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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

PAY IN THE COMING YEAR

Note by the Chancellor of the Exchequer

Objectives

We now need to consider our approach to pay in the coming year, from the autumn through to the summer of 1983. I start from the assumption that our economic priorities must continue to be a further reduction in the rate of inflation and the reversal of the upward trend in unemployment.

2. These priorities both call for a further deceleration in earnings growth over the coming year, to continue the downward trend of the past two years. As a minimum we should look for a reduction in the growth of nominal earnings in line with the prospective rate of inflation. If we are to do anything of what is necessary towards re-building profits from their present low point, then we should be seeking to do better than this and to secure at least some reduction in real earnings. The 12-month rate of price increase is expected to come down to $7\frac{1}{2}$ per cent or less by the middle of next year. To get earnings rising by significantly less than prices over the coming year would require growth of not more than, say, 6 per cent. Allowing for drift* settlements of little more than 4 per cent on average would therefore be needed.

Background and prospects

3. During our first year in office, between the summer of 1979 and the summer of 1980, earnings increased by over 20 per cent. But in the next year, to mid-1981, the growth was halved to just over 10 per cent, with settlements averaging $8\frac{1}{2}$ per cent. This sharp fall reflected the competitive and financial pressures on firms resulting not least from earlier pay increases, and the associated fast rise in unemployment.

* Attributable to factors such as understatement of settlements, topping up at plant level, productivity schemes, and changes in the structure of employment and in hours worked.

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4. In the past year there has been some further fall in the level of settlements, but no spectacular change. Settlements are likely to average 7 per cent, and the earnings increase around 9 per cent. The 4 per cent pay factor for the public services (although of course not followed precisely) was taken to some extent as a signal by others and therefore exerted some downward influence, as the 6 per cent factor did in the previous year. The modest size of the fall can perhaps be explained by the smaller fall in inflation than over the previous year, the slightly less acute company sector situation, and probably the less rapid rise in unemployment. But, more simply, the more we get the average rate of increase down, the harder it is to go further. As a matter of fact, average earnings have not, in real terms, declined over the past two years. And despite a significant improvement during 1981, UK unit labour costs are likely to be still over 30 per cent higher than our competitors' compared with three years ago.

5. This fact itself should make for some moderation on pay, at least in the private sector. So will the declining rate of inflation, the low level of profitability (despite some recent improvements), and the high level of unemployment. But equally, we face some of the problems inherent in any situation where nominal pay increases have decelerated for a substantial period. There will be a feeling, however unjustified, that living standards have suffered, and a desire to make up lost ground. And some of the fruits of restraint, such as the slower growth of unemployment and the modest recovery in profits, may themselves tend to remove some of the constraints on higher pay. Thus a further reduction in the rate of increase in nominal pay, will be difficult though not impossible to achieve.

The Government's message

6. We need to stress the following aspects of the situation:

- (a) Compared with 1979, unit labour costs in the UK are probably still over 30 per cent higher than elsewhere;
- (b) In the United States, Germany and Japan, average earnings growth looks like coming down to about 6 per cent in 1982 and staying there in 1983 (implying still lower settlements);
- (c) Lower pay increases ultimately mean lower unemployment, and higher real incomes in total (with more people employed): indeed if people were truly concerned about unemployment they would not be thinking in terms of pay increases at all;
- (d) Falling pay settlements have not meant a fall in real earnings over the past two years, because inflation has declined. That decline is continuing, and low settlements will therefore have much less effect on living standards than might be thought;

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- (e) Employers for their part have no escape from moderation of wage costs if they are to generate the much needed increases in profits.
- (f) Taxpayers and ratepayers, who have to meet the bill for public sector pay, also have a very direct interest in pay moderation.

Pitfalls to avoid are:-

- 7. (a) Talk of a reduction in living standards. This would not help if, as is likely after two years of lower settlements, it rallied opposition to a further fall;
- (b) Any focus on the level of RPI increases as a benchmark for settlements. The decline in the rate of increase is the point to stress.
- (c) Mention of specific target figures or norms, which are intended as averages but in fact become minima.

8. In sum, the message is the simple one that we need lower - and substantially lower - settlements than in the past year.

Getting the message across

9. But the right message will be of no use unless we convey it effectively and in the right way. This will require a co-ordinated and sustained effort by both economic and non-economic Ministers, both inside and outside Parliament. I suggest that officials should urgently prepare a programme for action between now and the summer recess. I am myself intending to open up the subject with a speech to the Industrial and Labour Correspondents Group on 6 July, drawing on the themes in paragraph 6 above.

10. We will also need to involve the CBI and other employers' organisations. The message which they convey to their members can be very important in setting the tone, particularly but not only in the private sector. Present indications are that while they share the general appreciation of the situation which is set out here, some at least of their members may be thinking of easing up on pay rather than maintaining strong downward progress. This is an attitude which we need to counter. The Chief Secretary and I have already been in contact with the CBI. Further contacts are a matter of urgency, since their consultative pay conferences with their members are already in progress. We need to influence the guidance which they formulate in the light of those conferences, and the public position which they take.

The public services

11. Besides what we say, there is also the question of what the Government does. This centres on our approach to public service

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pay in the coming year. The 6 and 4 per cent pay factors which we have published in the last two years respectively have undoubtedly played a useful part in moderating the rate of increase in pay in the economy generally, as well as in the public services. But their direct impact has been in the public services, where they have held back pay more than elsewhere (except for the police, the firemen and the armed forces). Coupled with less drift in the public services, this has meant that while earnings of the remaining public service groups have on average increased by more than 15 per cent, over the past two years, earnings in the whole economy have probably increased by more than 20 per cent. We can expect pressure to make up the lost ground in the coming year.

12. Against this background we shall need to decide whether we wish to use public service pay in order to give a lead to the rest of the economy. Since most public service settlements will not be due until the spring of 1983, this is partly a question of whether we give an early signal of our intentions as we did with the 6 and 4 per cent pay factors. We need to balance the risk of confrontation in the public services against the wider and beneficial effect on expectations. I do not seek a decision now on whether there should be a pay factor, let alone on what it should be. This is not urgent, and I will be bringing forward proposals in due course. But whatever our decision on the pay factor issue is, I am sure we need to be able to explain our policy towards public service pay in a way which reinforces our general message on pay throughout the economy.

13. Also relevant to public service pay will be the Megaw Report; our eventual decisions on the follow-up to the Scott Report on index linked pensions; and the question of longer-term arrangements for nurses' pay.

The public trading sector

14. The nationalised industries, and the public trading sector as a whole, raise a number of special issues. Some of the industries are monopolies, and in others labour is only a relatively small proportion of total costs. In both cases pay will be less constrained financially than in the public services. For the past year settlements in the public trading sector are likely to average $7\frac{1}{2}$ per cent, with earnings rising by around 10 per cent. But the nationalised industries (and some in particular) have a major influence on the general level of settlements. We therefore need the clearest possible understandings with the Chairmen on pay strategy, in the wake of the Investment and Financing Review, and on keeping the Government informed of developments as the year proceeds. My separate paper (E(82)54) goes into this in more detail.

15. Finally, the Secretary of State for the Environment has suggested (in his minute of 27 May) that we should offer to increase investment in the nation's roads, schools, hospitals, houses etc,

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to the extent of perhaps £1 billion, in return for continuing pay restraint. The Prime Minister has asked that we discuss this proposal at this meeting. After giving sympathetic attention to earlier versions of this attractive idea, I remain very doubtful whether such a scheme could be made to work successfully, and I hope that the Secretary of State for the Environment can explain his proposals in more detail.

CONCLUSIONS

16. I draw the following conclusions:

- (a) We need a further substantial reduction in the level of pay settlements in the coming year, to give a reduction in real earnings. I do not propose that we adopt any public target, but for our own purposes I suggest that we have in mind settlements of perhaps 4 per cent on average, to give an overall earnings growth of no more than 6 per cent.
- (b) As regards our public stance I suggest that we argue for a substantially lower level of settlements than in the past year, using the points in paragraph 6 above.
- (c) Officials should be asked to draw up a programme which will enable the message to be adequately put across. Besides our own efforts, we will have to involve the CBI and others.
- (d) We will need to determine an approach to public service pay which strongly reinforces our general message. I will be bringing forward proposals shortly on pay in the context of cash expenditure planning, including the pay factor question.
- (e) Nationalised industry pay will be crucial. I do not suggest that we change our basic approach, but we will need to set tight EFLs, and keep in close touch with the Chairmen both on strategy and tactics in the coming year.

G.H.

H.M. TREASURY
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