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MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

PAY : SOME CURRENT QUESTIONS

Memorandum by the Chancellor of the Exchequer

I attach a note by Treasury officials.

(G.H.)

HM TREASURY
3 July 1979

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Note by Treasury officials

INTRODUCTION

The purpose of this paper is to focus attention on some of the main issues the Government are likely to face in the pay field in the period ahead. Although the Government have laid down their general approach to pay in both the private and public sectors, interpretation of this approach in detail will be required in the coming months as the need for specific decisions, particularly in relation to cash limits, arises. With the current pay round due to end in less than a month's time, now is not too soon for more detailed consideration. To some degree, however, this paper, which should be read in conjunction with the separate and more detailed papers on cash limits, a national forum etc, is still perforce more of a signpost to further consideration than a prescription for action.

GOVERNMENT'S APPROACH

2. The Budget Statement sets out the essence of the Government's approach. In the context of the overriding need to "squeeze inflation out of the system", it stressed in particular that financial responsibility on the Government's part should be matched by responsibility in the field of pay bargaining. In the public sector, this requires full account to be taken of "what the ratepayer and taxpayer can afford"; in industry, it demands recognition of "what the customer is prepared to pay, what the firm needs to invest, and what the pressure of competition demands", and, in the economy as a whole, it requires acknowledgement of "the limits imposed by the need to control the money supply". The Prime Minister has also spoken in similar terms on a number occasions - for example, on 19 June when she referred in the House of Commons to the need for people to face the consequences of their own wage claims.

3. The Government's approach is thus a flexible one, designed to allow the market economy to work within a strict monetary framework. Success rests critically on individual awareness of the consequences

of irresponsible action. This has advantages from the point of view of flexibility on the one hand, and in providing a sustainable basis for policy on the other. However, given the imperfect state of the labour market, it is clear that there are potential obstacles to the Government's approach in the private sector; and the Government will in any case necessarily be faced with specific and in some cases very difficult decisions in the public sector by virtue of their role as employer.

4. The following paragraphs therefore seek to identify the main questions that are likely to arise and suggest some areas for further study. They deal first with the private sector, and then with the public trading and the public services sectors in turn.

THE PRIVATE SECTOR

5. The Government have made it clear that it is strongly in the interest of private sector employees and employers not to press or concede large pay increases: given the Government's intention to adhere to strict fiscal and monetary policies, and not to subsidise ailing companies, this could only be at the expense of already declining profitability and competitiveness and jeopardise future viability further. The hope is therefore that private sector negotiators will identify where their interests lie, and conduct pay negotiations accordingly. A great deal will depend on expectations - particularly about the extent to which the Government will in practice stick to its monetary and fiscal policies if and when the going begins to get rough. The initial response from the CBI at least has been very encouraging; they have stressed the responsibility that now rests with management. Moreover, the poor outlook for company profits should itself strengthen the resolve of management to resist large pay increases.

6. But in addition to any failure of inflationary expectations to adjust quickly to the tightening of monetary and fiscal policies there are a number of other reasons why earnings could grow faster than can be accommodated within the Government's monetary target:-

(i) Some employers may still decide to take the easy option under pressure and concede large claims that should be resisted, notwithstanding the damage this might inflict on the company in question in the longer term. This could happen for several reasons: for example (as with the road haulage dispute at the beginning of the year) no individual may be prepared to take a sufficiently strong lead, preferring instead to be guided by the behaviour of rival companies. Or again, a company faced with a dispute that it considers likely to cause a loss of market share may conclude that the immediate retention of that market share should take precedence over longer-term competitiveness.

(ii) Some companies enjoy a monopoly or quasi monopoly position in the market and, in the absence of price control, may feel able to pass the cost of pay settlements directly on to the consumer. Others may occupy a key strategic position in the economy (eg British Oxygen, whose settlement date falls early in the round), the implications of which would make it difficult to contemplate withstanding industrial action for any more than the shortest period. In such cases high settlements would be bound to affect the domestic price level and the 'tone' of the pay round, and the Government may find itself under pressure to intervene.

(iii) There are also some capital intensive industries where pay only constitutes a small proportion of total costs. Here large pay rises may well have relatively little impact on the company's operations, and employers may consider accordingly that they have little to lose by taking a soft line. Although this may be true in relation to such companies in isolation (although there are many capital intensive companies that suffer from over-manning and poor profitability), the possible spillover effects on other companies could be serious.

7. This last consideration underlines the fact that large private sector settlements, particularly if they occur early in the pay round, can pose substantial dangers for the conduct of pay negotiations in

general, even where those settlements can in some sense be justified in terms of what the individual company can afford. Encouraging negotiators to take full account of their company's financial position should help to reduce this risk, given the tight monetary context the Government will set. Some further suggestions for improving the climate for negotiation and making it possible for the market to work effectively are also discussed in paragraphs 26 to 32. But it is largely unavoidable that negotiators will use settlements reached earlier as a reference point, and an 'expectations effect' can easily build up as the pay round develops (for example, a clear progression was observable in the 1970-71 pay round).

8. A further important consideration is that at least some of the settlements in the private sector can be expected, through the concept of the 'going rate', to set the 'tone' for negotiations in the public sector. This risk may in some cases be increased by the formal relationship created through the establishment of the Standing Commission on Pay Comparability. This is discussed further in paragraphs 19-22 below and leads directly to consideration of the main potential problems in the public sector.

PUBLIC TRADING SECTOR

9. The Chancellor's paper for E Committee (E(79)) said that in principle the Government should disengage from individual nationalised industry negotiations, leaving management to reach settlements against the background of fixed financial targets or cash limits. This was against the background of the more general principle in the Manifesto that "In the great public corporations pay bargaining should be governed, as in private ones, by what each can afford".

10. The paper recognised that fixing cash limits necessarily involves the Government in taking a view on how much the industry can and should allow for its future pay bill. This should vary according to the commercial position of each corporation though there could be no question of those public utilities with a monopoly position in the domestic market being allowed to exploit it for the benefit of the work force. The paper also pointed out that in any event it was urgent to explore ways of preventing this risk whether by some more

direct constraints on the wage bill for each industry or by setting targets for improving unit costs or efficiency. In short, therefore, the paper identified the two critical issues of:- (i) the effectiveness of cash limits and the basis for setting them; (ii) the need to consider alternatives to relying on such limits.

Effectiveness of Cash Limits in the public Trading Sector

11. A general point on effectiveness stems from the fact that the cash limit for nationalised industries is on the external finance of a trading concern. The requirement for such finance is the difference between large flows: turnover on the one hand and current and capital expenditure on the other. It is genuinely hard to predict the outcome and the industries have not in practice produced mid-point estimates as the basis for cash limits. In aggregate the shortfall has been large in absolute and proportional terms, though it has been falling in recent years. In 1978-79 it was over £600 million - large in relation to aggregate cash limits of about £2 billion but much less in relation to aggregate turnover of the order of £30 billion. Nevertheless the past experience of shortfall, and the scope for determined industries to provide what amount to contingency allowances whose existence it is hard for Departments to demonstrate conclusively, cast a general doubt on the effectiveness of cash limits.

12. The scope for making the cash limit an effective constraint on pay - in the sense that an 'excessive' settlement puts a squeeze on employment and/or investment - will also vary greatly with the circumstances of different industries. It will be relatively large where labour costs are a big share of total costs (the share ranges from about 15% to 65%) and where prices are constrained by the market or fixed before the pay settlement and the industry is a net borrower. Most nationalised industry pay settlements are in the months between January and April and price increases for those industries which have a regular date fall within the same period so that both decisions are of great importance for the coming financial year. But the cash limit will not on present practice have been finally set by the time of the earlier negotiations, and there may be advantage in considering the scope for change here so that the cash limit is set earlier eg for steel.

13. Subject to these reservations it ought in principle to be possible to set relatively effective cash limits for rail, bus, steel, airways and, provided the oil price does not provide too much headroom, for coal (in the latter case free compeition from coal imports would be an added constraint on pay and prices, though it might have public expenditure costs to the extent that it held down prices). However, in some of these industries (eg steel and coal) market conditions can change so much and so rapidly that a given cash limit may become much more or less severe than originally envisaged. The main industries where it is difficult to make the cash limit an effective constraint, either because wages are a small proportion of costs or because they are monopolies and can raise prices, are electricity, gas, post and telecommunications. Moreover these industries are in most years net repayers of debt so that the Government are in a weak position to enforce 'negative' cash limits.

<u>Other means of influencing settlements in the public trading sector</u>

14. Three possible alternatives or supplements to cash limits or financial targets for these industries might be considered:-

(a) An efficiency or cost target (such as the published aim that overall real unit costs for the postal service should be kept constant) ought to help, but is unlikely to be decisive. First, such a target is more natural and more fairly monitored over a period of years than for each year individually. Secondly, it is understandably defined in real terms. Thirdly, there is no financial sanction, though one might conceivably be devised. These weaknesses might, however, be reduced if Ministers made it clear to the Chairmen that they would be held personally accountable for achieving the target in individual years. There is certainly scope for setting more targets since so far none have been set except for the Post Office. It is doubtful if scrutiny by the Monopolies Commission would add much on the pay as opposed to the efficiency front.

(b) Ministers could also set an annual limit on the wage bill or the increase in it. This would leave it to the

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industries to decide the balance between pay increases and productivity increases but would necessarily imply a figure for pay increases that would be acceptable if productivity did not rise at all.

(c) A third possibility would be to set limits in advance of pay negotiations for the price increases that would be acceptable to the Government. The intention would be to compel the industry to offset any excessive increase in pay by productivity increases or other current economies or by cutting investment. But this would expose two conflicting objectives. On the one hand Ministers may wish to prevent the exploitation of monopoly power for the benefit of the work force of the industries. But on the other, it could seriously compromise the Government's overriding PSBR objective. If higher (or second) price increases were ruled out as a way of dealing with unexpected cost increases or revenue shortfalls, there could be a major threat to the PSBR, since it is common for price increases in the major fuel industries and Post Office to be worth something of the order of £500 million a year each. This would be a slippery slope and is not recommended.

15. Assuming that the course in paragraph 14(c) is ruled out, there might be advantage in exploring further in regard to individual industries the suggestions at the end of paragraph 12 and in paragraphs 14(a) and 14(b). But both these last two suggestions, as also the setting of cash limits themselves, would effectively require the Government to form a view (though it would not necessarily have to be published) on the appropriate figure for pay underlying the limit or target in question. The position will vary in relation to different industries and the Government will no doubt want to start from the general proposition that incomes growth must be consistent with their monetary targets. But any figure chosen is also likely to be conditioned by whatever 'tone' of the round is established by the first wave of key private sector settlements. In the past Departments have asked the industries to ensure that their proposed cash limits are based on pay assumptions that are compatible with Government policy.

PUBLIC SERVICES

16. For part of the public services (civil service, armed forces, the Health Services) the Government are the direct employers and the only source of finance. For other services local authorities are the employer (teachers, firemen, police, local authority manuals and white collar workers) but the Government provide most of the finance. The local authorities prefer to run their own negotiations at arms length from the Government, but, particularly if the Government intervene, will expect the Government to meet their share of the settlement.

17. There is a tradition of negotiation over pay in the public services - at least apart from the grades covered by the three Review Bodies - which it would be difficult if not impossible to break. The question for the Government is therefore what constraints should be placed on negotiators and on what criteria those constraints should be founded. There seem to be two broad approaches.

Percentage Figure

18. One possibility would be for the Government to announce a percentage figure for pay increases in the public services, around which negotiators will be expected to bargain. Experience suggests that such a figure can rapidly become a minimum settlement figure. Any attempt to set a figure which applied only to the public services could in any case lead to widespread industrial action under the banner of "unfair discrimination", which would have full TUC support. It is assumed that Ministers will prefer not to adopt this course which seems so explicitly contrary to their basic approach.

Fair Comparisons

19. Another course would be to reinforce the "fair comparisons" system that already exists, if Ministers decide that it should continue. Until recently this applied only to the non-industrial civil service (and, up to a point, to the Armed Forces ranks covered by the Armed Forces Pay Review Body). The previous Government, however, agreed to extend it to the industrial civil service; and

subsequently extended it to virtually all the rest of the public services by establishing the Clegg Commission and referring the pay of a number of groups to it. The terms of reference in each case require the Commission to "assess the appropriate form of comparisons with terms and conditions in other sections of the economy, and to identify relative comparators".

20. A potential advantage of "fair comparisons" is that it can restrict the area for negotiation of the quantum of a pay increase. An immediate disadvantage, however, is that since it is being applied for the first time to a large part of the public services just when the sector as a whole has fallen well behind the rest of the economy in pay terms, large increases will inevitably ensue. But once the catching up this year has taken place, and provided the system is rigorously and consistently applied in future years, it might, if continued, help to restrain pay negotiators and ensure that the public services do not move ahead of the rest of the economy. Indeed it could mean that for most of the year the public services were kept behind. This consideration has in fact made some of the public service unions chary of accepting the system as a permanent feature of their pay determination system.

21. Ministers will, however, need to consider whether the present system, or something similar to it, should be maintained. If it is, it will be necessary to ensure that the mechanism for determining "fair comparisons" is applied with the utmost rigour. It should, for example, take account of factors such as labour supply and demand which may not always appear to be consistent with the application of strict comparability as at present perceived. It will also be necessary to insist that it is used as the basis for determining pay in the public services in each pay round - use at longer intervals is likely to produce inconveniently large pay figures which could upset the tone of the round in which they appeared; and to restrict severely, if not abolish altogether, the scope for subsequent negotiation on the basis of fair comparison results.

22. In the immediate future this means making sure that the Clegg Commission behaves in this way in relation to its existing remits. For the slightly longer term, whatever the future of Clegg itself,

consideration will need to be given to the complex of other pay determination systems in the public services to see whether they can be made tauter and more rational. These include the three Review Bodies, the Whitley Council bargaining system, and LACSAB in the local authority field.

Cash Limits

23. The choice of methods for determining pay in the public services - whether related to "fair comparisons" or derived from some other basis - is closely connected with provision in cash limits. This is discussed separately in E(79) which considers in more detail the issues that are likely to face Ministers.

24. A key question that arises is whether cash limits should include provision for future settlements. If, as the Treasury think right, they do, so that cash limits in effect determine pay settlements rather than the reverse, the following problems will arise. Since the cash limits for the most part will have to be set before settlements have been reached and evidence about the results of pay research or "fair comparisons" is available, the Government will have to make their own assumption about the appropriate pay increase to build into the cash limit. Such an assumption, which it will not be possible entirely to conceal, could become regarded as the Government's view of the acceptable level of settlements generally and set a floor, not a ceiling, to the outcome of pay negotiations.

25. To some extent this difficulty is inherent in any cash limits that include provision for pay from the outset. It might, however, be minimised if the Government made it clear that the dominant consideration was not any specific assumption about particular pay settlements, but a broader view of the quantum of cash limited expenditure that would be consistent with the Government's overall financial objectives. If this approach were adopted, further consideration would need to be given to how cash limits figures could be derived not only from the Government's planning decisions in the Public Expenditure Survey but also from their objectives for the PSBR and rate of increase of the money supply. The Government would also need to make it clear that if in practice any settlements

exceeded the provision in the cash limits, there would need to be corresponding economies, and Ministers would have to accept themselves that their previously approved programmes must be cut. This general approach would thus be consistent with the Government's broad approach to the private sector which will consist of setting a tight monetary framework within which responsible bargaining will be expected to take place.

RESPONSIBLE PAY BARGAINING: POINTS FOR FURTHER CONSIDERATION

26. The public sector issues referred to above, and in particular the basis on which cash limits should be set, will need further detailed study in relation to the industries and services concerned. There are, however, some more general points which it would be useful to identify, particularly given the overriding need to improve the general tenor of pay bargaining and to remove as far as is possible within the Government's own competence obstacles to the functioning of an effective labour market. The following paragraphs therefore list a number of questions to which further consideration might be given.

What should we do to improve education and awareness of the consequences of different levels of pay settlements?

27. At very least, the Government need to get across firmly and clearly to both unions and management the central thrust of the Budget, with all that it implies not just for the retail price index as a result of the once-and-for-all price increases but for take-home pay as a result of the large income tax reductions. In this context the work on the proposed new standard of living index may have an important role to play.

Is there any message specifically on pay that we should aim to convey?

28. Of paramount importance is projecting the credibility of the Government's determination to stick to their firm monetary and fiscal policies and not to be deflected from these by any short-term adverse developments on the pay front. Only this can generate the right expectations - and action based on them - and make it possible to convince both sides of industry that excessive pay rises will result in increased bankruptcies and unemployment. The Government will also

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need to support this by convincing industry that they will not intervene when companies find themselves in trouble as a result of having granted excessive pay settlements. At the same time, it would be helpful to dispel the belief (now growing in some quarters) that there will be a pay freeze some time in the near future. Although the expectation of a freeze might induce some negotiators to settle earlier and more moderately, there is perhaps the greater risk that it would serve to exaggerate and accelerate the pace of pay demands, and also lead to anticipatory price increases.

<u>What role should there be for the proposed National Forum?</u>

29. E(79) discusses the possibility of a Forum. The wider dissemination of facts and informed opinion is clearly one of its major objectives. It would be unwise to expect too much of it, especially in the short-term, but it could help in securing greater awareness and acceptance of the underlying state of the economy, including the long term trend of productivity and competitiveness.

<u>Is there any specific action we might take to improve the operation of market forces, with a view to restraining pay settlements?</u>

30. Further consideration might be given to the general field of competition policy. This is relevant both to the behaviour of private companies enjoying a very strong market position (as noted in paragraph 6 above) and to the nationalised industries. So far as the latter are concerned, freer coal imports and other forms of enhanced competition may increase pressure on some nationalised industries to keep costs down. A second area is the operation of the labour market generally. A good deal might be done to lubricate the supply of labour - including for example improvement in council housing allocation procedures, adapting housing and other policies so as to encourage greater mobility of labour, the operation of the apprenticeship system and so on. The proposals for the reform of the closed shop may also be relevant here.

<u>To what extent should we look to reform of industrial relations as a corrective to the current imbalance in collective bargaining?</u>

31. Above all it is necessary to correct the present bias in favour

of the union side. The proposals on secondary picketing, closed shop and trade union ballots which the Secretary of State for Employment will shortly be putting out to consultation are first steps. Further measures are under consideration, including substantial amendment of the Employment Protection Act and possible measures to oblige trade unions to bear more of the costs of strikes. However, all this takes time and changes in even the first three areas are unlikely to come into effect until well into next year. The coming pay round is therefore likely to start with the imbalance as severe as ever. In addition, there is a case for examining the scope for non-strike agreements. The Manifesto said:

> "In consultation with the unions, we will ... seek to conclude no-strike agreements in a few essential services."

Again, it would be a mistake to expect too much. The unions are likely to offer such agreements freely only in areas where strikes would be unlikely anyway: in other areas experience suggests they would be reluctant to control their members and indeed may not be able to do so. In any case they would demand a price for an agreement, probably in the form of specially advantageous treatment on pay. It will be necessary to weigh very carefully whether the price set is worth paying.

<u>Should we be doing anything more by way of contingency planning?</u>

32. Finally, the Government need to ensure that plans are fully laid for any industrial disruption in the coming winter. Departmental contingency plans will no doubt be under review following the experiences of this pay round, but the importance of this planning cannot be overstressed. All necessary precautionary measures, such as building up stocks of coal at power stations, must be completed as soon as possible. The Civil Contingencies Unit might be asked to furnish an early report on the state of preparedness.