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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

E(80)46  
2 June 1980

COPY NO 31

PUBLIC SECTOR PAY

Memorandum by the Chancellor of the Exchequer

Monetary Targets and Pay

1. The Government's economic strategy depends on sticking to its monetary targets and ensuring that the targets affect the general level of inflation as soon as possible. What happens in the labour market will influence both the speed at which the policy begins to have tangible effects and the transitional costs in terms of activity and unemployment of reducing inflation. Next year is of crucial importance. And our attitude to public sector pay will help determine the outcome both because of its direct influence on what happens in the private sector, and because it affects public expenditure and the PSBR - and so the overall effectiveness of the strategy.

The Outlook

2. Average settlements in the present round have been running at a higher level than was hoped. The latest weighted average level of current pay settlements for major groups monitored by the Department of Employment is about 17%, comprising 18% in the public trading sector, 14½% in the public services and about 18½% in the private sector. As the VAT increase in the 1979 Budget will drop out of the year on year index in July, we are likely to go into the next pay round with the RPI showing an increase over the previous 12 months of around 19%. Average earnings may show an underlying increase of about 22-24%. The level of settlements, which excludes wage drift, will be less than this - around 18%.

3. There is no reason to doubt that the reduction in monetary growth which we are now achieving will affect pay bargaining in the private sector and in time this will react on the public services through comparability. But the speed at which this is happening is still too slow. The link between pay expectations and the RPI must be broken and an important element in this will be the way in which we settle the pay of our own employees.

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Public Sector Pay

4. There is a distinction between:
- a. the Civil Service and other central government services, where the government's responsibility is direct, including the armed forces, NHS, MPs, doctors, dentists and judges.
  - b. Local government, where our influence - substantial but not decisive - is through the RSG cash limit; and
  - c. nationalised industries, where we have indirect responsibility and very limited power.

Comparability

5. The question for the public services is how far the principle of comparability can be maintained. Comparability has some obvious defects:
- a. it works with a lag. As earnings come down in the private sector under the impact of monetary policy, earnings in the public sector remain high - because they reflect the previous year's settlements.
  - b. it has produced results which are sometimes extremely suspect.
  - c. it prevents us from encouraging hard-pressed private sector firms because we cannot demonstrate that the government is pursuing an active restraint with its own employees. The graph at Annex <sup>6</sup> shows how well the public services appear to have been doing.
6. The choice we face is:-
- a. We could retain comparability but try to improve the present arrangements. This might seem to offer the prospect of a quiet life, but we could not be confident that it could be made compatible with the sort of cash limit regime which I regard as essential to the overall success of our policies.

b. We could abandon comparability and scrap existing institutions and methods completely.

c. We could try to "dethrone" comparability, so that it survives as only one limited consideration in pay determination. The Government would take it into account in negotiations but would not be bound by the results.

We cannot accept an obligation to allow pay in the public services to be determined solely by comparability when there is no assurance that the cash cost can be reconciled with our public expenditure commitments. I therefore believe that the choice is between the last two of these options, though that would not exclude a major effort to improve what comparability work continues to be undertaken.

7. The case for abandoning comparability altogether is that so long as it remains in any form, it will tend to re-emerge as the dominant factor in bargaining. But I am hesitant about sweeping everything away. Comparability arguments and figures cannot be excluded from negotiations even if the present formal structure goes. Union negotiators would continue to make their own comparisons based on very slanted data. But we do need to reduce the weight given to it. Other relevant factors such as job security, efficiency, supply and demand, and what the Government can afford to pay should also play an important part in pay settlements.

8. My instinct is that course c above is right. I suspect that accepting comparability evidence as an element in some cases, if only for historic reasons, but demoting its status and improving its nature and methodology will prove a more lasting solution. We should retain a fact-finding capability, raise the quality of the research undertaken and have an institutional structure which we could use for special inquiries if we needed it - rather than find ourselves driven into creating another Wilberforce or Houghton as the need arises. We could keep either some or all of the existing institutions or develop a new body to take over some or all of their functions. We could also try to enforce a more uniform, coherent and acceptable philosophy and practice in the body or bodies. But it has to be recognised that even course c will not be painless, and carries the risk of confrontation which - if we lose - could well result in higher rather than lower settlements. We shall therefore need to pick our path carefully.

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9. Whether comparability is abandoned or dethroned, there will have to be changes in the methods of determining pay levels in the public sector and especially in the civil service where the principle of comparability is most firmly established through the Civil Service Pay Agreement. The Government will have to form a view about what it can afford to pay in the public services, consistent with its objectives of reducing public expenditure, pay rates and inflation and embody this in cash limits. There must be an element of arbitrariness about this, but there is no reason why we should not produce figures which can be defended successfully. The exact figures and the method of setting and explaining them will need much careful thought. We should not try to settle them now. But in my view it will be imperative that cash limits should be set for central and local government which imply a smaller increase in pay in 1981-82 than in 1980-81. Cash limits would be the essential instrument for carrying out the policy. I attach at Annex <sup>g</sup> a note on the critical dates for cash limits and external financing limits.

10. The object of the exercise should be to retain comparability as a factor, but ensure that the machinery for comparability works more satisfactorily and that the results are made compatible with cash limits. This means that we have to consider:-

A. how the cash limit system can be reconciled with some continuation of comparability in the case of each of the main groups in the public sector;

B. the functioning of the existing bodies; the way they produce their data; and the use that is made of it.

A. Cash Limits and "dethroned" Comparability

i. The Civil Service

11. If one tries to retain comparability as one factor only but to reconcile it with cash limits, the options for the Civil Service would appear to be:-

a. to negotiate the cash limit with the unions. This would mean negotiating with the unions in the autumn about their pay settlement for the following spring, which would not only be undesirable but would mean that the chances of agreement would be minimal.

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b. to fix the cash limit without the prospect of subsequent revision, but continue the comparability studies in a modified form in the hope that the results would be compatible with cash limits, although in the last resort cash limits would prevail. This would seem reasonable to the general public and would form a clear background for negotiations provided the gap between what we propose for the cash limit, the findings of pay research, and the level of settlements expected in the private sector is not too great. Additional ways in which the results of the PRU could be reconciled with the cash limit might include:-

- i. modifying or abandoning the arrangement whereby the results of PRU are updated by reference to the RPI. At present the emoluments of those in jobs taken as analogues for the Civil Service are updated to 7 February of the year in question, and then the results are updated by the RPI to 1 April, the Civil Service settlement date. This is inconsistent with our policy of removing index linking and is indefensible at a time when we expect prices to rise ahead of earnings.
  - ii. staging, but insisting that stage payments should not raise the base for subsequent settlements.
  - iii. seeking offsetting savings on numbers, but this would depend crucially on the progress which Departments can make in 1981-82 towards the new manpower targets.
- c. to set the cash limit but maintain some flexibility to change it if the results of the comparability studies diverge very widely from it. This would be a difficult line to hold.

12. There is of course the risk that the unions will use their bargaining power to try to negotiate a higher settlement than would have been indicated by comparability. This year's conferences have made it clear that a majority of those present were prepared to take on the Government, if we attempt to interfere with comparability. But, in my view, our overriding need to reduce inflation requires us to aim for approach b. It is consistent with our policy of relying on cash limits to limit expenditure and will be evidence of our intention to be firm in handling public service pay.

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ii. National Health Service

13. Pay negotiations in the NHS are carried out through Whitley machinery within the overall constraints of cash limits. Only the doctors and dentists are covered by a Review Body arrangement (see paragraph 16). Whilst several NHS groups have been the subject of references to the Clegg Commission during the past year, there is no pressure on the part of the Staff Sides for continued use of formal comparability. The Government is not directly involved in negotiations, but the NHS fits fairly readily into a framework where finance (in the shape of the cash limit) can be made to determine broadly the level of settlements through the pressure it exerts on the NHS Management Side. I therefore see no difficulty in principle about applying the approach I have suggested above to the NHS. (I come to the question of the future of the Clegg Commission and the Review Bodies below.)

iii. Local Government

14. Apart from teachers (see below), we have no ultimate control over pay settlements in local government. Local authorities are free to set their pay rates. But this year's experience has shown that we can exert a powerful influence through the RSG cash limit. There also seems to have been a hardening of local authority employers' attitudes about pay bargaining. Formal comparability is not institutionalised in local government in the way it is in other parts of the public service, and many local government groups that have tried the comparability road over the last two years are unlikely to repeat the experiment. I doubt whether there is more we can do here than adopt an appropriately tough cash limit and, subject to what I say below about the Clegg Commission, leave the local authorities to negotiate using any comparability machinery they feel the need for.

15. Teachers' pay is dealt with under legislation through the Burnham Committee, over which we have influence but no direct control (except through the rather cumbersome mechanism of overturning the arbitration award through resolutions of both Houses of Parliament). One possibility, which I would not recommend, would be to transfer the cost of teachers' salaries, which represent a major part of total expenditure by LAs, directly to central government. But if we accepted direct responsibility

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for negotiating teachers' salaries, the system of control might well prove less efficient than the present arrangements. Primary legislation would be required, and it would call into question the continuation of local authorities' responsibilities for education expenditure.

B. Institutions of Comparability

16. i. PRU

We clearly need to look at the PRU machinery. Quite apart from the procedure for RPI updating, (see paragraph 11b.i. above) the PRU's activities need much more public scrutiny, and the powers and composition of the PRU Board must be reconsidered. We should moreover, need to amend the Civil Service Pay Agreement, in order to reduce the supremacy which comparability now has in the negotiations. This would be preferable to a simple failure to follow the Agreement fully, in the hope of acquiescence from the Staff Side.

ii. Review Bodies

The terms of reference of the Review Bodies require them to advise the Prime Minister on the pay of particular groups. There is no specific mention of comparability, but this has clearly been a major consideration in the findings of the Review Bodies. It would be desirable to change Review Body practice to reduce the weight given to comparability. This could be achieved by:

- a. changing their terms of reference to make it clear that they should take account of general economic conditions and the Government's public expenditure objectives.
- b. changing the Government's position on accepting the Review Bodies' recommendations, making it clear that the Government would take account of the factors described in b. when considering their recommendations.
- c. changing the membership so that it was more receptive to our aims and policies.

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A combination of these should go a good way to meeting out objectives. It would also leave us some flexibility on the treatment of particular groups, especially the armed forces, in the light of our commitments. But with any independent institution such as the Review Bodies there must always be a risk that it will produce recommendations that are unpalatable to the government of the day.

iii. Clegg

The future of the Clegg Commission is a particular problem. Professor Clegg is leaving in the autumn. The Commission's list of customers is fast running out. The unions have no love for it because they believe they can do better through a trial of strength. It would seem easy to let it go and gain the political credit for so doing. But we have to recognise that there will almost certainly be a need for some organisation at least to provide data relevant to the pay of these public service groups. If so, it would be better to have a standing body which had been allowed to build up sound methodology, rather than being forced into setting up ad hoc bodies. I am, therefore, inclined to keep the Commission in existence - albeit in rather a different form, even though it would not have much of a role for the immediate future. To meet our needs we would need to reconstitute the membership and alter the terms of reference, which at present explicitly recognise the principle of comparability. A more appropriate (and defensible) model might be based upon the terms of reference of the Review Bodies.

iv. Indexation

There are one or two cases where the arrangements depend not on institutions designed to produce comparability but on formal links with a given earnings index. Police pay increases, for example, are currently determined by the May figure for the year-on-year increase in the index of average earnings. We do not control the management side of the Police Negotiating Board, and police expenditure is not cash limited. The room for manoeuvre here is limited by our manifesto commitments. Fire service pay is similar, although this expenditure falls within the rate support grant. These groups require more consideration than I have so far been able to give.

Alternative Institutional Arrangements for Public Service Pay

17. Even if we retain the existing institutions for the time being, we should consider the proposal to amalgamate some or all of them in due course. A single body might take over the work of the Review Bodies. More immediately the capability of the various

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bodies might be brought together in a common secretariat embodying the PRU and the fact-finding work carried out by OME.

Nationalised Industries

18. The nationalised industries present a different problem. We have no direct control over pay. Yet the operation of monetary policy does not produce the same constraints on pay as in the private sector particularly in the monopoly industries. We have therefore used external financing limits (EFLs) to apply some additional pressure, and then left it to management and unions in each industry to make a settlement at a level that the industry can afford in the light of all its circumstances including the EFL.

19. EFLs were announced for 1980-81 in November, several months earlier than in previous years, in time to exert some downward pressure on pay bargaining. But they cannot provide a rigid barrier against excessive pay increases. They are set on the basis of a range of assumptions, and cannot in themselves prevent higher wage settlements than assumed - at the cost to an industry of lower profits and hence usually lower investment. The degree of pressure exerted on settlements varies according to such factors as the ratio of labour to total costs, and whether or not the industry is in a monopoly position, and thus able to pass on excessive costs through price increases.

20. So far in the pay round, the average level of nationalised industry settlements has been broadly in line with that in the private sector as a whole. EFLs may have had some constraining effect on pay negotiations, but we must recognise that the effect has been limited.

21. EFLs are not a powerful weapon; but to make them as effective as possible in restraining pay we should:

- a. include tight pay assumptions in the 1981-82 EFLs, to be announced this autumn (as this year these pay assumptions would not be made public).
- b. Make it clear to chairmen that they are expected to hold settlements down to those pay assumptions. Though this may only have a limited effect I think we shall need to use every card available to us if we are to achieve our aims.

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c. Require all the nationalised industries to adopt performance targets related to costs per unit of output before the Autumn. This will call for a determined effort by the Ministers concerned themselves. It could do something to stiffen the resistance of nationalised industry managements to excessive pay increases.

22. We could also consider tightening up EFLs by not allowing industries to switch finance within an EFL, thus turning a pay assumption into something more like a cash limit. But I doubt if this would be enforceable and it might be a mistake to try it.

23. We must, therefore, press ahead on broadly the same lines as this year. This means setting EFL pay assumptions in the autumn on assumptions broadly consistent with the figures we are putting into public service cash limits. I have it in mind to use F(NF) to consider any problems on EFLs and the associated pay assumptions which, as this year year, will vary considerably from industry to industry. They will therefore be of little help in influencing expectations, and I see no point in making them public, any more than we did this year.

24. We should certainly meet the nationalised industry chairmen in the near future to greatly stiffen their resolve and impress on them the need to take a tough line in pay negotiating. The nationalised industry settlements - particularly that of the miners whose next settlement is on 1 January - have an important effect in setting the climate of expectations early in the round.

Timing

25. We need to consider the point at which we should move to break current inflationary expectations. The established bargaining pattern means that there are very few settlements which we can hope to influence between now and November, when the next round of public sector settlements begins in earnest. The TSRB Report on MPs' and Ministers' pay is expected around the end of June. Under existing resolutions of the House, MPs' pay will rise on 13 June from £9,450 to £10,725, an increase of 13½%. On top of this, the TSRB can be expected to recommend an updating increase of some 18-19%. The reception given to the DDRB report shows the kind of public comment this is likely to arouse. There is something to be said presentationally for setting an example ourselves by forgoing some of the updating increase. If we adopted this

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approach, it would be difficult not to take a similar line with the rest of the top salaries group. (Their report is due ahead of that for MPs and Ministers.)

26. I see some attractions in this course. The sooner we begin to influence expectations downwards, the better, thus preparing the way for tougher cash limits in the autumn. But it will be seen to be very unfair and we should have to be confident of carrying the House. There would naturally be objections from the TSRB groups, who are among the last to receive their catching up increases under the present pay round.

27. If we adopted this approach we should have to move fast to prepare the ground. The alternative is to let the present round exhaust itself, thus removing the catching up element from the pay scene, and concentrate our efforts to reduce public sector pay on the next round beginning with the local authority manuals in November.

Publicity

28. Whichever approach we take, we shall need to mount a campaign to create an atmosphere in which pay bargaining will begin in the autumn at levels very substantially below the rates of the past year. In doing so, of course, we should avoid speaking in terms which get us hooked on to particular figures, norms or going rates. The essential message should be that the money supply has come under control and that inflation is bound to follow. Cost plus and comparability approaches to pay will achieve nothing other than lower activity and fewer jobs. We must use every available means and forum for doing this including securing the help of the CBI and making the most of NEDC. I have examined these issues more fully in a separate note.

Conclusion

29. The strategy I propose is not going to be easy:  
a. In the public services, we should set out to dethrone comparability as the sole determinant of pay, on the lines I have suggested above. If this is thought to be unworkable, I should prefer completely to abandon comparability and everything that goes with it, to achieve my main objective of ending up with a system in which the dominant feature is what the nation can afford, as embodied in the cash limit. We cannot continue with arrangements which effectively mean that the Government's

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need to control public expenditure and the PSBR can have no effect on public service pay rates.

b. In the nationalised industries we must rely on EFLs, including suitably tight pay assumptions, set in the autumn. We must also put pressure on the chairmen to be tough and insist on their adopting performance aims for unit costs to help stiffen their resolve.

30. It is wrong to hope for neat and tidy solutions: indeed I am suspicious of them. We are well aware of the problems of "solutions" such as formal pay policies. It will require determination and toughness to get as far as I suggest. But unless we get expectations down and dethrone comparability, we shall find the credibility of our strategy is increasingly called into question.

G.H.

HM TREASURY  
2 June 1980

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CASH LIMITS AND EXTERNAL FINANCING LIMITS

Cash Limits

Last year the cash limits were set at varying dates between October and February, and in constructing them qualified factors were included and published covering the increase in total expenditure to be allowed on account of increases in pay and prices during the coming financial year (13 per cent for local authorities and, in general, nationalised industries; 14 per cent for new pay settlements covered by other cash limits from due settlement dates). <sup>These factors were settled during November/December for all expenditures except that on the pay of the</sup> This was deliberately left until February, by which <sup>with</sup> time information about the outcome of pay research was available, but in practice the <sup>source</sup> decision was taken to fix the factor for this expenditure also at 14 per cent, because it would have been difficult to defend any discrimination in favour of the Civil Service.

Three points to be considered in relation to the cash limits to be fixed for 1981-82 expenditure are:-

- a. Timing: the cash limit for the rate support grant should be announced in mid-November (largely both to enable local authorities to plan their expenditure totals to influence the important negotiation on pay of manual employees which will then be in progress); there are also other important pay settlements around the turn of the year, notably the NHS ancillaries, which should be negotiated in the light of the cash limit factors which ought by then to have been announced. Apparent discrimination should be avoided, and it is desirable that cash limit factors relating to future pay and price movements should be settled for all groups of expenditure around mid-November. This will require a Ministerial decision in October or very early November, which can conveniently be part of their general review of public expenditure at that time.
- b. Form: In the 1980-81 cash limits a single factor was applied to all central government current expenditure covering both new pay awards and price increases, and a similar approach was used for the rate support grant. The purpose was to avoid a separate provision for future pay awards. There can be a double disadvantage in publicising the cash limits in a way which highlights a particular factor or factors relating to future pay settlements: such factors tend to have the

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appearance of "pay norms"; and, given possible variations of timing, they may bear no relationship with the actual experience of pay and price effects between one year and the next (eg the 14 per cent factor used for 1980-81 is consistent with an actual pay increase compared with the previous year of 23-25 per cent, because of the effects of staging of increases). It may be preferable to express cash limits in terms which come closer to the year-on-year effect of pay on the total wage bill; this could make it easier to accommodate a resolution of the conflict between financial constraint and agreed levels of pay settlement by staging the implementation of the settlement; there would however be some practical difficulties in expressing all cash limits in the way proposed. It would still be necessary to make some judgement about future increases in costs in constructing year-on-year limits. It would throw up apparently different figures for different pay groups which would not be easy to explain. The possibilities will be considered further by officials.

c. Substance: the central problem will remain, that the decision on cash limits, in whatever form it is expressed, will require a judgement of how much can be afforded, and how realistic that amount is likely to be.

External Financing Limits

Although these can in theory be set at any time between November and the Spring Budget, they need to be set in November ie at the same time as the cash limit for the rate support grant, as last year, if they are to have an impact on nationalised industry pay negotiations. This would point to a Ministerial meeting about the basis for the EFLs in September, consideration with the industries in October and an announcement in November. The miners' settlement date of 1 January is relevant in this context.

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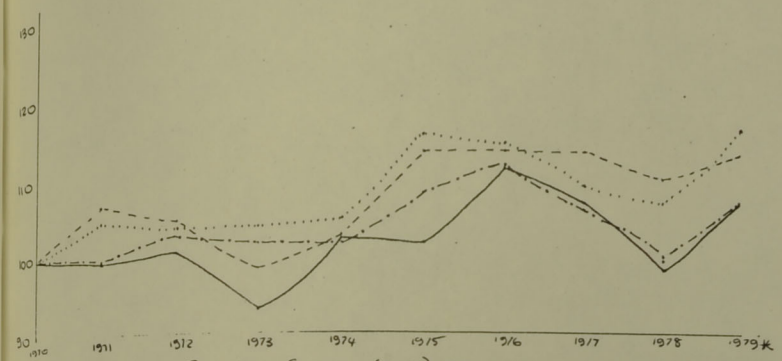
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AVERAGE WEEKLY EARNINGS MALES OVER 21: RATIO FOR VARIOUS PUBLIC SECTOR GROUPS TO PRIVATE SECTOR (1970=100)

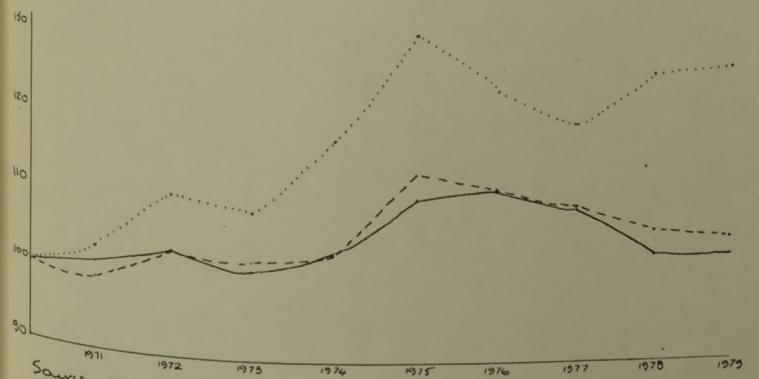
- = Central Government Manuals
- = Central Government Non-Manuals
- ..... = Local Authority Manuals
- = Local Authority Non-Manuals



Source: New Earnings Survey (April) 1970-79  
 \* Figures for 1979 are crudely adjusted to take account of class awards etc. (see note)

AVERAGE WEEKLY EARNINGS MALES OVER 21: RATIO FOR VARIOUS PUBLIC SECTOR GROUPS TO PRIVATE SECTOR (1970=100)

- = Public Corporations Manuals (All Industries)
- ..... = Public Corporations Manuals (Gas, Electricity, Coal)
- = Public Corporations Non-Manuals



Source: New Earnings Survey (April) 1970-79

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