PRIME MINISTER

PUBLIC SECTOR PAY

The Policy Unit has studied the four papers for discussion at E. Our comments can be summarised as follows:

(1) No problem which is so complex and so central can be seriously discussed on a basis of papers circulated at 48 hours' notice.

(2) Judging from the papers, no shared understanding of the problem emerged from the 19 May meeting.

(3) In particular, the crucial distinction between the process of curing inflation by monetary deceleration ("Transition Phase") and the resulting economic stability, essential for renewed growth ("Stable State") is not generally understood.

(4) The head-on collision between comparability and cash limits during Transition is not recognised in the Lord President's paper. Some numbers would clear the mind.

(5) The "fear of norms" comes close to paralysing our thought processes.

It is therefore likely that tomorrow's E can be no more than a further attempt to get general understanding of the problem. But it may turn out that a precondition for such understanding is a proper presentation to colleagues of the Medium-Term Financial Strategy.

1. THE PROBLEM

1.1 The four papers for discussion at E tomorrow address different parts of the same problem from different perspectives. The opening paragraph of the Chancellor's first paper comes closest to defining the central problem. We are engaged in a Transition Phase from high inflation, to a Stable State with low inflation through a published set of monetary targets. We have only a limited opportunity to achieve our objective. It is limited by time and by society's willingness to accept the inevitable pain of Transition.

1.2 As the Chancellor says, the pay outturn next year will be crucial in affecting the speed at which inflation is reduced and the unemployment and lost production involved in the Transition. The immediate problem is how to achieve a pay outturn low enough to set inflation on a sufficiently rapid downhill course.

2. THE OBJECTIVE

2.1 In his understandable anxiety to avoid appearing to suggest a norm, the Chancellor does not say what pay outturn he would like to see. Without this, and some rough indication of the consequences of a higher pay outturn, it is very hard for the colleagues to judge the size of the problem and the inadequacy of the proposed solutions. Perhaps he could be invited to comment on this, against the background of the target ranges for growth of M_3:

1981-81	7-11%
1981-82	6-10%
1982-83	5- 9%
1983-84	4- 8%

2.2 The immediate objective is next year's pay outturn. The main objective is to reduce inflation to around 5% by 1984, by which time we should have reached Stable State - ie a system which will prevent it getting out of hand again. Anything less than this would represent failure to achieve the central economic objective of the Government.

3. THE TRANSITION PHASE

3.1 Measures which may be necessary during the Transition Phase could be quite different from the sort of regime designed for the period when inflation is largely mastered. The Lord President's paper does not seem to recognise the crucial distinction between transition and subsequent stability. He advances many reasons why comparability may be the best solution to the sub-problem of Civil Service pay, but implicitly against a stable background. But he does not really acknowledge that "backward-looking comparability" could have very undesirable effects during a downward transition from high inflation to low inflation.

4. The private sector, the public sector and, more specifically, the Civil Service, must all be seen in the context of the Transition process.

4.1 The Private Sector

4.1.1 The Chancellor proposes a vigorous campaign of public education. He rightly points to the dangers of mere exhortation, but it is very hard to see how the message he describes at paragraphs 5 and 6 of E(80)47 can be convincingly put over without saying by how much real pay needs to fall, and what the unemployment and inflationary consequences will be of higher levels of outturn. But if we are to be so careful as to avoid mentioning any numbers, it will be very hard to achieve impact. Nevertheless, we entirely agree that Ministers must proclaim their determination to bring down inflation and leave no-one in any doubt about their absolute commitment to monetary targets, whatever the consequences. If we don't say it, no-one will believe we mean it.

4.1.2 It is not sufficient for the Treasury team to be left with the job of making clear the Government's commitment to monetary targets. Other colleagues need to speak up on this subject. But first, we must be sure that all colleagues understand the full significance of 2.1 above and the crucial distinction between Transition and Stable State. Some colleagues may not yet have realised that we must "de-index" the whole of public expenditure if we are not to end the Transition Phase having transferred further resources from the private to the public sector - the precise opposite of our declared objective.

4.2 The Public Sector

4.2.1 The Chancellor distinguishes the Civil Service and other central Government services from local government and nationalised industries where our influence is increasingly remote. He prescribes tough cash limits and EFLs, combined with pressure on nationalised industry chairmen and a fresh effort to produce performance targets related to costs per unit of output for each nationalised industry before the autumn. All this is worthwhile, but will it be sufficient? Because of the pervasive influence of the concept of comparability, much may depend upon the way that concept is used in the public services sector - particularly the Civil Service itself.

4.3 Civil Service Pay

4.3.1 The Chancellor argues for dethroning comparability and, if this is impractical, jettisoning it altogether. Since it cannot be unilaterally banished, he prefers reliable figures to the exaggerated figures that the Civil Service unions are otherwise sure to produce. The Lord President argues that the concept can be made more workable but cannot be dethroned as the central principle for determining Civil Service pay - without still worse results. There is a fundamental difference of approach here. We believe the Chancellor must be right in principle. Comparability must be dethroned because it cannot be reconciled with the cash limits essential to achieve Transition to low inflation. This is so because the results of backward-looking comparability will:

(1) be far removed from the level of cash limits in line with our monetary targets;

(2) risk a knock-on effect in the private sector and elsewhere in the public sector, disturbing the first faltering movements towards a downward trend.

4.4 The Lord President and any colleagues who see things his way need to recognise this incompatibility with public expenditure adjusted to accommodate the monetary targets - unless we resort to increasing taxation. This would be much clearer if the Chancellor was able to indicate what sort of Civil Service cash limit might be necessary next year. Could he do this? Could he also estimate now what PRU is likely to produce next year?

4.5 We believe that the problem of accommodating public expenditure to monetary targets next year may be much bigger than colleagues have so far realised. This may not emerge until the first round of public expenditure discussions in July. If we are right, an acute pay problem exists not only for the Civil Service, but also for the other public services. Failure to solve it will mean further arbitrary public expenditure cuts.

4.6 We think the best chance of keeping Civil Service pay increases to a manageable level next year may be through explaining the Transition process and ensuring similar, temporary, treatment as widely as possible in the public services sector. In convincing the public services of the need for such a reduction, we can point to a similar reduction in the private sector or, as seems more likely initially, mounting unemployment because of the failure to adjust.

5. TIMING

5.1 Much of the public services sector settles on 1 April. By this time, we hope that the downward trend of prices will have been established. Private sector pay settlements may also have begun to adjust downwards. But there are two important exceptions: local authority manuals (November); and NHS ancillaries (December). Should we be considering moving these dates? If all public services settlements were on the same date, it would make common treatment of them easier. (We believe these arguments could be extended to make a case for synchronising all pay: private and public sector. E Committee last July recognised the advantage of moving in this direction, as the CBI has advocated. There are many other arguments which could be adduced in favour of this.)

6. PUBLIC SERVICES SECTOR

6.1 The Chancellor has outlined one possible approach, but has not spelled out how it would work. Another possible approach would be to adopt equally tough cash limits for the different parts of the public services sector, without denying the possibility of a return to comparability when the Transition Phase is over. This rigid approach could consist of cash limits calculated to allow a similar percentage increase. Another variation would be a clearly-expressed limit for wages in the public services sector.

6.2 A further alternative would be a policy for thepublic sector expressed as a real cut of X%, with a guarantee to make up a few percentage points if the inflation rate turned out higher than anticipated. The CPRS paper suggests an interim settlement. No doubt there are other possibilities if colleagues accept that comparability cannot be reconciled with the need for a strict cash limit.

CONCLUSION

This is a complicated problem, interconnected with every other part of the jigsaw puzzle: cash limits, public expenditure, trade union power. It is necessary to address it in terms of the Transition Phase. We are still only in the process of getting the whole problem into focus. Much more work will be needed, but the first step is to get greater agreement on its real nature.

I am sending copies of this note to the Chancellor of the Exchequer, the Lord President, Sir Robert Armstrong and Robin Ibbs.

JOHN HOSKYNS