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28/11

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Leon Brittan QC MP
Secretary of State
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1E 6RB

26th November 1985

Dear Leon,

PAY IN THE PUBLIC TRADING SECTOR

As usual at this time of year, I am writing about the approach we should take to pay in the public trading sector.

Settlements in the 1984-85 pay round were generally too high. In the economy as a whole, they were slightly up on the average level of a year earlier. The underlying rate of growth in average earnings, which had been stubbornly fixed as an annual rate of increase of 7½ per cent for some time, edged up to 7¾ per cent in September this year, reflecting settlements in the previous 12 months. Unit wage and salary costs have been growing at about 5 per cent a year, while those of our major overseas competitors have been stable or falling.

Moderate pay settlements are essential for the continuing success of our economic strategy. In the private sector, they are vital to improving our cost competitiveness. In public trading, they allow lower prices and greater investment within the financial constraints which apply to the nationalised industries. In the public services, they mean a higher level of service can be delivered without increasing public expenditure. In all three sectors, pay moderation is linked to employment. High pay settlements mean fewer jobs.

In principle, the prospects for lower settlements in the new pay round should be encouraging. Following its "blip" earlier this year, RPI inflation has been falling and is set to fall further over the coming months reaching under 4 per cent in the last quarter of 1986. On average, those in work are better off than they have ever been. And although company profitability is at a healthier level now than a few years ago, it is still not high by international standards. Despite all this, however, the prospects for pay are worrying. We need to do much more to hammer the pay message home.

First, we must continue to do all we can to encourage employers and employees in the private sector to show moderation on pay. The CBI conference has rightly emphasised
... the importance of this and we need to do the same. I attach to this letter some speaking notes which I hope colleagues will draw upon in their informal contacts with both sides
... of industry as well as in speeches. Also attached for convenience are the key points about the pay aspects of the move to running costs which I circulated to colleagues with my letter of 14 October.

Second, in the public sector, it is important that we continue to impress upon the chairmen of public corporations the further need for pay restraint. Every 1 per cent extra on the paybill of public corporations adds about £125 million per year to their costs. EFLs, financial targets and performance aims do impose pressures upon the industries but we must ensure as far as we can that unexpected improvements in trading conditions or reductions in investment do not feed through into increases in pay. Nor should pay increases be allowed to feed through into higher prices or reduced investment. Within our agreed spending plan our priorities are cost reductions which can be passed on to customers and worthwhile investments. Excessive pay awards will jeopardise these objectives, put pressure on public expenditure and encourage high settlements elsewhere. We need to bring this home to the chairmen.

Similarly there is a need for moderation in pay increases for nationalised industry board members to avoid giving the wrong signals. We should remind the chairmen of the campaign which the CBI, to which several nationalised industries belong, are conducting and press them to back it by aiming at a 2 per cent reduction in nationalised industry settlements compared with last year.

I hope colleagues in charge of departments sponsoring public corporations will make these points to the chairmen when reminding them of their undertaking to keep Ministers in touch with their pay negotiations and to give the Government 7 days notice of firm offers. As in previous years I would like notice of all initial offers and of cases where a previous negotiating ceiling is to be exceeded. I leave it to colleagues to judge the timing of each approach but I would be grateful to learn of the outcome in each case.

Finally there are the public services. Next year's running cost targets and the RSG Settlement, of course, include some margin for pay increases. But the public service paybill is over £40 billion per year, so every 1 per cent increase above the levels we have been envisaging would add over £400 million to that paybill. Clearly excessive pay settlements here, as well as giving unfortunate signals to the rest of the economy, would constitute a direct threat to the priorities we have set within the Autumn Statement public expenditure totals. We have taken the opportunity of last week's meeting with LACSAB to urge on the local authorities the need for pay moderation if jobs are not to be lost and rates are not to rise. When

And take ~~total~~ amount of ~~public~~ services to the public the Government is the direct employer, we will obviously be looking for moderation in settlements. But our chances of succeeding are obviously very much reduced if there are higher average pay settlements in the private and nationalised industry sectors.

I am copying this letter to the Prime Minister, other members of E(PSP), to the Secretaries of State for Scotland, Wales and Northern Ireland and to Sir Robert Armstrong.

Yours ever,

JM

JOHN MacGREGOR

SPEAKING NOTES ON PAY

Pay-Jobs Link

- Pay-jobs link is obvious common sense.

1a - Higher pay settlements, not matched by productivity, mean costs go up. It is less profitable to employ labour and so fewer jobs provided.

b - High unemployment is partly the result of paying ourselves more than the value of what we produce.

- Yet trades unions continue to demand higher wages and shed crocodile tears about lost jobs.

- The remedy is in their hands. A reduction in the rate of increase in pay would create more jobs that would last in the long-term than any of the half baked proposals for reflation made by the unions.

- Government is not arguing for pay cuts, simply a moderation in the rate of increase.

Competitors Competitors.

1(c) A - In the last pay round underlying earnings growth was 7½ per cent, underlying productivity growth was 2½ per cent. Result: unit labour costs rose 5 per cent. And, at a time when our major competitors have secured constant unit labour costs, this means lost jobs.

- We must do better, both on earnings and productivity.

- Lower earnings growth would mean companies buying and selling more, higher exports, fewer imports, and therefore more jobs.

- Contrast between UK and USA very instructive. Real wages in USA have fallen in recent years, while at the same time employment has increased. Exact reverse of UK situation.

Inflation

Inflation

-Prospects for inflation very good.

-After reaching a peak of 7 per cent in the middle of the year, it is now on a firm downward trend. Having already fallen below 5½ per cent inflation is expected to fall below 4 per cent by the end of nex year.

-Negotiators should take account of this declining trend.

Take-home Pay

-Those at work have done very well in recent years. Average earnings have been increasing at about 3 per cent more than prices in the last few years. Take-home pay has been increased further by income tax cuts. Real take-home pay of someone on average earnings is 12 per cent or so higher than in 1979.

-These high increases have kept the unemployed out of work. It is the unemployed who are paying the price of excessive pay settlements.

What settlements does the Government want

-Up to employers and employees in the private sector to decide what pay should be, not Government.

-CBI has called for settlements at least 2 per cent lower than in last pay round.

-If this were achieved, it would lead in time to between 200,000 and 400,000 more jobs.

Government attitude towards pay

-Private sector determines pay.

-Incomes policies do not work; they only produce rigidities in the labour market which sow the seeds of their own destruction.

- Government hopes private sector bargainers will be sensible and will realise the relationship between pay and jobs.

- Government's monetary and fiscal policy sets the framework for sustained non-inflationary growth. This framework will not be abandoned in order to bail out excessive wage settlements: to do so would trigger off inflation, which destroys jobs.

- Government has made clear that an unchanged monetary and fiscal framework means that slower growth in earnings creates more room for increased output and employment.

Company claims that they can afford high wage increases

- Profits in UK companies low by international standards.

- Lower profits means lower output, lower investment and therefore fewer jobs.

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.