SECRET

25 June 1980
Policy Unit

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PRIME MINISTER

PUBLIC SECTOR PAY - E

I attach a paper on Public Sector Pay, for tomorrow's E.

1. E Committee has not yet started to come to grips with the public sector pay problem, because the essential first step, of defining the problem, putting numbers to it, and setting it in the context of the Medium-Term Financial Strategy, has not yet been done.

The meaningless objectives shown in paragraph 2 of the CPRS paper, E(80)55, demonstrate the impossibility of trying to address what is essentially a "numbers problem" without any numbers.

2. Public sector pay is at the heart of public expenditure, pay pressures in the economy, and thus the whole financial strategy. At present, we don't know by how much we are trying to keep public sector pay down; or the risks attaching to different ways of doing it; or the implications of different degrees of failure.

3. Clearing minds on this question is tedious and difficult. The problem looks increasingly daunting as the numbers emerge - when they emerge. It is no answer to say that life is complicated and messy and cannot be reduced to such simple logic. Of course it can't. No-one suggests it can be. But such a response amounts to saying "Since life is confused, the future unpredictable, and all plans go awry, why bother to clear our own minds? Why bother to have any plans at all? Let's have no objectives and no plans, so that we need never know whether we've failed at all."

I have copied this paper to members of E, Sir Robert Armstrong and Robin Ibbs.

JOHN HOSKYNS

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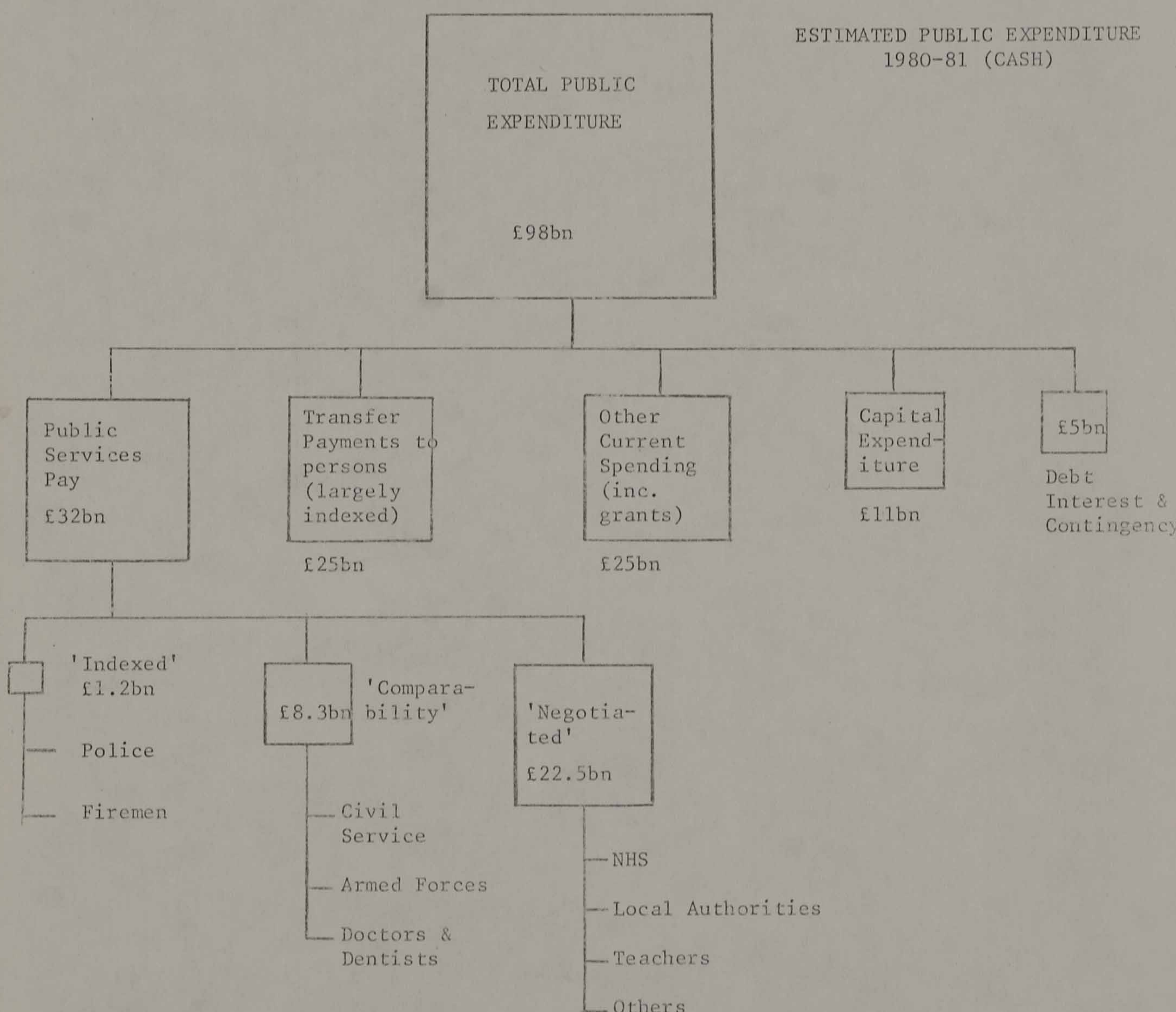
PUBLIC SECTOR PAY

E Committee is working its way through the annotated agenda, E(80)55, suggested by the CPRS. In the our view, it is not possible to make real progress with this agenda without more numbers. This paper attempts to structure and quantify the problem.

1. THE SIZE OF THE PROBLEM

1.1 The diagram below may be helpful:



Public expenditure, like everything else, will try to index itself. Much of it is effectively indexed now. It will therefore be pressing for between 12% (£11.7bn) and 18% (£17.6bn) during 1981-2.

1.2 This paper concentrates on public services (£32bn), whose outturn will affect, and be affected by, settlements in both the nationalised industries and the private sector. Nationalised industries should be looked at separately. Their pay settlements are not under Government control; they are quite different from public services and from each other - profitable/loss-making, growing/shrinking, monopoly/open to competition.

1.3 Public services pay. The figures in E(80)56 suggest increases of about 18% (including drift) over the period February 1980 - February 1981, for the economy as a whole. On that assumption, 'Comparability' settlements (£8bn out of the £32bn, backward-looking and linked to those still in jobs in the private sector and nationalised industries) would be about 18%. It seems likely that similar figures would apply for the indexed and the negotiated portions of public services. Public services pay would therefore tend to grow by about 18% - from £32bn to just under £38bn.

1.4 The problem is the "gap" between the results of this self-indexing tendency and the desired outturn, implicit in meeting the Medium-Term Financial Strategy, for the public services.

What is the desired outturn? There has been talk of "single figures". A 9% objective would thus give a nine point gap (£2.88bn). "Less than last time", ie 13%, would give a five point gap (£1.6 bn).

2. THE CONSTRAINTS OF THE MEDIUM-TERM FINANCIAL STRATEGY

2.1 The MTFS is concerned with Transition from high inflation to Stable State. That Transition process requires public expenditure, like the rest of the economy, to "settle for less than the going rate". How much less, we are not yet sure. This deceleration is over and above, and quite distinct from, the need to cut public spending and reduce the PSBR.

2.2 If public sector pay does not accommodate to the MTFS, then some combination of the following will result:

- Inflation will take longer to come down.

- The private sector will be badly damaged.

- The knock-on effect will further damage the private sector.

- Further de-manning of public services will be necessary, but in many areas like the NHS, impossible.

- Capital spending in the public sector will be cut, creating more problems for the future (eg Post Office).

It would presumably be possible to simulate the effects of different levels of failure to match public expenditure to the MTFS, in order to get a better idea of what is at stake. The Economist has tried to do something more general on pp. 108-9 this week.

2.3 The MTFS contains monetary targets. These in turn imply cash limits in the public sector. What are they? Can they be set late, to accommodate likely pay settlements; should they be set early, in order to constrain those settlements?

2.4 Cash limits will imply a level of public service pay settlements. What will it be? "Less than last time"? Single figures? If it's single figures, how do we achieve it? Are we about to get off on the wrong foot, politically, in our treatment of MPs' pay and Boyle generally?

2.5 External Financing Limits. Should monopoly nationalised industries be free to raise prices as necessary to stay within EFLs? Is this a "solution" to the problem, or is it simply price inflation by other means?

3. OBJECTIVES, CONSTRAINTS, RISKS

3.1 Objectives

3.1.1 In the public services, our objective is presumably to make pay outturns match the MTFS. Or is it? We have suggested in Section 1.4

above, that this means closing a gap of between five and nine percentage points (£1.6 bn and £2.88bn).

3.1.2 For the nationalised industries, the question is: to what extent do we allow nationalised industry management to meet EFLs by postponing capital spending or raising prices? Our initial "arm's length" position was to leave it to the industries concerned. But we are already moving towards making nationalised industries hold prices and delay badly needed investment. The Post Office is a case in point.

3.2 Constraints

3.2.1 To say that we want "minimum disruption" would be meaningless. Are we aiming to avoid public service disruption absolutely? Or are we saying that we would accept disruption as the price of achieving our objective, provided it does not jeopardise that achievement? Before we can decide on the latter, we have to look at the risks.

3.3 Risks

3.3.1 For each area of public services, we have to ask:

First, what is the likelihood that the disruption would happen in the different parts of public services?

Second, if disruption did occur, would it jeopardise the achievement of the desired outturn? What are the lessons of past public sector and public service strikes? What is the risk that disruption, particularly selective action, leading to concessions by Government, would bring larger aggregate settlements?

Third, what would be the political and economic consequences of being forced either to relax the MTFS or to slide it forward by, say, a year?

3.3.2 We may have to take the risk of disruption, but we should have some idea of what that risk involves. We are not suggesting that there is some simple mechanistic process for getting "correct answers" to these questions; simply that there is information available which can be used methodically to make an informed judgment.

4. OPTIONS

4.1 The options facing the Government lie between two extremes:

(1) At one extreme, the Government avoids all disruption, at the cost of abandoning the desired pay outturn, and thus breaking cash limits and thus the MTFS, or else fudging on manning levels and capital spending.

(2) At the other extreme, it goes for single figures in aggregate, which means certain and widespread disruption.

4.2 It is not possible to evaluate the different options because we don't yet have the numbers, and we have not yet analysed the risks. However, the main options seem to be:

(1) Accept the status quo. With comparability still in place, "doing the best we can", case by case; no disruption; cash limits and MTFS broken, or else fudged by de-manning and capital investment delays; knock-on effects in the private sector. The long-term political and economic costs of this option have not yet been assessed.

(2) Comparability less X%. The X% would be designed as a compromise between certain disruption on one side and breaking cash limits, MTFS etc, on the other. Would this be presentable as fair within the public services? Could it still cause problems with the private sector? Does it dangerously extend the principle of comparability just when we would really like to dethrone it? Much would depend on whether the nationalised industry settlements turn out, under recessionary pressures, to match fairly closely.

(3) Impose a figure for the public services. This would be rather similar to (2), but with greater certainty that the totals would turn out the way the Government wanted. The figure could be based on partial indexation. Partial indexation, by offering the certainty of a limited downside (as with de-indexed social security) could be cheaper than a norm, provided it really was partial and properly designed. (The Callaghan 5% norm was offered regardless of how inflation might actually go.) Could such a figure be imposed on the public services and not on the nationalised industries? Would it unite public sector unions

against the Government? How much would that matter, how long would the trouble last? Would it be saleable if private sector settlements were running higher (notwithstanding the resulting private sector unemployment)?

5. FURTHER WORK REQUIRED

5.1 Establish our objectives

This paper raises questions that have not yet been answered and which are essential to decision-making:

- Are the constraints of the MTFS understood?
- What are the cash limits?
- What are the desired pay outturns?
- How far are we prepared to go in delaying capital spending?
- Can we afford to give nationalised industries carte blanche to raise prices?

5.2 Risk analysis

For each key area in the public services (and perhaps also in the nationalised industries):

- What is the impact of disruption among the different groups? What is the likely outcome in terms of "who wins" and the subsequent level of settlements?
- What is the probability of it happening, at different levels of "pay compression"?
- What steps could be taken - apart from simply abandoning the attempt to compress - to make it less probable?
- What would breaking the MTFS really mean in political and economic terms?

6. <u>CONCLUSION</u>

It is not really possible to make decisions of principle and then, at a later stage, decide about numbers, which is what the CPRS paper, E(80)55, suggests. This particular problem is concerned essentially with numbers. <u>That is what the problem is all about</u>. Until the problem and the objectives can be expressed in numbers, it is not really possible to start work, because no-one knows what the Government <u>has</u> to achieve as a minimum, or what it would <u>like</u> to achieve if circumstances allow.