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cc Mr. Hoskyns
Mr. Walters

PRIME MINISTER

Pay and Price Factors for the Public Expenditure Survey

attached. You will be seeing the Chancellor after your meeting on inner cities on Monday morning, to discuss his draft paper for 15 September Cabinet on the pay and price assumptions to be built into this year's public expenditure exercise. Because of the box arrangements for the weekend, I have not seen the final version of the Chancellor's paper at the time of writing this note; but I am working on the assumption, which his Private Office believe to be correct, that the Chancellor will be recommending a pay factor of 4%, and a non-pay factor of 9%. The 9% is subject to confirmation by the Treasury forecasters, and the Chancellor is known to be opposed to a gap between the two factors - implying a fall in living standards for wage earners - of more than 5%.

There are two issues prior to the setting of the precise figures. First, whether there should be two factors, or one which provides a weighted average of both: because the gap between the two is so large, there can be little doubt that a single figure would be seriously misleading, and would be too high to have the desired effect on pay expectations. Second, whether the assumptions should be announced: the need to show that the Government is prepared to set an example in the new pay round, together with the virtual certainty of a leak if we try to conceal the decisions, argues strongly in favour of an early announcement accompanied by an appropriate explanation.

As for the figures, the non-pay assumption clearly ought to be the Treasury's best estimate of the year on year increase in prices. Otherwise Ministers will be taking public expenditure decisions on an inaccurate basis. But the pay assumption has something of the character of a self-fulfilling prophecy, in that, up to a point, the lower it is the lower the actual outcome on pay will be.

The argument against a very low figure is that the greater the implied fall in living standards, the more likely that the figure will provide a rallying point for union opposition, and that

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it will be breached so frequently as to lose credibility. We did consider the case for announcing that the pay factor would be provisionally set at 0%, with any actual pay rises having to be justified on their merits, but the resulting public expenditure figures would not be consistent with the recent decision to move to cash planning.

There are very strong arguments indeed in favour of a very low pay assumption;

- there are good indications (the FT of 1 September, attached) that at least parts of the private sector are looking to start the pay round at 0% or even lower, and these would be threatened by a possible 5% public service norm;
- whatever figure the Chancellor proposes to Cabinet is rather likely to be increased by 1% or so as a result of Cabinet discussion;
- the Government is committed not to predetermine Civil Service cash limits, and to go to arbitration if necessary, which means that civil servants will expect perhaps 2% more than the pay assumption;
- it will greatly strengthen the hands of Ministers responsible for nationalised industries if they can point to low single figures as being the expectation in the public services.

We think therefore that the Chancellor is being insufficiently ambitious in proposing 4%, with a probable willingness to go up to 5%. We ought rather to be saying that last year we set a pay factor of 6%, and achieved an out-turn in the public services as a whole of just over 8%; this year we should halve the pay assumption to 3%, in the hope of achieving an out-turn of below 5%. That would considerably ease our public expenditure problems and would be consistent with the Government's responsibility to set an example of what is necessary to regain competitiveness.

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As to the announcement, we think it should be made in the terms that although this is an across the board pay assumption, it does not follow that any public service group is automatically entitled to a pay increase: all pay rises will have to be justified on their merits.

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3 September 1981

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