Public Talks

# Alliance Policy and Economic Realities

Gladstone Club, London

12th March 1984

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Tomorrow will be 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 Mr. John Horam at Harrogate, I accepted an invitation to speak tonight to the Gladstone Club on the economic realities that Alliance policy will have to take into account if the party is firstly to win the next General Election, and then to 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 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, but it must be capable also of immediate application in existing conditions.

A new government needs to produce a new Budget within a few weeks of taking office. First things first, therefore; what then are the economic realities that this first Alliance Budget, say four years hence, will have to take into account?

For more than 200 years the British people have lived and have also 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 rest 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, or 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 that Alliance policy must take into account.

Basic to the functioning of any market is the mechanism of the bargaining process – the interaction between the 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 upon 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. 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 in fact a derived demand – it is a demand derived from the prior demand for the products of labour.

This is the accepted supply and demand theory, but I trust with the Gladstone Club, I can now 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 we have that system, 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 of labour cannot fall. But what determines this bottom limit?

According to David 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,[1] but today employees do not strike for a slice of bread, but to pay for their television sets and package holidays.

1 Such as the Labourer's Revolt of 1830-1831, also known as the Swing Riots.

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 that employees are prepared to accept at any time and place – is determined directly by psychological forces, and not by market forces.

These psychological forces are very 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[2] does not have to take my word for this, but the word of his compatriot – 218 years ago Adam Smith, a fellow Scot, recognised the realities of our present economic system.

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 is 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 A. W. Phillips accepted this prediction in a well-researched paper he published in 1958.

This was the paper that included what is known as the Phillips curve hypothesis. The relationship between the price of labour and unemployment, which Professor Phillips had calculated from 1860 estimates, performed well enough through the subsequent periods which he investigated, but it was soon found not to hold in the conditions of the 1930s – nor has it held since.

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2 David Steel was Leader of the Liberal Party from 1976 until March 1988.

The monetarists stepped in with their own version, which they called ‘the expectations-augmented Phillips curve hypothesis’.

Experience over recent years suggests that this hypothesis too is just as much a broken reed as Professor Phillips’s 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.

All contracts of employment in this country, with very, very few exceptions, attract taxation – PAYE, income tax, employers’ and employees’ social security taxes and, tonight if not tomorrow, the National Insurance Surcharge.[3] These pay bargain taxes drive a wedge between what an employer pays out for labour (employers’ labour cost), and what an employee receives for that same labour (employees’ take-home pay).

In the decade after the end of the Second World War, the pay bargain tax wedge contributed about a quarter of the government’s tax revenue. Today it accounts for about 50%. Worse, during the past twenty-five years the share of 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 increased by a multiple of three; from just 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 have increased the size of the pay bargain tax wedge, until it has 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 change the labour market ceased to operate as a competitive market, bringing human beings together to strike a bargain with some give and take, and began to operate the other

3 The removal of the employer’s National Insurance Surcharge was announced the following day, in the March 1984 Budget.

way round, as if it were a monopoly market with a take-it-or-leave-it fixed monopoly price determining the market conditions.

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 around to that originally hypothesised by Professor Phillips.

The price of labour has ceased to be the result of a pay bargain positively responsive to the level of unemployment; today the level of unemployment responds instead 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 the trade unions that has created a fixed-price labour market, but the power of taxation, imposed by Parliament.

The mass unemployment that 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 a 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. In turn, this underlying discordant condition 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, and visions of Utopia are the stuff of economic policy only for a party that expects to be in permanent opposition.

The economic policies of any party putting itself forward as an alternative government must first take into account the economic realities of existing conditions, for it is in these existing conditions that they will be called upon to implement policies and to resolve immediate issues. Whether or not a new government is given the opportunity to realise its visions for the future will depend upon its ability to resolve immediate issues in existing conditions.

Thus, the economic realities that 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 the conditions in all the 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 of 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 three realities it follows that the point of effective immediate action for any 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 first show that it has broken the mould of fixed government thinking on economic issues. Face up to these economic realities, and it is then 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 own economic policy, but a new enquiry, however well it is funded, will give value for money only to the extent that it faces up to 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.