The incomes policy cycle in Britain: an attempt at explanation

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British economic history shows a recurring cycle of incomes policies, which may be inevitable in a mixed economy with a large public sector. The long-term answer is to extend the influence of monetary policy instruments

The approach of successive governments to controlling inflation has oscillated in the last thirty years between incomes policy and monetary restraint. For most of the period incomes policy has been the preferred method; attempts to establish it in a workable and meaningful form have been almost continuous. However, none of these attempts has been successful for long and incomes policy is best analysed in terms of a cycle. Indeed, the rise and fall of incomes policy have been a recurrent drama in British political life and are central to understanding macro-economic policy. An explanation of the incomes policy cycle may also be useful in assessing the viability of the present government's strategy in which reliance is being placed almost exclusively on monetary control. As we shall see, the alternation from incomes to monetary policy reflects the different impacts of the two on the public and private sectors. In this sense the policy discontinuities are the product of a mixed economy.

The incomes policy cycle has been played out several times. The first began with the wages bargain between the Labour government and the TUC endorsed by a special conference of trade union executives on 24 March, 1948; it ran until October 1950, when the TUC refused to accept wage limitation any longer. The most recent was inaugurated by the White Paper *The Attack on Inflation* on 11 July, 1975 and ended at an indeterminate point probably in the autumn of 1978. Two well-defined intervening cycles occurred in 1964–69 and 1972–74, while government-union talks in 1956 and some income restraint machinery between 1961 and 1964 are more difficult to classify. There have been different nuances on each occasion, but certain themes are shared.

Events tend to follow a characteristic sequence. The breeding ground for incomes policy is disquiet about the economic situation, with high inflation and an unfavourable balance of payments being the main talking points. Meetings are arranged to discuss what should be done. The relevant producer groups posture, exchange courtesies, and at this stage typically do nothing. The trigger for substantive action has almost always come from an external development such as bad trade figures or an attack on sterling in the foreign exchanges. The government reacts in part by conventional deflationary measures, but also by putting renewed emphasis on tripartite negotiations between it, the unions, and employer organisations. An accord is reached, specifying either a complete freeze on prices and profits or a quantified limit over their increase in the coming year. This limit is ambitiously low in comparison with the previous year.

Semblance of harmony

In the first year the limit is respected, inflation falls and the balance of payments improves. The parties to the agreement congratulate each other and set about another round of negotiations. By now there is no question of a freeze and the envisaged restraints on wages growth are less demanding than in the first phase. As the second year progresses, a number of dissident groups make it known that they do not wish to abide by the restraints and economic ministers have to conciliate them by recognising their 'special case' status. A semblance of harmony may be preserved for the third round of negotiations, but discontent in the trade union movement has become general and certain industries are visibly evading the government's controls.

Another specific limit is agreed, often at the cost of concessions to the trade unions on policy issues far distant from pay and prices. But the limit cannot be enforced and the policy crumbles as one group after another settles for more than is supposed to be permitted. Although those involved in wage bargaining know when the policy has finished, it is rare for governments to announce explicitly the date of its demise. It is left to a successor government, of a different political complexion, to abolish the formal pay and price controls.

A period without incomes policy follows, often marked by rhetoric about the virtues of the monetary weapon to combat inflation. This may be translated into tangible measures with higher interest rates or quantitative restrictions on bank credit. However, within the electoral timetable, these measures seem too slow-acting. The government once again begins consultations with the unions and employer organisations on more direct control over incomes. Another incomes policy cycle is under way.

The cycles have not conformed exactly to this pattern. For example, the build-up to the 1964–69 incomes policy was gradual, with the government and the trade unions putting together a 'joint statement of intent' on 16 December, 1964 long before the imposition of a compulsory freeze in July 1966. The preliminary phase, which was voluntary and set a 3–3½ per cent guideline for the growth of incomes, was less tough than the second which was statutory and envisaged no growth at all. This broke the rule that incomes policies become more relaxed the longer they last.

Repetitive cycle

Moreover, it would be schematic to pretend that there is an overlap between other regularities in Britain's political economy, such as the stop-go cycle, and the incomes policy cycle. The 'counter-inflation programme' of the Heath administration was introduced early in a vigorous upturn in business activity, whereas the next incomes policy, which began in July 1975 with the formula of a £6-a-week maximum increase for all workers, coincided with a severe decline in demand. But the broad outline of the cycle has been, to say the least, rather repetitive and is now well-known.

The fortunes of competing economic doctrines have fluctuated according to the stage the cycle has reached. Thus, the collapse of the first Wilson government's pay policy in 1969 was accompanied by renewed attention to monetary theory. Although prompted mainly by the IMF visit and balance-of-payments difficulties, the concept of domestic credit expansion made its appearance at that time when disillusionment with incomes policy was widespread. Interestingly, the only prolonged period since the war in which the government eschewed incomes policy—between 1950 and 1961—was also one when conscious and deliberate use was made of monetary policy. The failure of the 1956 pay restraint initiative obliged the authorities to concentrate on monetary policy, a bias which was articulated by Thorneycroft when Chancellor of the Exchequer in 1957. For a time ministers paid lip-service to such abstractions as the quantity theory of money.

There has been a tendency to bracket conscious resort to monetary policy with 'monetarism' and to incomes policy with 'Keynesianism'. The categorisation, although perhaps vulnerable to exegesis of 'what Keynes really said', certainly corresponds to the reality of the economic debate in Britain. In consequence, triumph and defeat in the running battle between monetarists and Keynesians has been determined by perceptions about the validity of incomes policy. In general, monetarists favour the free enterprise economy dominated by private property and the price mechanism, whereas Keynesians are more sympathetic to nationalisation, planning and the public sector*. This contrast provides a useful clue to detecting the origins of the incomes policy cycle. The hinge of the argument is the very different character of public and private sector employment.

Public sector insulated

Most incomes in the public sector are not related to the sale of a final product. The output of civil servants, teachers and doctors is not marketed, but instead paid for by taxpayers through the government. As an employer the government is unique. It can never go bankrupt and, indeed, can obtain command over resources at will through taxation. As a result fluctuations in the demand for public sector output need not be followed by changes in its levels of income or employment. In other words, if a shift from a relaxed to a tight monetary stance reduces aggregate demand in the economy, the public sector may be quite unaffected. It is difficult to provide government employees with a persuasive rationale for redundancies because their 'sales revenue' cannot be identified. The public sector is insulated from monetary policy and the market force pressures it generates.

These remarks have to be qualified in the case of the nationalised industries. They do have measurable sales revenue and they do have to adjust the wage bill to variations in demand. But the scope for borrowing, via the National Loans Fund, from central government allows the financial disciplines to be less exigent than in the private sector. Workers in the nationalised industries are tempted into believing that their ultimate paymaster is the government, not the general public which buys their products or services. The nationalised industries therefore occupy a grey area between general government and the private sector; they are influenced, but not strongly, by changes in monetary policy.

As the output of government employees is not subject to market judgment, functions are standardised and pay is determined by uniform scales. Low rates of labour turnover are also common. In consequence, the public sector is ideal for well-organised collective bargaining and unions are deeply entrenched. This is true of the nationalised industries, as well as the civil service and local government. In 1974 83 per cent of workers in the public sector were unionised, whereas the figure in the private sector was only 35 per cent.

The position of the private sector is very different. Wages and profits (or losses) taken together equal the value of sales. Factor incomes are fully exposed to variations in demand and decision-takers are susceptible to market risks. The private sector's vulnerability is confirmed by the responsiveness of incomes to aggregate demand changes. According to Dean,

> ... during periods when the economy has been in a downward phase of the cycle earnings in the public sector have generally been increasing faster than earnings in the private sector, and 'vice versa' during the upswing*.

It is also possible that wage movements in the private sector are tempered by high unemployment to a greater extent than in the public.

The private sector encompasses a wide diversity of job-types and payments arrangements are complicated. Incomes typically have several components, such as a basic rate, overtime, payment-by-results supplements and bonuses determined by profitability. Labour turnover varies from industry to industry, but can be very high. It is often difficult for large private sector companies to keep full control over wage costs because of a fragmented and decentralised administrative structure. The dependence of incomes on local and specific needs, and the mobility of workers between companies and industries, militate against strong trade union representation.

Liquid assets

The private sector's exposure to market forces has implications for the effectiveness of monetary policy. Future variations in the demand for a company's product or in an individual's income are difficult to predict. To mitigate unforeseen income changes private sector agents keep a cushion of liquid assets, with bank deposits being the most important. This is reflected in their ownership pattern. On 21 May, 1980 the total sterling bank deposits of UK non-bank residents stood at £48,437 millions, of which £47,420 millions was held by the private sector and only £1,017 millions by the public sector. In consequence, monetary policy has direct repercussions on the private sector, a situation which contrasts sharply with the immunity of

*The divergence between the monetarists and Keynesians, and its intellectual roots, are discussed in the last chapter of T. Congdon, *Monetarism: an Essay in Definition*, Centre for Policy Studies: London 1978. A table of political economy 'schools of thought' is given on p. 4 of P. Davidson, *Money and the Real World*, Macmillan: London 2nd ed. 1978.

*A. J. H. Dean 'Earnings in the public and private sectors 1950–75' *National Institute Economic Review*, November 1975, pp. 60–70. The quotation is from p. 65.

general government and the indirect effects on nationalised industries.

The obverse of the private sector's sensitivity to monetary policy is the ease with which it evades incomes policy. In the not so short run, and despite institutional impediments which vary between industries, wages in the private sector respond to supply and demand. The complexity of the private sector wage packet, with the big element of overtime and bonuses, frustrates attempts to identify when official pay limits have been exceeded. Moreover, as incomes policy negotiations are conducted between government and unions, and most private sector workers do not belong to a union, they can legitimately claim they are not parties to the agreement. Particularly when an incomes policy is voluntary compliance is likely to be unsatisfactory. If there is any downward pressure on private sector pay it tends to be confined to the early years of a policy and to stem from the 'demonstration effect' of low settlements for highly visible public sector groups.

Inconsistent objectives

Violations in the private sector are the main reason why incomes policies do not last. The trouble may arise because the government pursues a macro-economic programme inconsistent with its incomes restraint objectives. Thus, as in 1978, it expanded the money supply at an annual rate of 15 per cent while the official pay norm was 5 per cent. Demand for many products, including cars, rose quickly and made the 5 per cent norm untenable. A long strike at the Ford motor company, which was concluded with a 17 per cent award, overwhelmed the government's policy. But confrontation with private sector workers is unusual. The more normal pattern is for private sector earnings to creep ahead insidiously, in part because they are difficult to monitor and the pay control bodies cannot ascertain when the limits are being exceeded.

As enforcement in the public sector is easier, compliance tends to be much better until about the middle of the second pay round covered by the policy. One or other public sector group then has a sense of grievance and it seeks the 'special case' status which is invariably the tocsin of a policy's disintegration. If the government 'loses' a major public sector dispute, the policy loses credibility. A flurry of settlements follows and nominal incomes return to the level justified by underlying macro-economic realities. The 'catch-up' in both the public and private sectors is enough to wash out the effect of incomes policy.

Demand expansion

Incomes policies may sow the seeds of their own destruction by encouraging expansionary demand management. In the first year or eighteen months, when they seem to moderate wage increases, the government may be duped into thinking that there has been a permanent improvement in the unemployment-inflation trade-off. The advantages of reflationary measures seem compelling, but once they have been taken the labour market tensions caused by an incomes policy become more severe and its breakdown is accelerated. The lesson was demonstrated most clearly during the counter-inflation programme of the Heath government. If an incomes policy does induce aggressive demand stimulation, wage and price levels may eventually be higher than if there had been no policy at all.

But it may be wrong to emphasise the threat to incomes policy from the incompatibility of overall macro-economic policy with wage ceilings*. The implication would be that an incomes policy could survive indefinitely if operated in conjunction with appropriate fiscal and monetary policies. The objection to this view is that an economy does not expand uniformly, with every industry having the same rate of productivity and output growth. Instead,

*Some writers have been encouraged, perhaps because this criticism of incomes policy has been particularly popular, to regard incomes and monetary policy as complementary. See P. J. Dawkins 'Incomes policy' in P. Maunder (ed.), *The British Economy in the 1970s*, Heinemann: London 1980 pp. 61–85, particularly p. 79, and A. A. Stevenson and J. A. Trevithick 'The complementarity of monetary policy and prices and incomes policy: an examination of recent British experience', *Scottish Journal of Political Economy*, 1977 pp. 19–31.

both trend and cyclical factors cause some industries to have sales and output performances which diverge markedly from average. Demand and supply may point to wage and price behaviour which cannot be accommodated within incomes policy constraints, even though macro-economic policy may be consistent with the pay norm. For example, an incomes policy may specify that wages must not rise by more than 5 per cent, while profit margins are to be held constant. For the economy as a whole that may seem sensible in relation to an expected long-run growth rate of 2 or 3 per cent. The second stage of the Heath government's counter-inflation programme took precisely this form, specifying a £1 plus 4 per cent limit for increases in weekly pay and 'reference margin' ceilings to restrict profits.

But a particular company may experience a 20 per cent sales increase in a year. What can it do? The success of its product should be translated into either more pay or higher profit margins, but neither is allowed. One possibility is for the company to slow down its sales campaign, despite the buoyant demand for its output. The disturbance to supply-demand relationships, and the consequent structural imbalance, may permanently stunt the economy's growth momentum. More probable, however, is evasion of the incomes policy.

Private sector

This source of slippage, caused by micro-economic distortion and not by inconsistent macro-policies, is likely in the private sector rather than the public. In general government the problem does not arise; in the nationalised industries deviations from the economy's average performance should be minor because their size makes their growth dependent on aggregate demand conditions, not on special demand variations due to a taste change or technical innovation. Moreover, micro-economic distortion is more difficult for the government to identify in small private enterprises than in the nationalised sector.

In the final analysis, therefore, the difficulties of securing observance of incomes policy in the private sector are responsible for their downfall. Monetary policy is needed to check wages and prices in the private sector because, sooner or later, incomes policy fails.

So often have incomes policies broken down that it may seem puzzling they still command widespread support. Even now Opposition politicians and trade union leaders are having discussions on a pay and price concordat to be available at a moment's notice if an election was called. According to newspaper reports, the CBI has also been approached*. Is there any point in all this? Or is it low-grade theatre between miscellaneous public figures with nothing better to do?

Negotiations between the government and the trade unions do, in fact, serve a function. The unions dominate the public sector where market disciplines on pay are weakest. Because nearly all public sector employees are union members, and as long as inter-union co-operation is firm, the general secretary of the TUC can 'deliver' pay restraint in a large segment of the economy. This is a genuine bargaining counter. It is extremely valuable if the pursuit of conventional anti-inflationary fiscal and monetary policies is jeopardising the government's popularity. Public sector observance of pay norms in the first year of incomes policy has always been good.

Commissions of enquiry

It is therefore quite wrong to dismiss talks between Labour politicians and TUC officials as a meaningless charade. To adopt a sociologist's distinction, they are behaving in ways which, 'if not rational in the economist's sense', are 'still intelligible'*. It is also wrong to underestimate the problems of assessing the right pay levels in the public sector. In the absense of a well-defined market relationship, they are often determined by *ad hoc* commissions of enquiry. As Blackaby has remarked,

> These bodies work without any reference to each other and, because each of them is concerned with only a very small part of the working population, they generally conclude that their recommendations will have no macro-economic consequences. Bodies of this kind inevitably become advocates for the groups whose relativities they are examining†.

The natural solution might seem to be a single arbitral body whose task is to ensure that the competing claims of the various supplicants are resolved with some degree of consistency. For a time incomes policy accomplishes this objective, by laying down that every public sector group should receive the same increase. The trouble comes when the private sector, where even the most conscientious TUC leaders are helpless against inflationary market pressures, has moved ahead of the public sector.

This disparity between public and private sector income increases has another role to play in the government's policies. By doctoring the 'relative price effect', it may enable the budget deficit to be reduced without the pain of cuts in expenditure volume. Incomes policy may be regarded as a supplement to fiscal deflation as well as a complement to monetary restraint. Healey exploited this

*'Murray suggests link with CBI', *The Financial Times*, 14 July 1980.

*The phrases are taken from p. 195 of J. H. Goldthorpe 'The current inflation: towards a sociological account' in J. H. Goldthorpe and F. Hirsch (eds.), *The Political Economy of Inflation*, Martin Robertson: London 1978.

†F. T. Blackaby 'The reform of the wage bargaining system', *National Institute Economic Review*, August 1978 pp. 49–54. The quotation is from p. 53.

possibility in 1977 and 1978, his middle years as Chancellor of the Exchequer*. It seems that, between August 1977 and July 1978, the 10 per cent guideline was observed in the public sector, whereas earnings in the private sector rose by about 15 per cent.

Incomes policies are therefore inequitable in impact. However, monetary policy also has its drawbacks. As the transmission mechanism between monetary events and pay increases is discernible only in the private sector, there is a danger that periods of tight money will be accompanied by the public sector gaining ground at the expense of the private. The 1974–75 wage explosion was contemporaneous with free collective bargaining and a drastic slowdown in monetary growth; it certainly saw bigger settlements in government and the nationalised industries than in the rest of the economy. The Clegg comparability awards of 1979 and 1980 had the same result, again while a tough monetary policy was being applied. If incomes policy discriminates against the public sector, monetary policy seems in recent years to have discriminated against the private.

Monetary restraint inevitably causes some loss of output and employment. The size of these losses depends on how quickly expectations respond to a lower money supply growth rate. However, expectations about justified wage awards depend not only on market conditions in the industry under consideration, but also on settlements achieved by comparable groups of workers in, for example, the public sector. If public sector increases are much in excess of the money supply growth rate, the 'wrong' expectations are formed and the private sector adjusts badly. The losses of output and employment are greater than if expectations formation had been more benign.

Differential effects

Moreover, monetary policy has differential effects within the private sector. Perhaps because for most of the 1950s and 1960s the availability of bank finance was determined by quantitative lending restrictions rather than regulated by its price, businessmen have tended to neglect interest rate changes as an advance indicator of industrial activity. The psychological impact of minimum lending rate has been muted. In consequence, interest rate changes have had to be larger than if expectational responses had been more nimble. The disruption to industries which are interest-sensitive, such as property and house building, has been correspondingly greater. The heightened contrast between interest-sensitive and interest-insensitive sectors is another symptom of macro-economic maladjustment to monetary restraint.

*The relative price effect measures how costs are rising in the public sector relative to those in the economy as a whole.

The tribulations of monetary policy, including high unemployment and inflation's slow reaction to financial measures, provoke unfavourable comparisons with the supposed simplicity and certainty of incomes policy. After a phase of single-minded monetary restraint, a press campaign therefore develops for the re-introduction of direct controls over wages and prices. Although the government may dither for a time, a 'crisis' of some sort supervenes, an incomes policy is declared and the cycle starts afresh. The initial impetus for another attempt comes from dissatisfaction with the monetary approach to defeating inflation.

The partial effectiveness of monetary weapons in a mixed economy may be indicted as one culprit for the incomes policy cycle. The cycle can also be interpreted as a symptom of the failure of the public and private sectors to reconcile their conflicting demands. Although this analysis intrudes a political dimension, which is perhaps unpalatable to economists, it seems inescapable that there is practical logic in enforcing—or, at least, trying to enforce—an incomes policy in the public sector. Arguably, the more formal and explicit the policy, the more beneficial is it likely to be in operation.

Perverse adjustment

The difficulty is that an incomes policy cannot be confined to one part of the economy because it creates a perceived risk of relative income loss; and, as has become familiar from many years' experience, an economy-wide approach founders on the twin obstacles of inconsistent macro-economic policies and micro-economic distortion. Moreover, large swings in comparative public and private pay levels, which have been a feature of recent incomes policy episodes if not of those before 1970, impede the formation of uniform and stable inflation expectations. The economy's adjustment to anti-inflationary monetary medicine is more perverse than if public sector-private sector differentials had not been unsettled by artificial incomes restraint.

Is there a solution? The present government's firm commitment to monetary policy, and only monetary policy, suggests that it should be possible—in perhaps two or three years' time—to tell whether reliance on one anti-inflation instrument is sufficient. If the strategy succeeds, incomes policy should be discredited and another cycle may never recur. However, it is difficult not to conclude that an incomes policy cycle is inevitable in a mixed economy with a large public sector. To say this is emphatically not to recommend an incomes policy, but simply to make an observation about the real world. The long-term answer is to extend the area over which monetary instruments exert sway. That involves further denationalisation of publicly-owned assets and reinforcing market disciplines in those parts of the public sector where they already have some influence.