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LECTURE NOTES

Alliance Policy and Economic Realities

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Tomorrow is Budget Day but tonight I have been invited to speak on a more important future issue.

The Liberal Assembly last September decided, I understand, to look again at economic policy and to this end set up an adequately funded enquiry. In a discussion with your Chairman and John Horam at Harrogate, I accepted an invitation to speak to the Gladstone Club on the economic realities that Alliance policy will have to take into account if the Party is to win the next General Election and then get re-elected at the General Election following; a double-first being a necessity if visions for the future are to be realised.

Party policy is a more important issue than tomorrow's Budget, for there is nothing any of us can do now to influence the proposals to be set before Parliament, but as members of the Gladstone Club your actions over the next couple of years can exert a significant influence over Alliance policy at the next General Election.

Party policy, to win the approval of the electorate, must not only be relevant, and be seen to be relevant to whatever the electorate may consider to be the most pressing issue, it must be capable also of immediate application in existing conditions. A new government needs to produce a Budget within a few weeks of taking office. First things first; what then are the economic realities that this first Alliance Budget, four years hence, will have to take into account?

For more than 200 years the British people have lived and attempted to earn their living in an economy dominated by the employee and employer relationship. Today, more than 90% of the working population are classed as employees. This is a reality that will not change significantly over the next four years. In order to earn a living these employees must strike a bargain with an employer. The employer offers a chance to earn a living but, since the employer has title to whatever is produced, the employees can offer in return only their labour.

On the one side are the employers - buyers of labour. On the other side are the employees - sellers of labour. Thus there exists what might properly be described as a labour market. Moreover, on this labour market rests all other markets, because nothing can be produced without labour. Whether the economy as a whole performs well, or performs badly, depends on the prevailing conditions in the labour market. One may object to the existence of a market for labour, one may intend to reform the system so that a labour market ceases to dominate, but unless the Alliance intends an immediate revolution the conditions in the labour market will determine the performance of the British economy for at least the life of the first Alliance government and probably beyond. This is the fundamental economic reality Alliance Policy must take into account.

Basic to the functioning of any market is the mechanism of the bargaining process - the interaction between buyers and sellers which, in a monetary economy, determines the ruling market price in terms of money. In any particular bargain this money price is always within a top limit set by the buyer and a bottom limit set by the seller. The buyer has a money sum in mind above which he is not prepared to strike a bargain with the seller. The seller has a money sum in mind below which he is not prepared to strike a bargain with the buyer. Where between these limits the bargain is struck will depend on the bargaining skills and the bargaining powers of the two parties.

The mechanics of the labour market are not essentially different from any other market and at the very beginnings of the industrial age Adam Smith observed closely the human and economic realities of the system that continues today. He observed that when employees have nothing to sell but their labour then money wages become the price of labour, and this price is determined on the one side by the demand for labour and on the other by the "price of the necessaries and conveniences of life."

In the labour market the buyers of labour are the employers - the employers fix the top limit above which the price of labour cannot rise. However, the employers demand for labour is a derived demand - a demand derived from the demand for the products of labour. This is the accepted supply and demand theory, but I trust with the Gladstone Club I can cut through the theory and be more direct. It is the need to make some margin of profit that determines an employer's demand for labour and his top limit in the labour market. If an employer fails to make that profit then he is forced out of business and drops out of the labour market as a buyer. Given our economic system, employers can demand labour only to the extent and at a price that it is profitable for them to do so.

This is another economic reality Alliance Policy must take into account. The first Alliance government will have to work through the mechanisms of the present economic system, and given that system then no good purpose is served by considering profits as a dirty word.

On the other side of the labour market employees are the sellers of labour, and as sellers they fix the bottom limit below which the price cannot fall. But what determines this bottom limit? According to Ricardo and associated so-called Classical economists this bottom limit towards which the price of labour tends automatically is determined by the cost of subsistence of the present generation of employees and the cost of raising the next generation. This may have appeared valid enough at the time of the 'Labourers' Revolt' but today employees do not strike for a slice of bread but to pay for their television sets and package holidays.

As I have mentioned, Adam Smith came much closer to the realities whilst Ricardo was still a toddler. He not only observed that the employees' bottom limit is determined in relation to the "price of the necessaries and conveniences of life", but also that these will vary from place to place and from time to time. In other words Adam Smith calls our attention to the reality that, given a market for labour, the bottom limit - the least employees are prepared to accept at any time and at any place - is determined directly by psychological forces, not by market forces. These psychological forces are powerful and once they have established a limit then that limit will be subject only to a very slow rate of change. This is yet another economic reality Alliance Policy must take into account. An incomes policy cannot work. A statutory incomes policy may look tough on paper but in practice the human psychological factors on the one side and the profit factor on the other will prove tougher. Your leader does not have to take my word for this but the word of his compatriot - 218 years ago Adam Smith, a Scot, recognised the realities of our present economic system.

However, within the limits of the most employers can afford to pay and still make a profit and the least employees are prepared to accept, it seems reasonable to expect the price of labour, however measured, to be responsive to conditions in the labour market; rising in good times, falling in bad times, this is what pay bargaining should be about - indeed, this is what the established theory of supply and demand predicts. Professor Phillips accepted this prediction in a well - researched paper he published in 1958. This was the paper that included what has become known as the Phillips curve hypothesis. The relationship between the price of labour and unemployment, which Professor Phillips calculated from 1860 estimates, performed well through the subsequent periods he investigated, but it was soon found not to hold in the conditions of the 1930s - nor has it held since. The monetarists stepped in with their own version: "the expectations augmented Phillips curve hypothesis." Experience over recent years suggests this hypothesis too is as much a broken reed as Phillips' original version.

How is it that the relationship between pay and the availability of jobs, which appeared to hold for decades, has ceased to hold? How is it that a theory applicable to all other markets now appears inapplicable to the labour market? What has changed? The answer is that what has changed is the method of raising tax revenue.

Contracts of employment in this country, with very, very few exceptions, all attract taxation - PAYE, income tax, employers' and employees' social security taxes and, tonight if not tomorrow, National Insurance Surcharge. These pay bargain taxes drive a wedge between what an employer must pay out for labour (employers' labour cost) and what an employee receives for that labour (employees' take-home pay).

In the decade after the end of World War II, the pay bargain tax wedge contributed about a quarter of the government tax revenue. Today it accounts for about 50%. Worse, during the past 25 years the share of the Net National Product at current market prices appropriated by tax revenue has increased by one half. Thus the real burden of pay bargain taxes has been increased by a multiple of three, that is, from less than a 7% share of the product to near a 20% share of the product.

What has happened in the labour market is that successive governments increased the size of the Pay Bargain Tax Wedge until it absorbed the whole of the difference between the most employers can afford to pay and the least employees are prepared to accept. As a result of this the labour market ceased to operate as a competitive market which brought human beings together to strike a bargain with give-and-take, and began to operate the other way round; i.e. as if it were a monopoly market with a take-it-or-leave-it fixed monopoly price determining market conditions, and an indicator of these labour market conditions is the level of unemployment.

A kind of Phillips curve relationship still holds, but it works now the other way round to that hypothesised by Professor Phillips. The price of labour has ceased to be the result of a bargain positively responsive to the level of unemployment; today the level of unemployment responds to the size of the Pay Bargain Tax Wedge and pay bargaining is a cause of discord. Note well, it is not the power of Trade Unions that has created a fixed-price labour market, but the power of taxation imposed by Parliament. The mass unemployment we have today is not the result of employees pricing themselves out of employment, it is the result of successive governments taxing them out of employment.

This brings me to the final economic reality for tonight. Alliance policy must take into account the fact that successive governments, by their tax policies, have created in effect a fixed-price monopoly market for labour, and in turn it is this underlying discordant condition that is largely responsible for our relatively poor economic performance and for the combination of the social evils of inflation and mass unemployment. A significant cut in pay bargain taxes to free the pay bargaining process is a necessary preliminary for an expansion of employment without an upsurge of inflation.

To sum up: Catchy slogans, bright ideas, visions of Utopia are the stuff of economic policy for a Party in permanent opposition. The economic policies of a Party putting itself forward as an alternative government must take into account the economic realities of existing conditions. For it is in existing conditions that they will be called upon to implement their policies and resolve immediate issues. Whether or not a new government is given the opportunity to realise its visions for the future will depend on its ability to resolve immediate issues in existing conditions.

The economic realities Alliance economic policy must take into account are:

First, our economic system has called into being a market for labour and it is the conditions in this market that largely determine conditions in all other markets and the performance of the economy as a whole.

Second, employers can offer employment only to the extent that it is profitable for them to do so given the current cost of labour and, outside a fully controlled economy, statutory powers can never overcome the profit factor and the human factors affecting the labour market.

Third, the tax policies of successive governments have caused the labour market to operate as if it were a fixed-price monopoly market.

From these realities it follows that the point of effective immediate action for a policy intended to expand the economy without an upsurge of inflation is a cut in pay bargain taxes. A significant cut in these taxes will change the conditions in the labour market and this will change in turn the conditions in all other markets and the performance of the economy as a whole.

If the Alliance is to break the mould of British politics then it must show first that it has broken the mould of government thinking on economic issues. Face up to the economic realities, and it is possible to reduce unemployment without causing an upsurge in the rate of inflation and without recourse to a controlled economy.

I welcome the intention of the Alliance to look again at its economic policy, but a new enquiry, however well funded, will give value for money only to the extent that it faces up to the realities and puts first things first. No government can expand output and employment without first freeing the labour market from the ball and chain of pay bargain taxes.

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