B/C: MR LANKESTER

Econ Pol

10 DOWNING STREET

6 August 1981

Dear Gordon

Public Expenditure and Public Service Pay

After your meeting on 31 July which discussed the paper you circulated under cover of your letter of 28 July to Brian Pearce, I had a word with Peter Dixon to say that the more I reflected on the implications of the options for the pay and non-pay factors, the more I was attracted to announcing that the provisional figure for pay would be 0%. Having now discussed this with Alan Walters and John Hoskyns here, I thought it might be useful if I committed this thought to paper before departing on leave, in the hope that there might be an opportunity to probe this option further at the beginning of September before the options are put to Ministers.

If I recall it correctly, your conclusion from our discussion on 28 July was that there would have to be two factors, because the spread was too large to make a single factor work, even for a short time; and that the best way to encourage Ministers to focus on the issues would be to put to them the proposal that the factors should be 5% for pay, and 10% for non-pay. And I think we agreed that it would be useful for the Chancellor to have a word with the Prime Minister about this before it was discussed even among a small group of the Ministers principally concerned.

At your meeting the disadvantages of the 5% and 10% formula were very clearly aired. I think we all recognised that the 5% figure could provide a rallying point for public service union opposition, and that because of the undertakings given to the Civil Service unions it would be regarded by them as a floor, on top of which another 2% or so could be expected by arbitration. I must say I find the argument that it would be possible to start off the negotiations by offering them less than the pay factor unrealistic. On top of these practical disadvantages, a 5% factor would be as widely regarded as a "pay norm" as the 6% factor was last autumn, whereas we ought to be encouraging the concept of a spread of settlements in response to varying labour market factors.

/Against

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Against this background, it does seem to us that we ought to consider announcing in September that the non-pay factor would be 10 or 11%, or whatever the year on year inflation rate was expected to be, but that because the pay round had scarcely begun the provisional factor for pay in the cash limits would be set at zero. Of course, we would say, that is not intended to be a freeze, nor is it expected to be the outcome in many cases - but all public service pay increases would have to be argued for and justified. We would, in short, be setting an example by getting away from the concept of an automatic entitlement to an annual pay increase. We would be allowing ourselves the flexibility of providing for larger increases for, for instance, the firemen than for, for instance, the teachers; and we would completely circumvent the problem of having to show our hand in advance to the civil servants.

There would, it seems to us, be another important advantage. We know that some of the private sector groups who settle early in the round are hoping to get away with very low figures. By showing that we ourselves are operating zero based budgeting for the public service, and by avoiding the public indication of our willingness to go for middle single figures, we should be increasing the chance of the pay round starting with some low single figure settlements.

Peter Dixon has explained some of the difficulties to me, and indeed some of them are clear from the discussion at your meeting. At a time when Ministers have decided to go over to cash as a basis for their public expenditure decision making, we may be in danger of offering them distorted figures. To the extent that the need to accommodate pay rises within a low figure for the pay bill will provide an incentive to reduce manpower, that may be no bad thing; but we clearly ought not to be presenting Ministers with public expenditure options on the basis of misleading figures for the cost of labour intensive programmes. One possibility might be to provide Ministers with their own private figures indicating more realistic assumptions. This is the kind of point that it might be useful to investigate further, together with the question of at what point the "true" figures would end up being written into the public expenditure survey.

I am sending a copy of this letter to Alan Bailey and Brian Pearce.

Yours

John Locke

G S Downey, Esq CB
HM Treasury

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