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TO: See below

Meeting on Pay

I enclose an amended version of the paper on "Inflation, Pay Determination and the Labour Market" for the meeting in the Leader of the Opposition's office at 5.30 p.m. on Monday, 20th March.

sl.

GEORGE CARDONA

16th March, 1978

c.c. Mrs. Thatcher ✓
Sir Keith Joseph
Sir Geoffrey Howe
Mr. Prior
Mr. Lawson
Mr. Nott
Mr. Howell
Mr. Patten
Mr. Cardona
Mr. Shepherd

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INFLATION, PAY DETERMINATION AND THE LABOUR MARKET

Preamble

1. The mastery of inflation is the most important single task which must be fulfilled if our society and economy are to be restored to health and economic growth resumed. With endemic inflation come instability, uncertain and (nearly always) diminished profits, the erosion of business confidence, a reduction in the momentum of growth and, in time, lasting stagnation. That is not all. Inflation threatens to an equal degree the confidence of the individual both in the strength and virtues of the mixed economy and a free society as a whole; and his confidence in the security of his position in it, whether of his job, his earnings, his savings or the future of his family.

2. The fact that inflation has fallen back from its peak levels of 1975/6 can all too easily be taken as grounds for according the fight against it a lower priority in the future than in the recent past. However we cannot accept this view. Inflation continues at levels which are still high both by current international standards and in relation to our past experience. It could easily and quickly return to its recent peak levels and worse, as the dramatic acceleration of 1974-5 shows. The fight must go on.

Some lessons of the last decade

3. Since the mid 1960s the chief weapon in the fight against inflation has been a series of statutory and quasi-statutory

incomes policies. Some people think that these policies have been the major reason for such intermittent successes as can be registered in controlling inflation. Others hold that the explanation for periods of falling inflation is to be sought elsewhere, and in particular in changes in the money supply.

3 Wherever the truth may lie, we do not believe it desirable or possible to continue with this approach. The resort to detailed intervention in the labour market, the over-riding of a mass of subtle and complex bargaining machinery by a few crude and simple rules, backed by the threat of statutory or administrative sanctions, is an open confession of pessimism and failure. After more than a decade in which the Government has been trying to second-guess the market, with little more sustained success than the proverbial backseat driver, the time has come to shift priorities to trying to get the mechanism to work properly on its own once again before it atrophies irretrievably.

4. The impossibility of lasting success with any centralised and detailed method of wage control outside a command economy should be self-evident. But it is just as important to remember, the specific difficulties near-continuous wage control has brought us, some of which get dramatically worse year by year and spawn whole families of problems of their own:

1) The compression of differentials, the distortion of pay structures, the absence of flexibility in the face of changing circumstances, the divorce of changes in relative or absolute pay levels from market conditions, the near moratorium imposed on major reforms in payment systems in many firms and organisations.

(e.g. Leyland), and the perversion of those features of pay bargaining (such as productivity agreements) which happen to constitute loopholes in the system of control.

2) The tendency for a much publicised and politicised norm to become both the minimum increase which every employee believes he must win and the maximum which any employer can award. For to receive less than the norm involves gross injustice, or involves at least deep feelings of it. While if one employer awards more than the norm, the same misplaced criterion of justice and fairness comes to be the justification for most other employers to be pressed to do, and to do likewise as soon as possible. All this is aggravated by the growing sophistication and spread of information amongst wage negotiators (which would be to some degree happening anyway) and the growing tendency to view each settlement against the backdrop of wage negotiations throughout the economy which is fostered by national wage policies.

3) The price which normally has to be paid to obtain the acquiescence of the Union movement to the imposition of controls. For this bargaining between Government and unions engenders the feeling that responsible wage negotiations bring no rewards of their own, but are a painful sacrifice which must be "rewarded". It has tended to involve the Government ceding radical, lasting and normally harmful social, economic and political changes in the structure of the economy in exchange for, at most a year of transient restraint at a time. The analogy of selling one's birthright for a mess of pottage cannot be denied. Furthermore it may be the case that employees credit the Government rather than their employers for wage increases.

4) More specifically wage control has come to be coupled with cumbersome and damaging price controls which have reinforced the already serious and damaging effects of inflation on profits; and with arbitrary and draconian dividend controls which have penalised those dependent on savings and pensions - who are hard enough hit by inflation in any case; and have seriously hampered the operations of the capital market.

5) At some periods part of the price of restraint successfully demanded by the unions has been expansionary policies which committed Governments, as we have since learnt, to reflation and monetary expansion on a scale greater than the economy could stand, leading paradoxically to not less but more inflation and (even) greater problems at a later date than the crisis to which the restraint was directed as a remedy. Hand in hand with this can be discerned the tendency for Governments to feel unable to lower expectations to realistic levels, as to do so would provoke a breakdown in relations with the unions.

6) We have witnessed the growing politicisation of major wage negotiations. This is inevitable as soon as the outcome of any settlement is made into a test of Government policy by the mere existence of the Government's rules or laws for wages. Since there are always powerful groups who can hope to break the policy because of the vulnerability of a modern economy, and since many of those groups are led by factions hostile even to an average Labour Government, let alone a Conservative one, we have seen wage controls become a major incitement to, and target for, militant and extremist action.

7) The latest development of the present round of incomes policy threatens the frightening extension of the power of the state to use its executive and legal authority to exercise arbitrary pressures on private firms. These pressures are potentially equally frightening whether directed generally and indiscriminately or at carefully selected targets. The scope they offer a future left wing Government to force through fundamental and radical new policies, or to victimise firms which it dislikes, cannot be underestimated.

8) Wage controls have weakened and perhaps even (in some cases) destroyed the conventions, structures and framework of collective bargaining. These were never perfect and were becoming inadequate in a number of respects even by the mid 1960s. But every additional year of rigid controls weakens them still further and makes the task of ultimate reconstruction more difficult.

9) Finally wage controls have probably weakened the resolve of employers to fight their own battles, to explain and fight for economic realism in their dealings with their employees, these tasks being discreetly passed on increasingly to Government which, with its limited resources and ignorance of particular circumstances can only discharge the task intermittently, in very general terms, and in a manner which will only have an impact if employers play a fuller rather than a more limited role in spelling out the constraints of economic reality.

Some difficult trends

5. The problems of pay negotiation have been aggravated further

by a number of important economic and social developments, some of which have been occurring in every major economy, while some are peculiarly British and result largely if indirectly from the problems already cited.

6. The balance of power between employee and employer has shifted radically against employer, partly because of the growing legal powers of rights of unions, partly because of their growing vulnerability to industrial action. At the same time the disappearance of the so-called "money illusion" which acted as a vital lubricant to the economy in the past (particularly in wage bargaining) has greatly sharpened the struggle which appears to be between capital and labour but is in fact both between different groups of labour and between spenders and savers. To cap it all the sizeable growth in public spending, in the burden of taxation both overall and at the margin, has made that already sharpened conflict yet more acute still.

7. Under these circumstances the necessarily relatively subtle imperative of sustaining profits takes second place to the fight for higher wages, whose gross increases must, so it comes to be believed, do far more than better the going inflation rate if real take home pay is not to fall. And the ease with which this suicidal philosophy can be pursued gets steadily greater.

The Priorities Henceforward

8. This diagnosis points clearly to the priorities which must be followed henceforward:

1) Employers and employees must regain the latitude to determine themselves how wages, salaries, prices and dividends are to be set, a latitude which they have enjoyed at almost all periods in every market economy. Naturally that freedom must be subject to employers not indulging in restrictions of competition. And the Government must still be prepared to investigate cases in which there is a widespread belief in that excess profits are being made, prices are "too high" or competition restrained, if only (in most cases) to prove that the suspected abuse is not taking place, and to educate people about economic reality,

2) We must re-establish conditions in which pay increases can and do vary and are not all constrained (up and down) to a single "norm".

3) There can be no more social contracts, in which unions undertake (at best) to exercise the restraint which is in their and everyone's interests anyway in exchange for Government actions which are damaging and in the interests only of small segments of the labour force (if that). This applies both to lasting changes in the law, and to unrealistic growth strategies.

4) Major wage negotiations must be depoliticised; the collective bargaining system strengthened and re-established to operate properly under its own steam as soon as possible and as far as possible; employers must reassume their unavoidable responsibilities; and the balance of power must be redressed in their favour. *bb?*

5) The Government must do all it can to create an atmosphere in which expectations of growth are realistic, the vital importance of restoring profits is appreciated, and the conditions recreated in which responsible, realistic bargaining between employer and employee becomes possible once again.

Towards responsible bargaining

9. The first pre-requisite for progress towards responsible collective bargaining is control of public spending and a reduction in its share of the national economy. This will allow reductions in the burden of taxation, both overall and at the margin; an increase in the incentives to and rewards for work, effort and responsibility; the re-establishment of a more reasonable relationship between gross and take-home pay; and easier conditions in which to improve profitability.

10. The second is the removal of current controls on wages dividends and prices other than those genuinely required for competition and consumer policy and subject to the qualification (Implied) on page 31 in "The Right Approach") that it would be imprudent absolutely to rule out the possibility of some period of direct intervention - e.g. a freeze - in exceptional circumstances - though both the anticipation and the repercussions of a freeze, however short, are far more likely to make the problem worse rather than better. Faced with the recent wholesale misuse of Government powers revealed by the blacklisting controversy, it will probably be necessary to go further. ? [Action may be needed both to restrict the use of powers arising from ECGD, grants and assistance to industry, and so on in the ways we have recently seen to be possible, whether for counter-inflationary policy, or for other objectives unrelated to the purpose for which the powers were

created such as the extension of planning agreements. Only by so doing is it possible for profits to be rebuilt to healthy levels, for the capital market to function properly and for employers to regain the discretion they need to negotiate the right pay for the specific job and individual, or modify bargaining systems, salary and career structures in general as changing circumstances demand.

Monetary Policy - a key element in economic strategy

11. The need for conscious and determined pursuit of monetary discipline and restraint was not a very serious issue before the system of fixed exchange rates collapsed between the years 1971 and 1973. Under the Bretton Woods system it was enforced automatically. Since we now operate a system of floating exchange rates the automatic discipline has gone. The deliberate imposition of a policy of tight monetary control has now become inevitable, even if for no other purpose than the maintenance of order in our international trade and finance.

12. But monetary policy must now play a wider and even more central role in economic strategy because of the part it can and does play in the inflationary process. The posture of monetary policy determines how far cost pressures are accommodated or restrained. Once the limits it imposes are exceeded, economic activity is reined back, profits are squeezed, borrowing becomes dearer or even impossible, people price themselves out of jobs, thus ensuring that inflationary tendencies are met by a variety of sanctions in the market place and by bringing supply and demand pressures into play. The existence and under-standing of these forces and processes can have a crucial effect on inflationary expectations and thus on price and wage-setting behaviour.

13. Monetary targets, openly proclaimed and explained, can therefore play a crucial part in mastering inflation and must be at the centre of our counter-inflationary strategy. It is the proper task of the Bank of England to set these targets, in consultation with the Government, in a manner which reduces the scope for and temptation to outside interests to exert pressure on the authorities to finance an excessive rate of inflation and to abandon the disciplines of targets. We recognise that this means giving the Bank a slightly different role which would enable its voice to be heard by strengthening the link between it and Parliament.

14. The targets must be set to ensure a gradual reduction in the money supply and rate of inflation over a period of years. The rate at which it is appropriate to attempt to squeeze inflation out of the system cannot be precisely determined at a point in time, and will be constrained both by economic conditions in other countries and our judgement of the pace at which we can reasonably reduce inflation. In the final count the targets adopted will have to be open to periodic revision and adjustment in the light of the success already achieved and changing circumstances. One way of doing this might be by "rolling" targets. But we recognise that such technical devices can weaken the discipline inherent in the philosophy and that they will need to be critically examined before we can endorse them.

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Government by Explanation

? 15. No country has operated with monetary targets for long -
? because monetary continence used to be implicit in the system -
so inevitably their implications both for economic management generally
and for inflationary expectations cannot yet be properly appreciated.
This means that their significance can only be learnt by a slow
and painful process of conditioning (bursts of inflation followed by
painful periods of unemployment and weakened output) until and unless
that process can be pre-empted and short-circuited by education and
explanation. No Government or Bank can hope to achieve that on its
own. But the task can be achieved in time by operating through those
at the apex of the collective bargaining process; and by ensuring that
public opinion and our political institutions - Parliamentary and
otherwise - are brought into play. The leaders of the employers and
unions can be mobilised to educate and inform their own communities
while public and political opinion represents a hitherto untapped
reservoir of influence which can be exploited, at least informally,
to generate direct pressure on those taking the key decisions over
matters of wages, productivity, costs, prices, profits and jobs.
The media, too, may have a useful part to play.

16. All this can be set in train by a process of evolutionary
change without creating new institutions. A number of undramatic
innovations would be needed.

3 17. The National Economic Development Council could be expanded to
include the Governor of the Bank of England and a wider range of
industrial, commercial and professional interests, to serve as

an economic forum - somewhat on the lines of Germany's "Concerted Action" meetings. It would hold a major meeting at least once (and probably more often) in the year to consider the Bank's monetary targets, the prospects for growth, productivity, jobs, profits and the framework within which collective bargaining would have to take place if inflation is to be reduced as implied by the nation's objectives and the monetary targets. Clearly the agenda could range over other issues on some occasions as circumstances demanded. The debate at such meetings would be central to spelling out the links between the monetary targets and inflationary expectations.

18. A strengthened Select Committee of the House of Commons would be empowered to cross-examine the Bank of England regularly about its monetary targets and policies, perhaps quarterly as its normal in the USA. The same committee system would also be empowered to establish a link with the expanded NEDC and to pursue issues raised at a major meeting. A wider role for such committees is in any case essential if Budget and public spending issues are at last to be handled properly by Parliament. With the introduction of broadcasting and possible scope for extending it in time to committees, these changes could, in time, have a considerable direct influence on public attitudes.

19. There is also a case for setting up a group of independent economists, who could service the discussions of the major NEDC meetings and submit reports to Parliament. The case for so doing would be partly to free the Government from the very legitimate and understandable criticisms it would encounter if it continued to rely solely, as at present, on the delphic ex cathedra pronouncements of the Treasury economists. The second reason is that it would free Ministers and officials from some of the very onerous tasks of economic exegesis which already threaten to overwhelm them. The third reason is to build up alternative sources of authoritative economic advice.

20. Starting from such foundations "jaw-jaw" would replace "war-war", education might shoulder out confrontation and the first steps toward responsible collective bargaining could be made.

Responsible Collective Bargaining

21. Within this framework of national economic policy making, there should be as swift as possible a withdrawal of the State from intervention in collective bargaining. Of course this general principle has to be qualified in a number of respects:

- to the extent that the state, as employer, cannot withdraw itself from negotiations with its own employees;
- to the extent that the state has a part to play in stimulating though not itself carrying out, improvements in the machinery of collective bargaining; *And as?*
- to the extent that the state may have to change the wider economic and social framework to redress the balance of power between employers and unions. *In planning?*

22. In the private sector it will be possible once again to resume collective bargaining - free from Government control - leading to varied (rather than uniform) settlements reflecting conditions in the labour market, the competitive position of employers and their profitability, the scope for productivity increases and so on, and the degree of access to credit permitted by monetary policy. Naturally this return to realistic bargaining conditions will not induce responsible behaviour if the Government or its agencies continue to step in to bail out individual firms in difficulties, or show themselves willing to relax credit conditions in periods of crisis.

23. In the public sector market forces can scarcely be brought into play at all in some areas, and only to a very limited extent in others. Many "outputs" are not marketed, and hence there can be no discipline of increased prices, falling demand and profits (or all three) which can penalise excessive wage claims with loss of jobs. In some areas bargaining is not with the Government at all, but with other kinds of employer. In some areas there are special review procedures and bodies which largely determine the outcome of collective bargaining. Nonetheless, despite this confusion and variety, the cash limit system offers a procedure which can both simulate some of the disciplines of the market throughout the public sector and be seen as a translation into public sector terms of the money supply increase permitted for the economy as a whole. Since the cash limit system is still in its infancy, there may be aspects of it which will need modification or strengthening in years to come.

24. In Central Government ways must be found to align the system of pay research - now being reinstituted in modified form and which should take into account relative job security and other relevant factors - with the timetable for establishing cash limits and expenditure planning.

? Pay research makes no provision for demand.

25. In Local Government there may be a similar case for altering the timing and procedures of establishing the rate support grant and the major LA wage negotiations which currently take place in the autumn.

Why? - this system would be used to justify whatever increase is the result of demands.

26. In the nationalised industries and lame ducks the current cash limits on recourse to external finance may need to be augmented by procedures which ensure that labour costs per unit of output are properly constrained, thus ensuring a trade-off at the margin between jobs, wages and efficiency.

How?

27. In the case of the uniformed services (Police and Army) procedures are needed to underwrite the independence of the review procedures which establish their pay. The same is true of the Top Salaries Review Board. There may in time emerge a case for changes in a number of the other review boards, not least to ensure that the basic principles on which they operate are consistent.

28. In many parts of the public sector pay and fringe benefit levels moved dramatically ahead of comparable private sector earnings during 1974-75. This change has to be reversed and steps taken to ensure that it does not happen again.

Guidance about Wage Increases ???

29. The Government's involvement in collective bargaining within the cash limit framework, and in the more general process of clarifying monetary targets and charting out the strategy for mastering inflation raises the issue of what kind of guidance should be given about permissible wage increases. The unavoidable priorities are clear.

- a) It is imperative that settlements should no longer be constrained by a narrow norm or concept of a going rate, and that wide variations should be possible;
- b) it is equally imperative that the generally perceived trend of the aggregate of wage settlements should be consistent with the monetary targets;
- c) the government's own status and success or failure in managing the economy must be as far as possible detached from the outcome of collective bargaining.

30. These three priorities are difficult but not impossible to reconcile. For the reconciliation to be possible

- a) the guidance generated about the wage implications of the monetary targets will have to focus at least as much on the variability of wage settlements as on the aggregate wage movements permitted by them. And this guidance must to a considerable extent come not from Ministers or Departments but from other sources - for example the independent economic experts.
- b) in the public sector the overriding target will be the size of the total increase in wages and salaries, not the growth in per capita earnings.

31. In the longer run the problem may well diminish considerably since it will come to be appreciated that the target money supply increase will almost always be very close to the permitted increase in total wages and salaries.

Collective Bargaining Reform

32. This is an area where it is easy to assert that something has to be done and very difficult to say who is to do what. Initially the Government's own hands will be full enough with the changes set out in paragraphs 23-28 above. Its principal objective will simply be to generate and keep going a proper debate and to provoke action amongst employers and unions.

33. In very general terms, a maxim it may wish to follow is to engineer greater synchronisation of public sector settlements and to ensure as far as possible that they are later in the wage round. The fact that the Financial Year currently begins on April 1st makes this comparatively easy. The basic philosophy of most public sector wage bargaining is retrospective - keeping up with the private sector. By and large the likelihood of excessive awards in the private sector is much lower than in the public. By allowing the private sector to settle first, presumably at lowish levels, one both reduces the scope for public sector settlements setting bad precedents, and ensures that the pay research and comparisons which provide the basis for most public sector settlements suggest modest increases.

The balance between employers and unions

34. While pursuing all these policies very much in public, it

3 is also necessary to pursue a series of actions as part of a deeper strategy to redress the balance of power. The details of such a programme are at present under discussion with the CBI and others.

35. There are also steps which we might wish to see taken by employers on their own initiative. The most obvious example is the organisation of various kinds of employer solidarity in the face of threats of industrial action, such as the CBI have recently suggested.

16th March 1978