

S E C R E T

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DoK

PUBLIC SECTOR PAY POLICY

..... I enclose a copy of the Chancellor's paper for the Prime Minister's meeting at 4 p.m. on Monday, 19th May.

I am copying this letter, with enclosure, to the Private Secretaries to the Home Secretary, the Lord President, the Secretaries of State for Industry, Employment, the Environment, and Social Services, and to Alastair Pirie, David Wright and Robin Ibbs.

Yours ever,

M.A.

M.A. HALL

S E C R E T

PUBLIC SECTOR PAY

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. We are likely to go into the next pay round with the RPI showing year-on-year increases 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. 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.

Public Sector Pay

4. There is a clear distinction between:
- a. central government services, where the Government's responsibility is direct;
 - b. local government, where our influence - substantial but not decisive - is through the RSG; and

- c. nationalised industries, where we have indirect responsibility and very limited power.

Public Services: Cash Limits and Comparability

5. There is no alternative to cash limits as the basis for our policy for the public services. It is imperative that this year's limits for central and local government should be struck at levels below those of 1979-80.
6. We must not be so ambitious that we fail to take account of likely pay settlements as well as trying to influence them. And if cash limits set the broad framework for pay settlements there must still be some room for negotiation and manoeuvre. But 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. It is quite clear that we must give primacy to cash limits.
7. Comparability also has some obvious defects:
- 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. There is a potential clash with cash limits which fits badly with the medium term strategy of reducing inflation.
 - it produces results which are extremely suspect.
 - 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 A shows how well the public services appear to have been doing.
8. The various bodies and techniques involved in comparability are summarised in Annex B.
9. The Government is therefore faced with a choice:
- We could accept the disadvantages set out above and retain but improve the present arrangements based on comparability. This might seem to offer the prospect of a quiet life, but I do not see how 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 decide to scrap existing institutions and methods completely.

c. we could attempt to "dethrone" comparability, so that it survived 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.

I believe that the choice is between the last two of these options.

10. The case for abandoning comparability altogether is that so long as it remains in any form, it tends to re-emerge as the dominant factor. Abandonment seems to be the simplest way of establishing the primacy of cash limits. But I am hesitant about sweeping everything away. Comparability 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.

11. My instinct is that course (c) above is right. I suspect that accepting comparability as an element, if only for historic reasons, but demoting its status will prove a more lasting solution. We should retain a fact finding capability and have an institutional structure which we could use if we needed it - rather than create another Wilberforce or Houghton as the need arises.

12. This is bound to lead to a messy solution. The elements would be:

a. renegotiation of the Civil Service Pay Agreement, to change the status of pay research so that it becomes one element only in the subsequent negotiation.

b. modification of the membership and terms of reference of the Review Bodies so that they take account of Government policy and economic conditions.

c. 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. It would seem easy to let it

go and gain the political credit for so doing. But we have to recognise that there may 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 tempted to leave the Commission in being, but with a reconstituted membership and terms of reference: though it would not have much of a role for the immediate future.

d. Some sort of special treatment may still be appropriate for the police and firemen.

13. This is not intended to be a blueprint for the future. It might, for example, be possible to bring together the various organisations involved with comparability into a new body whose primary purpose would be to assemble the facts. This has considerable merit in its own right. Its powers would be not unlike those conferred upon the National Board for Prices and Incomes in Part I of the Prices and Incomes Act 1966. Part I of that Act was endorsed by the full ideological range of the then Conservative Opposition. This would at least have the advantage of providing a single and consistent source of information. And we may be able to sort out some of the major methodological problems in the present system at the same time.

14. If our re-designed system allows the gap between pay research - as modified and highly qualified - and the cash limits to be not too large, it may be possible to keep comparability running in this modified form. But the future depends on modifying the system so that the findings on comparability are used within the constraints set by cash limits. Having set a programme for manpower reductions we cannot expect to reconcile cash limits with the findings of pay research by looking to further reductions in Civil Service numbers.

15. I do not underestimate the difficulties of negotiating this - or any other departure from the existing arrangements - with the unions. But unless we move towards establishing the primacy of cash limits over comparability a public service pay round of 18-20% seems possible. We cannot just continue with what we have. My

approach seems to be the most durable of the alternatives. But if it is thought that this solution is unacceptable, I should prefer to abandon comparability completely and everything that goes with it. The main object must be to end 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 need to control public expenditure and the PSBR can have no effect on public service pay rates.

Local Government

16. 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 leave the local authorities free to use such arrangements on the lines of paras 12 and 13 as survive.

Nationalised Industries

17. 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.

18. 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.

19. So far in this 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. (The table at Annex C compares settlements with the assumption underlying the EFLs).

20. 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. put more pressure on chairmen (in private) to hold settlements down to those pay assumptions. This may have a limited effect but I think it will be essential if we are to achieve our aims.
- c. press ahead with the development of performance targets for the industries' costs, including labour costs - something which can hardly be expected to produce useful results within the next year but should help in the longer term.

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. I doubt if this would be enforceable and it would probably be a mistake to try it.

21. We must therefore press ahead on broadly the same lines as this year. This means setting EFL pay assumptions in the autumn, broadly consistent with the figures we are putting into public service cash limits. But as with this year, they 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.

22. I do however think we should 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.

Expectations

23. We must mount an intensive 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.

Conclusion

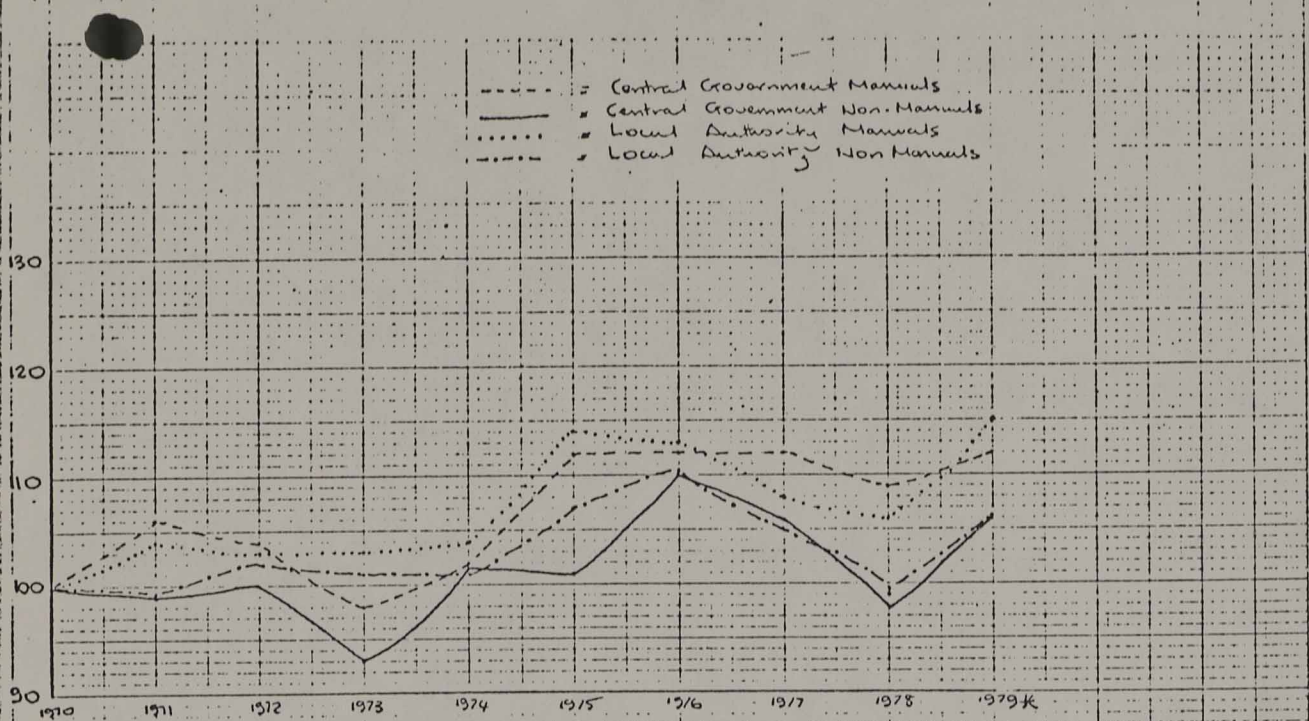
24. The strategy I propose is not going to be easy:

- a. The private sector should respond to the monetary regime - although this is bound to be uneven.
- b. In the nationalised industries there will be differing settlements in part reflecting monopoly power, but influenced by the EFL's (which should be set in the autumn at the same time as the RSG), the attitude of the Chairmen, and the level of settlements in the private sector.
- c. In the public services, the Government has to decide on its attitude to its own employees. The main weapon to get pay down must be the cash limits and the RSG. We cannot stick with comparability as the sole determinant of pay. The alternatives are to modify the present arrangements or abandon them. I prefer the former but can see the arguments for the latter.

25. 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 gear expectations down, dethrone the RPI and the associated menace of cost plus pay increases and comparability, we shall find the credibility of our strategy is increasingly called into question.

15.5.80

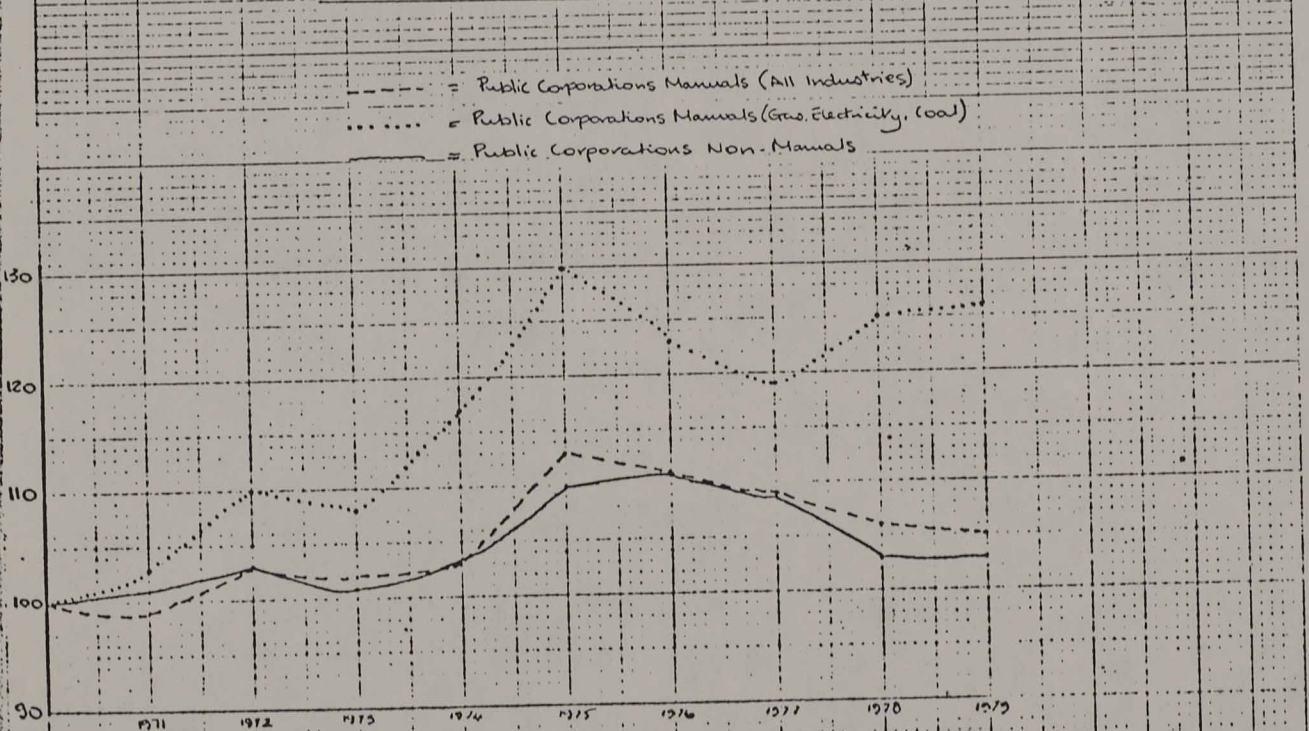
AVERAGE WEEKLY EARNINGS MALES OVER 21: RATIO FOR VARIOUS PUBLIC SECTOR GROUPS TO PRIVATE SECTOR (1970=100)



Source: New Earnings Survey (April) 1970-79

* Figures for 1979 are crudely adjusted to take account of day awards etc. (see note)

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



Source: New Earnings Survey (April) 1970-79

ANNEX B: Comparability in the Public Services

1. Comparability is not however applied in a uniform manner throughout the public service. It covers:

- a. Pay research for the non-industrial civil service. The industrial civil service is not at present part of a formal comparability system, but outside comparisons conducted by the Pay Research Unit are used in determining the "key" basic rates of pay, on which the negotiations as a whole are based. It is nearly 25 years old and for the majority of that time it has worked smoothly.
- b. The 3 Review Bodies - the Top Salaries Review Body (TSRB), Armed Forces Pay Review Body (AFPRB) and the Doctors' and Dentists' Review Body (DDRB), where broadly similar justification is made.
- c. The Standing Commission on Pay Comparability (the Clegg Commission), which has so far conducted "one-off" exercises for a large number of groups, including local authority manuals, NHS ancillaries, nurses and teachers.
- d. The LACSAB "in-house" comparability study for the local authority administrative, professional, technical and clerical (APTC) group. There has not been the same long term tradition of systematic comparability for these groups.
- e. Indexation - for police and firemen.

2. These cases cover a variety of methods of comparison, of greater or lesser accuracy, technical sophistication and desirability. They are:

- a. job-for-job comparison, - pay research, Clegg reports on IA manuals and NHS ancillaries.
- b. factorial comparison, where there are no direct equivalents elsewhere to the jobs which are the subject of comparison and where the jobs are dissected into the factors that compose them, and compared with similar factors in outside jobs - AFPRB, Clegg report on nurses (the Clegg Commission failed to produce sound factorial comparisons for teachers in the time available).

- c. broad equivalence - TSRB, DDRB, LACSAB "in-house" study.
- d. indexation, either to average earning generally (police) or to a particular point in the index (firemen).
- e. comparison for a particular point on the earnings scale, with remaining rates set on the basis of internal relativities - Clegg on teachers.

In some cases the results of comparability are applied directly, in others they are a matter for subsequent negotiations. In the latter case, the negotiations are sometimes constrained by the comparability findings.

PAY SETTLEMENTS & NATIONALISED INDUSTRIES EPLs
1980/81

Industry	Pay Settlements Assumed in EPL %	Pay Settlements Conceded %	Excess £m	EPL £m
British Airways	18½	13½	-	230
British Airports Authority	16	16	-	20
British Steel (1) Corporation	no assumption	(11+5=)16	132	450
British Railways Board (2)	14	20	58	750
National Freight Corporation	16	16-17	2	24
National Bus Company	14	18	15	85
British Gas Corporation (3)	17	18	-	- 400
Posts (4)	11	15	-	} - 280
Telecommunications (5)	11	15.7	60.7	
British National Oil Corporation (6)	-	-	-	- 200
National Coal Board (7)	15	18	55-60	834
Electricity Boards (8)	12*	19 ^φ	80	(187 (59 (73
British Shipbuilders	self-financing	11½	5-10	120
TOTAL:			c. 407-417	

*plus 6% expected carry over from previous year

^φplus 3% actual carry over from previous year (2% in respect of arbitration award)

Productivity in the public sector,