Original returned to J. Hoskyns

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PRIME MINISTER

PUBLIC SECTOR PAY

Geoffrey's paper can do no more than open up a big subject. Public sector pay is an integral part of the bigger inflation problem - part knock-on cause, part effect. I suggest that public services pay is the top priority, since it is under greater Government control and is part of the "leading edge" of Government's own contribution to achieving monetary targets and reducing pay expectations in the private sector. As Geoffrey's paper says, every nationalised industry is different and we have pointed to some of the differences in our recent paper on the lessons of the steel strike, which suggests that much more collective thought is required on each one.

This paper therefore comments on public services only and not on nationalised industries or local government.

1. CASH LIMITS ARE NOT ENOUGH

Cash limits are really only the local equivalent of monetary targets, a necessary but not sufficient device. Higher pay and lower numbers within those cash limits are not therefore a satisfactory answer. They would represent worse value to the taxpayer and a knock-on effect in pay expectations and the ability to attract labour elsewhere.

2. HOW DOES PUBLIC SERVICES PAY ACCOMMODATE TO MONETARY TARGETS?

If cash limits accommodate to monetary targets, then public sector pay may do so. But it may not, with staff cuts (and to a lesser extent capital spending) absorbing the difference. The Public Expenditure White Paper shows a small, real, aggregate reduction each year. I assume that this will be reflected in a year-by-year nominal reduction, which is correspondingly greater than is necessary to accommodate to the monetary targets.

3. THE CHANCELLOR'S PROPOSALS

3.1 It must be right to dethrone comparability, which is a mistaken concept. That may lead to trouble with Civil Service unions and we should be thinking about whether likely strikes are winnable. Some institution for the preparation of data must be necessary, and Geoffrey's point about such an institution being allowed to build up a sound methodology rather than the Government relying on ad hoc bodies, is important.

3.2 Could the indexing of firemen and policemen be on a forward-looking basis rather than a retrospective basis, once inflation is declining?

3.3 In paragraph 23 of his paper, Geoffrey proposes an intensive campaign to create an atmosphere in which pay bargaining will begin at substantially lower rates in the next round. But since your recent discussion with Robin Ibbs, we have had some talks with CPRS about this problem of changing expectations and expectation. We think that a campaign of explanation is important. But it is very difficult in practice to persuade specific groups to act against their own interest, when their behaviour is based on the assumption that other groups will act on the assumption that other groups . . . etc. This recurring problem (the "Prisoner's Dilemma" familiar to students of Game Theory) cannot really be resolved by exhortation. And it is also difficult to see how the RPI can be dethroned, since this is the guiding norm to which they will look and we certainly don't propose a different one.

4. PUBLIC SECTOR PAY INEVITABLY RAISES LARGER QUESTIONS

4.1 In the end, pay in both public and private sector, both of which have tended to be habitually self-indexing, must somehow partially index themselves, during the period of the medium-term financial plan.

4.2 As noted in section 2 above, cash limits (and thus, other things being equal, public services pay) must be "de-indexed" more than their private sector equivalents. If that doesn't happen, the brunt of monetary deceleration will be borne by the private sector. We could then find that, having set out to try and make the private sector grow and the public sector shrink, we end up achieving the precise opposite; or, at best, we end up with significantly higher pay levels in the public sector, relative to the private (which would cause, during the transition process, private sector pay to be even stickier in its own de-indexation, making the whole transition process more damaging).

4.3 The question really is whether these things will happen, in line with our broad economic strategy for reducing inflation, with the present institutional arrangements as modified by Geoffrey's proposals. We may need to ask more "what if . . ." questions to see how, with public sector pay - and, indeed, pay as a whole - behaving in different ways, the numbers would come out for the national economy. For example what would happen if public service pay outturn was 20% - or 10% - in the next pay round? These simulations have probably already been done and could be looked at.

I have copied this minute to the Chancellor and to Robin Ibbs.

JOHN HOSKYNS