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Less Pay More Jobs?

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Today there are in this country, and there have been for some time passed, over three million people in receipt of unemployment benefit; this means most certainly that there are over four million people who are unemployed in the sense that they would take up paid employment if it were available. We are back to prolonged mass unemployment, just forty years after the British Government accepted responsibility for maintaining, as it was put in the 1944 White Paper, a high and stable rate of employment.

The present Conservative administration has reneged on the 1944 White Paper and does not accept responsibility for maintaining any level of employment. It has reverted to nineteenth century economics with its claim that unemployment is largely the result of employees pricing themselves out of the market, on occasion with the connivance of employers. Whilst the benefit of a free market and the efficacy of free market forces are applauded, all changes in the labour market conditions during this century are ignored.

The Labour Party being the official opposition, assert that government is responsible for maintaining a high and stable rate of employment. They propose to cut unemployment by deficit government spending. This is to ignore, not only changes in labour market conditions, but also the changes that have taken place in all other markets since the end of World War One. The Labour Party opt for the advice that was given by most academic economists over fifty years ago, to deal with a slump of the early 30s. Then, following upon a decade of falling prices, some recovery in the general price level was considered to be a prerequisite for any

recovery of output and employment.

The Alliance Parties being in opposition also, agree with the Labour Party that responsibility lies with the government. The Alliance propose to cut unemployment by, amongst other things, some increase in government spending and by the preventing of employees pricing themselves out of the market. This amalgam ignores most of the changing facts of economic life and in the probable circumstances following immediately upon the next general election it is likely to produce the worst of all possible worlds.

Lord Keynes took into account the prevailing circumstances when formulating policy proposals, and as a result he was pilloried persistently throughout his life for ever changing his mind on issues of economic policy. In the New Statesman and Nation of April 4th 1941 he replied to these critics. Some of you will know the reply, but it does bear repetition.

He wrote: "I seem to see the older parrots sitting around and saying, 'You can rely on us; every day for thirty years regardless of the weather we have said what a lovely morning, but this is a bad bird - he says one thing one day and something else the next'." The unchanging sayings of the older parrots serve no useful purpose in the formulation of economic policy. One may use the tools of analysis fashioned by earlier masters or even those fashioned by the older parrots but if those tools are used objectively, and conditions are different, then also the policy prescription will also be different; as if one applies a lighted match to a gas jet in one set of conditions, one may end up with 'the cup that cheers'; in a different set of conditions one may finish up in the mortuary.

It is not in the spirit of Maynard Keynes to put forward today policies he formulated to meet very different circumstances of 55 years ago, any more than it is in the spirit of free market economics to put forward today policies formulated by free market economists a century ago. In particular, employment policies for the day must take into account the labour market conditions of

today, and the policy is to be assessed on the facts of current experience. Let us compare with the evidence the Treasury view and the statement on unemployment the Chancellor made at the House of Commons in October last year. The Chancellor said “A 1% change in the average level of real earnings will, in time, make a difference of between 0.5% and 1% to the level of employment; that will mean, in all probability, between 150,000 and 200,000 jobs.” The Chancellor went on to suggest that “if average earnings did no more than keep pace with rising prices, then 500,000 new jobs could be created each year and the effect would be cumulative.” He then said “If one year of pay in line with prices, instead of rising at 3% ahead of prices, eventually means an extra 500,000 jobs, two years of the same would mean 1,000,000 extra jobs and three years would mean an extra 1,500,000 jobs.” A talk such as this is not the place for a technical criticism of the Treasury’s method of handling statistics, so as to produce support for their master’s policy. In any event the Treasury view was stated clearly and concisely in the Economic Progress report they published in January 1985. The opening paragraph states: “The basic link between pay and jobs is clear. If people cost less to employ, more of them will be employed.”

This Treasury view is a nonsense. Employers can offer employment only to the extent that it is profitable for them to do so, given the current cost of labour. When creating new jobs, an employer must bear two facts in mind, the cost of the labour and what Keynes called the proceeds, that is the net income an employer expects to receive from selling the output of that labour. What matters to an employer is not the nominal or even the real cost of labour, but the cost of labour relative to the expected net income from employing that labour, in other words the product share represented by labour cost. As for an employer, so also for the economy as a whole.

At the beginning of this month the Central Statistical Office published detailed estimates showing how the economy has been

doing over the last eleven years. On the basis of these estimates in the first full year of Mrs. Thatcher's Prime Ministership, 1980, the average cost of labour to employers was 67.9 pence out of every pound of net income generated in the economy as a whole. In 1984 the figure was 61.6 pence in every pound of net income generated. Over four years this is a fall of 3.7%, close to 1% a year. Now if one follows Mr. Lawson's statement to the House of Commons, one might expect this fall to have generated at least an extra 800,000 jobs. But the official estimate is that from June 1979 to June 1984 the number of jobs fell by 2,000,000.

Looking back to the 1950s, the hey-day of full employment, we find that in 1955 when the total number registered as unemployed was less than 200,000 then the average effective cost of labour to employers was fractionally higher than it was in 1984. Since, over a period of 30 years, the average effective cost of labour has only barely kept pace with growth and inflation, then, on the basis of Mr. Lawson's argument it is reasonable to expect the number of jobs to increase, yet according to the government estimate there was an actual fall. In June 1955 there were 100,000 more jobs than in June 1984. These official estimates show up even more if we take the period from June 1955 to June 1980. During that period 1,714,000 extra jobs were created whilst the average effective cost to employers rose by 10%.

The official estimates it appears, are one thing, the Treasury view quite something else.

It is the Treasury view and their method of presenting statistics that enabled Mr. Lawson to stick to his motto of Less Pay, More Jobs and in so doing deftly shift responsibility for prolonged mass unemployment away from government. But if he can get away with it, why not? He's a politician, holding government office. It is the job of the opposition parties to confound the Chancellor with his own official estimates. Is the opposition too inclined towards the Treasury view - that if people cost less to employ, more of them will be employed?

It’s a view supportive of those holding office, and the opposition aspire to that office. Nonetheless, political knock-about apart, established economic theory does provide some basis for the Treasury view - the theory of supply and demand tells us, that when the price of a commodity falls then the demand for that commodity will tend to expand. This accords with everyday experience, so why should not labour markets operate as do commodity markets?

Indeed in 1958 Professor A. W. Phillips published a well-researched paper based on a hypothesis drawn from the theory of supply and demand. Taking money wages to be the price of labour, the unemployment rate as a measure of demand deficiency and with the base period as the latter part of the nineteenth century, Professor Phillips found a stable statistical relationship between the rate of change in money wages and the rate of unemployment, to hold for nearly a 100 years, through to the early 1950s. This was the paper that gave rise to the so called Phillips curve hypothesis.

The hypothesis stated that: “As the rate of unemployment falls the rate of pay increase rises, and as the rate of unemployment rises the rate of pay increase falls, until at a certain rate of unemployment there is stability, and any additional unemployment results in an actual fall in money wages.”

Of course as you may have noticed this hypothesis does imply a relationship between jobs and pay to be the opposite way round to the Treasury view and to what the Chancellor fondly supposes; rather than Less Pay More Jobs, Professor Phillips found that in the years prior to 1950 it was more jobs more pay, or less jobs less pay. But no matter; the Phillips relationship was found not to hold in the conditions of the 60s nor has it held in the 70s or 80s. That the relationship ceased to hold does not denigrate Professor Phillips’ research, nor deny his conclusions - it could be that conditions have changed.

One changing condition was emphasised by Milton Friedman, the post-war phenomenon of persistent inflation, that is still with

us. As Friedman put it: “You cannot fool all of the people all of the time.” As inflation becomes fully anticipated, he argued, pay settlements in money terms rise in line with the rise in prices, irrespective of the unemployment rate. Thus in the longer run, the Phillips curve becomes a vertical straight line, determining what he called the natural rate of unemployment.

For those charged with implementing public policy, Friedman’s natural unemployment rate hypothesis has a defect similar to the defect in his monetary theory. If one accepts that inflation may be squeezed out of the system by restricting the money supply then the monetary authorities must needs be informed precisely as to what this money supply is that they have to restrict.

So far the monetarist school of economic thought has not come up with a practical definitive answer. As regards the natural rate of unemployment all that the monetarist school tells us, is that over the past decade the ‘natural rate’ appears to have been rising in the United Kingdom. The all important hows and whys are wrapped up in numerous additional hypotheses, such as the expectations augmented Phillips curve hypothesis.

In this country we have been on the receiving end of an interesting experiment; interesting, that is, to academics, and those not on the receiving end.

Another change in labour market conditions and one rarely mentioned along the corridors of power or in its waiting rooms, is the post war phenomenon of imposing withholding taxes on incomes from employment and taxing employers for giving employment - what I call pay bargain taxation.

To understand the workings of this phenomenon we need to go back to the great granddaddy of all economists, Adam Smith. Over two hundred years ago he wrote: “The money price of labour is necessarily regulated by two circumstances; the demand for labour and the price of the necessaries and conveniences of life.”

Pay bargaining is, at root, much the same as any other bargaining. On one side there is a buyer of labour, the employer.

An employer's demand for labour is derived from the demands for the products of that labour and the most he can afford to pay for labour is determined largely by the net receipts he expects to receive from selling those products. As a buyer of labour the most an employer can afford to pay for the amount of labour demanded fixes the top limit above which a pay settlement cannot be agreed.

On the other side there is a seller of labour, the employee. As a seller, an employee determines the bottom limit below which an agreed pay settlement cannot fall, the least an employee is prepared to accept in return for supplying the amount of labour demanded by the employer, and this least is determined, in turn, by the price of the goods and services the employee wishes to purchase out of his pay. As Adam Smith put it, "by the price of the necessaries and conveniences of life."

All pay settlements must fall somewhere between the limits determined at the top end by the most an employer can afford to pay for the amount of labour demanded and at the bottom end by the least an employee is prepared to accept in return for supplying that amount of labour. The precise point between these limits at which the bargain will be struck depends on the bargaining skills and the bargaining power of the two parties.

Thus given a relatively free and competitive labour market with a stable general price level, then it is to be expected that Professor Phillip's relationship will hold. In boom time when labour is much in demand the bargaining power will swing in favour of employees and pay settlements will tend to rise. In a slump, the bargaining power will swing in favour of the employers and pay settlements will tend to fall.

The Phillips Curve hypothesis will apply for just so long as the necessary conditions are fulfilled. Given a relatively free and competitive labour market but in times of fully anticipated persistent inflation then Milton Friedman's hypothesis is likely to fit the case. As prices in general rise then the most an employer can afford to pay will rise and as the prices of consumer goods rise

then the least employees are prepared to accept will rise. With both the top and the bottom limits constraining the pay bargain rising it is to be expected that pay settlements will rise irrespective of the rate of unemployment. Friedman's hypothesis will apply for just so long as the necessary conditions are fulfilled.

Should government start interfering with the pay bargaining process through their methods of raising tax revenue, then both these hypotheses break down, for the reason that the necessary conditions are no longer being fulfilled.

When governments impose some form of payroll tax such as the Employers National Insurance contributions or the now abolished SET (Selective Employment Tax) and the National Insurance Surcharge, the impact effect of the tax is to increase the cost of labour to the employer by the full amount of the tax. At the next pay round, the payroll tax operates to reduce by the full amount of the tax the most the employers can afford to pay their employees in return for any given amount of labour.

When governments impose withholding taxes on employees pay, such as Pay As You Earn, Income Tax and employees' National Insurance contributions, then the impact effect is to reduce employees' take-home pay by the full amount of the withholding tax. At the next pay round the employees take the withholding tax into account and the least they are prepared to accept is increased by the full amount of the withholding tax.

The Economic Study Association (E.S.A.) has drawn attention to this in a number of papers and recorded talks, and now even the Organisation of Economic Co-operation and Development (OECD) admits that net of tax wage bargaining is the norm.

Thus sooner rather than later, from both sides, pay bargain taxes squeeze the room for manoeuvre as between employers and employees, and so make for friction, industrial disputes, and loss of output.

Far worse, as pay bargain taxes are increased a point is reached eventually when there is no room for manoeuvre left, and the

burden of payroll taxes cause the most employers can afford to pay for any given amount of labour to press upon the least employees are prepared to accept in return for supplying that amount of labour, which has been inflated by withholding taxes.

When this point is reached a fundamental change occurs in labour market conditions. The labour market ceases to operate as if it were a free market and begins to operate as if it were a fixed price monopoly market, with the effective fixed market price determined not by market forces, but by a majority vote in the House of Commons agreeing the level of pay bargain taxes.

Indeed, in the present case of the teachers,[1] it would appear that the least employees are prepared to accept is well above the most their employers can afford to pay. So long as that is the case there can be no agreed settlement; the difference, however, between the teachers and their employers is insignificant compared with the payroll and withholding taxes the central government collect from both sides. For a settlement of this dispute it is not necessary for the government to make more of the tax payers' money available, providing they stopped taking so much away in the first place.

These are the circumstances brought about by the tax policies of successive governments. Rising unemployment in the United Kingdom is not something that came in with Mrs. Thatcher - it has been a feature of the British economic scene for 25 years or more.

Statistical investigation of the U.K. economy shows that the post war phenomenon of pay bargain taxes now account for some 50% of central government tax revenue.

This post war phenomenon of pay bargain taxes causes the original Phillips Curve to be replaced by a kind of reversed Phillips Curve. One can forget about take-home pay and labour costs, for it is the rate of unemployment that is switched from being the independent variable to the dependent variable, and pay bargain taxes take the place of unemployment as the independent

1 A series of teachers' strikes took place across the UK throughout 1985, prompting eventual parliamentary action.

or causative variable. As pay bargain taxes are increased then in line with a stable curved linear function the rate of unemployment rises some 12 to 15 months later. On those rare occasions when pay bargain taxes have been reduced for a time, then in line with the same function, the unemployment rate has tended to fall, or at least, not to rise as fast, some 12 or 15 months later.

Over the past 25 years unemployment in this country has increased by a multiple of 13 - for every person unemployed in 1960 there are about 13 unemployed today. During this time the pay bargain tax approach explains some two thirds of the increase in unemployment. The longer governments pursue these disastrous tax policies, the more prolonged will be mass unemployment and the more difficult it will be to eradicate this particular social evil.

We're now in the midst of the microchip revolution - excellent past experience shows that similar technological advances lead in total to more rather than less jobs. Today, however, the weight of taxes imposed on employing people is misdirecting this particular breakthrough, by placing a premium on labour saving investment, and encouraging the destruction of one set of jobs whilst preventing the creation of other jobs. Once firms have invested their capital fund then that investment lasts a long time and is slow to respond to changes in tax policy.

It was no accident that the surge of investment in self service shops followed upon the imposition of SET in the latter part of the 1960s by the then Chancellor of the Exchequer, Mr. Callaghan.

There was a time when the boss men of many retailers had started as errand boys, but this is no longer a possibility, for the bottom rungs of that ladder have for some time been knocked away by taxation. Today pay bargain taxes have knocked away the bottom rungs to most ladders, and as a consequence the youth of Britain are languishing in idleness, relieving their boredom from time to time by creating civil commotion or worse.

Whether or not governments should be responsible for maintaining a high and stable rate of employment, is one issue.

Whether or not government are responsible for the mass unemployment of today is a different issue. In the former case there is room for differences of opinion, in the latter case there is none. The evidence leaves no room for reasonable doubt that it is the methods by which successive governments have raised public revenue, that is, in this country the cause of a major part of unemployment today. The method of raising public revenue is wholly the responsibility of government.

It is not a case of people pricing themselves out of a job; it is a case of government taxing them out of jobs. Yet, in political circles, it is still being mooted that Domestic Rates should be abolished and be replaced by a local income tax, that regional governments should be set up financed by regional income taxes, and so on. In practice these additional income taxes mean additional withholding taxes on employees' pay, and the result of such increases in present conditions would be a disaster. They may seem good ideas, they may initially be calculated to win votes, but the methods proposed to finance them would cause unemployment to rocket.

At present mass unemployment is the responsibility of government, for a major part is the direct result of ill-conceived tax policies pursued by successive post-war governments, continued by this government, and which the opposition parties also propose to continue if they are successful in their bid for office. The eradication of the social evil of mass unemployment is not an issue about what government should do, it is a matter about what government is doing and should stop doing.

If political parties wish to pursue their bright ideas and at the same time eradicate the social evil of mass unemployment, then they must find other ways of raising public revenue, and then, first, use that revenue to abolish pay bargain taxes.

The facts of experience show that this must be the first step from where we are towards a just and prosperous Great Britain.

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