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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

INFLUENCING NATIONAL PAY BEHAVIOUR

Memorandum by the Chancellor of the Exchequer

We have agreed on the need for a campaign of public education designed to bring home economic realities as they affect pay bargaining. We must get on with this urgently, and in doing so I believe we shall have to make some use of figures.

2. Although there has been quite a wide variety in the level of settlements over the last year, there has still been a tendency for some kind of going rate to emerge. The range of expectations for settlements has, at least until recently, been in the upper teens, with total earnings some 3 per cent above this as a result of 'wage drift'. Clearly we cannot afford to move into the autumn with expectations still hovering at around this level. Settlements of say 12 per cent or 13 per cent would then be regarded as low and 15 per cent or 16 per cent considered satisfactory. We have to create a climate in which the figures to which people's minds naturally move are distinctly lower than this, bearing in mind that the growth of earnings always exceeds settlement levels by several percentage points.

3. In using figures to support our case we must avoid giving the impression of setting a norm. In countries which have been more successful in dealing with inflation, such as Germany, there is no norm; but there is a range of influences on employer and employee behaviour which help keep expectations within a range which is compatible with the Government's inflation objectives. We too must therefore avoid concentrating attention on a single figure which all pay bargainers would seek to 'beat', and instead use a variety of arguments, often tending towards different figures, but all to low ones. And there is much to be said for pointing to the consequences of certain figures, especially in terms of unemployment, rather than recommending them on behalf of the Government.

4. Whatever figure or range of figures we may use will of course have an important bearing on the level at which cash limits for the public services for 1981-82 will be set, although I do not propose that we should set them just yet.

The consequences of excessive settlements

5. Unemployment is now rising rapidly and this is, in part, a consequence of the excessive pay increases we, as a country, have given ourselves in recent years. A continuation of pay settlements and growth of earnings at anything like the current rate over the next year must mean a further very substantial rise in unemployment. We have got to get the message across that, looked at from this point of view, we are behaving as a country in a most extraordinary manner, quite unlike our main competitor countries.

6. The link between unemployment and rapid increases in pay can be demonstrated effectively in two ways: one is by reference to the growth of the money supply and the other is by reference to international competitiveness. Both approaches provide a fairly clear indication of the level to which pay increases should be held, on average, if we are to avoid storing up for ourselves a further increase in unemployment, beyond that likely to occur in any other case.

Monetary Growth

7. If wage increases in general exceed the growth of the money supply significantly, jobs will be lost. It can be shown that during the 1970s unemployment rose when the growth of earnings exceeded the growth of M3, with only a short lag, and fell when they grew more slowly than M3. The graph at Annex A shows the relationship between unemployment and the ratio of average earnings to the money supply.

8. The rapid growth of earnings in the past means that there is already a considerable rise in unemployment in the pipeline. But on recent evidence and given the monetary target, figures not exceeding 9 per cent or 10 per cent are needed to prevent even greater unemployment than would occur anyway.

9. We must be prepared for criticism that our policies are wrong and that it is therefore the Government, rather than excessive pay settlements, that are creating the unemployment. But we must nonetheless keep using the argument that any other course could only raise the rate of inflation. Only if pay negotiators are absolutely convinced that we will stick to our policies will the financial framework we have set really bite and expectations in the labour market be influenced. Accordingly we must continue to repeat that there is no question of our monetary targets being shifted to accommodate high levels of pay settlements.

Competitiveness

10. An approach based on our competitive situation points to similar conclusions. We can point to past losses in competitiveness. If we lose competitiveness further by allowing our labour costs to continue to grow faster than in other countries, jobs will be lost. Over the last year we have suffered a serious loss of competitiveness, with our earnings rising at about double the rate in other OECD countries on average (20 per cent as against 10 per cent) and the exchange rate appreciating by about 8 per cent at the same time. This loss of competitiveness must already entail a substantial rise in unemployment. Responsible financial policies to prevent

high inflation and the effect of North Sea oil mean that we must reckon on a firm exchange rate. So any further rise in our unit labour costs relative to those of our competitors must mean more unemployment, especially in those parts of the economy involved in international trade.

11. Once again one cannot be very precise. The OECD forecasts that earnings in the OECD area this year will rise by about 10 per cent and one might reasonably assume that the rate of increase will be similar in the first half of 1981. Since 1973 productivity (output per manhour) in manufacturing in our main competitors is estimated to have increased by about 4½ per cent a year. Thus a rise in wages abroad of 10 per cent would be consistent with an underlying rate of growth of unit labour costs of around 6 per cent. Estimates of productivity growth in the UK vary, lying in the range ½ per cent to 2½ per cent. But wherever it lies within the range, wage settlements here ought to be well down into single figures if any further loss of competitiveness is to be avoided (a modest objective given the loss we have already suffered). Because of our inferior productivity growth, even if earnings increase in manufacturing matched those abroad, our competitiveness would deteriorate and further jobs would be lost.

The Retail Prices Index

12. The RPI has a powerful influence on pay expectations - indeed perhaps the most powerful single influence. If we are to achieve the step change we want in expectations, then we must break this influence insofar as it encourages people to think in terms of pay increases matching those in the RPI.

13. We will be able to take credit for the fall in the rate of increase of the RPI that will be occuring in the next few months, particularly as last year's VAT increases fall out of the 12-monthly figure in July. We can also indicate that the RPI will be decelerating further over the next year or so (for reasons other than pay restraint), and try to get across the implications of this for pay bargaining.

14. We should not neglect to use the elementary argument that, at least in the short run, excessive pay increases must increase pressure towards higher prices. Pay increases substantially below the rate of inflation are necessary if we are to achieve a swift reduction in inflation and minimise the rise in unemployment.

15. One can reinforce this by pointing to the behaviour of other countries. In the OECD as a whole average earnings have increased by less than retail prices over the last year, although this picture is dominated by experience in the United States, where earnings have been increasing by about 6 per cent less than consumer prices. But in a number of other countries also - Netherlands, Sweden and Australia for example - earnings are rising more slowly than prices. In Germany, France and Japan earnings are just keeping pace with inflation; nevertheless, because of high productivity growth, this implies an increase in unit labour costs in these countries well below the rate of inflation.

Level of service

16. Showing that the Government intend to adopt firmer policies with its own employees will be an important argument to influence the private sector. This can be reinforced by arguments aimed directly at pay in the public services. The Government is committed to keeping public expenditure under tight control. This is essential if Government borrowing is to be reduced, interest rates brought down, and the private sector enabled to create the wealth which alone can pay in the longer term for a higher level of public services. Meanwhile cash limits show what the country can afford. Excessive pay settlements mean a lower level of service. Some examples are at Annex B.

Conclusion

17. The arguments above do not indicate a single figure for economically affordable pay increases; but they do point clearly to the consequences of earnings increasing beyond certain magnitudes, and thus to low figures for pay settlements in the next round.

HM TREASURY
4 July 1980

(G.H.)

ANNEX A
earnings /M3
unemployment
1960
1961
1962
1963
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252

Implications of Excessive Settlements for Levels of Service

National Health Service

Each 1 per cent rise in National Health Service salaries costs around £45 million. A new district general hospital costs around £25 million in broad terms. So that each additional 1 per cent on the wage bill for one year only would mean cutting out virtually 2 new complete hospitals.

Civil Service

The cost of each additional 1% on the Civil Service wage bill is about £40 million. £40 million would pay for over 40,000 new places for unemployed school leavers in the Youth Opportunities Programme. Or it would pay for building three new medium sized prisons.

School Teachers

The cost of each 1 per cent pay award to school teachers is around £40 million. A sum of this size would allow for expenditure on books to be increased by ⅔. It would enable planned provision for under fives to be increased by about one quarter. It would pay for an extra 5,000 school teachers, which would enable class sizes to be reduced.

Local Authorities

The cost of a 1 per cent rise in pay for local authority manual and non-manual employees (excluding teachers) is about £61 million. This would build 120 old peoples' homes. It would pay the costs of running over 500 such homes. It would provide over 16,000 home helps for a year.