E(79) 17

COPY NO 56

CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

PAY: THE NEXT ROUND

Note by the Secretaries

The attached note by the Central Policy Review Staff is circulated for discussion by the Committee at its meeting on 9 July 1979.

Signed JOHN HUNT
P Le CHEMINANT
P MOUNTFIELD

Cabinet Office
5 July 1979

PAY: THE NEXT ROUND

Note by the Central Policy Review Staff

1. The Ministerial Committee on Economic Strategy intends to return to its discussion on the next pay round in the context of the following papers which have been commissioned:

(i) the possibility of a 'forum';

(ii) cash limits for central and local Government and the nationalised industries:

(iii) pay, prices and efficiency in the nationalised industries.

This present note by the CPRS looks at these issues in the context of the next pay round: and raises some of the practical questions which Ministers will have to deal with in the coming months.

Climate

2. It is difficult to judge at this stage the climate of the next pay round. Adverse factors include the following:

(i) The Government has forecast that the year-on-year inflation rate will be $17\frac{1}{2}$ per cent by November. After that the rate is forecast to fall but such a fall may seem more speculative.

(ii) Large public sector awards have been agreed and others will be emerging from the Clegg Commission. This may well raise expectations generally.

(iii) The cutback on public expenditure and public service manpower will add to union hostility.

(iv) The attitude of employers is ambivalent. Some will be prepared to pay up rather than face a strike.

3. On the other hand, some things are working in the Government's favour:

(i) There is a greater public awareness of the dangers of inflation, and of the futility of paying ourselves more than we earn.

(ii) The Government's monetary targets will help to dampen expectations. The trade-off with unemployment is now more widely appreciated. Unemployment may well be rising.

(iii) The unions are in some disarray and have forfeited public sympathy in recent months.

(iv) Substantial tax cuts will be coming through in October.

(v) There is likely to be some pressure on company liquidity and profitability. This is particularly in view of the world market prospect for those firms who rely on exports. The high exchange rate poses an additional problem for such exporting firms (and for those competing in the home market with imports). The threat of bankruptcy and redundancy may be a restraining influence.

4. It will be important for the Government to reinforce the favourable factors at every opportunity. This will require a continuous effort in public education. A 'forum' could be useful, though in the short run its effect is unlikely to be great. Equally important is for Ministers to ram home in speeches, and in discussion with both sides of industry -

(a) that there really has been a decisive break with past policies;

(b) that the Government is resolved to squeeze out inflation, if necessary at the expense of short-term unemployment;

(c) that individual earnings must depend on performance - not national wage rates or existing relativities;

(d) that only this approach will create the conditions in which li ing standards in this country (and employment) can start to rise more in line with those of other countries;

(e) that tax cuts are better than pay increases (they do not add to unit costs) <u>but we cannot have both</u>.

It is very important that these points should be kept continuously in the public eye. A campaign on these lines should be co-ordinated - perhaps by the Paymaster General.

<u>The Pay Round: General</u>

5. The Government will wish to avoid, so far as possible, setting a wage norm. Experience has shown that a norm becomes a floor, not a ceiling; and it does not allow for market conditions and variations in performance. In the absence of a norm, however, what can the unions be expected to aim for, on the most favourable assumptions?

6. It is possible that the unions will enter the next round believing that the Government will soon be forced into a pay freeze. This may not be a bad thing. It could mean that negotiators would be anxious to settle early, rather than stick out for the biggest gains. The most favourable outcome within the likely range would be for the unions to attempt merely 'to preserve the real value of their members' incomes intact'. But this would secure only a small reduction in the annual rate of inflation (depending on the rate of increase in productivity, the terms of trade, the exchange rate and perhaps income tax cuts not matched by offsetting increases in indirect taxes).

7. The reason why this apparently modest trades union objective (maintain real incomes for their members) means a continuance of rapid inflation is that on past experience 'maintaining real incomes' is equated with wages increasing at the previous year's rise in the retail price index. Anything less than this is regarded as accepting a fall in real income - even if there are good reasons for believing that next year's inflation rate will be less than last year. Squeezing inflation out of the economy over a period of two to three years will require acceptance of such a 'fall in real incomes'. At present we do not have means of determining that this will happen in the next pay round. Indeed we cannot be sure of making even modest progress. The remainder of this note seeks to identify some of the problems which will need to be tackled.

Private Sector

8. In the private sector the Government's strict monetary and fiscal stance will dampen expectations and reduce company liquidity. But some of the problems are bound to remain and now is the time to consider the Government's response. For example:

(i) One of the earliest negotiations will be Fords, who may be able to meet large pay increases, despite continued overmanning (multi-nationals can, if they wish, escape the domestic monetary squeeze). Up till now, the Ford settlement has set the pace for British Leyland. But certainly the volume car side of British Leyland cannot afford to pay Fords wage rates, and maintain its investment, without Government support. Has the time come to withhold this support, and what would be the consequences? How can the management and unions be persuaded that the Government will not in the last resort again come to the rescue?

(ii) Another early settler is the British Oxygen Company, which has much of British industry in a stranglehold. Can a large settlement here be prevented from setting the pace for other negotiations? Again, this raises questions of publicity and public education.

(iii) Other obvious candidates for high settlements are road haulage (the employers will not want to risk another dispute), tanker drivers and refinery workers.

9. The logic of free collective bargaining should be pursued as far as possible. Major variations in pay settlement from area to area and from company to company must be allowed to develop. The Government should not step in to help those who settle at rates they cannot afford. But there could be a good deal of disruption in parts of industry, and our contingency plans should be made as ready and as effective as possible. Can employers be helped to withstand strikes? What emergency and voluntary support could be mobilised? These questions need to be examined urgently by the Departments concerned.

Public Services

10. The Clegg awards are meant to correct the anomalies in the current round: it is important that they should not be allowed to affect the climate of the next.

11. If the most serious anomalies are eliminated by Clegg, it may not be too much to hope that there will be relatively few public service pay disputes in the next round. However, the problems will not disappear altogether. The groups involved will want their awards topped up by something approaching the 'going rate', and the Government, as principal paymaster, has to take a view on what it will afford.

Local Government

12. The first major problem arises in October/November when the level of rate support grant must be settled for local authorities. This will necessarily include some allowance for pay increases. The Government cannot avoid giving a fairly clear indication about the level of pay settlements which it thinks employing local authorities could reasonably concede.

13. Local authorities will, of course, already be under considerable pressure to reduce their expenditure programmes. The further cuts envisaged as part of the public expenditure review can be thought of as the counterpart to the gradual reduction in the money supply targets affecting the private sector. In these circumstances the aim should be to allow for cash limits which are tight, but realistic. One possibility might be to take the estimated inflation rate minus Budget-induced price increases for which compensation has already been received through tax cuts. This would preserve real income.

Central Government

14. Cash limits for central Government services (including the National Health Service) do not have to be set until February when the Parliamentary estimates are prepared. However, if the Government wished to reinforce

Private Sector

8. In the private sector the Government's strict monetary and fiscal stance will dampen expectations and reduce company liquidity. But some of the problems are bound to remain and now is the time to consider the Government's response. For example:

(i) One of the earliest negotiations will be Fords, who may be able to meet large pay increases, despite continued overmanning (multi-nationals can, if they wish, escape the domestic monetary squeeze). Up till now, the Ford settlement has set the pace for British Leyland. But certainly the volume car side of British Leyland cannot afford to pay Fords wage rates, and maintain its investment, without Government support. Has the time come to withhold this support, and what would be the consequences? How can the management and unions be persuaded that the Government will not in the last resort again come to the rescue?

(ii) Another early settler is the British Oxygen Company, which has much of British industry in a stranglehold. Can a large settlement here be prevented from setting the pace for other negotiations? Again, this raises questions of publicity and public education.

(iii) Other obvious candidates for high settlements are road haulage (the employers will not want to risk another dispute), tanker drivers and refinery workers.

9. The logic of free collective bargaining should be pursued as far as possible. Major variations in pay settlement from area to area and from company to company must be allowed to develop. The Government should not step in to help those who settle at rates they cannot afford. But there could be a good deal of disruption in parts of industry, and our contingency plans should be made as ready and as effective as possible. Can employers be helped to withstand strikes? What emergency and voluntary support could be mobilised? These questions need to be examined urgently by the Departments concerned.

CONFIDENTIAL

Public Services

10. The Clegg awards are meant to correct the anomalies in the current round: it is important that they should not be allowed to affect the climate of the next.

11. If the most serious anomalies are eliminated by Clegg, it may not be too much to hope that there will be relatively few public service pay disputes in the next round. However, the problems will not disappear altogether. The groups involved will want their awards topped up by something approaching the 'going rate', and the Government, as principal paymaster, has to take a view on what it will afford.

Local Government

12. The first major problem arises in October/November when the level of rate support grant must be settled for local authorities. This will necessarily include some allowance for pay increases. The Government cannot avoid giving a fairly clear indication about the level of pay settlements which it thinks employing local authorities could reasonably concede.

13. Local authorities will, of course, already be under considerable pressure to reduce their expenditure programmes. The further cuts envisaged as part of the public expenditure review can be thought of as the counterpart to the gradual reduction in the money supply targets affecting the private sector. In these circumstances the aim should be to allow for cash limits which are tight, but realistic. One possibility might be to take the estimated inflation rate minus Budget-induced price increases for which compensation has already been received through tax cuts. This would preserve real income.

Central Government

14. Cash limits for central Government services (including the National Health Service) do not have to be set until February when the Parliamentary estimates are prepared. However, if the Government wished to reinforce

the formula applying to the Rate Support Grant, it could take an earlier and public decision that these cash limits would be based on the same formula. This is, of course, setting a norm for the public services, but in the view of the CPRS, this is at some stage unavoidable.

15. A decision will also be needed on whether the Clegg Commission is to continue, once its current work is completed. This will depend, to some extent, on its early performance: but the CPRS believes that a system of periodic references to the Commission, or something like it, may well be the best way of preserving a reasonable balance between the public services (for whom there is no market determined rate) and other groups.

Nationalised Industries

16. Some of the most difficult pay problems are likely to arise in the public trading sector. When these industries and services are subject to market competition (e.g. British Airways) it may be possible to treat them more or less like the private sector. But -

(a) some have monopoly power (e.g. British Gas, CEGB) and are able to increase prices to meet 'excessive' wage settlements without a significant loss of market sales;

(b) some are highly capital intensive (e.g. CEGB, telecommunications) and the wages bill represents a small proportion of total costs;

(c) some have a declining unit cost technology and can afford large increases (e.g. telecommunications);

(d) some are loss makers (e.g. British Rail, British Steel) to which the Government is committed to maintain some form of subsidy.

17. With such differing circumstances it is unrealistic to look for a single, common approach on pay. But it is worth considering whether there are any underlying principles which should be taken into account in judging each case separately. These might be as follows:

(i) Comparability as such should <u>not</u> be adopted for the public trading sector.

(ii) Less weight should be given than in the past to comparisons with other groups, to past relativities, etc.

(iii) Wage bargaining should be influenced by demand and supply of labour in the industry (and in the area); and should take into account manning levels.

(iv) It should take account of productivity (or profitability where appropriate).

(v) Wage settlements should not be at the expense of essential investment.

18. The extent to which nationalised industries can be allowed to negotiate their own settlements varies with their individual circumstances. For the most part, as with the public services, the Government will have to take a broad view about what is appropriate. The elements from which the Government might construct its pay policy in the nationalised industry field are -

(a) some idea about the average out-turn for the round (fortunately the main nationalised industry settlements do not take place until the Spring);

(b) cash limits on borrowing;

(c) financial targets; and

(d) control of prices and investment.

19. The question is to what extent these elements can be adjusted to meet the varying circumstances of the different industries. It is possible to think of the Government keeping out of individual negotiations; setting (b), (c) and (d) so as to circumscribe what the industries can afford; and to do so in such a way as to take some account of the 'going rate' and of the

the formula applying to the Rate Support Grant, it could take an earlier and public decision that these cash limits would be based on the same formula. This is, of course, setting a norm for the public services, but in the view of the CPRS, this is at some stage unavoidable.

15. A decision will also be needed on whether the Clegg Commission is to continue, once its current work is completed. This will depend, to some extent, on its early performance: but the CPRS believes that a system of periodic references to the Commission, or something like it, may well be the best way of preserving a reasonable balance between the public services (for whom there is no market determined rate) and other groups.

Nationalised Industries

16. Some of the most difficult pay problems are likely to arise in the public trading sector. When these industries and services are subject to market competition (e.g. British Airways) it may be possible to treat them more or less like the private sector. But -

(a) some have monopoly power (e.g. British Gas, CEGB) and are able to increase prices to meet 'excessive' wage settlements without a significant loss of market sales;

(b) some are highly capital intensive (e.g. CEGB, telecommunications) and the wages bill represents a small proportion of total costs;

(c) some have a declining unit cost technology and can afford large increases (e.g. telecommunications);

(d) some are loss makers (e.g. British Rail, British Steel) to which the Government is committed to maintain some form of subsidy.

17. With such differing circumstances it is unrealistic to look for a single, common approach on pay. But it is worth considering whether there are any underlying principles which should be taken into account in judging each case separately. These might be as follows:

(i) Comparability as such should not be adopted for the public trading sector.

(ii) Less weight should be given than in the past to comparisons with other groups, to past relativities, etc.

(iii) Wage bargaining should be influenced by demand and supply of labour in the industry (and in the area); and should take into account manning levels.

(iv) It should take account of productivity (or profitability where appropriate).

(v) Wage settlements should not be at the expense of essential investment.

18. The extent to which nationalised industries can be allowed to negotiate their own settlements varies with their individual circumstances. For the most part, as with the public services, the Government will have to take a broad view about what is appropriate. The elements from which the Government might construct its pay policy in the nationalised industry field are -

(a) some idea about the average out-turn for the round (fortunately the main nationalised industry settlements do not take place until the Spring);

(b) cash limits on borrowing;

(c) financial targets; and

(d) control of prices and investment.

19. The question is to what extent these elements can be adjusted to meet the varying circumstances of the different industries. It is possible to think of the Government keeping out of individual negotiations; setting (b), (c) and (d) so as to circumscribe what the industries can afford; and to do so in such a way as to take some account of the 'going rate' and of the

underlying principles in paragraph 18. But the margins of error would be substantial and the effects uncertain. Also if there is a strike in an essential service, it is difficult for the Government to stand aloof for long. It is therefore likely that the Government will be drawn, however reluctantly, more directly into the negotiations.

Conclusion

20. It would be foolish to think that the Government can prepare itself for every eventuality in the coming wage round. But some preparation is possible and it is important to settle the general approach.

21. There are some things working in the Government's favour and the unions may want to avoid confrontation. It will be important to reinforce the favourable factors by a co-ordinated campaign of public education, of which a 'forum' would be only a part.

22. It will be possible, at best, to secure only a gradual fall in the rate of inflation. Even this will be difficult.

23. In the private sector the policy will rest on tight monetary policy and a squeeze on liquidity. Much greater variations in pay must be expected from company to company and from area to area. As far as possible, problem points should be identified well in advance.

25. In the public service the Government will need to build an allowance into cash limits - perhaps based on estimated inflation minus Budget-induced price rises.

25. Similarly for the nationalised industries, though the allowance should, so far as possible, pay some regard to market factors and the performance of the industry. Some direct Government intervention will probably be unavoidable.