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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

PAY IN THE COMING YEAR

Note by the Chancellor of the Exchequer

The level of pay settlements is now averaging just under 10 per cent in both public and private sectors. This represents approximately a halving of the rate of increase up to last summer. The averages conceal wide dispersions, and the concept of a 'pay round' is in any case artificial. But a pattern has emerged over the past year of settlements lower than in the previous year. It is now time to ask what are the prospects for the coming year (broadly coincident with the next session of Parliament) and what the Government can do to improve them and so help to restore competitiveness, enable people to be priced back into jobs and hold back the increase in public expenditure.

2. This note is in three sections:-
  - A. The past year;
  - B. Aims and expectations for the year ahead;
  - C. Action required by the Government.

- A. The past year (August 1980 - July 1981)
  - (i) Developments

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3. After an average rise in earnings of 22 per cent in 1979-80, the period began with minor settlements of about 14 per cent or 15 per cent, though there was a wide scatter and no clear "going rate". Thereafter the trend came down sharply, helped by low settlements at Vauxhalls (8.4 per cent) and British Leyland (6.8 per cent) and by the agreement on minimum rates for engineering workers (8.2 per cent). By October, the average rate of settlements was around 10 per cent.

4. On 24 November 1980, after some public indications of the direction the Government was going, it was announced that the pay factor for the RSG cash limit in 1981-82 would be 6 per cent and the non-pay factor 11 per cent, and that broadly similar financial disciplines would apply elsewhere in the public services. After the early setback of the firemen's 18 per cent, the local authority manuals settled unexpectedly quickly for 7½ per cent; and this was eventually followed by school and university teachers and NHS ancillaries at comparable or lower levels. The Civil Service and most NHS grades, however, have yet to settle.

5. The public trading sector has divided into two broad groups. The pace for the monopoly utilities has been set by the miners' settlement of 1 January 1981; this produced an earnings increase of 9.8 per cent, but it ran for only ten months and was widely regarded as worth about 13 per cent. This was broadly the subsequent level in water, gas and electricity. Other industries have settled at lower levels, down to 5 per cent in the case of the National Freight Corporation.

6. Overall, the average level of settlements in the period so far is just under 9 per cent (public trading sector just under 10 per cent, public services 8½ per cent, private manufacturing just over 9 per cent, private non-manufacturing just under 9 per cent though some important groups have yet to settle). Settlements in the private sector have covered a wide range - from little or nothing to as much as 15 per cent.

(ii) Likely outcome for 1980-81 as a whole

7. By the third quarter of 1981 it is likely that average earnings, allowing for drift, will be perhaps 10 per cent higher than a year earlier; retail prices up 11 per cent; and the tax and price index, perhaps 14 per cent. This implies a fall in average real take-home pay of up to 5 per cent over a year earlier, partly as a consequence of tax and National Insurance changes, partly because of the level of wage settlements being rather below the rate of inflation. This fall in real take-home pay follows a 12 per cent rise over the three years to 1980.

(iii) Lessons to be learnt

8. The halving of the rate of increase (both settlements and total earnings) compared with the previous year, was no doubt the result of a combination of economic factors and other influences on expectations. Monetary policy was acting as a national cash limit and contributing to the maintenance of a high real exchange rate, while the effects on costs and profits from previous excessive pay increases were still coming through. The rise in unemployment in the year to April 1981 was over a million, which will have weakened pressure to maintain real take-home pay. The exchange rate and the squeeze on margins helped to curb price increases more sharply than expected so that the prospective loss of purchasing power did not immediately occur. The rapid deceleration of pay increases in the public services may also have influenced the private sector result. The efforts of the Government and CBI in the summer and autumn of 1980 did much to create a public belief that (a) such a change could occur and (b) that the Government was determined to promote it.

9. The following points emerge:-

- (a) A substantial change in the level of settlements can occur with the first big clutch of settlements in the autumn. While those settlements are not decisive for the subsequent year, the possibility of getting them down from earlier levels is an opportunity to be grasped.

- (b) It has been demonstrated that such a downward change can occur in the absence of a specific incomes policy and that settlements are not necessarily determined by the year-on-year RPI figures.
- (c) Although the Government has been successful in getting reasonable settlements accepted in the public services (subject to the outcome of the Civil Service dispute), the monopoly nationalised industries remain a major problem with a tendency to be well above the average.

#### B. Aims and expectations for the year ahead

##### (i) Policy aims

10. What general level of pay settlements is it desirable to aim for in 1981-82? One approach is to start from the monetary target (likely to be in the region of 7 per cent next year) and see what that implies in terms of the growth of money GDP (say 8 per cent - 9 per cent). This constitutes a sort of national cash limit, combining both real growth and price changes. Unless there is a better outcome than in the recent past cost and price increases will erode almost all the scope for real growth. On the other hand, lower wage increases associated within the national cash limit with an improvement in profits - would, after a short time lag, permit higher output and enable people to be priced back into employment.

11. One can also look at competitiveness. The loss of competitiveness in manufacturing in the last three years (1978-1981), as a result of movements in the exchange rate on the one hand and relative unit labour costs on the other, is of the order of 60 per cent. A huge reduction in labour costs (not just a reduction in the rate of increase) would be needed to restore a significant part of the competitiveness lost over recent years.

12. The conclusion is that pay increases need to be well below the rate of price inflation for two years or so in order to give the economy the best chance of substantial revival. The need to reduce relative costs in the public sector is also important.

13. Recent experience shows that it is possible to see ten percentage points knocked off the rate of pay increases in a year. If such a thing were to happen again it would imply zero average increases, and therefore in very many cases actual cuts in money wages. If that cannot be regarded as realistic, can we envisage halving the rate of increase of earnings, i.e. an average of less than 5 per cent, including increases obtained by higher productivity? This would imply zero pay-increases in some cases. Any implied fall in real take-home pay would depend also on the behaviour of prices and on budgetary decisions next Spring; but should be less than over the previous year. The CBI are working towards an objective of this kind.

##### (ii) Prospects

14. Pay settlements will continue to be affected by the tight profit and cash position of many companies, the high level of unemployment and the declining rate of price inflation. Some early private sector settlements (Vauxhalls, BL, Fords, Road Haulage and the National Engineering Agreement) are in sectors under continuing financial pressure.

15. On the other hand the reduction in real take-home pay may stiffen wage claims; company profitability may be recovering, and, while unemployment will be rising and price rises declining, both will be occurring more slowly than in the 1980-81 round. Moreover the police settlement in September (linked to average earnings) will appear high; political changes in local authorities will make their actions unpredictable; and the tone for the Nationalised Industries will again be set by the settlement for the miners (now advanced to 1 November 1981).

16. In the light of all this, a wide range of outcomes is possible. But the assessment reflected in the assumptions for the FSBR and MTF5 is for wage settlements averaging no more than 6 per cent (earnings 7 per cent). On this sort of basis there would be no further fall in real take-home pay (assuming tax allowances and rates are adjusted for inflation in the 1982 Budget).

C. Action required by the Government(i) Public presentation of objective

17. There needs to be an early opening up of the case for getting pay settlements down and creation of expectation that this is possible and that the Government will play its part. Although the Government has used a 6 per cent factor for pay in the coming year (for setting cash limits in the current financial year where the pay and financial years do not coincide), this was expressly stated to be provisional. The new 7 per cent general price/pay factor for use in the public expenditure survey has rightly been seen as indicating lower rates for pay alone, and the assumed further deceleration in later years has been noted. When things are next said in public, we should try to lead opinion in the direction of low single figures (implying an average nearer to zero than to ten), and the maximum coverage of any increases by productivity improvement.

18. This carries the danger of confusion with an explicit pay policy. It is important, therefore, that the task of setting the scene, in which the level of expectations steadily falls, is shared by others.

19. Deceleration in the past year owes something to the CBI's conferences with employers in the middle of 1980 and speeches by Sir Raymond Pennock. They are planning similar conferences on 18 and 25 June this year. If they achieve consensus, as they hope to do, on the sort of objective in paragraph 13, this could form the basis of a valuable campaign, as last year.

20. A plan therefore needs to be prepared for getting this message disseminated on the broadest front, through government, the NEDC if possible, and other channels. The theme would be the need to allow the economy to grow within the national cash limit.

(ii) Public services

21. The Government's approach to cash limits has had a stiffening effect in the current round. The Lord President's assurance to the Civil Service unions that the Government will next year enter

negotiations without a predetermined cash limit must not now be taken as indicating a more relaxed attitude. On the contrary, comparisons with average private sector trends will remain inappropriate so long as the level of private sector pay deals implies more unemployment. And, if we do see a lead towards lower settlements coming from the private sector, it is vital that the public sector reinforces it with disciplines at least as strong. Spending authorities must be encouraged to squeeze pay so as to get the best outcome in terms of volume. If the aim is to finish up at less than 5 per cent, starting points will need to be very low indeed to allow room for negotiation. A method of handling this will have to be worked out; the best context is probably the Ministerial Committee on Public Services Pay.

(iii) Nationalised industries

22. The nationalised industries, especially those with monopoly power, pose exceptional difficulties, in the light of their above-average settlements, the concessions made to the miners and the strategic advancement of the miners' settlement date by two months. Financial pressure is not holding down labour costs as in the private sector (or even the public services). The bargaining positions of the unions are strong, and preventive measures (eg coal stockpiling) difficult to take on a significant scale. Nationalised industry settlements are highly visible and influential.

23. A plan is therefore needed for handling critical issues as they arise in the next nine months. The Official Committee on Nationalised Industry Policy (NIP) could provide an umbrella for work on this.

Conclusion

24. Further deceleration of pay increases is vital. If competitiveness is to be restored reasonably quickly - after years of increases that were far too high - then there should theoretically be no increases at all, even in money terms. A programme of action should be worked out, including the following elements:-

- (a) Public opinion needs to be conditioned to increases

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substantially lower than in the current round. Without suggesting a norm, opinion should be focussed on "low single figures", as necessary to allow the economy to grow. This implies work by officials to prepare for:

- (i) a sequence of Ministerial speeches;
- (ii) liaison with CBI;
- (iii) other forms of publicity to emphasise the consequences, especially for employment, of failing to achieve a further deceleration.

(b) A plan for handling public service pay negotiations in the next round, including the timing and nature of statements about cash limits; this might be handled by the Ministerial Committee on Public Service Pay.

(c) A review by officials of the prospects for pay settlements in the nationalised industries and the means available for influencing them.

(G.H.)

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