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E(80)115
10 October 1980

COPY NO 55

CABINET
MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

COMPARABILITY AND CASH LIMITS

Note by the Chancellor of the Exchequer

At E(80) 27th Meeting on 23 July it was agreed that I should arrange for officials of the Treasury, the Civil Service Department, the Department of Employment and the Central Policy Review Staff to consider further on a contingency basis and in consultation with other Departments as necessary, the options for determining civil service pay in the longer term.

I attach a note by officials in pursuance of this remit which takes the form of a progress report. My own first impression is that it does not deal sufficiently with the fundamental issues. I invite members of the Committee to indicate any preliminary reactions they may have to the work undertaken to date and to accept the recommendation of officials that they should examine further the implications for cash limits and public service pay generally of the options identified.

G.H.

H.M. TREASURY

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COMPARABILITY AND CASH LIMITS

Note by Officials

Ministers have already decided (E(80)27th Meeting, item 1) that cash limits will be the major determinant of civil service pay in 1981, and the Lord President has geven notice of this to the unions. The civil service pay agreement will therefore in effect by in abeyance, although the collection of pay research data will be available to the parties. The level of the pay element in the FY 1981-82 cash limit, for the civil service and other public service groups, will need to be decided by Ministers shortly.

2. The paper considers the larger term options for determining civil service pay in the light of discussion at E(80)27th Meeting and in particular of the remit to the Chancellor of the Exchequer to arrange for officials to refine the options set cut in his paper E(80)71. The implications of those options for other public service groups and cash limits genally and considered briefly, but these need further examination. This paper is therefore a progress report, and only a preliminary reation is sought from Ministers.

3. The intention of the options in the Chancellor's paper was to reconcile cash limits with the maintenance of some element of comparability. We have examined the respective merits of these options against two objectives:

(a) to achieve the lowest possible settlements which do not create substantial 'catching-up' problems;

(b) to achieve settlements which will in no way inhibit the private sector from reducing the level of their settlements as strongly as they can.

4. The options are:

A. pay research operating annually, but as only one input to the negotiations;

B. a year of suspension followed by a return to settlements based on improved pay research, operating on an annual basis;

C. pay research operating, say, every three years with cash limited or negotiated settlements in the intervening years;

D. settlements based on cash limits, but an arrangement for 'topping-up' if necessary each year by reference to the increase in private sector earnings;

E. pay research based settlements at periodic intervals, with settlements and 'topping-up' as in (D) above in the intervening years, ie, a combination of (C) and (D).

5. All the options involving pay research are based on the premise that satisfactory improvements to pay research on the lines agreed by E Committee can be negotiated with the unions or imposed successfully. The Lord President will be reporting to colleagues in a separate paper: but for convenience the changes so far proposed are summarised at Annex A.

A. Pay research operating annually but as only one input to negotiations

6. Under this option, pay research would continue on a modified basis, but its results would be only one element in the pay negotiations. The present civil service pay and arbitration agreements would have to be withdrawn or substantially amended. These restrict negotiators and arbitrators within closely defined limits. It would be necessary to restrict access to arbitration so that it was by the agreement of both parties, rather than unilateral: otherwise, given the binding nature

of the arbitration, the unions would be likely to force claims to arbitration in the hope of the arbitrator 'splitting the difference' between the two sides, and the Government would lose control over the outcome.

7. It is hard to predict what the unions' attitude to this option would be. The explicit removal of unilateral access to arbitration would be a difficulty. In fact, Ministers have always been able to block access to arbitration if necessary (though this is currently being challenged in the Courts). The unions would certainly object and seek concessions in return, but in the end they might acquiesce. Whether the unions would co-operate in the continued collection of any research data is also doubtful. If they did not, data could nevertheless be collected without union co-operation and used as an input into bargaining. The effect would be that the data would not necessarily be accepted by the unions, and thus the system would be closer to unconstrained free collective bargaining.

8. This option would leave both the Government and the unions more freedom to influence the desired outcome by introducing factors other than pay research into the negotiations. The unions' attitude would no doubt be made more aggressive by the uncertainty and lack of clear guidelines inherent in this system. It would thus involve a high risk of friction and strike action year by year, with the unions trying to emulate those groups in the public trading sector who have the muscle to bring the country to a halt. It is therefore quite possible that a system based on free collective bargaining would result in higher increases than under present arrangements. Some civil service unions have recently contemplated a move to free collective bargaining for precisely this reason.

9. This option probably comes nearest to dethroning comparability, depending upon the extent to which one takes account of the pay research data. Much would remain to be considered about how

the Government would formulate its bargaining position from year to year. It is thus the least structured and defined of the options, and therefore the most unpredictable. The tighter the financial constraints, the greater the risks involved in this option.

B. Settlements based on improved pay research operating on an annual basis

10. Under this option, annual pay research - on an improved basis - would be resumed in 1982, as a basis for determining pay. Not all of the proposed improvements would directly affect the level of the pay research results: some are more concerned with making the pay research machinery more independent and impartial, and others (regional and merit pay) are being sought primarily for management reasons. But some of the changes proposed (including those that may result from the Scott Enquiry on pensions) could produce a one-and-for-all downward step in the relativity between Civil Servants and the analogues with which they are compared (though it must be recognised that if the existing Pay Agreement is opened up for re-negotiation, there are areas where the unions can be expected to oress for changes which would be in their favour).

11. In favour of this option, it can be argued that if Civil Service pay is too high in relation to pay elsewhere, it is not because comparability as a principle is wrong, but that it has been applied wrongly. Once a step change has been made in the relationship between Civil Service pay and pay elsewhere, then Civil Service pay would have thereafter to move in line with pay elsewhere. On this view, a step change must be the right aim rather than to depress Civil Service pay year after year by annual increases below the national average, which would not be sustainable as a policy.

12. In weighing this option against others, Ministers will need to form a view as to whether modifications in the way the pay research system is operated, including any changes that result from the work of the Scott Enquiry, are likely to result in a step change. But if this approach is accepted, it argues strongly for a return, after the step change, to a thorough system of comparability, acceptable to the unions and capable of producing the reasonably harmonious staff relations that would be the objective of this option.

13. If the step change were not achieved, then there clearly would be a risk of a "catching-up" problem when comparability was restored in 1982.

14. As to union acceptability, the indications are that, however unhappy they may be about the arrangements for 1981 and the proposed changes thereafter, the unions might be prepared to acquiesce. But they would be likely to seek some kind of commitment (perhaps in legislation) to the implementation of the modified pay research on a continuing basis in future years and to their right to arbitration. Much will depend upon the circumstances between now and next April, the credibility of the commitment, the mood of the union conferences, and the extent to which the unions see Civil Service pay as falling behind in 1981 and 1982.

C. Pay research operating, say, every three years, with cash limited or negotiated settlements in the intervening years

15. The Priestley Report, which forms the basis of the present pay research-based system, provided for pay research at intervals, with increases negotiated centrally in intervening years. This worked well with low inflation, but came under increasing pressure as the reate of inflation increased. The interval between pay research years lessened, and in 1975 pay research was put on an annual basis.

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16. In this option much would depend on how cash limits were set in the intervening years. If they were set to reflect the expected pay outturn in the economy, then the risk of a significant catching-up problem in the pay research year would be minimised. There would also be room for genuine negotiations on the size of the settlement (albeit with the risk that the unions, knowing the size of the provision, would refuse to settle below it). However it might lead to difficulties in achieving appropriate increases within the overall total for individual grades (unless the settlement were divided up according to the pattern of movement of pay research analogues in which case there would be little point in not having full pay research each year).

17. If, however, cash limits in the intermediate years were set tightly, then there would be virtually no room for negotiations over the size of the settlement negotiation would be restricted to the distribution between the different grades. It would certainly be necessary to prevent arbitration taking place in the cash limit years. Whether or not to withhold arbitration in the pay research year would depend upon whether the settlement was to be based fairly closely on the pay research evidence, or whether the amount of catching-up required some squeezing of the settlement.

18. This option is unlikely to be negotiable with the unions: they attach much importance to annual pay research to prevent 'falling behind', whilst this approach would institutionalise such falling behind in intervening years. The changes on arbitration would also be extremely troublesome. From the Government's point of view, the purpose would be to keep down Civil Service settlements in the interim years to prevent any knock-on effects to settlements in the private sector and the public trading sector. But the corollary to this is that there would be a major catching-up exercise in each pay research year. On past experience this is likely to more than outweigh the relatively small benefit in the interim years.

D. An arrangement for 'topping-up' settlements based on cash limits

19. Under this approach, Civil Service pay would be determined by cash limits set in advance: but there would be a safety valve. It would be possible to reopen the settlement if the increase turned out to be significantly below the average increase received by the private sector during the round. This would ensure the primacy of cash limits in the main settlement and that Civil Service pay increases could only follow, and never lead in any year.

20. This arrangement would need to specify the basis for topping up and when it would operate. Sincethe objective would be to reassure the private sector, it might be more appropriate to base topping-up on what happened in the private sector (though on past experience, bringing in the nationalised industries as well would produce lower figures). Settlement data would be too inaccurate. Earnings data would have to be used, and is available separately (though not publicly) for the private sector. If however the topping-up were to be made to correspond more closely to settlements than earnings, an adjustment would have to be made to eliminate 'wage drift' which is higher in the private sector than the public services, and distortions to the earnings figures caused by extraneous factors (particularly back pay).

21. Topping-up could in theory operate in two ways. It could seek to reimburse any increase in private sector earnings over and above the cash-limited settlement. But this would virtually amount to automatic indexing to private sector average earnings and we do not think this can be seriously considered. The better way would be for it to operate as a safety-valve if the discrepancy between the cash-limited settlement and private sector average earnings became too great. There would be a threshold: private sector earnings adjusted for wage drift would have to exceed the pay award by say 2 per cent or 3 per cent before topping-up operated. But once the threshold was reached, topping-up should probably cover the whole gap.

22. Although this option is in a general sense market-related, it would move away from the market in that it would mean all grades getting the same annual increase, so that relativities within the civil service would tend to get out of line with the market. This would in time create management problems which would have to be dealt with in some way. Further, it is a crude system which would probably not be acceptable to the unions. It would inevitably mean falling behind in some years, with no guarantee that the loss would ever be made up in the future. The approach is therefore inherently unstable and would be likely to lead to catching-up problems. The unions would no doubt object to the deduction for earnings drift, but without that deduction the system would not be defensible.

23. There are other problems with this option, which are considered under option (E), though in fact they apply more strongly to option D. But even without considering these, our view is that the disadvantages set out in paragraph 21 are such as to require this option to be rejected.

E. A less crude version of the above would be a pay-research-based settlement at periodic intervals, with settlements in the intervening year based on cash limits with 'topping-up'

24. This would be a combination of (C) and (D) above, which would thus remove some of the crudeness of (D) by allowing a periodic pay-research-based settlement. The main arguments against this option are:-

i. it could be criticised as inconsistent with the principle of pay settlements lasting for a full year, and thus encourage re-opending

ii. it could lead to pressures for similar treatment from public and private sectors which would tend to encourage pay bargainers to concentrate onthe concept of a 'going rate'.

iii. being based on the average increase in earnings across the pay round, it could not allow for any downward movement in settlement patterns during the course of the round.

25. The strength of objection (ii) above is a matter of judgement. If the approach were adopted only in the public services it could, in fact be helpful. It would mean that cash limits set for the public services could have an influence on the rest of the economy. And to the extent that all (or most) groups were encouraged to have lower initial settlements, the result would be to depress the increase in average earnings so that little or no topping up was required.

26. The effect on negotiations in the public trading sector and the private sector is more problematical. The approach would certainly be unattractive to the stronger groups, and given the adjustment for wage drift (paragraph 20) and the threshold (paragraph 21), probably to the weaker groups as well. But it might well encourage weaker groups to press for topping-up on the basis of full indexation to average earnings, and this could cause some embarrassment for the government.

27. In favour of this option it can be argued that:-

(i) a cash limit for pay set in advance for the public services could influence expectations in the rest of the economy;

(ii) civil service pay increases would emonstrably follow and not lead private sector pay in each pay round;

(iii) it would be unelikly to lead to substantial catching-up problems;

(iv) it might be negotiable with the unions.

28. The inclusion of a pay research year in the cycle under Option E would avoid the main problems identified with option (D). It would re-establish periodically relativities with the market (although any distortion that had occurred in the interim would add to the difficulties in the pay research year). Equally, it might be negotiable with the unions because it would offer the prospect that any falling behind will be made good in the pay research year. Whether there would be catching-up problems would depend on the way cash limits were set in the non-pay research years.

Implications for cash limits and for other public service groups

29. The choice of any of the options above has important implications for cash limits generally, and for pay in the rest of the public service. None of the options considered avoids the basic dilemma of reconciling pre-determined and rigid cash limits based primarily on financial considerations with pay settled by reference to the principle of comparability (and still less with pay settled by free collective bargaining or by arbitration). The effective choice lies between accepting the principle that cash limits fixed in advance of pay negotiations may have to be increased in the even to accommodate the settlements reached; and secondly, fixing the cash limits at the same time as pay negotiations are completed, or at least at the same time as the results of pay research become available, so that they are potentially reactive to pay research rather than determined solely by financial considerations.

30. One possible approach, if we were only dealing with the Civil Service, might be to make special arrangements whereby it was agreed in advance that the Civil Service cash limit could be increased, exceptionally and if absolutely necessary, to accommodate the results of pay research or the need for "topping-up", without undue damage to the cash limit regime. Such an arrangment would be analogous in principle with the specific arrangement already made to deal with the paying of the armed

forces. But the implications for the rest of the public services (essentially the NHS and local authority employees including teachers) of speical treatment of the cash limit for Civil Service pay are far-reaching and complex. In particular, they would raise the question of whether the treatment to be accorded for Civil Service pay could be contemplated without giving similar treatment to other central government employees, especially those employed in the NHS despite the fact that there might not be the same formal arrangements for comparability as for the Civil Service. There might be less difficulty in regard to local authorities since the pay assumption in the RSG will not closely determine pay settlements in any case, but this would not stop the local authorities demanding that the Govenrment ought to pay its share of the cost of any sattlement over the burden assumed. Any extension of this more flexible approach to cash limits beyond the Civil Service would, moreover, represent a major change in the cash limit regime, as it has been applied in the past 18 months. Furthermore, there are obvious presnetational difficulties in introducing such flexibility for pay in particular, when other forms of expenditure continue to subject to the full rigour of cash limits.

31. The second way of dealing with the dilemma would be to attempt to set cash limits taking account of the results of the pay research studies. In principle, this should be possible for the Civil Service under any of the first three options A - C, though it would not be possible to reconcile this with the years when topping-up operated under proposals D & E. At present, Ministers take decisions on cash limits towards the end of October (this is determined by the RSG timetable). On the present timetable an assessment of the likely outcome of pay research could not be made before early December. It would be possible to postpone the setting of the Civil Service cash limit until December; but this might not in practice increase flexibility by much since, as last year, the cash limits for the Civil Service would be likely to be constrained by the decisions already taken for other public service groups.

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32. To get around that difficulty, and still achieve synchronisation of cash limits with pay research information, it would be possible to bring forward the pay research timetable. This would still not necessarily make the decision easier. In some years, the pay research outcome might fall within a cash limit determined on primarily financial grounds. In others, the gap might be small enough to be accommodated within the negotiating margin for the settlement, or by volume reductions, or carried forward to the following year. But where the gap was large, Ministers would be faced either with increasing the cash limit provision above what they would otherwise have wished (with implications for other public service cash limits), or setting a cash limit significantly lower than the pay research outcome, thus abandoning comparability for the year and creating at best a catching-up problem in the following year, and at worst a breach of cash limits. But this is a dilemma between comparability and cost they would have to face at some stage whatever the method of fixing, or adjusting, cash limits.

33. A further variant would be to synchronise the setting of the Civil Service cash limit and the actual pay settlement. In practice, this would mean delaying setting the Civil Service cash limit, to, say, February, since there would be dangers in moving the settlement date forward to such an exposed position as September, at the beginning of the pay round. It would also mean that the pay negotiations were not taking place within any cash limit. The cash limit would be set as a reaction to the settlement rather than acting as a discipline. Such a change for the Civil Service would inevitably have repercussions for other public service cash limits. Either these will in effect constrain the Civil Service negotiations, or the Civil Service will get more favourable treatment, in which case there will be pressure from other groups for the same.

Conclusion.

34. There are a number of options for determining Civil Service pay in the future, but none of them resolve the dilemma of reconciling

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pre-determined and rigid cash limits with pay settled by reference to comparability. Furthermore, the decisions on the method of setting Civil Service pay and the treatment of the cash limits for Civil Service pay have important implications for other public service groups. In the time available we have not been able to consider these fully.

35. Ministers may feel there is no urgency for a final decision on the future treatment of Civil Service pay and that rather there would be advantage in delaying a decision until the results of the Lord President's exercise and the Scott Enquiry into pensions become clearer in a few months time. However we invite Ministers to note the options described in the paper, and to ask officials to examine them further in the light of the implications of cash limits generally and the pay of other public service groups.

H.M. TREASURY
9 October 1980

PROPOSED IMPROVEMENTS TO PAY RESEARCH

The Lord President's recommendations in E(80)53, and agreed by E Committee, are to :

1. increase the independence of the Pay Research Unit (PRU) by recruiting a strong outsider as the next Director, and increasing the proportion of outside survey officers

2. reinforce the membership of the Pay Research Unit Board

3. urge the Board to pursue its examination of the PRU's choice of analogues

4. empower the Board to examine and report as a matter of priority on the principles underlying the use made of the PRU data in the subsequent negotiations (including fringe benefits, uprating, pensions and job security)

5. consider the introduction of regional variations to the national rates produced by pay research

6. seek improvements in the arrangements for encouraging and rewarding individual merit at all levels of the civil service