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Michael Scholar, Esq.,
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Dear Michael,

ECONOMIC ASSUMPTIONS

We spoke this morning about the Chancellor's minute of 27 October to the Prime Minister about the economic assumptions to be given under the Industry Act and to the Government Actuary, and in particular the figure of $7\frac{1}{2}$ per cent for the increase in earnings between 1981-82 and 1982-83. You told me that the Prime Minister was unhappy with this figure - not least because it might be seen as rather far from the 4 per cent figure being used in connection with cash planning in the public sector - and that she had asked whether it might not be better to proceed on the basis of using three figures - $5\frac{1}{2}$ per cent, $6\frac{1}{2}$ per cent and $7\frac{1}{2}$ per cent. - will Hqs

I have taken advice, and am assured that there really is no escape from using a single figure for earnings. This is because the earnings assumption is required not for the Industry Act forecast but for the Government Actuary's report made in connection with changes in National Insurance Contributions to take effect from next April. The Actuary has to produce one set of figures, and for this purpose one earnings assumption has to be made. It is true, of course, that the Actuary also provides a ready reckoner showing by how much the surplus on the Fund would be higher or lower if earnings were higher or lower than assumed, but there has to be one principal number used for the purpose of the work.

As to comparisons with the 4 per cent figure, it is perhaps important to note that the figures are on slightly different bases. The 4 per cent pay factor is in respect of the total pay bill in the current pay round, i.e. a compound of settlements, earnings, and numbers employed. The $7\frac{1}{2}$ per cent proposed by the Chancellor was for earnings for the financial year 1982-83. Earnings figures tend to be higher than settlement figures because of "drift" and higher overtime as the economy picks up. We estimate that these two factors might account for $2-2\frac{1}{2}$ per cent of the $7\frac{1}{2}$, leaving an implied settlements figure - if one ignores numbers employed - of $5-5\frac{1}{2}$ per cent, or not so far from the 4 per cent.

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It is relevant that we last year provided the Government Actuary with an assumption of $10\frac{1}{2}$ per cent for earnings, at a time when we had announced a 6 per cent pay factor.

It is also relevant that an assumption of settlements of $5-5\frac{1}{2}$ per cent, or an earnings increase of $7\frac{1}{2}$ per cent, is itself already on the low side by comparison with outside forecasts of earnings growth (at present 9-10 per cent for calendar 1982); with an expected RPI increase, both in the Industry Act forecast and many outside forecasts, of around 10 per cent, and particularly if fiscal measures are announced or presaged in November - eg on employees' National Insurance contributions and possibly on personal direct taxation - which point to a further reduction in real incomes. For these reasons, I suspect that the Chancellor's point about the need to consider credibility would apply rather forcibly to going below $7\frac{1}{2}$ per cent in the Government Actuary's report. On the other hand, I am sure that the Chancellor would be more than ready to look for ways - whether in the Government Actuary's report or elsewhere - of making it clear that the $7\frac{1}{2}$ per cent and the 4 per cent are not directly comparable one with another.

*Yours ever,
J. O. Kerr.*

J. O. KERR