Ken Berrill's paper

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PUBLIC SECTOR PAY POLICY 1980-81

Comp. - This year
Temp. Cash

The present Government came to power with the most radical approach to Britain's problems which had been seen for over 30 years - reduce the power of the trades unions; reduce the scope of the nationalised industries; contain the spendthrift habits of many local authorities; improve the efficiency and reduce the size of the public bureaucracies central and local; reduce the level of personal direct tax etc.

Some such radical approach was long overdue for although little of this programme is completely new the essential difference has been this Government's willingness in the first year of office actually to grasp these politically dangerous nettles which its predecessors talked of but in the event largely avoided. The surprising result, so far, is that the public has, in general, applauded the boldness rather than cavilled at the effects. Perhaps it is because the extent of Britain's slide has finally penetrated the public consciousness and they really do now want something to be done even if that something is painful.

But these changes can, in the main, only show significant results in the next Parliament. In this Parliament the Government is likely to be judged in the one field in which it has been (untypically) less courageous than many of its predecessors. That is the field of pay policy and the rate of inflation which is so closely linked to it. The Government's caution in this area is understandable. The history of post-war Britain is littered with failed pay policies; including the immediate precedents of Mr. Heath and the miners and the collapse of the 1975-8 Labour Government's incomes policies. The lessons seemed obvious. Avoid overt incomes policies; they are bound to lead the Government of the day into major pay battles in the heavily unionised public sector which the unions will win. The public will resent the disruption and neither thank the Government nor support it. So keep out of the firing line by relying on tight monetary limits in the private sector and tight cash limits in the public sector to reduce the employers' ability to pay. Reduced ability to pay will, through the operations

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of the labour market, cut back on pay settlements and inflation without the Government having to put itself into the front line defending an overt incomes policy where it is bound, sooner or later, to be defeated.

This analysis obviously has a great deal to support it and is much more attractive to this Government at least, than incomes policy. Provided always that it actually works. In the Government's first year of office the policy 'worked' in one sense, but only in one sense. There were indeed few worrying wage confrontations in the public sector. The steel strike was the exception and it was no part of the Government's intention that the clumsiness of the steel managment should provoke the steel workers to strike. But by good fortune it was a strike which would not inconvenience the public and which would not cause an immediate loss of jobs elsewhere. Indeed it was a strike which the Government could 'win' - provided there was little sympathetic action by other unions. It was a strike which may have been 'worth it' by helping to convince the steel industry to accept the major management changes and capacity reductions which are needed. But perhaps most important of all it was a strike which filled the media for many weeks and gave the public the impression that the Government refusal to ease the cash limits for steel meant that it was being tough and resistant on public sector pay whereas in practice it was quietly allowing settlements around 20% wherever resistance might lead to a troublesome battle.

In the first year the Government policy of relying on M3 and cash limits worked in the sense of enabling it to avoid being in the firing line of wage confrontation but by the fundamental measure of holding back wage settlements and inflation it was little short of a disaster. (Little short that is of the disaster of 1974-75). Earnings and prices rising at over 20% despite the support of a high exchange rate is not what was expected in Opposition. But last year's experience is past and there were special features of the Government inheriting the collapse of the previous pay policy and the Clegg commitments. The important question, indeed the only question, is what happens next. And by 'next' is meant the next pay round and the one following. After that it will be getting uncomfortably close to the next election.

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In the end reduced 'ability to pay' through M3 and cash limits will affect pay settlements in the private sector, nationalised industries, and local goverment and comparability will mean that central government will, after a lag, follow them down. But how long would this take and what damage would be inflicted on the way.

The ease with which monetary discipline works in an economy depends very much on the structure of the labour market. There are three features of the British labour market which in this context are important: (i) the tradition of annual wage settlements with, as a mimumum, backward looking indexation (ii) widespread nationalised industries, many with monopoly powers (iii) pay research and comparability in the central public services.

Backward looking indexation implies that, irrespective of the likely rate of inflation in the year ahead, the minimum wage increase is one which compensates for the rise in the RPI in the past year. And indeed this seems only fair and proper for if a certain level of real wages was agreed a year ago such an approach is only reconfirming that previous agreement. Britain is, of course, not alone in this approach. Italy has it in a highly institutionalised form in the official economy, if not in the informal.

But if the RPI rise in the year ahead is less than in the year which has passed, backward looking indexation means that the level of real income in the year ahead will be higher than over the past year by half the difference between the two inflation rates. In the period immediately ahead in Britain it will be very difficult to give higher real incomes across the board for output is unlikely to rise nor the terms of trade to improve. So in today's conditions in Britain, backward looking indexation, which appears a modest, even minimal, request makes it impossible to reduce inflation at all rapidly. Yet it will be hard to shift peoples' belief that such indexation is "fair"; particularly when the complex web of advisory bodies and past commitments continues to institutionalise this approach.

Of course, backward looking indexation is not wholely impervious to the pressures of 'ability to pay'. M3 and cash limits will be

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having their effect but the impact of this effect is very varied. Some nationalised industries are in a monopoly position and may be little affected; some sectors of private industry are similarly comfortably placed (eg the banks or those service industries not liable to international competition); some large firms are in a strong position to borrow money at home or overseas. So, many of the larger industrial employers can, and will, grant at least backward indexation rather than face damaging industrial action. These large settlements are the ones which receive media publicity and tend to set the 'tone of the round'.

Meanwhile, of course, the pressure of M3 will be doing its work; indeed those who can escape the pressure do so at the expense of intensified pressure on those who cannot. The crunch comes in sectors open to international competition and in particular on the small and medium sized firms in those sectors. These sectors face the effects of the high settlements being granted elsewhere; the intensified scramble for credit which pushes up interest rates and the effect on sterling which this creates.

So the very 'modest' approach of backward looking indexation makes a rapid reduction of inflation over the next two years very difficult to achieve and enhances the tension between those who can get credit or raise their selling price and those who cannot. M3 and cash limits will work in the end but the end is further off and the cost of getting there that much higher than in some other economies. It was, in part, this dilemna caused by backward indexation constraining the reduction of rapid inflation, which led past UK Governments to try to cut the Gordian Knot by a wages freeze or low norm - which might achieve 'success', if only temporarily and at considerable subsequent cost. The alternative is to try to buttress the 'ability to pay'/M3/cash limits approach by constraining the prices increases of nationalised industries, putting pressure on eg the banks and the oil companies not to grant large pay increases out of large windfall profits and conducting a compaign pointing out that failure to compensate for past RPI increases does not necessarily reduce real incomes if future RPI increases are less.

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Such a campaign would need to be directed at advisory bodies as well as at the private sector and the public at large. Even then there would still remain the commitments to armed forces, police, fire etc.

The second feature of the British labour market which reduces the impact of the ability to pay approach is the power of unions in the nationalised industries and the ability of those industries to find the money for large pay increases by raising prices (or by reducing investment and stocks, or by changing their source of raw materials eg importing coal). Here there is little choice. If in the area of nationalised industries the Government wants to reinforce the pressure of the 'ability to pay' on wage settlements they cannot both do so and continue to remain out of the firing line. The experience this year with the steel industry would need to be risked in a number of nationalised industries. The dangers are obvious but the alternative is to see the nationalised industries setting the pace for continued inflation with high settlements and high price increases in areas which have an immediate effect on the public - postal charges, commuting costs, water rates; in addition to the high costs of keeping up with the world price for heat and light.

The third feature of the British labour market which contains the operation of the 'ability to pay' is pay research and comparability in the determination of pay levels in central government. It is not an adequate defence of this system to point out that in recent years local government pay has risen faster than central government, or that by definition comparability can only follow the rise of incomes in the private sector and not lead them. The Government has decided to be quite tough on local authorities in fixing cash limits and facing spendthrift authorities with financial penalties. So the experience of local government pay may be different in the years immediately ahead to those just past. Also comparability in the central public sector can indeed be a constraint on the reduction of inflation. In part because the lagged way in which comparability operates has a similar slowing effect to backward looking indexation and in part because the pay research system tends to look mainly at

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"comparable employers". That is mainly to the larger employers in both private and public sectors and to the service industries. These are the very sectors least likely to be affected by the squeeze on 'ability to pay' and so pay research tends to extend this protection to yet another area of the economy. Reform of pay research by changing the choice of analogues so as to remove this bias would be some help b ut would not remove the effect of pay research being lagged and reflecting last year's increases; a feature which produces the backward indexation type of constraint on rapid deceleration.

To sum up: the Government has wanted to keep out of the 'incomes policy' forming line by relying on reduced ability to pay (M3 plus cash limits) cutting back on wage settlements and on inflation. To date this policy has manifestly failed. A failure in the first year can, reasonably, be blamed on the inheritance from Labour. The question which matters is how soon this policy will succeed and at what cost.

These are features of the British wage bargaining system which suggest that it will work only slowly and do considerable damage; particularly to the internationally competitive sectors of our economy and to the smaller firms. In this situation alternative policies must be faced: these are (i) a complete turn round to a wages freeze or a low norm incomes policy and (ii) a less dramatic policy shift with the Government having an incomes policy in the sense of an overt assault on the backward indexation approach; on pay research and comparability as at present practised and on nationalised industries agreeing large pay settlements and finding the money by price increases, investment cuts, etc.

Either of these new approaches would mean the Government abandoning its policy of avoiding overt involvement in pay disputes. The wage freeze or low norm has the presentational advantage of appearing "fair" - though frequently it is not. The other policy is less of a U turn and does allow the Government to pick and choose its battlegrounds. Battles these are bound to be and the Government would have to risk quite a number if the new approach was to have appreciably more "bite" than the present "ability to pay". In particular the nationalised industry

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battlefields are littered with old casualties, including past Governments. But the next battles might not be replays of the past. There are very important trends in the Government's favour:- the public attitudes to unions after the winter of 1978-79 and the desire for trades union reform; the lack of cohesion between unions; the belief among workers that some of their jobs may really be at stake and the willingness cross picket lines accordingly; plus signs of weakness in some public sector unions (teachers, S. Wales miners).

Be that as it may, what is completely clear is that the Trades Union leaderships would only collaborate with this Government on any form of incomes policy (a 'social contract') on terms that would be unacceptable, such as the abandonment of legislation on Trades Union reform. So the assumption has to be that no form of incomes policy would be agreed by the unions and the Government has to face a battle on either of the two alternatives to the present approach of leaving it to "ability to pay".

If the Government decides against the wage freeze or low norm it will need to plan its strategy along the lines of:-

1. An attack on backward looking indexation and its comparability counterpart by widespread publicity on the real effects of this approach; by pressure on the protected parts of the private sector (e.g. banks) not to give high awards; by improvements in the pay research system. But the Government will not wish to have too many battles at once and it will need to decide which of its firm commitments it will adhere to (Armed Forces, Police, Fire, various advisory bodies). Avoiding most unpleasantness and risk would of course negate the change of policy.

2. An attack on wage settlements in nationalised industries via involvement in price increases and wage offers. Again on a selective basis and again on the principle that no good will have been achieved if most risks are avoided.

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So the basic decisions required are:

(a) Is it acceptable, in British conditions, to soldier on till reduced ability to pay has reduced wage settlements and inflation rates to the point where the economy can expect to re-expand on a firmer foundation;

(b) If not, is the alternative to be a wages freezes/low norm type policy or buttressing the "ability to pay" approach with overt attacks on those features of the British system which constrain the "ability to pay" approach from being rapidly successful (accepting always that such a new "high profile" will mean battles).

(c) If the latter course is chosen then where are battles to be risked and where avoided; and around what figure for wages increases are the battle lines to be drawn - 10%? 15%? These detailed issues are obviously important and need much working out and accepting by Departments (all will want to avoid battles on their territory). But the essential first step is for Ministers to agree whether or not they do want to change policy. If they do then the change must be a real one to justify the extra risks and officials must be instructed to examine the detailed alternatives with this fact firmly in mind.

10 June 1980