclusions

24. The advantage of Course A is that, if credible, it gives the unions some incentive to show moderation in negotiations. The difficulties depend on the degree of success achieved by the policy. If there is reasonable success, so that in practice settlements both in the private sector and in the public sector are moderate, and in the public sector not greatly in excess of the provision made in the cash limits, then Course A would maintain consistency and be sustainable. Even so, there would need to be some flexibility in offsetting increases in certain cash limits by reductions in others,

or by other adjustments in public expenditure programmes, including the contingency reserve.

25. If the policy is less immediately successful, so that settlements run well ahead of the provision made, and the sanction of additional volume cuts in expenditure programmes to offset them has to be invoked on a large scale, Course A could break down if Ministers were not prepared to make substantive volume cuts in programmes which would already have been reduced.

26. A key consideration may be a judgment whether the establishment of published assumptions as in Course A is in practice helpful or unhelpful to the Government in securing moderation in wage bargaining. Course A will certainly be resisted by the public service unions, and if the judgment is that in practice it would also lead to higher settlements than would be made under Course B, it could be better to go for Course B.

<u>Consultation with unions</u>

27. The manifesto said: "In consultation with the unions, we will reconcile these [arrangements for conducting pay bargaining] with cash limits used to control public spending". So at some stage it will be appropriate to consult the unions about the course of action in view.

(G.H.)

HM Treasury
5 July 1979

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ANNEX

CASH LIMITS AND PAY : TIMETABLE

The following gives a broad indication of the timing of the decisions which (under present arrangements) need to be taken on cash limits and public service pay during a typical year.

1. The first important public service settlements are those for the police, effective from September, the universities, effective from October.

2. The first cash limits (ie those on the Rate Support Grant) have to be settled after negotiations with the local authority associations in November. For this purpose, pay and price assumptions need to be provided by end-October. The way in which the cash limit is made up is explained in a circular published in December.

3. A number of important pay settlements in the public services (including the local authorities' manuals and National Health Service ancillaries and firemen) take place in November/December; the National Health Service maintenance staff and ambulance men have settlements in January; and ambulance officers settlements in February.

4. The Central Government cash limits are determined between Christmas and the Budget. As pay is included in a very large number of central government cash limits, the calculations take some time to complete, and explicit assumptions must be given to all the different departments concerned. These assumptions are needed in December, if possible, and not later than mid-January. The cash limits themselves are published with the Estimates in the weeks leading up to the Budget and the assumptions will become public then.

5. Cash limits for nationalised industries settled in March/April and published at the time of the Budget.

6. The non-industrial civil service, armed forces, teachers, and the rest of the NHS have pay settlements in April; and the local authority white-collar staffs in July. The industrial civil service settlement date is also in July.