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Prime Minister

PRIME MINISTER

As expected, the Chancellor's critique of the draft "issues" paper concentrates on the need to give prominence to "affordability" in any new pay system.

INQUIRY INTO CIVIL SERVICE PAY : THE "ISSUES" MEMORANDUM

I have seen a copy of the draft "issues" paper enclosed with the letter of 3 September from the Lord President's Private Secretary to yours.

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2. It seems to me that the paper seriously fails to explain why we think the Priestley system has proved so very unsatisfactory and what we think the task facing the Megaw Committee really is. The Committee needs much clearer guidance from us about the fundamental problems. The draft misses a number of crucial points.

(a) It makes virtually no reference to the key consideration of the availability of finance or "what can be afforded". When the CBI saw me last week, they told me that they regarded it as essential that any new pay system following the Megaw Inquiry should take full account of this factor - as, of course, any outside employer must. I accept that what can be afforded has rather different meanings for the Government and for private employers; but that does not imply that it is any less important in the case of the Government. We must get it before the Inquiry as a central issue.

(b) The draft does not sufficiently recognise the point I made in my minute of 6 August, that the question of what can be afforded must be brought

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in at a formative stage, as an integral part of the system, and not as an extraneous reason for eventually overriding the results which the system generates.

- (c) It does not sufficiently bring out that market tests, such as recruitment and retention, are measures of reality which is primary, and comparability is only a guide to, or an imperfect proxy for, such tests. For every private employer probably the most important market factor are the likely limits of his cash resources.

3. I suggest therefore that paragraphs 4, 7 and 8 of the paper - at least - will need to be redrafted, on the lines of the attached Annex. These suggestions have been quickly put together (and may well not be enough), but I hope they give colleagues some insight into my deep anxiety about the whole flavour of the present text.

4. It may well be that we shall need to discuss these matters. If so, I think that we might also exchange views about paragraph 9 of the draft (the role of arbitration). This is less explicit than the synopsis we agreed in July, though it is probably not incompatible with the synopsis. The natural inclination of an Inquiry under the chairmanship of a distinguished judicial figure will be to assume that if the Government agrees to go to arbitration it should be obliged to accept the results; and if we wish it to reach a different conclusion, I think we shall need to say so explicitly. This is, of course, another reason why any fact-finding or arbitral process should not override, or be blind to, the fact that money may simply not be available.

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5. I am sending copies of this minute to the Lord President, the Secretaries of State for Employment, Defence, and Social Services, the Attorney General and Sir Robert Armstrong.

Peter Jenkins

for G.H.

September 1981

(Approved by the Chancellor of the Exchequer and signed in his absence).

Suggested redraft of paragraph 4

The Committee will wish to know why the Government believes that the system derived from Priestley should now be brought into question. There are four main reasons.

- (a) Whatever its abstract merits, the Priestley system has not in practice worked well in recent years. In nine out of the last fifteen years the system has been over-ridden or implemented only after delay. This in itself is an indication that the system is intrinsically unsatisfactory: on more occasions than not it does not provide a means of solving the problem of pay for the Civil Service. This is partly because economic circumstances have changed since the mid-1950s, when inflation was not a serious problem and pay increases indicated by the system were generally modest. It is also because of some characteristics of any such system. There are two particular defects. First, a system based on comparability is almost bound to be "backward-looking" and so likely to generate increases which may be out of line with increases taking place elsewhere in the economy at the time. This poses particular problems at a time when the national interest requires a substantial reduction of inflation and inflationary expectations. And second, because any such system tends to establish expectations of entitlement to an increase in pay - but does nothing to take account of the fact that the cash allocations to meet these expectations cannot reasonably be made available
- (b) An essential test of a pay system must be the market: does the system generate the pay rates, no less and no more, required to recruit, retain and motivate the appropriate number of staff of the right quality? In the post-Priestley system this is a subordinate element. It is assumed, in effect, that the pay rates indicated by "fair comparisons" are a reasonable proxy for the market. But it is increasingly

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questioned whether the system provides an an adequate reflection of market rates of pay. It has tended to insulate government employees from the facts of life as they exist in the private sector, partly because intangibles such as job security, which cannot be easily reduced to a cash value, are under-rated. The Government believes that, as part of the system of pay determination, there should be a systematic analysis of statistics of recruitment and wastage to determine whether pay rates are in line with the market for each particular type of labour or not. "Fairness" to employees, if it means paying more than the going market rate, is unfair to the taxpayer.

- (c) The truth is that we live in a world in which rapid economic changes - for example drastic changes in the price of oil - may require equally rapid and often harsh reaction. In such a setting "fairness" - certainly desirable - may not always be sustainable. Trading concerns have to react to such circumstances by laying off employees, or by acknowledging that no pay increase at all is possible. The public sector cannot expect to insulate itself from such changes by relying upon its power, in the last resort, to tax the wealth creating sector. Above all, the question of availability of finance and what can be afforded are treated as secondary in the post-Priestley system and introduced, if at all, only as reasons for over-riding the system and not as part of it. Outside Government, the ability of the employer to pay is inevitably a crucial part of the process of determining pay. It is true that the question of the Government's ability to pay involves judgements which are different from those which have to be made by private sector employers and often more complex. But the question is no less important for the Government for that reason. It involves the interests of every taxpayer and the economic health of the country.

Clearly these must be an integral part of the processes of determining what pay should be. A system which ignores these facts and appears to generate pay rates which are in some abstract sense "correct" is artificial and unreal. It has been said in the past that "the system having willed the ends must will the means". This, too comfortable, insight rests upon the mistaken belief that there is no limit, practical or theoretical, to the means that can sensibly be made available.

- (d) Even on its own terms, the old comparability system no longer commands confidence that it gives truly "fair" results. In the Government's view it is questionable whether comparisons were made with the right outside analogues; whether the wider problem of "circularity" was not compounded by the use of public sector analogues; whether, given the growth of fringe benefits in the private sector, the valuation placed on them had not become too detailed and mechanistic; whether adequate allowance was made for the benefit to civil servants of index-linked pensions; and whether the methods used to evaluate pay research evidence, and to bring it up-to-date as a basis for negotiation, were justifiable.

Suggested redraft of paragraphs 7 and 8

7. At the same time, the Government strongly believes that it would be undesirable for any new arrangements to give rise to a presumption of an automatic entitlement to rates of pay based on pay comparisons without adequate regard being paid to other relevant considerations, including the Government's duty to control public expenditure and to manage the economy in the interests of the population as a whole.

8. This means that any new system must take full account of the availability of finance, and as an integral part of the process, not merely as an extraneous factor to be brought in when the system has completed its operations. In addition, the Government must retain the right, in the last resort, to decide whether on

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any particular occasion the wider national interest should take precedence over the operation of any system, however well constructed. But the Government believes that a system giving full weight to all relevant factors should make it possible for agreed settlements to be the general rule, and for resort to "override" to be necessary, if at all, only in exceptional circumstances.