Prime Minister
For E tomorrow.
MCS 30/6

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MR SCHOLAR

THE NEXT PAY ROUND - THE TREASURY VIEW

1. The last two years

The Chancellor points to a remarkable deceleration in the rate of growth of earnings over the past 2 years (20% → 10% → 9%). He also points out a remarkably close grouping of pay rises within the public sector over the past year. Virtually all of the major settlements in the last public pay round have produced earnings rises between 7% and 8% - much the same as the average in the private sector. All settlements have been well below the year-on-year increase in the Retail Price Index.

2. The Chancellor rightly calls this a "not unsatisfactory" outcome. Equally rightly, he stresses that it is essential to aim for a "further deceleration in earnings growth" over the coming year. Our minimum target should be "a reduction in the growth of nominal earnings in line with the prospective rate of inflation". If the RPI is rising by 7% or less by the middle of next year, then we should aim for earnings growth of no more than 6%. That means settlements of little more than 4%.

We believe that it would be more helpful for the reduction of inflation and unemployment if settlements were lower than this, at 2-3% which we would expect to drift up to an outcome of 4-5%. The lower we start, the lower we shall finish.

3. We do not, however, agree with the Chancellor in seeing public sector pay as "giving a lead" to the rest of the economy. The reality - which it is important for us to establish - is that the public sector tends to follow the lead of the private sector, and not the other way round. It is our firm belief that public sector pay should be determined primarily by the ease of recruitment, by whether there are substantial unfilled vacancies and by the labour turnover rate.

Indeed, the Chancellor seems himself to recognise this when he argues that there is a "risk of confrontation" in the public sector because of the widening gap between public and private sector pay rates over the past 2 years; there will be "pressure to make up the lost ground".

This argument usually depends on the year from which you start measuring the lost ground. If we take the past 3 years - that is, including the Clegg year - there is little gap between public and private pay rises; if we go back further still, the gap widens again.

Now, in the longer term, it is true that public and private pay will tend to shuffle back into line with one another. But the process is and ought to be a gradual one. The Winter of Discontent in 1978-9 happened because the Treasury abruptly - and prematurely - picked the unrealistic figure of 5% which turned out to be way out of line with the going rate of more than 15% in the private sector.

By contrast, in the coming year it is an educated guess that earnings overall will rise by slightly less than in 1981-2. The London Business School forecasts 8% earnings growth.

4. The Chancellor mentions his intention to set the tone for pay restraint in the next round by a series of contacts with the CBI and other employers' organisations, and by his speech to the Industrial and Labour Correspondents Group. The psychological value of such exhortations is, however, surely somewhat weakened if the Government is seen to lack the will to announce pay bill targets within its own domain. Surely this was the lesson of 1979-80. The Treasury seems a little hesitant about announcing a pay factor for the coming year. And yet not to announce such a factor would almost certainly be taken as a signal that the Government was once again adopting a passive stance towards its own pay bill. That was how the unions interpreted the no-figure policy of 1979. It is surely important that union negotiators should be aware in the public sector that management is constrained by some clearly expressed limits beyond which it cannot and will not go. This is the only way to give genuine meaning to the phrase "there's no more money left". This planned housekeeping is quite distinct from giving a lead to the private sector.

5. One real difficulty not mentioned by the Chancellor is the problem of getting reductions in real pay at the lower end of the scale

where, as Frank Field pointed out so cogently in his letter some weeks ago in the Financial Times, a lower wage rate combined with indexed benefits, means that more people will find they are almost as well off or, indeed, better off on the dole than in work. This provides a floor to real wage reductions at the lower end. There is no easy solution to this, but we need to be aware of the problem.

6. We have commented before (Alan Walters' minute to ~~you~~ J Vereker of 2 June) attached on the Secretary of State for the Environment's suggestion about relating investment in infrastructure to pay restraint. It is wrong in principle and pernicious in practice. Investment in essential public projects should be undertaken on their own merit and within responsible totals of public expenditure. What happens if the trade unions abandon pay restraint after the infrastructure scheme has been started? Is the scheme to be abandoned half-finished?

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