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Treasury Chambers, Parliament Street, SW1P 3AG

14 October 1985

The Rt Hon George Younger MP
Secretary of State
Scottish Office
Dover House
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Dear George,

I promised after Cabinet last week to let you have a note of guidance on the presentational aspects of introducing running costs limits in 1986-87, which I hope will be helpful to colleagues also. My officials will be circulating more detailed guidance on both Estimates treatment and Civil Service pay arrangements following the MISC 66 discussions. I think it would be useful to give colleagues now a summary of the points to be made in answering questions on running costs such as the transition away from central pay assumptions. You were particularly concerned about what to say on provision for pay in departmental limits; a line is suggested in D attached. You may also like to look particularly at the note at the end on "Dropping an Explicit Pay Assumption - Key Points".

Decisions on individual running cost limits have not yet been reached, let alone announced. But I want to make an early announcement confirming the decision to move to control of running costs and ending the pay assumption because of the linkage with discussions with Civil Service unions on long-term pay arrangements and the need to consult the relevant Parliamentary Committees on Estimates treatment of running costs. This announcement could be immediately after the House returns after the Recess. The attached notes are intended to help departments take a consistent line. The detailed limits for running costs will then be published early next year in the Public Expenditure White Paper or with Estimates. I will consider then what further guidance would be useful.

I am sending copies of this letter to the Prime Minister, members of Cabinet, other colleagues in charge of departments and Sir Robert Armstrong.

Yours ever,
JH

JOHN MACGREGOR

RUNNING COSTS CONTROL

Background

1. Expenditure discussions this year have given particular attention to departmental running costs. The aim has been to agree limits for all expenditure on administration in 1986-87. This is the first year of a new system (announced 24 May).
2. Running costs do two things:
 - (a) they are better than a manpower control alone and get away from a central assumption on pay. With a leaner civil service, value for money and administrative efficiency are the proper criteria for decisions;
 - (b) they encourage good financial management. The FMI is all about delegated financial management. Running costs are an important step.
3. Running cost limits will make realistic but demanding provision for departmental expenditure based on department's own realistic estimates. These include estimates about pay. They will be tight estimates and tight controls. That is as it should be. Running costs totals will be budgetary limits so that programme expenditure is not available to finance overspends on running costs.
4. Running cost limits are still under discussion in the Survey and the agreed figures for departments will not be announced before publication of the Public Expenditure White Paper.

RUNNING COSTS: DETAILED POINTS TO MAKE

A Development of Civil Service Management

- (i) Ensures better planning, monitoring and control. Running costs above inflation for last few years, so control important.
- (ii) Running costs ensure planned efficiency. Old controls forced in-year changes of plan which were disruptive and inefficient.
- (iii) Consistent with developments in financial management in departments.
- (iv) Control limits will be for total administrative costs. Encourages departments to make appropriate choices in allocating resources (e.g. between staff and contracted out services).
- (v) Consistent with proposed way ahead on Civil Service pay.

B Effects on pay and Civil Service numbers

- (i) Running costs limits will govern amount department can spend on pay bill and other administrative expenses. No separate central pay assumption.
- (ii) Overall manpower controls will remain with published targets to 1.4.88. When running costs control working effectively, Government will review need for separate manpower control.
- (iii) No slackening of Government policies on pay. Continuing need for pay moderation in economy as whole. With inflation coming down, nominal settlements must come down faster. Where Government is direct employer it will look for reasonable and moderate settlements within

financial disciplines. Excessive settlements will still cost jobs. Additional points on wider implications attached.

C End of central pay assumption

- (i) Running costs limits, built up from departments' own estimates and negotiated with Treasury, will now determine cash available for wide range of administrative costs. New regime will be more effective than central pay assumptions which applied only to pay.

D Assumptions about future pay settlements in departmental running cost limits

- (i) Settlement with Treasury on limit concentrated on overall cash figure for running costs;
- (ii) department bid, on which settlement of limit based, a composite of a number of elements for pay, accommodation, external services and other administrative expenses;
- (iii) Necessary to make assumptions not only about increases in costs, of which pay rates one factor, but also about wide range of running cost elements - manpower numbers, grade mix, overtime, incremental drift etc.
- (iv) Important to stress that running costs limit is a single control total covering pay and other non-pay costs. Assumptions about pay rates only one factor in building up totals on which limits based.

DROPPING AN EXPLICIT PAY ASSUMPTION - KEY POINTS

Pay assumption never intended as a norm or entitlement, or to have wider meaning beyond being a necessary element of public expenditure planning. But came to be taken as signal of Government pay aims more widely.

In that respect has been useful. But usefulness running out; perceived differences between assumption and what people saw pay settlements to be actually damaging, as weakening force of the Government's message.

2. No change in Government's view on need for pay moderation in the economy as a whole. This is as strong as ever. Real earnings have been rising at 2 to 3 per cent per year, damaging employment. With inflation coming down nominal settlements must come down even faster.

3. So far as private sector goes, Government will maintain firm monetary and fiscal policies. No intention of bailing out companies who damage themselves and others through excessive settlements.

4. In the public services, where the Government is direct employer it will ensure moderate settlements; new running costs regime managerially more sensible and just as effective as pay assumption. For local authorities no intention of letting up on financial disciplines and penalties. Not a "victory" for public service unions who have campaigned for getting rid of the pay assumption; excessive settlements will still cost jobs.

5. Pay bargaining essentially a matter between employer and employee. But Government look to both sides to understand link between pay and jobs and act accordingly.