Prime Minister (1)

As you requested, I have arranged for you to have a talk* with Alan Walters. Would it not be a good idea for John Sparrow also to be present? Yes MT

cc/JU

*next Tuesday

CONFIDENTIAL

Qa 05875

To: PRIME MINISTER

From: J R IBBS

30 March 1982

MCS 30/3

CPRS Interim Report on Unemployment

1. I have seen Alan Walters' minute to you of 26 March.

2. There seems to have been a misunderstanding. Like Alan Walters, we think that it is the marginal situation facing an unemployed person on return to work that matters. To get a balanced picture, we have to look at a representative sample of unemployed with different family circumstances. We know already that for a minority (particularly some family men with children) the effective marginal 'tax' rate is 100 per cent or more and this is included in our Interim Report. The heart of the problem lies in estimating the numbers who are in this kind of situation, not in the concept.

3. Because of the importance we attach to establishing the numerical relationship between unemployment and wage rates and benefit levels, and the need to throw light on special circumstances in this country which exacerbate the unemployment problem (including unionisation), we wanted to commission further work on international comparisons. We welcomed Alan Walters' offer to supervise this work, particularly in view of his familiarity with Professor Minford's methodology. This arrangement, which we have always regarded as one of amicable co-operation, frees resources within the CPRS to concentrate on the practical policy implications, which is the essential role of the CPRS.

4. The aim of the Interim Report is to encourage comments so that the study does not go off-course. The drawing together of some soundly based lines of practical strategy remains our final objective. I hope that Alan Walters' minute does not mean that the study is about to fragment into two separate exercises. If I were remaining at the

CPRS I would want to ensure that we stayed in very close touch with the work Alan Walters is supervising, as it develops. But obviously this is something you will wish to discuss with John Sparrow.

5. I am sending copies of this minute to the Chancellor of the Exchequer, the Secretary of State for Employment, Alan Walters, and Sir Robert Armstrong.

29 March 1982

PERSONAL AND CONFIDENTIAL

MR WHITMORE

cc Alan Walters.

JOHN VEREKER'S NOTE ON CPRS/No.10 ARGUMENT ON THE UNEMPLOYMENT STUDY

Just a quick note to say that I do not agree with John Vereker's proposed approach. If there is disagreement, we should get it out in the open and not seek an artificial consensus. I am talking with Alan about this. We cannot afford to fudge the report on such an important issue.

JOHN HOSKYNS

1

CONFIDENTIAL

Prime Minister.

MR. WHITMORE

My preference is to let this work rest until John Sparrow arrives (next week) and can get to grips with it. I would hope that he and Alan Walters, working together, would be able to reconcile the two different conceptual approaches and agree on the way forward. dtd 26.iii.82.

I will see Alan Walters

cc Mr. Walters
Mr. Hoskyns

CPRS Unemployment Study

We spoke about the handling of the CPRS interim report on unemployment, submitted under cover of Robin Ibbs' note today. Alan Walters in his own note makes clear his disagreement with the CPRS basic approach. As you know, I have to some extent been holding the ring between the opposing factions, and I have observed that there is a substantial amount of fundamental mutual disagreement. I think we must pause to consider the handling of further work.

The main issue seems to me to be whether it is sensible to proceed with, in effect, two teams working from totally different conceptual foundations: on the one hand the CPRS team, whose approach is demand-based, although they are prepared to make a nod or two in Patrick Minford's direction; and on the other hand the Alan Walters/Adrian Smith/Patrick Minford team whose approach is based on the marginal analysis of the labour market. I am convinced that if further work continues on this basis, it will lead to disagreement about the eventual report, with a high probability of Alan Walters dissenting from the recommendations; and I fear that such disagreement on this politically charged subject might find its way into the Press.

At this stage the disagreement is about economic principles, not policies. The Prime Minister may feel that it would be right for her to instruct that economists get together to agree a conceptual framework on which further work on policies will be based, before such further work is authorised. That might best be done by the introduction of a hitherto neutral party, such as Terry Burns: but I must make it clear that I have not had an opportunity this evening to discuss that suggestion with Alan. I think also, as I have said before, that we may need to look again at the desirability of allowing the eventual further work to be done in two separate sub groups, and John Sparrow might be

/encouraged

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encouraged to consider whether Adrian Smith ought not to be physically integrated with the rest of the CPRS team. In short, I believe that these conflicts should be resolved at as early a stage, and at as low a level, as possible.

26 March 1982

CONFIDENTIAL

26 March 1982

ALAN WALTERS

PRIME MINISTER

CPRS INTERIM REPORT ON UNEMPLOYMENT

1. The CPRS have consulted me frequently about their study. They have taken many of my points of criticism into account in the existing interim report, both as regards the content and the proposed work programme. However, CPRS do not believe they can take on board some of the central points of methodology and approach which I believe are essential.

2. One matter of crucial importance is that CPRS believes that, in the tax benefits wage nexus an analysis of the average ratios of benefits to net wages is adequate for discussing the effects of tax rates and benefits in generating unemployment. I believe this is quite wrong. In economics it is always the marginal rates that matter for incentives employment and unemployment. To illustrate this simple point: consider a tax system that takes 5% of income up to £3,000 then confiscates all income above £3,000 at 100% rate. The effective average tax rate in that system would be 5%, since no one would earn more than £3,000. But the 100% rate at £3,000, although no income would be earned there nor would tax be collected, would have an enormous effect on incentives. It is the marginal rates and only the marginal rates that matter. Similarly, with all benefits and wages, we should analyse them in terms only of the marginal rates. The averages are irrelevant.

3. An analysis of these marginal rates will give us the basic material on which we can proceed to discuss those methods of reforming the tax structure and benefit systems which are most cost-effective and which give us the biggest incentive effect. Since I believe this is absolutely central to our policies and since the CPRS do not seem to be so persuaded, I have undertaken to supervise some additional work. This will be done mainly by Patrick Minford on the Liverpool computer, assisted by an economist who I have borrowed from the FCO, Adrian Smith. We will also at the same time compare the marginal rates in different European countries. And of central importance, a point again that I believe CPRS has missed because of its devotion to average rather than marginal relationships, we shall examine the important effects created by unions, and in particular the fact that the choice for an unemployed man is likely to be a non-unionised wage. The division between the unionised and the non-unionised sector for marginal analysis seems to me quite crucial.

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4. Much of the rest of the report provides useful information and provokes thought. As an interim report, however, it lacks incisiveness. It requires a great deal more critical reflection.

5. I am copying this minute to the Chancellor of the Exchequer, the Secretary of State for Employment and Robin Ibbs.

26 March 1982

ALAN WALTERS

copy of this minute is in the attached wallet.

CONFIDENTIAL

Qa 05874 26 March 1982

To: PRIME MINISTER

From: J R IBBS

CPRS Unemployment Study

1. You asked us to undertake a study into the causes of unemployment, obstacles to the creation of jobs and possible remedies.

2. It is now two months since we began and I attach an interim report which embodies the first stage of our work so that you can see before I leave how the study is developing. The report and annexes are mainly concerned with diagnosis, but sections 7 and 8 list possible remedies on which we propose to do further work. Annex A reports progress on the particular question we were asked on the measurement of unemployment, and again suggests some areas (paragraph 9) which could be explored more fully in the final report.

3. Our first purpose in submitting this report is to set out the broad analysis of the causes and to indicate the further work we propose. The subject offers a wide range of ramifications that could be explored and we have to be selective. It would be helpful to know at this stage whether Ministers accept our initial assessment of the causes and whether they are content with the proposal for further work in this area.

4. After describing in Section 4 the reasons for the rise in unemployment over the last fifteen years, we list in Section 5 the main causes as we see them:

(a) low world growth;
(b) poor UK economic performance;
(c) previous policies which have contributed to poor performance (accommodating supply-side weaknesses, adding to labour costs);
(d) structural shifts (from manufacturing into services);
(e) lack of real wage flexibility (influenced by a number of factors, listed in paragraph 34, including trade union power

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CPRS UNEMPLOYMENT STUDY

INTERIM REPORT

March 1982

CONFIDENTIAL

CONTENTS:

FIGURES:

ANNEX:

CPRS UNEMPLOYMENT STUDY: INTERIM REPORT

SECTION 1 - INTRODUCTION

1. Our remit is to examine the causes of unemployment, the obstacles to the creation of jobs, and possible remedies. This interim report sets out our main findings on causes, indicates the further work we plan on this aspect, and makes proposals for work on remedies.

2. The remit also includes examination of whether the unemployment register totals are the best measure of unemployment. Our tentative conclusions on this question are set out in Annex A.

3. In producing this interim report, we have studied the literature, held discussions with some academic economists (including Professor Patrick Minford), and obtained views from the CBI and one or two large employers. We have also had assistance from the Government Departments concerned, but have not sought an agreed view.

4. We invite Ministers to consider whether they agree with our analysis, and are content that we should carry out further work on the lines proposed, in particular some aspects of causes (Section 5) and remedies (Sections 7 and 8).

SECTION 2 - THE CPRS APPROACH

5. People are unemployed because the supply of labour (those wanting work) exceeds the demand for labour (jobs offered by employers). The supply of labour is mainly determined by demographic and social trends, and is affected by willingness to work at given wage levels. The demand for labour depends on a variety of factors - wages and other costs of employing labour, shifts in productivity, success of companies in meeting the requirements of the market, and the overall performance and growth-rate of the economy.

6. Unemployment can be seen as fundamentally a problem of labour market rigidities. It has been put to us strongly that, if wages could be brought down enough (in real terms), employers could afford to take on more people and there would be jobs available for all those willing to work at these lower rates.

7. The reasons for "real wage stickiness" have been much discussed, and we have looked in particular at the work of Professor Minford on trade union power and the effect of social security benefits. He has examined the numerical relationship between unemployment and these factors. We believe that an understanding of these relationships is valuable and we propose with his help that further work should be done on them by making some international comparisons of the apparent effects of these factors. However, in our view the behaviour of employers also contributes to real wage rigidity.

8. We consider that the role of the CPRS must be to work towards realistic remedies for Ministers to consider. It is worth trying to establish the probable numerical relationship between levels of real wages and unemployment for the range of wage reductions that might be politically feasible. But in practice there are constraints on the speed and extent to which real wages and social security benefits can be brought down. It is our belief that the reduction in unemployment that could in practice be achieved reasonably soon by this route will be insufficient. Hence we have not confined our attention to real wage reductions. We are convinced that in practice it will also be important to find ways of improving the performance of the economy, and in particular the productivity and competitiveness of the trading sector, both manufacturing and services.

9. Unless world growth recovers, the need for continued improvements in efficiency is likely to mean little or no net increase in employment in the trading sector - indeed, there may be some further reduction. But this is not a reason to prop up uncompetitive enterprises indefinitely - on the contrary, Government action needs to be directed towards encouraging entrepreneurial skills and innovation that will lead to new sources of employment.

10. In the long term, competitive success in the trading sector could generate enough wealth to allow the non-trading service sector within the United Kingdom to expand and provide jobs for most of those now seeking work. Obviously the lower real wages fall the easier this will be. However, because of the inevitable delay in the improvement of the trading sector, part of the immediate adjustment needs to be through shorter hours and more work-sharing if this can be achieved without raising unit costs. But at best there will still be problems of mismatch in the medium term between the demands for labour and the skills and expectations of the work force. Therefore, substantial unemployment is likely to continue as these structural adjustments work through. We propose to extend our examination of remedies to include the scope for shorter-term measures to ease this, eg on the lines of the community work scheme announced in the Budget.

KEY FACTS ABOUT UNEMPLOYMENT

SECTION 3

11. Data are provided in figures 1-7 which can be found at the end of the report. They suggest three basic phenomena to be explained -

a. the rising trend in United Kingdom unemployment from around 350,000 (1.5 per cent of employees) in the mid 1960s to 1.3m (5.6 per cent of employees) in the late 1970s (see figure 1);

b. the steep rise since 1979 to the level of 2.8m in February 1982 (seasonally adjusted, excluding school leavers);

c. in part the increase has been an international phenomenon (figure 2). Thus the secular rise to 1979 occurred in other European countries though Britain's relative position deteriorated from about the middle of the pack in the early 1960s to near the top of the unemployment table by 1981.

12. Associated with the rise in unemployment were certain key developments in labour supply and employment patterns -

- the most significant loss of jobs has been in manufacturing (figure 4). This is associated with the fall in male employment since 1966 (figure 5) and with the rise in total unemployment (figure 6);

- but total employment declined only slightly between 1966 and 1979 (figure 3) as a result of growth in non-manufacturing jobs;

- the growth in non-manufacturing jobs was concentrated in the public sector and largely benefited part-time female workers (figure 5);

- this growth in female employment drew on the very long term tendency for an increasing rate of participation of married women in the workforce particularly in the early 1970s. Since 1974, however, female unemployment rates have been rising (though partly as a result of an increased propensity to register) (figure 1);

- there was a surge of young people coming onto the labour force after 1974 (the consequence of the 1960s baby boom); and a sharp rise in youth unemployment;

- despite these changes in participation and composition of the work-force, the average annual increase in the labour supply between 1974 and 1979 was similar to that experienced in the full employment years in the first half of the 1970s (figure 3).

- employment in full time jobs has been falling since the early 1960s: in 1978 there were 1.7 million fewer full time jobs than in 1961. For the last fifteen years part time employment has been the only type of employment to grow. Self employment has been static;

- labour mobility also appears to have declined. There has been a downward trend in labour turnover rates in manufacturing industry for the last fifteen years.

SECTION 4 - HISTORICAL BACKGROUND TO THE GROWTH OF UNEMPLOYMENT

13. Unemployment has traditionally been classified under the following headings. There will always be some frictional unemployment however many jobs are available, since some people take time to find a new job. Structural unemployment comes when the productive resources available do not match the requirements of the market (eg a mismatch of skills to jobs and also insufficient adaption by both employers and potential employees). Cyclical unemployment arises from a deficiency of demand. This division has to some extent broken down with the emergence of accelerating wage inflation at levels of unemployment significantly in excess of the apparent level of vacancies. (This has led to the concept of the "natural rate of unemployment" which is broadly understood to be that level at which inflation is stable.) Also trade unions and their advisers have encouraged a tendency for economic realities to be lost sight of so that people have in effect been quite ready to risk pricing themselves out of jobs. When unemployed some have not sought work that is available, or have held out for higher wages or better jobs than are currently offered: such unemployment is voluntary.

14. We use these categories in looking at the period since 1966 in 3 phases; 1966-74, 1974-79 and 1979-81.

1966-1974

15. Up to 1966 there had been no significant trend increase in unemployment. High GDP growth, associated with strong investment and export demand, assured growing employment accompanied by expanding labour supply. From 1966-74 GDP growth on average remained at previous levels and, as can be seen in table 4.1, and figure 6, the demand for labour remained high as measured by notified vacancies and by the percentage of firms reporting skilled labour shortages to the CBI. Despite these factors, the unemployment rate began to rise during the period. Of several possible explanations, two are the most plausible.

Table 4.1 **UNITED KINGDOM DEMAND FOR LABOUR**

Peak to Peak Averages	Unemployment GB (excluding school leavers) (000)	Vacancies (000)	CBI Capacity (% of firms working below capacity)	CBI skilled labour (% of firms reporting shortages of skilled labour)
1960-1964	388	194	53	22
1964-1969	426	220	52	30
1969-1973	668	174	55	21
1973-1979	1020	209	63	24

Source: Department of Employment and CBI

16. The first explanation is that the economy was experiencing the beginnings of structural changes, a phenomenon common to other industrialised countries. The impact of these on unemployment was exacerbated by the underlying weaknesses of the United Kingdom manufacturing sector, which had persisted at least a century and had been largely concealed in the early post-war period by favourable world conditions and accommodating fiscal and exchange rate policies. But by the middle of the period the weaknesses - in terms of lack of motivation and entrepreneurship, weak management and poor industrial relations, resistance to change and the effect of restrictive labour practices - were making it increasingly difficult to match foreign competition. Moreover wage demands were increasing because monopoly trade unions could exercise greater power in the relatively tight labour markets, and the fact that inflation eroded the value of nominal wage increases was becoming more clearly recognised. These wage demands made it harder for government policies both to contain inflation and to maintain employment.

17. During this period there was a fall in employment in manufacturing, mining and construction of 1.3 million. Though the fall in industrial jobs was matched in terms of numbers by a substantial rise in service employment (mainly part-time), it called for a different quality of labour (in particular high female employment in the service sectors) from that released from declining industries. The mismatch of people to jobs was especially marked in the regions formerly dependent on the old basic industries: the new manufacturing jobs have arisen mainly in other regions, in part to avoid reputed bad labour relations. Figure 6 shows a close relationship between the loss of manufacturing jobs and the increase in unemployment over this period.

18. The second explanation is that increased unemployment benefits, primarily affecting male workers, had made unemployment financially less of a hardship. Important legislative initiatives occurred in 1965 and 1966 with the introduction of the Redundancy Payment Act and the Earnings Related Supplement (ERS). Unemployment and other benefits subsequently rose sharply, both in real terms and in relation to workers' take-home pay (see figure 7). Whilst the great majority of people were still significantly worse off when unemployed, the incentive to work declined. Various

econometric studies have shown that there is a relationship between the "replacement ratio" (the ratio of net income out of work to net income in work) and unemployment. The higher the ratio, the more people may be willing to become unemployed or, more importantly, the longer they are prepared to stay unemployed while looking for other work. (These issues are discussed further in Section 5 and Annex C.)

1974-1979

19. The difficulties leading to a secular rise in frictional and structural unemployment in the previous period were further aggravated between 1974 and 1979 by -

a. a world-wide fall in economic growth (partly associated with the slow-down in the pace of technological change);

b. world inflation (which had begun to emerge in the late 1960s);

c. shifts in relative prices - in particular of oil and energy - which in the short run added to inflation, depressed profits in the industrial world, and on balance reduced world demand.

20. These developments (particularly the much higher energy costs) required rapid adjustment of relative prices, and of wages in particular. A combination of overseas borrowing and a willingness to allow the external value of the pound to fall delayed the immediate need to adjust internally. But this was at the price of -

a. the postponement of some necessary structural changes both within industries (eg in the steel industry), and in the development of new ones;

b. the failure to adjust long-term wage aspirations to the reduced growth prospects: hence a build-up of inflationary pressures.

21. The effect on unemployment was a significant increase of some 700,000, though the fall in productivity growth indicates that the necessary degree of labour-shedding was being avoided. The loss of manufacturing employment was also offset to some extent by the continued growth of employment in the service sector, especially in public services such as education and health.

1979-1981

22. After 1979 the task of achieving the necessary adjustments was tackled through a policy of fiscal and monetary stringency. Unfortunately the problems of adjustment were exacerbated by the coincidence of severe domestic and international events, notably -

a. high inflation of 1979 and 1980, partly the overhang of previous incomes policies;

b. the oil price rise of 1979

c. the sterling appreciation of 1979-1980.

23. The combination of these shocks meant that, by 1980, many companies were finding their financial position worse than expected. Lower profits from domestic and overseas sales left little internally-generated cash to finance investment plans, maintain dividend levels and keep prudential levels of liquidity. Mindful of the liquidity crises which many companies had suffered under similar circumstances in 1974, they resorted to de-stocking on a large scale, lower investment and a shake-out of labour. The high exchange rate, in particular, rendered many low productivity activities unprofitable and, where productivity could not be increased substantially, many were closed entirely.

24. Business in the trading sector took a somewhat harder line on pay than public sector employers (with the exception of British Steel), and the EEF fought a long and expensive battle over the 39 hour week. In general it had been assumed that prices in the UK economy could not diverge for long from

world prices, and therefore that, despite increases in the exchange rate, international pressures would bring it back towards a level reflecting the comparative level of costs between the UK economy and elsewhere. From autumn 1979 it became increasingly clear that this might not be so, and that the combination of petrocurrency pressures and higher interest rates could extend the period when the UK's unit costs were out of line with its competitors. This has led many companies to take a much more drastic view of the need for cost reduction (and in some cases to abandon businesses). The resulting substantial shake-out of labour represented a start in tackling many years of accumulated inefficiency.

25. The experience of this period illustrates the central importance of the inflation problem. Up to 1980 wages and prices continued to follow each other closely even when the underlying situation could be resolved only be a fall in real wages. This reflected the pushfulness of wage-bargainers seeking recompense for past price increases (and even additions to real incomes) and comparable gains to those made elsewhere. But also, despite the uncertainties described above, employers granted wage increases which were soon shown to be too high in relation to their deteriorating financial position. It was not until 1981 that real wages began to fall back. By this time unemployment had risen over 2½ million.

SECTION 5 - CAUSES OF UNEMPLOYMENT

26. There are several problems of definition and analysis in offering firm conclusions on the causes of unemployment. More detailed work still needs to be done, especially drawing on international comparisons. In this interim report we offer the following tentative list of main causes, based on the discussion of historical trends in Section 4. As noted there, unemployment is inextricably bound up with the general problems of the economy. There is no single cause but a set of inter-related causes.

(a) Low World Growth

27. Rising unemployment is a world-wide phenomenon, and reflects the fall in the rate of growth of world output, which has halved since 1973. The two oil shocks have contributed to this, and there appears to have been a period of reduced technological change and hence fewer new employment opportunities.

(b) Poor United Kingdom Economic Performance

28. The poor relative performance of the United Kingdom economy has persisted for most of the last century. The relatively low trend rate of growth of productivity, and inadequate non-price competitiveness, have meant that the turn-down in world growth led to a more rapid decline in the United Kingdom manufacturing sector than in other industrialised countries. More recently the exchange rate rise reflecting the petro-currency status of sterling has aggravated this trend. The economy has not shown enough flexibility and determination in moving out of declining sectors into new products and processes designed to meet changing demands. Hence not enough viable jobs have been generated in the trading sector.

(c) Policies Contributing to Poor Performance

29. In Annex B we note that a major factor has been the past accommodation of supply side weaknesses by exchange rate, fiscal and monetary policies (plus ill-directed industrial subsidies and occasional incomes policies). This has underwritten the modes of behaviour which need to be changed to derive a high-wage high-productivity economy (especially the lack of management motivation to squeeze costs and go for higher value-added

products). Such accommodating policies could work only for a short time, and only then if the community at large were willing to accept the slow growth of real incomes which is the concomitant of low productivity growth. If there is no such willingness, lax monetary and exchange rate policies seeking to compensate for an indifferent industrial performance can only lead, and have only led, to inflation. Nevertheless balance is important in that an excessively high exchange rate for a prolonged period can do permanent damage to the industrial base and jobs.

(d) Structure

30. Some of the unemployment in the United Kingdom is structural - that is, labour released as a result of decline in some sectors has not matched the job opportunities arising in the expanding sectors in terms of skills, attitudes and location (or willingness to accept the pay rates offered). Hence the relatively low absorption of males into the service sector where employment is typically female and often part-time. The education and training system has not done enought to create and adapt skills to meet the needs of sectors where opportunities have been expanding, including the advanced technologies.

(e) Lack of Real Wage Flexibility

31. The economy could have adjusted to these factors (structural shifts, low world demand, lack of competitiveness and exchange rate fluctuations) with a lower level of unemployment, if real wages had been more flexible. Lower real wages would have made the manufacturing sector more competitive and reduced the loss of jobs.

32. The evidence suggests that wages in the Unied Kingdom are more rigid than in most developed economies, except those with a very high degree of wage indexation (eg Belgium, Italy). Various efforts have been made to quantify the impact of a fall in wages on the demand for labour, but the scale and timing of the effect are very uncertain. There is no doubt that a fall in real wages would increase employment and the key question is how such a reduction in real wages could be brought about.

33. We were asked to look particularly at the work of Professor Minford in this area. He identifies trade union power, the level of unemployment benefits, lack of mobility (especially because of housing policy) and high taxes as the key factors causing labour market rigidity and hence unemployment. We agree that these factors are central, although the quantification provided by his model is open to doubt. This is further discussed in Annex D. We propose as part of the second phase of our study to extend his work to some other countries so as to get a better appreciation of the impact of these factors. The important aspect at this stage is to consider what practical policy recommendations follow from the analysis.

34. The causes of real wage rigidity are complex (as discussed in Annex C) but trade unions and social security benefits have played a significant part. Trade union coverage has increased over the last twenty years both in absolute terms and relative to the position in most of our main competitors. This increased bargaining power could be expected to show itself in a widening of the union/non-union wage differential. The differential did indeed widen up to 1973, but since then it appears to have remained roughly constant. The current size of the differential is a matter of some debate. The most recent direct estimates suggest a figure of around 10 per cent for male manual workers in manufacturing industries, smaller than that implicit in Professor Minford's work. Nevertheless there is no doubt that many unions have exploited their growing monopoly power to oppose falls in real wages, or improvements in productivity, even though the result is higher unemployment either within the industry or (through higher prices and/or taxes) elsewhere in the economy.

35. Social security benefits are higher in relation to earnings than in the early 1960s (as illustrated in figure 7) and this has made unemployment less of a financial hardship. The level of benefits must set an ultimate floor to wages, below which people are unwilling to take jobs and employers do not offer jobs. Current evidence on the extent to which this occurs is not clear (see Annex C) and needs to be explored further. The most comprehensive survey in this area, the DHSS Cohort Study, found that among men entering unemployment in 1978 there was a small group - 7 per cent - whose

incomes out of work were higher than their incomes in their last employment. In addition a larger group - 12 per cent - experienced a drop in income of less than 20 per cent. These percentages include men in receipt of occupational pensions. Excluding this group suggests that around 15 per cent of those becoming unemployed had limited financial incentive to return to work. On the other hand, for nearly half the men entering unemployment loss of work is associated with a drop in income of at least 50 per cent, and for most of the men, who are without families, even the lowest wages on offer are a good deal higher than their benefits. The main effect of security benefits on wages is probably that employers are unwilling to offer wages below the level of the supplementary benefit payable to a family man with children - even though this level does not in fact apply to the majority seeking work.

36. While important these factors do not provide a complete explanation of wage rigidity. Downwards adjustment of real wages has been difficult to achieve in other times and in other places even in the absence of the present degree of union power and the present levels of benefits. Other important influences are -

i. There has been a growth of "internal labour markets", where large employers in both private and public sectors offer "career jobs" sheltered from direct influence of competitive forces.

ii. The monopoly position of some employers in both public and private sectors has protected their substantial labour force from immediate market pressures.

iii. Social pressures, centred on notions of "fairness" and "the going rate", below which even employers outside the unionised sector are reluctant to offer jobs to full-time male employees. Adjustment is also delayed by the importance attached to "traditional" earnings differentials across industries and occupations.

(f) Wage Inflation

37. The United Kingdom appears to be particularly prone to wage inflation and the need to control this has prevented Governments from allowing output to expand. The causes are closely related to those listed above under "real wage rigidity" - just as the growth of nominal wages cannot quickly be adjusted downwards even in a recession, so nominal wages rise to take advantage of any expansion in demand. One view is that since the late 1960s there has been an "aspirations gap" - a desire for a growth in real living standards in excess of what the economy can deliver in the form of rising productivity. The slow-down in productivity growth in the early 1970s and the fall in real incomes caused by higher real oil prices may have contributed to such a gap. These developments have also affected other countries and could help to explain the world-wide increase in wage inflation. In the United Kingdom over-ambitious aspirations have been translated into particularly inflationary settlements because the strength of union bargaining power is not restrained by an understanding that profit levels need to be held up to maintain jobs. Weak resistance by nationalised industries and other employers enjoying protected markets has also played a part.

SECTION 6 - PROSPECTS

The Trading Sector

38. An improvement in the competitiveness of the United Kingdom trading sector is essential for securing further employment opportunities overall. However, in the short run, the continued pressure on profitability and the need for further improvements in working practices will mean that the expected recovery of output is likely to be associated with some continued shake-out of labour (though not on the scale of last year). This view is supported by statements of a number of leading businessmen that they expect not to increase the size of their work force to a significant extent. This underlines the importance of getting inflation under control so that the economy can move into sound, sustained growth which will inevitably bring new opportunities for jobs.

39. In the longer term, companies in manufacturing and internationally traded services will need to move "up market" into newer product ranges, embodying new technologies, which tap the fastest growing markets internationally. New products and processes are unlikely to be particularly labour intensive and therefore may not directly create many jobs. This is as true of services as it is of manufacturing: there are signs of increasing capitalisation within some internationally-competing service activities (eg financial services and shipping) stemming from the increased sophistication of technology. Moreover the mismatch between the skills required for the new sectors and those available from the shake-out in the declining sectors will contribute to a continuing unemployment problem for some time. The benefit to jobs will come through the general up-grading of performance in the United Kingdom, the improvement in living standards that this delivers and thus the higher level of activity which is sustainable without balance of payments and inflationary difficulties.

The Non-Trading Sector

40. The commercial success of the trading sector determines the sustainable long-term rate of expansion of the other areas of the economy which serve domestic needs. Taxable capacity and the need to limit public expenditure will continue to limit the growth of public services (a major source of employment growth in the early 1970s). On the other hand house-building, an important source of new employment in the 1930s. should show some expansion

if interest rates continue to fall. There may also be modest expansion in the services sector with the growth of small businesses. It is particularly in this sector that more jobs can be created if real wage flexibility can be increased.

Implications

41. It is very hard to forecast the longer-term trend in aggregate unemployment. Although demographic trends of labour supply are predictable, at least up to 16 years ahead, other factors which influence employment trends (eg activity rates, economic growth, and technological change) are uncertain. A number of studies have pointed to a pessimistic view of the prospects based on the belief that technological advances will eliminate many jobs. By contrast, there are some United States predictions which take a more optimistic view. We believe these differences should be explored and propose to do so in further work though the time-scale of this may extend beyond our next report. In particular we propose to test remedies (including labour market proposals) to assess their likely effect against these longer term projections.

42. But the immediate outlook remains difficult particularly in view of the unavoidable transitional problems of creating a more competitive trading base. The implications are particularly disturbing for:

- the long-term unemployed. In the course of 1982 the numbers continuously unemployed for over 1 year are expected to exceed 1 million, double the maximum experienced in the 1930s. By the beginning of 1983 over 400,000 will have been unemployed for over 2 years without a break. Post-war experience suggests that it is exceedingly difficult to re-absorb the long term unemployed into regular employment.

- the traditional industrial regions. Unemployment continues to be heavily concentrated in areas which seem the least likely to generate new high technology industries, and lack the income base on which to found continuing growth of private sector service employment.

- the growing labour force of young people in their teens and twenties. The access of the better qualified to worthwhile careers will continue to be restricted by low levels of recruitment to large organisations and the public sector. Many will have to settle for less good jobs, displacing the less well qualified into irregular employment and the least employable into long term unemployment. It is in this age group that the gap between aspirations and reality is likely to be greatest and to have the biggest social consequences.

43. It is against this background that we have started to examine a whole range of ways that could contribute to reducing unemployment and mitigating the consequences.

SECTION 7 - MEASURES TO REFORM THE LABOUR MARKET

44. For this Interim Report we have concentrated our initial thinking about cures on measures to reform the labour market, which is a central part of our remit. But we believe that a comprehensive strategy for tackling unemployment will need to contain other elements, including measures to speed up innovation, steps to develop new patterns of working time and measures to deal with the residual unemployment problem. These other elements are discussed in Section 8. The ideas and comments which feature here and in Section 8 are not our final views. Nor are they comprehensive. The aim is to enable Ministers to indicate any preliminary views about the areas which should receive priority in our further work.

45. It is important to distinguish between measures to reform the labour market which, however desirable, can only affect unemployment in the medium to long term and those which may offer more immediate benefits: ie within the course of this Parliament. We discuss long term measures in paragraphs 43-51 and shorter term measures in paragraphs 52-55.

Long Term Reforms

46. Almost everything in this section has already been considered by Ministers in MISC 14 and elsewhere. The problem has been that most radical reforms offer uncertain and relatively small benefits for employment in the short term, whereas they generally involve very immediate political difficulties. Nevertheless, in view of the serious prospects for unemployment, they deserve re-examination.

a. Further steps to reduce the power of organised labour

47. Ministers have decided that the present Employment Bill (subject to possible scope for amendment) is the limit of what can be achieved in the present Parliament. But thought needs to be given to further measures which might be taken in the next Parliament, eg a requirement for secret ballots before strike action. Other areas for consideration include ways of -

- inducing unions to broaden their bargaining aims to take a more balanced view of the trade off between wages and jobs (see also paragraph 57)

- trimming the monopoly power of public sector unions eg by breaking down monopolies in product and service markets

- removing constraints on the expansion of the non-union sector (see b-d below).

- repealing the Fair Wages Resolution.

b. Abolition of Wages Councils

48. Insofar as Wages Councils enshrine in statute the principle of the going rate and the associated idea of a family wage, they are a fundamental obstacle to the generation of new jobs. The strength of the case for abolishing councils in their present form has been recognised, but it is thought to be dependent on an international agreement which cannot be denounced before 1985. We see merit in the Government's -

- exploring the feasibility of narrowing the scope of Wages Councils, by reducing the number of trades covered or by keeping them simply as a safeguard against abuse of a labour monopsony

- initiating with European and OECD partners a debate on the need to reform labour market conventions which impede employment.

c. Repeal of employment protection legislation

49. In circumstances of deep recession and uncertainty like the present, this legislation operates against the interests of those already employed by discouraging employers from taking on more labour. Ministers have relaxed the obligations on small firms and some further modifications are being studied. So far Ministers have rejected ideas such as enabling recruits to opt for an "unprotected" employment contract, or exempting small firms from the state redundancy scheme. These ideas may bear re-examination. They probably would have little impact on the practices of firms which are unionised or operate company labour markets. But they could be important as part of a strategy for encouraging the non-union sector.

d. Reform of the benefits and tax system

50. The Government have acted to improve incentives by abolishing earnings - related supplement and by taxing unemployment benefits. It would be possible to go further eg by -

i. tying the minimum uprating of benefits to the lower of increases in prices or earnings

ii. imposing a simple benefit limit, eg a fixed percentage of average earnings (previous earnings as a basis for limiting benefit proved in practice to be excessively complex)

iii. reducing the independent entitlement to benefit of people who do not head families. (About 40 per cent of all benefit recipients are not householders.)

51. A more radical step would be to abolish unemployment insurance benefit. This could be seen as a logical development following the abolition of earnings related supplement and the growing dependence on supplementary benefits. It would also result in very substantial benefit and staff savings. However, it would have very little impact on high income replacement ratios, which are mainly determined by supplementary benefits, and hence on work incentives. But it might have some limited discouraging effect on the incentive of marginal groups, such as occupational pensioner and some married women, to register as unemployed.

52. A constraint on the introduction of the above measures especially at a time of mass unemployment is that they need to seem fair when set alongside the treatment of other groups such as the sick and elderly. The increasing pressure to put the benefits for long term unemployed on a par with other long term recipients of supplementary benefits is evidence of this.

53. Fundamental reforms not only of benefits but also the tax system may be necessary to deal adequately with the problem of work incentives while enabling society to provide a minimum standard of living both for the unemployed and those in low paid employment. In particular, child support

and the support of housing costs are both areas in which the low paid receive less support then the unemployed, thus worsening the incentives problem. Proposals for radical reform of tax and benefits have foundered in the past on the cost of making changes without large numbers of losers, and the administrative complexity. If Ministers were prepared to tolerate a large number of losers it would be worth re-examining the scope for moves in this direction. Alternatively, there are more modest steps that could be taken, building on existing schemes. If the tax and benefit systems can become more effective in compensating for the cost of dependents, there may be greater scope for employers to offer more jobs at low wages.

e. Reform of the housing market

54. Proposals for radical reform of the housing market (both public and private), including Professor Minford's suggestion of abolishing private rent controls, have foundered primarily on the lack of clear evidence about the gains which would accrue to the economy. In the case of private renting there has also been the prospect that the opposition would commit themselves to reintroduce controls, thereby discouraging landlords from taking advantage of their removal. Moreover there is a widespread feeling that, with high levels of unemployment everywhere, geographical mobility has become less important. However, if the restoration of fuller employment is to depend heavily on the creation of new service jobs in the non-trading sector it may be necessary to make it easier for more of the unemployed to live nearer to where the people with high incomes are mostly to be found ie in the South East. Also the high proportion of the young and single among the unemployed suggests in principle a higher latent level of mobility than is sometimes assumed. It may be worth re-examining the obstacles to mobility in this new context.

Gaining public acceptance of the need for radical change

55. If a programme of radical labour market reforms is to succeed in a democratic society, there has to be public acceptance of the need for radical change. There are a number of obstacles to this. At most levels of society many still believe that Governments can deliver both full employment and stable or rising living standards. There is insufficient understanding

that crude attempts to do this lead to continued economic decline. A fear of unemployment and understanding of its consequences are not widespread, since the experience of unemployment is confined to a much smaller segment of the population than in, say, the United States. Achieving acceptance of change will be partly a question of convincing people of the seriousness of the problems, and partly of allaying fears about the hardship or social dislocation which might result from the cures. The inclusion of some measures which alleviate the consequences of unemployment (discussed in Section 8) will be important in the latter context.

Shorter term measures

56. There are a number of less radical ideas for labour market reform which could have a beneficial impact on unemployment in the next two or three years. These can be grouped under three headings -

a. Increasing the influence of the unemployed on the labour market

57. We have noted that the existence of a large pool of unemployed has had relatively little influence on the wage bargaining stance of employers or the employed. The influence of the unemployed on wage negotiations could be increased gradually by -

i. measures to improve their employability. These could include basic remedial education and training in general working skills. The long term unemployed might be enabled to have short periods with employers in order to let them acquire relevent work experience. There could be more hostels and furnished accommodation for the young and mobile in areas where job opportunities are better;

ii. incentives to employers to hire the unemployed at low wages. The idea in the Young Workers scheme of linking subsidies to wage levels might be extended to adults. An alternative which might be worth exploring is offering vouchers to the long term unemployed which they would pass to employers willing to hire them.

iii. incentives to the unemployed to accept low paid jobs. The Family Income Supplement effetively offers a small subsidy to people with families who accept low paid jobs. This aspect might be developed.

b. Changing the aims of the bargaining process

58. At present employers and employees have a common interest in adapting to cuts in demand by reducing employment rather than wages. At the margin it may be possible to change the balance so that restraint of wages is chosen instead of cuts in hours or further redundancies; for example by -

i. reducing the generosity of the state redundancy scheme for employees to increase the financial penalty of being made redundant.

ii. encouraging the greater use of profit related schemes in wage bargaining so that employees relate more closely their demands for wages to the future competitiveness of the firm.

c. Speeding-up job search among the unemployed

59. Two possible developments that could be psychologically important are -

i. to amend the "suitable work" definition in unemployment benefit regulations to make it clear that the unemployed are expected to take work offering below the "normal rate", provided that it is at a level above their unemployment benefit;

ii. to require the employment service to concentrate on getting and advertising the maximum number of vacancies, including low paid and casual work.

60. A longer term development that would speed up job search and assist the testing of "work availability" would be to bring together Job Centres and Unemployment Offices. This would reverse the change made during the 1970s.

SECTION 8: OTHER REMEDIES

61. For the reasons discussed earlier a balanced package for tackling unemployment would need to go beyond measures to reform the labour market. Other necessary elements would include measures -

a. to accelerate innovation and new jobs in the trading sector;

b. to develop new patterns of working time;

c. to deal with the residual unemployment problem;

62. As yet we have done no detailed work on remedies in these areas. The following paragraphs indicate the aspects we think important.

Accelerating Innovation and New Jobs in the Trading Sector

63. There has to be a shift of attention away from the support of old industries, including fundamentally unviable parts of the public trading sector, towards support for new activities and new technologies. Any shift has to be gradual, since the resources of labour, capital, and management and technical expertise tied up in old industries could not switch overnight to new products or markets, however flexible the labour market might be.

64. But there is a continuing need to stimulate growth and innovation in new areas of activity. A wide range of Government policies (including trade, public purchasing, regulation, taxation, education, training and so on) have an impact on the performance of the United Kingdom trading sector. Some industries, particularly in advanced technologies, are directly dependent on public sector support. Without discouraging enterprise or imposing a rigid "industrial strategy", Government policies need to adapt more rapidly to match industrial priorities, so that innovation keeps up with our international competitors. In particular there is a need for greater innovation within existing large and medium sized businesses.

65. Some existing policies are more appropriate for an economy in which labour is in short supply and where capital needs to be subsidised to compensate. On top of high real wages, employers also have to face additional costs of employing labour in the form of national insurance contributions, redundancy payments, industrial tribunals and health and safety regulations. Combined with high real wages and increases in labour taxes, the effect has been to encourage labour shedding and low capital productivity. Consideration should therefore be given to ways of reducing the costs of employing labour. These arguments also apply to the non-trading sector.

66. One important policy objective is to encourage the formation and expansion of new businesses as competitive growth points for output and employment. In addition to the range of business start-up measures introduced by the Government, the following deserve further investigation -

i. whether large companies could be given incentives which would make them more likely to encourage ambitious managers to use the skills developed within their mainstream activities to branch out and develop new businesses. An alternative is to encourage managers to acquire the ownership of businesses.

ii. whether measures designed to alleviate unemployment, particularly in severely affected areas, should be more directly aimed at helping people to become employers, rather than employees, along the lines of the pilot Enterprise Allowance Scheme. One feature of this scheme is a regular payment to compensate for the loss of benefit as soon as a person is classified as self-employed. It may be possible to extend this idea more generally.

iii. whether successful entrepreneurs can be given better inducements to go on expanding their businesses, to grow into medium-sized and, ultimately, big firms.

67. There is a potentially fast growing world market for tradeable services, for which the United Kingdom has a high reputation eg university teaching and research, broadcasting, health care. The obstacle to the expansion of trading is that many of these are provided primarily as a public service, by people not particularly motivated to selling their services. We need to investigate the scope for developing a more entrepreneurial approach, without jeopardising the quality of public services.

Assisting the Development of Forms of Work Sharing

68. Part time work has been the only growing form of employment in the last twenty years. It is worth exploring how far it is possible by more flexible working arrangements to shorten the total number of hours per worker per year and to increase the job opportunities for part time work, without raising unit labour costs. Ideas to this end include -

i. incentives to employers to split normal full-time jobs, perhaps linked with the requirement that the new part-time jobs so created be filled from the (long term) unemployment register;

ii. incentives to employees to retire partially, or more generally to reduce their hours, (and their pay) thereby releasing jobs for the unemployed;

iii. reorganisation of the social security benefit system to give incentives for the unemployed to seek part time work; and for those who do a reasonable amount of part-time work to be treated as employed and eligible for family income supplement.

A cost-effective approach to the residual unemployment problem

69. On any reasonable expectation of success in creating new jobs in the viable market sector, it is still likely that there will be a significant level of 'long term' unemployment for some time to come - and that this group will consist of a high proportion of unskilled manual workers, and a growing number of young people. In order to retain public support for the economic policies which are necessary to restore competitiveness, it will continue to be necessary to take measures to alleviate the consequences of unemployment.

70. There is already a large array of special employment measures, but the overriding emphasis is on schemes which are cost effective in reducing the unemployment register. In our further work we shall try to address the following questions -

i. should there be more emphasis on the net resource effect of measures, ie should more weight be put on the value of the output which schemes produce?

ii. should there be an attempt to discern the main features of unemployment which give rise to public anxiety (perhaps poverty, local unrest, lack of career prospects for the young) and to tailor measures more directly to relieving those concerns?

iii. can existing measures be tailored - and any new measures designed - so as to do more to speed the adjustment of the labour market?

iv. which is the most cost effective way of relieving the financial and personal hardship associated with long term unemployment (work programmes, higher benefits, training and so on)?

Conclusions

71. We are conscious that these proposed remedies would have varying effects, in varying time-scale, and fall a long way short of a comprehensive strategy. They are put forward specifically as suggestions on which, subject to Ministers' views, we would wish to do more work. In our final report, when we are in a position to make a better assessment of their individual merits, we plan to consider how they might be fitted together and presented as a coherent strategy for tackling unemployment.

FIGURE 1 **Registered unemployment in United Kingdom, 1961–1981**

Registered unemployed, excluding school-leavers

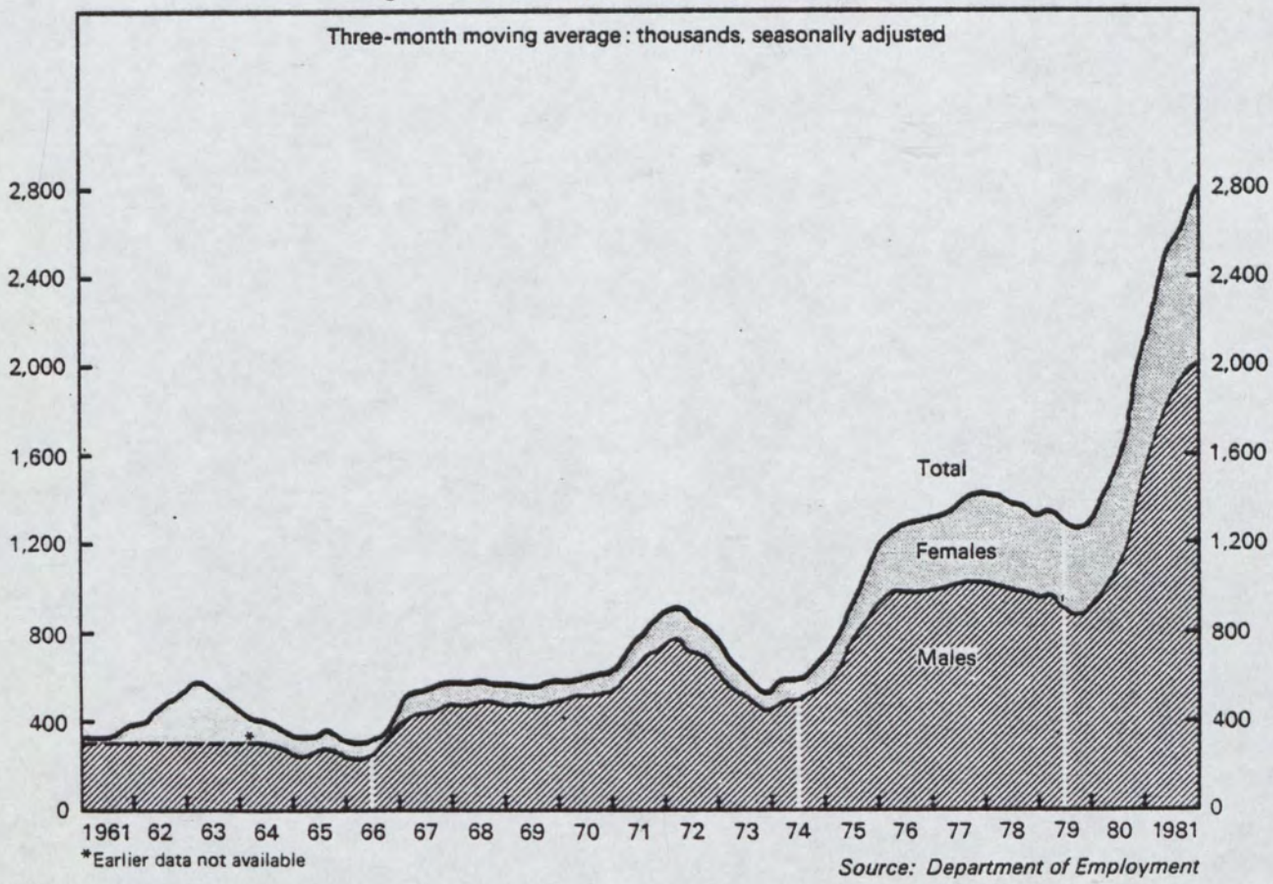
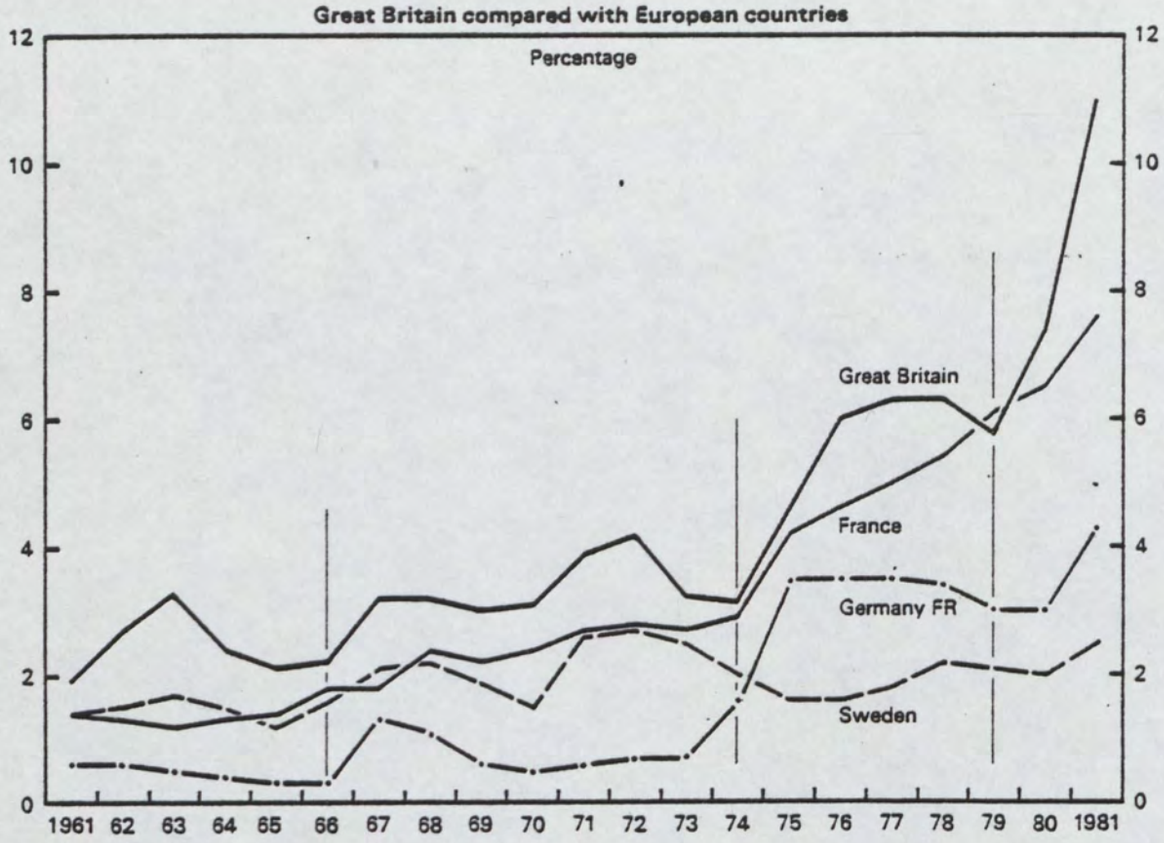
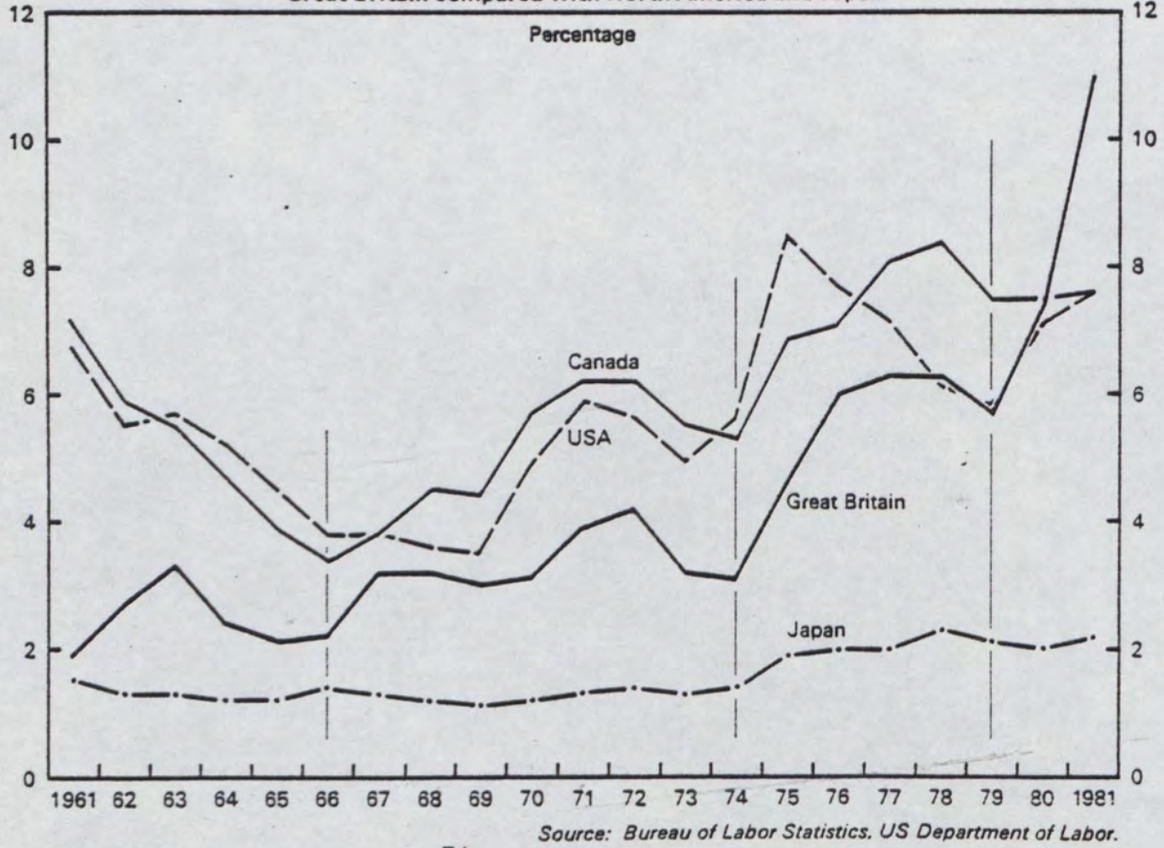


FIGURE 2 **International trends in unemployment, 1961–1981**
Unemployment rates adjusted to US concepts

Great Britain compared with European countries



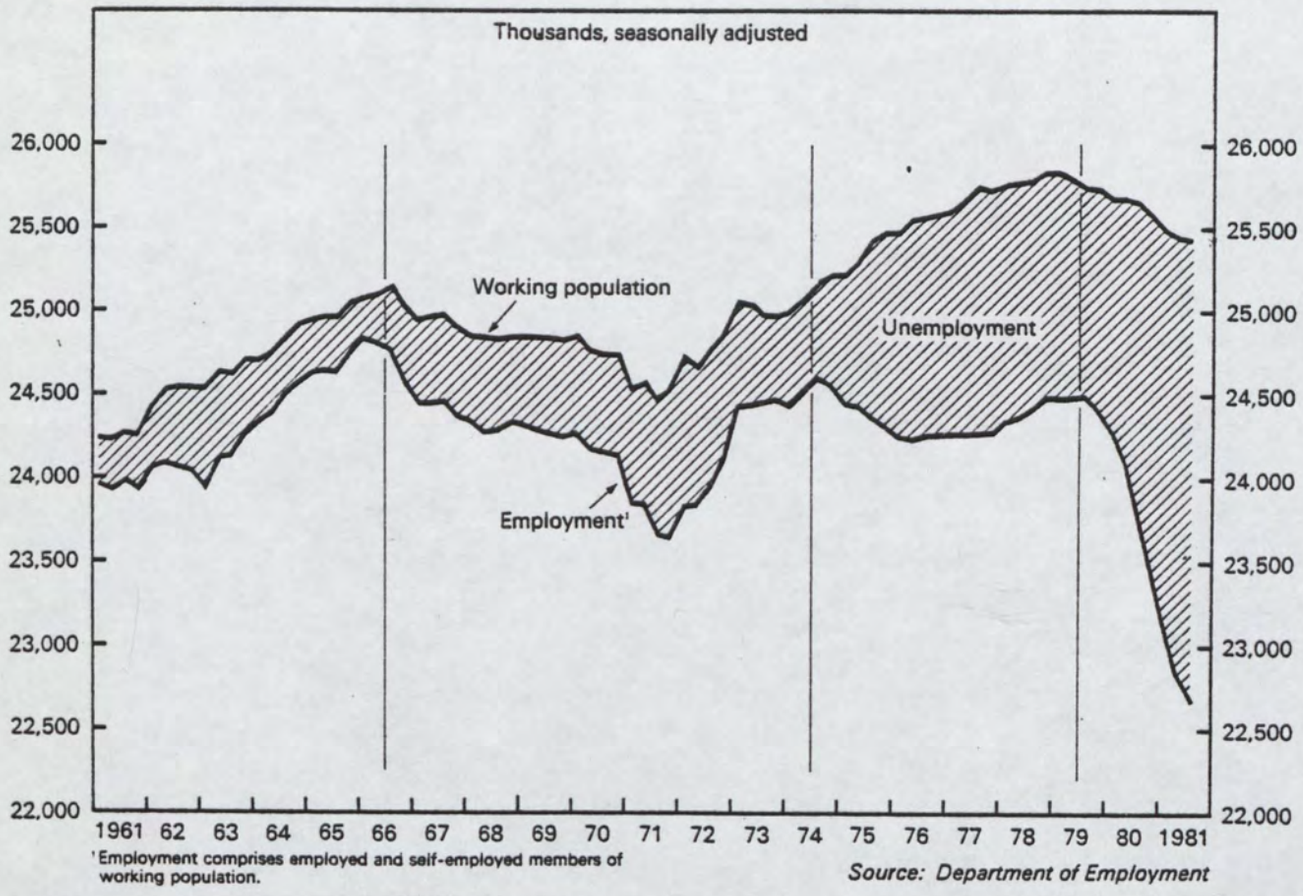
Great Britain compared with North America and Japan



Source: Bureau of Labor Statistics, US Department of Labor.

FIGURE 3

Employment, labour supply and unemployment, Great Britain, 1961–1981



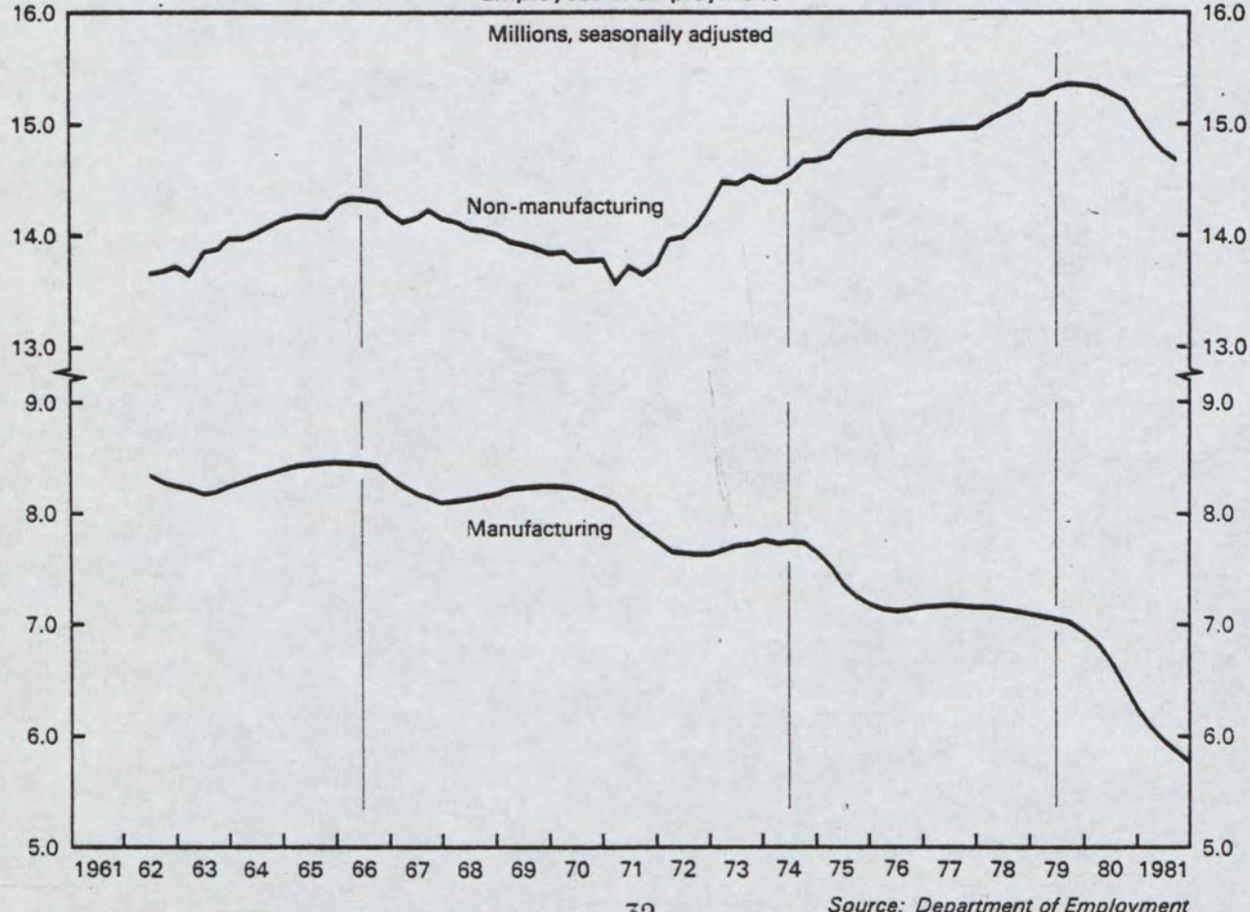
¹ Employment comprises employed and self-employed members of working population.

Source: Department of Employment

FIGURE 4

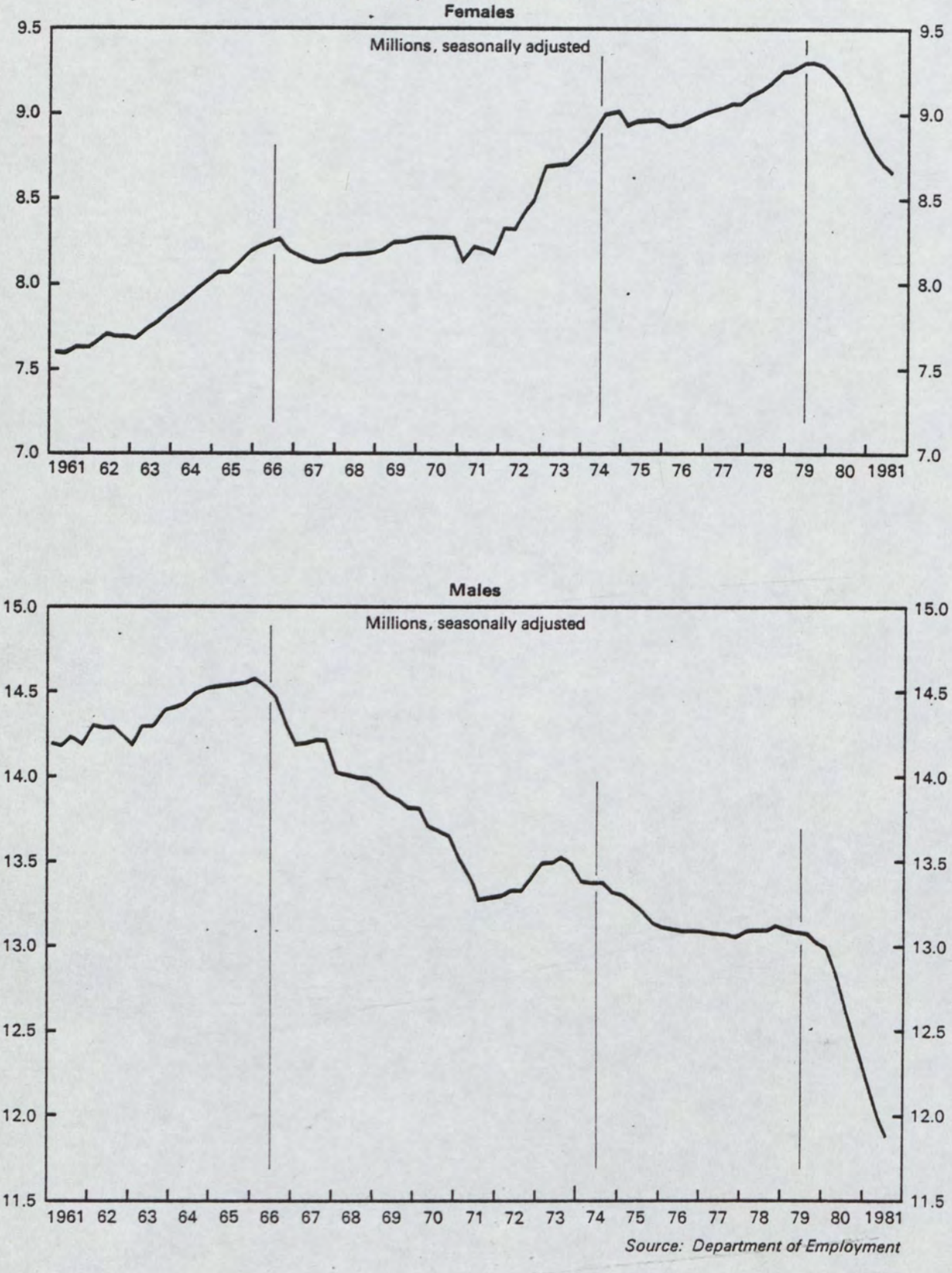
Manufacturing and non-manufacturing employment, Great Britain, 1961–1981

Employees in employment



Source: Department of Employment

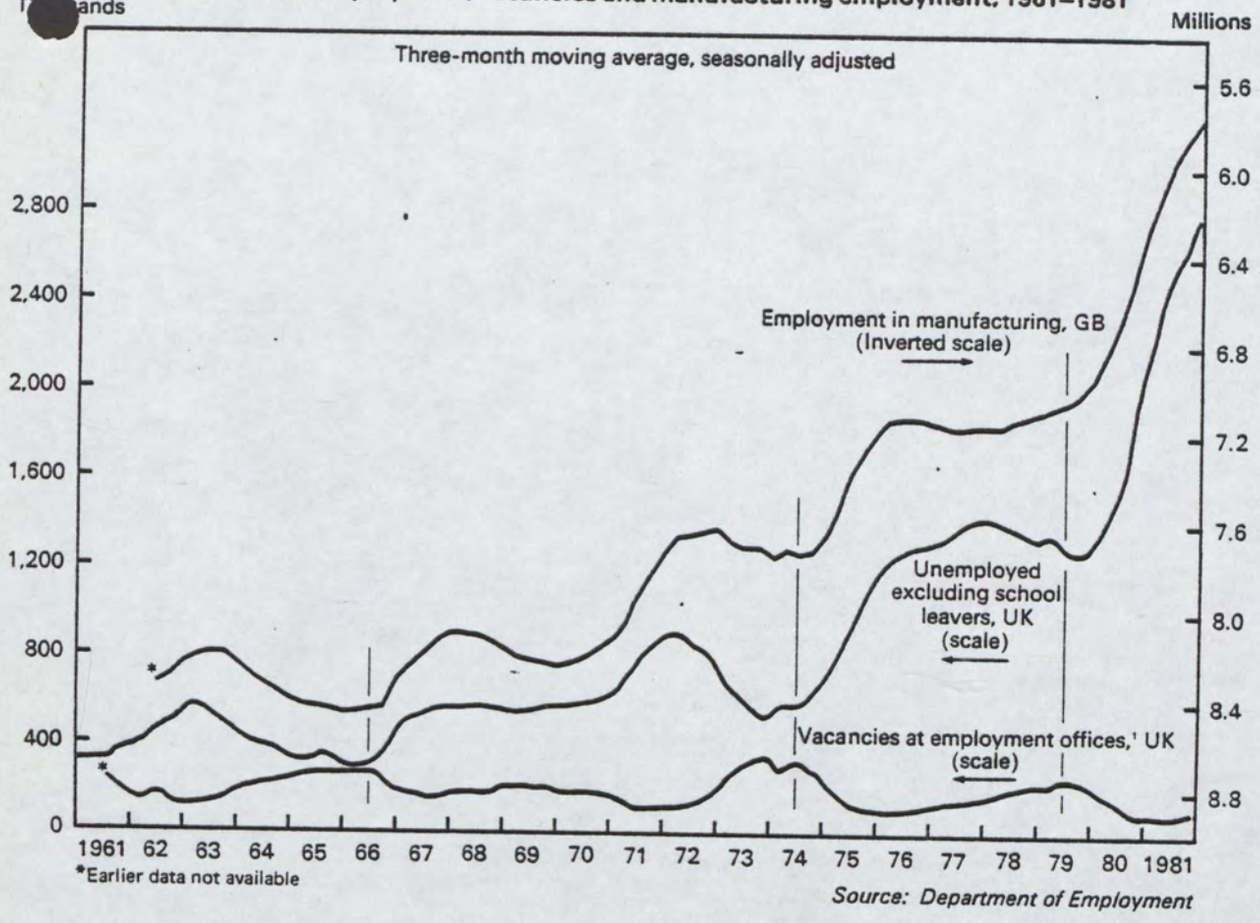
FIGURE 5 **Trends in male and female employment, Great Britain, 1961–1981**



Source: Department of Employment

FIGURE 6

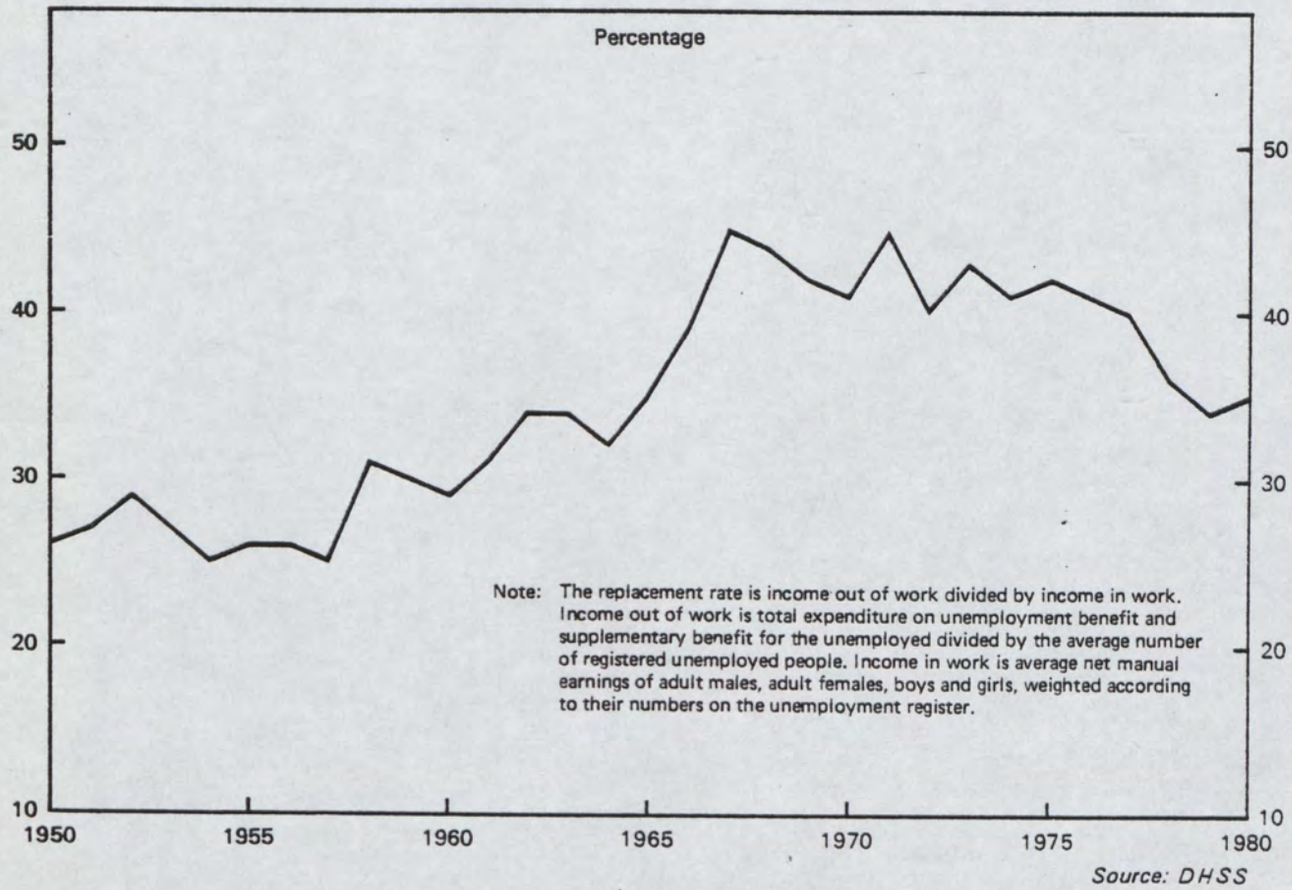
Trends in unemployment, vacancies and manufacturing employment, 1961–1981



Source: Department of Employment

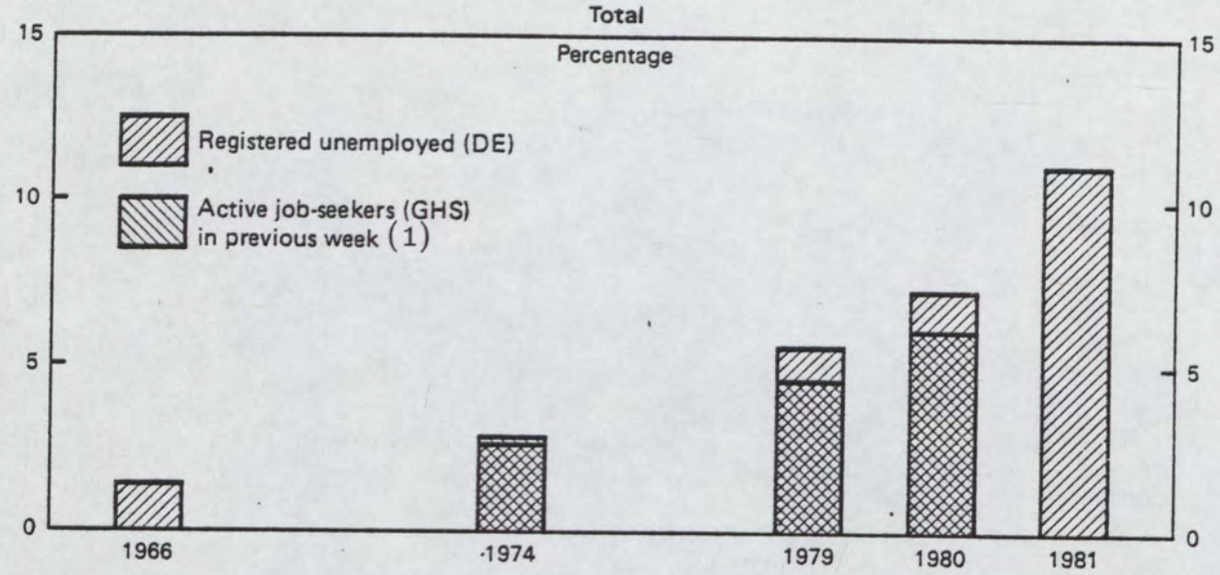
FIGURE 7

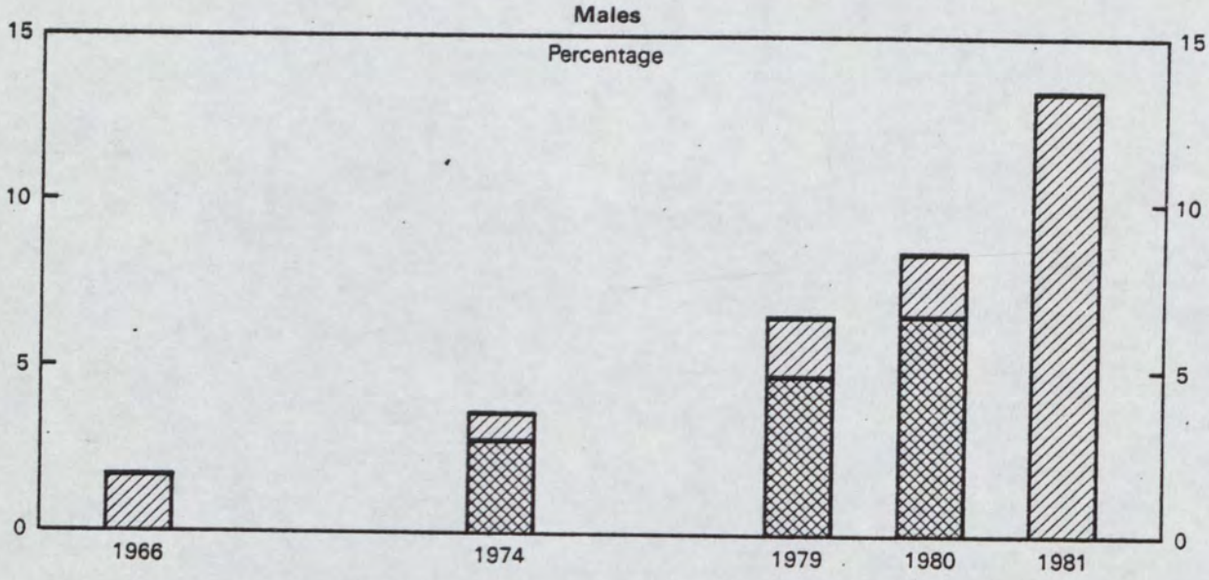
Replacement rates for unemployed, Great Britain

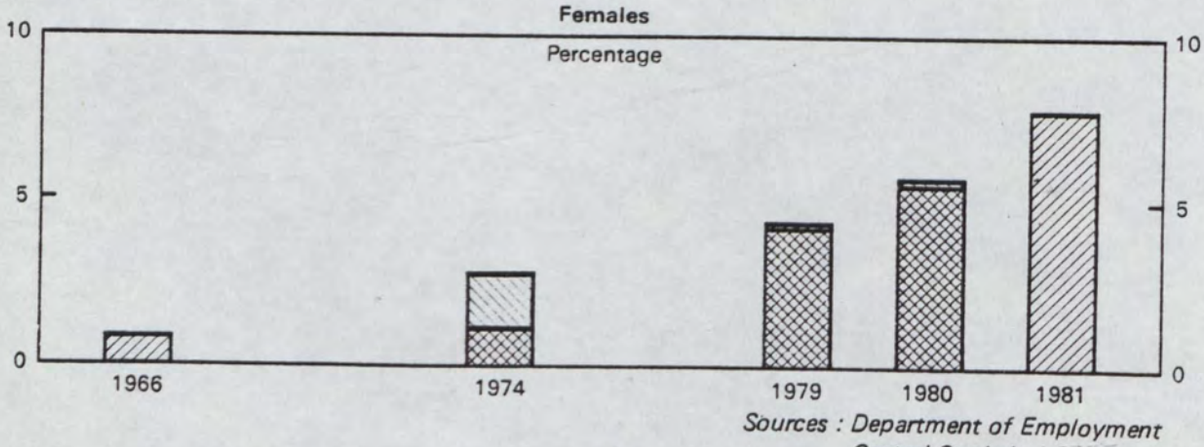


Source: DHSS

FIGURE 8 **Unemployment rates in Great Britain (annual average)**







Sources : Department of Employment
Central Statistical Office

(1) There may be technical deficiencies in the GHS rate - see Annex A.

ANNEX A

CATEGORIES OF THE UNEMPLOYED

1. Our remit includes an examination of the categories making up the unemployed. We understand that the main purpose of this is to shed light on whether the unemployment register provides an accurate measure of the true level of unemployment, and a good basis for international comparisons of unemployment.

2. Paragraphs 4-9 of this annex summarise our provisional conclusions and indicate where further work is planned. Paragraphs 10-21 discuss the principles and practical difficulties of measuring unemployment. Paragraphs 22-40 assess the possible extent of overcounting and undercounting in Britain's current unemployment register. Paragraphs 41-42 touch briefly on the international implications.

3. The Department of Employment and the Central Statistical Office have supplied helpful material for the preparation of this Annex. But there has not been time to consult them about our provisional findings, including our assessment of the register.

Summary of main points

4. There seems little doubt that the great majority of the current register are genuinely unemployed (as defined in para 11 below). However is seems possible that the register exaggerates by several hundred thousands the readily available supply of labour. Our guess is that somewhat over half a million of the present register are not a readily usable supply (para 33) while only one or two hundred thousand seekers of full-time, permanent jobs do not register. On the other hand there may be a considerable unrecorded demand for part-time jobs (para 37). Moreover the shortfall of viable jobs in the economy (to replace special measures and jobs in lame duck industries, and to reabsorb workers who have left the labour force involuntarily) is probably several hundred thousand greater than the size of the register (para 36).

5. Similarly the substantial increase in the register over the past decade is for the most part a true increase in unemployment, although it has probably exaggerated by several hundred thousand the increase in the effective supply of unemployed workers (paras 39-40).

6. However, all these comments are hedged around with great uncertainties. The simple fact is that the register has become a less certain measure of unemployment, now that there is such a shortage of vacancies to test availability. We see advantage in making greater use of household surveys to cross check the evidence from the register.

7. Greater use of household survey material would also help to remedy a further deficiency in the register, namely its inability to measure the impact of unemployment on households. Such information, if more widely used and collected on an up to date basis, could help rebut some of the more extreme claims about the social consequences of unemployment. For example, the number of households on the official poverty line because of unemployment is considerably smaller than is suggested by the number of unemployed claimants of supplementary benefit.

8. No single figure can adequately measure all the economic and social dimensions of unemployment for which people attempt to use the present figures. It is therefore worth considering the compilation of a range of regular unemployment measures. (The Americans have U1 to U7). For example there could be an unemployment rate confined to active seekers of full time jobs, a rate for part-time job seekers, a rate for the "3 months plus" category of unemployed, a rate for prime age workers (25-55 year olds) and so on.

9. There are four main areas which can be explored more fully for our final report -

1. a fuller examination of survey evidence on the trend and level of unemployment up to 1980 (and perhaps 1981);

2. the household incidence of unemployment as measured by household surveys;

3. the effect on the unemployment figures of the black economy;

4. international comparisons.

Uses for unemployment figures

10. It is unlikely that a single figure can satisfactorily measure all the dimensions of unemployment. People use unemployment figures -

- in political debate, as a yardstick of economic success, of social problems and of a burden on taxpayers.

- in economic policy making, as a measure of labour supply.

- in social policy making, as an indicator of financial hardship or social need.

11. Official unemployment figures in Britain, and abroad, are designed to meet the needs of economic policy. For this purpose, the aim is to count people who are (a) capable of work, (b) without work, (c) available for work and (d) looking for work. It is immaterial from the economic policy viewpoint whether people are dependent on work for their livelihood (a criterion suggested by Beveridge in the 1930s). The figures make no attempt to measure this, nor to measure the impact of unemployment on families, nor the extent to which the unemployed are being supported by the state. In view of the intense social and political concern about unemployment we find it regrettable that there is so little information on such topics, and that so little use is made of what is available. Such evidence as there is suggests that the degree of household poverty associated with unemployment is well below the level suggested by the degree of dependence of individual claimants on supplementary benefit, and that the incidence of unemployment among heads of families with dependent children is lower than for other categories of the unemployed. This kind of information could be useful in rebutting the more extreme claims about the consequences of unemployment. There is however a scarcity of up to date informtion and some problems in reconciling evidence from different sources. We intend to do further work on this for our final report. Our provisional view is that more use should be made of household surveys to provide regular and up to date information on the incidence of unemployment, and its financial impact, by household.

Measuring unemployment

12. This annex focusses on whether the register succeeds in its aim of measuring unemployment in the conventional economic sense, according to the 4 criteria at the beginning of para 11. Paras 13-21 set out some general observations about the problem and methods of measurement.

13. There are some unavoidable problems, whatever the method of measurement. "Work" is not a standard commodity and very few people are totally unrestricted in the kind of work that they seek or can do. Thus the economic significance of unemployment figures depends on how selective job seekers are in their search for work, and how wide a range of work they are capable of performing. The answers to these questions are largely matters of subjective judgement. Hence availability and capability for work cannot be measured in a hard and fast way.

14. There are two ways of measuring unemployment. The first, used by Britain and most European countries, is linked to registration for unemployment benefits and state employment services. The second, used in North America, Japan and Sweden, is to use a regular household survey which questions people about their employment status.

15. The main advantages of <u>registration based figures</u> are that -

a. they are a complete count, free from the sources of error associated with sample surveys;

b. provided there is a reasonable supply of vacancies, the act of registration is a more stringent test of availability for work than simple answers to household surveys.

16. Their main disadvantages are that -

a. they may include people who are not available for work, but register in order to obtain benefits;

b. they may exclude people who are available for work but choose not to register;

c. the propensity of job seekers to register may change over time, or differ among countries, eg because of differences in coverage of benefits, thus obscuring trends over time and international comparisons.

17. The main advantages of survey-based figures are that -

a. they are free from the "benefit" distortions listed in paragraph 16;

b. they are somewhat more likely to get honest answers about the employment status of black economy workers;

c. they can be designed so as to facilitate international comparisons;

d. they can measure the incidence of unemployment among households, not merely individuals.

18. Their main disadvantages are that -

a. they are liable to sampling errors

b. they rely entirely on what people say

c. their definition of unemployment (having looked actively for a job in the last week, or month) may include people who are not looking very seriously, or who are highly selective about the work they would accept

d. the same definition may miss people who want work, but do not look in the specified period because they reckon no jobs are available for them

19. In paras 22-37 below we try to quantify the possible sources of under and over-counting in the UK register. However, accuracy is not possible, particularly in present circumstances when there are few vacancies relative to the supply of unemployed, so that it is hard to obtain a positive test of availability for work. It may no longer be sensible in these circumstances to rely exclusively on the register for our basic measure of unemployment. Greater use of household surveys may be desirable, for the reasons given in paragraph 17.

20. Britain has in fact collected a limited amount of survey information about unemployment since 1970, in the annual General Household Survey (GHS). We have also participated since the early 1970s in the European Community's biennial Labour Force Survey. And further information about the incidence of unemployment can be obtained from the Family Expenditure Survey. All of these are based on small samples and the latest information currently available is for 1980. Hence they can shed no light as yet on the current level and incidence of unemployment. Nevertheless it is of interest to establish what pattern of unemployment they show for the 1970s. We are currently working on this with the help of the Central Statistical Office and hope to report our findings in our final report.

21. As an indication of the present state of uncertainty, figure 8 (at the end of the main report) shows unemployment rates compiled from the GHS alongside the registered rate for the 1974-1980 period. The GHS confirms the existence of a rising trend and a high level of unemployment in 1980, but the rise is less steep and the level in 1980 in not so high as the register. It would be premature to draw conclusions from the GHS figures. There are a number of technical problems which cast doubt on their reliability. Also, the GHS count is based on active job seekers in the previous week (a shorter period than in comparable surveys in other countries) and thus excludes discouraged workers (see para 18 d.). We need to cross check the GHS findings with other surveys and investigate further the differences between them and the register before we can draw conclusions about which source gives the better measure of unemployment.

Over and under counting on the register

22. Subject to the preceding caveats we now set out our current best estimate of the adequacy of the register. Estimates of the size of particular categories are largely illustrative and subject to revision upwards or downwards in the light of further work.

Possible sources of over counting

23. The register may overstate unemployment because it includes the following categories. (Note that several categories overlap).

a. "Unemployables"

24. Strictly, these are people unable to hold down jobs for various reasons, mainly health, disability, poor mental capacity or personal difficulties. The nearest to an objective estimate derives from surveys in the mid 1970s which put about 135-150,000 into this category. (Some subsequently did find work.) There is no evidence of a subsequent net rise. Higher and longer term unemployment may have led to an increase, but some people previously registered as unemployed may now be treated as long term sick, a group which has increased by over 100,000 since the mid 1970s.

25. However, the unemployable are probably part of a larger group, those who are very hard to place in employment, except in a tight labour market. The over 60s (220,000 unemployed for 4 weeks or more) and the very long term unemployed (130,000 under 60 continuously unemployed for 3 years) give some clue to the size of this wider category. (Many of them will feature also in category c below.)

26. Another group with restricted chances of employment are unskilled manual workers with low educational standards and few attributes to fit them for non-manual or service jobs. These are the areas in which job vacancies are increasingly concentrated. Nearly a million of the register are unskilled labourers and even larger numbers lack minimum educational qualifications (60 per cent of unemployed males under 40 and 75 per cent of those over 40 in the late 1970s). We know nothing about their level of literacy, numeracy or spoken language skills, hence we cannot pinpoint a particular number who would be difficult to place in non-manual or service work.

b. Unavailable because working

27. This category comprises people who are not available for work because they are already working in the black economy. (Not all those who work while on the register are in this position. Some will still be in the market for regular jobs.) A Rayner scrutiny in 1980 estimated that a minimum of 8 per cent of unemployed claimants of supplementary benefit (who made up half the register) were working. In 9 cases out of 10 the amounts earned were not trivial but it is not known how many were no longer on the market for regular jobs. There is no comparable information for claimants of unemployment benefit. Nor do we know how the picture has been affected by the rise in unemployment since 1980. Our study of the black economy will try to shed some light on this difficult area. In the meantime we are in the area of guesswork. If, for illustration, 5 per cent of today's register are doing enough work to make them unavailable for regular work they would account for 150,000 of the total. (To the extent that larger numbers of registrants are able to supplement their benefit with small amounts of earnings, the black economy will also contribute to the phenonemon of selective job seekers discussed in paragraph 30.)

Not available for work

28. This group would de-register rather than take a job, if deprived of benefit. They primarily include older workers who have retired on an occupational pension, or on grounds of health and redundancy, but sign on to claim benefits or preserve state pension rights. There are also others- mostly but not exclusively married women - who have withdrawn from the labour force for domestic reasons but sign on for a period to draw NI benefits. Survey evidence suggests that about 150,000 registrants may regard themselves as retired. There may also be small numbers of workers who want and can afford a short rest between jobs, but sign on for benefits in the expectation of not being offered a job rapidly. We have no idea how many people, if any, are in this category. The point is that not every slow job changer would speed up his spell between jobs if benefit was withdrawn; some might de-register.

d. Not looking for work

29. This is a category who would need to work if deprived of benefit but do not look for work. Special surveys suggest that the most common reason for not looking is that people believe (perhaps mistakenly) there are no jobs available for them. This phenomenon is bound to have risen at current levels of unemployment. The people concerned are best regarded as genuinely unemployed. This leaves the "workshy", people who prefer living off benefits to working. It is often argued that people with high benefit/work income ratios wil fall into this category. Yet evidence suggests that such people look harder for work than others. They are more properly regarded as selective job seekers (para 31).

e. Selective job seekers

30. There are probably considerable numbers of people who are genuinely seeking work, and who would be publicly regarded as unemployed, but who contribute to a higher than necessary level of unemployment by being selective in the kind of work they will accept, with the result that vacancies remain unfilled longer.

31. We have not found it possible to put a particular figure on this category, for two main reasons. First, most people are selective to some extent - the rules for unemployment benefit and the aims of the employment service, with their emphasis on "suitable employment", sanction this. Hence in present circumstances it would not be possible to sustain the argument that people were not unemployed simply because they were selective. Secondly, the effect which people's selectivity has on the register is unclear. In present circumstances, getting some people back to work more quickly would, to a considerable extent, displace others into unemployment.

32. Lower benefits, stricter rules on refusal of job offers and more effective control of fraudulent working - all of these would probably lead to a fall in the register, through faster job filling. For example, econometric studies suggest that in present circumstances a 10 per cent cut in benefits would reduce the register by 100,000. But it is not possible to deduce from this hypothetical estimate a particular component of existing unemployment which could be regarded as not genuine.

Summary of "overcounting"

33. There is considerable overlap among the above categories. Our current best estimate is that, taken together, the very hard to employ, fraudulent workers and the unavailable cause the register to overstate the readily usable supply on the register by at least half a million. But the uncertainties surrounding this figure are great.

Sources of under estimation in register

a. Uncounted registrants

34. Students registering for vacation work (up to 200,000 at the seasonal peak), non claimants seeking part-time work (about 45,000), and people laid off temporarily (10-20,000) are excluded from the regular count. A case can be made for these exclusions on the grounds that the prime measure of unemployment should be restricted to people seeking permanent full time jobs. But in that case the regular count should also exclude claimants seeking only part-time work. (Such claimants probably number a few tens of thousands.) This could be supplemented by a more comprehensive measure including seekers of part time and seasonal work.

b. Unregistered job seekers

35. The Department of Employment estimate (from household surveys up to 1980) that about 300-350,000 people, not on the register, are looking for work. Three quarters are women, two in three of whom are seeking part-time work. Their value to potential employers will be limited in many cases by their need to find hours and conditions of work which fit in with domestic responsibilities. The TUC argue that the recession will have raised the number to 670,000. Some increase is likely to have occurred but unregistered unemployment tends not to rise as rapidly in a down-turn as the register does.

c. Special Measures

36. Over 300,000 people without real jobs are currently kept off the register by special employment and training measures. They are a labour supply in the sense that the schemes would be wound down if enough real jobs were available, and on some schemes (eg YOP) participants are encouraged to

continue looking for jobs. But it can be argued that people whose jobs are kept alive in fundamentally unviable activities by public subsidy are equally lacking in real jobs. On this analysis special measures are a partial record of underemployment, not an uncounted category of unemployed.

Summary of "undercounting"

37. If the register is regarded as a measure of permanent full time job seekers it probably counts all but 100 or 200 thousand of them, though it underestimates the shortage of viable jobs in the economy. But much of the work which becomes available is on a part-time basis. The register is not a good measure of the labour supply for part-time work, because benefit claimants have little incentive at present to take part-time work (legally), whereas large numbers of retired people, housewives, students, school children and those already in work are potentially available for part-time work, without necessarily registering or looking regularly for work. Only a household survey could provide information on the full extent of the potential demand for part-time work. So far as we know this has not yet been attempted.

Implications for the trend of unemployment

38. The register's rise since the mid 1960s has probably exaggerated, by several hundred thousand, the rise in the effective supply of unemployed workers. But it may not exaggerate the increased shortfall of viable jobs in the economy.

39. On the one hand higher benefits probably induced about 50,000 extra "voluntary" unemployed by the early 1970s; the decline of traditional male manual employment may have added a few hundred thousand to the ranks of "hard to employ"; and laxer administration coupled with shortage of notified vacancies may have allowed some tens of thousands more to participate in the black economy. Also at least 100,000 of the increase reflects an increased propensity of job seekers (mostly on the part of women and girls) to register as unemployed.

40. On the other hand the increase since the mid 1970s could have been much greater but for the introduction of special employment measures, the support of jobs in unprofitable industries and the withdrawal of large numbers of workers from the labour force in the present recession. Some measure of this effect is given by the estimate that on past experience, in an economic recovery unemployment will fall by only 3 for every 4 extra jobs generated.

Implications for international comparisons

41. Our work on international comparisons of unemployment levels is at an early stage, since the first requirement is to gain a better understanding of the British figures. DE normally estimate that putting our figures on an international basis would add one percentage point to the unemployment rate primarily because of the unregistered unemployed. But an internationally standard rate based on household survey evidence would measure job seeking activity in the previous month. This might not be higher than the register, if it proves to be true that a good number of registrants are not actively seeking work.

42. However, even internationally consistent definitions of unemployment can mean different things in different countries. In Japan, for example, large companies keep "unemployed" workers on the payroll, while in Sweden the number on special training and employment measures greatly outnumber the unemployed. Also, unemployment can differ qualitatively. In the United States for example a given level of unemployment involves more people in shorter spells of unemployment than is the case in Britain. We shall pursue these issues in greater depth for our final report.

ANNEX B

STRUCTURAL CHANGES: THE PROBLEMS OF MANUFACTURING INDUSTRY

The main paper identified the fall in employment opportunities in manufacturing industry in the United Kingdom and the general problems of securing growth without inflation as factors contributing to the secular rise in unemployment. This annex looks at the issues in greater depth.

2. The key points are as follows.

(i) Poor Productivity

3. The central weakness of industry is its poor stewardship of resources and its lack of innovation and adaptability, all this reflected in low levels and rates of change of productivity of both capital and labour. Poor productivity and lack of innovation in turn undermined the ability of manufacturing industry to compete internationally, leading to a secular deterioration in trading performance. But favourable world developments in the 1950s and 1960s and accommodating fiscal, monetary and exchange rate policies helped mask these underlying weaknesses. Manufacturing employment was thus maintained, at least until the mid 1960s.

4. However, the efficacy of easy money policies dwindled - harsher, more competitive world markets and increasing dissatisfaction with low standards of living at home severely blunted the ability of conventional policies to sustain jobs without simply creating inflation. Lax monetary policies pursued before 1979 also tended to ossify the industrial structure by removing incentives to improve performance and upgrade the quality of goods produced.

5. Upwards movements in labour costs, relative to the costs of investment, may also have encouraged labour-saving investment with a consequential loss of job opportunities.

(ii) Common Industrial World Developments

6. Although the UK's relatively poor industrial performance goes someway to explain why unemployment since the early 1960s has been higher compared with many other main industrial economies and, in particular, with our major European competitors, the rise in unemployment has become a common feature, especially since the early 1970's, in the OECD area. Further work will be required to establish firm conclusiions but our preliminary view is that there are common changes in the pattern and growth of activity - in particular, a decline in manufacturing industry - which has contributed to rising unemployment internationally.

7. For the UK, we note that unemployment has emerged because jobs lost in manufacturing have not been fully matched, in terms of quantity or quality, by the relative expansion of the service and energy/oil sectors. Other countries have seen a rise in service employment but many are less fortunate than the UK in not having sizeable indigenous oil reserves. The effect of the energy problem on unemployment and, in the UK, the connected influences of North Sea oil and the real exchange rate, are particular areas which require further study.

LOW PRODUCTIVITY

8. The facts about productivity in the UK are familiar. Productivity growth has been persistently worse in the UK than abroad (Table B1) with the inevitable result that there has emerged an ever-widening gap in levels of productivity.

9. Several studies - the following are just a small sample - illustrate this:

i. In a National Institute article published in 1976, Jones estimated that, even in 1955, manufacturing output per man hour was higher (by a factor of 8-18 per cent) in major European countries, with the exception of Italy which caught up with UK productivity levels by the late 1960s. Preliminary findings from a recent and, as yet, unpublished National Institute paper updating Jones' work suggest that this gap had widened by 1973 to between 29 per cent (Italy) and 83 per

TABLE B1: Manufacturing Industry - Output and Employment Growth (Average annual rates of change, per cent)

	EC FIVE			UK		
	Output Growth	Employment Growth	Productivity Growth	Output Growth	Employment Growth	Productivity Growth
1955-60	6.9	2.2	4.6	3.0	0.6	2.4
1960-64	6.6	1.7	4.8	3.2	0.1	3.1
1964-69	6.5	0.5	5.9	3.2	-0.2	3.4
1969-73	5.4	0.7	4.6	2.6	-1.6	4.3
1973-78	1.7	-1.5	3.3	-0.8	-1.5	0.7

Sources

i. EC Five, 1955-73, D T Jones: Output, employment and labour productivity in Europe since 1955, National Institute Economic Review, August 1976. EC Five, 1973-78, estimated from unpublished National Institute paper. Figures are not stictly comparable with those in Jones or for the the UK.

ii. UK data from Department of Employment; National Income and Expenditure, 1981. Employment data for 1955-60 are more than usually uncertain. The figures shown are very close to those presented by Jones.

Notes

i. EC Five - Belgium, Netherlands, France, Germany and Italy.

ii. Productivity - output per employee; no allowance for hours worked though Jones (p78) finds that comparison between UK and EC Five is not affected by adjusting for hours.

cent (Netherlands). The same paper estimates that by 1980, manufacturing output per worker in the UK was less than half that prevailing in the United States, the Netherlands and Japan; little more than half that of France, Belgium and West Germany; and around two-thirds of the next lowest country, Italy*.

ii. Also in 1976, a study by Pratten, using data supplied by international companies for their factories in the UK and abroad, showed that, compared with the UK, average labour productivity in the USA in 1972 was over 50 per cent higher, while in Germany it was over a quarter and in France 15 per cent higher.

iii. The 1975 CPRS report on the future of the British car industry found that overall labour productivity in British car plants was some 30 per cent lower than in France, Italy and West Germany in 1973; comparable figures compiled by Pratten and Silberston in an earlier study showed that the UK motor industry had had the highest labour productivity in Europe in 1955, although it was then less than 40 per cent of the US level. By 1973, US productivity was twice the European level but only 20 per cent above Japanese productivity which had risen dramatically over the period.

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* These results are obtained by converting one currency into another at a rate that equates amounts of currency of equal purchasing power. From the point of view of international competitiveness, it is however more appropriate to use the going rate of exchange. Other calculations by Jones suggest that if this is done the comparison is even more unfavourable (by a factor on average of nearly 10 per cent) to the UK. All these estimates are subject to a wide band of uncertainty though the broad picture is clear.

10. This long standing malaise in British industry cannot be explained away by purely economic factors. Relative to the level of output, productive investment in the UK does not compare unfavourably with abroad*; capital productivity - the increment to output achieved from investment - is, like labour productivity, a major weakness. Lack of R & D expenditure, lack of scale, excessive product ranges, high marginal tax rates, and uncertainty created by stop-go macro-economic policies all contribute something to the explanation, but not the whole story.

11. A pervasive factor, which has been identified by commentators for over a century, is the lack of adaptability of UK industry; its unwillingness to innovate and inability to secure a good return when it does.** This deficiency, together with the poor productivity of existing resources, seems in turn to derive from long-standing weaknesses in motivation; reflecting our divisive class structure, the poor quality of management and industrial relations.

Impact on Output and Employment

12. Such fundamental deficiencies could be expected to prejudice our trading performance and industrial profitability. The UK's share in the value of world trade in manufactures halved between 1955 and 1973 (from 20 per cent to 10 per cent), though it is stabilised thereafter. Such a decline might of course have been expected; it is the natural concomitant of a relative shrinkage in the UK component in total world activity and is not necessarily prejudicial to domestic employment. The rising share of imports in home markets, which paralleled the loss in export markets, is similarly less disturbing than might appear at first sight since the phenomenon is a general one, reflecting increasing intra-industry specialization in the industrial economies.

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* Based on OECD data, the ratio of investment to value added in manufacturing (valued at market prices) in 1978 was, in per cent, 11.9, 8.9. 10.4 and 15.3 in the UK, US, Germany and France respectively. An estimate for Japan in 1976 is 15.0 per cent. (Figures provided by Department of Industry economists.)

** The appendix, prepared by Department of Industry economists, amplifies on this theme.

13. What is without question abnormal and worrying is that, in the UK, imports of manufactures have grown much faster in volume than manufactured exports (Table B2), giving rise to the potential dilemma of maintaining, at the same time, external balance and full employment. Associated with the decline in trade performance went a fall in profitability which, while apparent in other sectors, was particularly marked in manufacturing.

TABLE B2: Growth in Volume of UK Manufacturing Trade
Annual average change per cent; cyclical peak years

	1964-69	1969-73	1973-78
Exports	6.7	5.5	3.4
Imports	8.3	13.4	5.7

Source: Monthly Review of External Trade Statistics

14. Reflecting on these developments in trade and profitability, some commentators have gone so far as to suggest the emergence of a downward spiral: poor productivity performance and lack of innovation leading to balance of payments problems, low growth and thus low profitabilty, this in turn reducing the wherewithal and incentive to invest in new products and processes, a development which, in the long run, intensifies the trade and profitability problems. There is some weak support from this view in the imperfect correlation between the evolution of R & D expenditure and manufacturing profitability - Table B3 - and the UK's relatively poor showing in terms of the amount and effectiveness of R & D expenditure compared with major competitor countries (see Appendix).

15. Given all these weaknesses at home (low productivity and low profitability) and externally (poor manufacturing trade performance), the query arises why it was at all possible to maintain a growth in manufacturing employment (until 1966) and output (to 1973). (After 1973 output fell absolutely; employment continued to decline until the next peak year at a trend rate similar to that of the late 1960s - Table B1).

16. We believe that a major factor which served to paper over the cracks in the post-war period, and perhaps in earlier times, was the accommodation of supply side weaknesses by exchange rate, fiscal and monetary policies, buttressed in various episodes by resort to incomes policies. But such policies could work only as long as the country was willing to accept relatively low real living standards - the concomitant of low productivity - and as long as wages responded only weakly to increases in prices and taxation.

17. Accommodation of supply side difficulties also carried the disadvantage of underwriting the very modes of behaviour - lack of motivation and entrepreneurship, weak management and poor industrial relations - which in the long run had to change if the UK was to evolve into a high wage-high productivity economy.

The Historical Pattern - Pre 1979

18. This interpretation of history could be illustrated in the following broadbrush way.

19. In the 1950s, and apart from the Korean war, world economic developments and the UK external trade performance were favourable: real commodity prices fell, world trade grew rapidly and our major competitors were still undergoing post-war reconstruction; the UK still had close trading links with the Commonwealth, though this was to prove less of an advantage as trade became increasingly one of an exchange of manufactures between industrial economies; quantitative controls on UK manufactured imports were not fully withdrawn until the late 1950s (thus helping to disguise any underlying weaknesses); the current account was generally in surplus.

TABLE B3: UK Manufacturing Profitability and Research and Development (R & D) Expenditure

	1960	1964	1969	1973	1978	1979	1980
1. Gross Profit share %	31.6	30.0	26.3	26.0	23.7	18.6	15.3
2. Net Rate of Return %	12.1	10.5	8.1	7.2	4.8	2.7	1.1
3. R & D (£mn 1975 prices)	na	1365	1491	(1376)	1512	na	na
4. (3) % of value added	na	6.1	5.6	(5.1)	5.4	na	na
5. (3) % of gross capital stock	na	2.1	1.9	(1.6)	1.5	na	na

na = not available

Notes 1. Gross trading profits in manufacturing industry (private and public sector) net of stock appreciation, gross of capital consumption, as a percentage of value added, net of stock appreciation.
Source: National Accounts, CSO

2. Gross trading profits as in 1. net of stock appreciation and capital consumption as a percentage of mid-year estimates of the current relacement value of the net capital stock plus the book value of stocks.
Source: National Accounts, CSO

3. Manufacturing industry expenditure on research and development related to science and technology. Bracketed figures are for 1972.
Source: Economic Trends, August 1981, p 108.

4. Value added calculated at constant 1975 prices.

5. Gross capital stock estimated for mid years at 1975 prices.

20. An underlying bonus to industry, enabling it to compete in price and cost terms over this period, derived from the massive (30½ per cent) sterling devaluation in 1949. As Professor Burns and his colleagues have noted the competitive advantage so conferred was gradually whittled away by higher rates of UK inflation but while this adjustment took place "the level of output was higher than it would have been and the balance of payments better. This resulted in an enormously optimistic unemployment objective". (Ball, Burns and Laury; the Role of Exchange Rate Changes in Balance of Payments Adjustment - the UK Case, Economic Journal, March 1977.)

21. By the early 1960s, this price/cost advantage was almost completely eroded. In addition, Europe and Japan emerged as major competitors; in the late 1960s, newly-industrializing countries also posed a threat. Inflation and the current account were becoming persistent problems. Policy-makers over the next two decades responded in a variety of ways:

- there were repeated attempts at incomes policies aiming to improve or maintain competitiveness;

- fiscal incentives were strengthened, particularly in the form of increased capital allowance nationally and in the regions; debt financing became more advantageous from a tax point of view after the introduction of corporation tax in 1965 - this kept down the post-tax interest cost of financing investment; more generous capital allowances and stock relief were introduced in the 1970s;

- various efforts were made to speed-up industrial change and improve technological performance;

- public expenditure and public employment were increased, partly in response to unemployment; combined with the fiscal easements to industry, this led to a rising personal tax burden;

- sterling was devalued again in 1967 and allowed to depreciate repeatedly after 1972.

22. Some would claim that, to a certain extent, these policies were successful. Their broad rationale was to offset the adverse competitiveness and profitability effects of low productivity of labour and of capital by making labour and capital cheaper. Thus:

- international price and cost competitiveness, contrary to popular belief, improved between the early 1960s and late 1970s;

- furthermore, despite rising cash wages per unit of output, real wages (real in terms of manufacturers' output prices) did not rise relative to productivity between 1960 and 1978 on a secular basis (though there were substantial year-to-year variations) - monetary and exchange rate policies were therefore sufficiently accommodating to allow prices to rise in line with unit cash wages;

- on a post-tax basis, tentative calculations by Professor King suggest that profit share in manufacturing was stable until the late 1960s (despite a falling pre-tax profit share); the decline thereafter into the early 1970s may have been due simply to the delayed introduction of stock relief.

23. Thus, despite losses of trade share, manufacturers enjoyed some gains in price competitiveness which helped sustain output and employment; similarly investment remained buoyant, even in the 1970s, despite a significant fall in pre tax "real" profits. Some of these developments are shown in Table B4.

TABLE B4: Trends in UK Manufacturing Industry

	Competitiveness Index(1)	Index of Real Wages Relative to Productivity(2) 1975 = 100	Effective Tax Rate (3) on gross trading profits	Effective Tax Rate (3) on "real" profits	Gross Capital Expenditure(4) 1975 prices, including leased assets £mn	Gross Capital Expenditure(4) 1975 prices, including leased assets Percentage of value added
(5)						
1960	(109.8)	91.1	24.8	31.6	2818	14.2
1964	105.1	89.8	21.0	27.5	3056	13.5
1969	95.3	91.0	16.9	26.8	3877	14.7
1973	88.7	93.0	11.6	24.4	3440	11.7
1978	96.0	88.0	na	na	4137	14.7

na = not available

Notes

(1) UK unit labour cost competitiveness, cyclically-adjusted. Bracketed figure is for 1961. A decline in the series indicates an improvement in competitiveness. Source: Monthly Review of External Trade Statistics.

(2) Calculated by dividing an index of the wage and salary bill in manufacturing by a index of the value of gross output - the output volume index multiplied by the index of wholesale prices of goods sold at home. Sources: CSO, National Accounts, Economic Trends.

(3) From M A King, The UK Profits Crisis: Myth or Reality?, Economic Journal, 1975, Table III. Refers to manufacturing excluding metal manufacturing. "Real profits" are gross trading profits less capital consumption and stock appreciation. Effective tax rate is the ratio of tax liability to profits.

(4) Value added calculated in 1975 prices by applying the output index to the GDP contribution of manufacturing in 1975. Source: National Accounts, Economic Trends.

(5) The years chosen are cyclical peaks in manufacturing though there is some uncertainty whether 1978 or 1979 represents the last peak. 1978 is preferable for illustrative purposes in that it precedes the recent large change in competitiveness trends.

Policy Weaknesses

24. But the policies designed to make UK labour and capital cheap had, in the long run, serious weaknesses which in our view outweighed any short run benefits:

i. We believe they reduced the incentive to improve non-price competitiveness - ie to improve product quality and reliability. UK goods sold abroad failed to tap the strongest growing markets; domestically, imports responded disproportionately to increases in output and income. The existence of favourable trends in price/cost competitiveness (para 22) and the results of wider academic work (by eg Soete and Keesing) linking economies' export performance to measures of innovative activity, strengthen the view that it is poor product quality and marketing - related to lack of technological development and exploitation - which is the source of these difficulties. Furthermore by weakening the incentive to move "up market", conventional policies exposed UK producers to competition from less developed countries who were expanding into product areas involving simple technology and cheap labour.

ii. Some commentators believe that fiscal incentives for capital investment, given the continued upward movement in real wages, magnified by the imposition of labour taxes, may have induced excessive labour saving investment, reflected in artificially high rates of labour productivity growth; it is claimed that this helps explain the fall in manufacturing employment from the mid-1960s despite increasing output levels (until 1973) and buoyant investment.

iii. Most seriously, the policies led to rising inflation: triggered by the 1967 sterling devaluation, the breakdown of incomes policies and the rise in world prices, inflation accelerated from the late 1960s.

25. Our interpretation of the wages explosion in the late 1960s and thereafter is that there emerged through that decade (in the UK and elsewhere) increasing awareness of, and resistance to, the effect of inflation and rising taxation on real living standards; this blunted the ability of accommodating fiscal, monetary and exchange rate policies to offset underlying supply weaknesses and thereby secure employment. For the same reasons, conventional income policies were only of temporary effect. The world stagflationary condition in the 1970s and the associated slowdown in productivity growth severely aggravated these tendencies by reducing the sustainable growth of real incomes. The response of UK governments was, however, largely one of increasing the dosage of old medicines; but the patient hardly responded. Inflation accelerated; manufacturing employment and output fell.

26. As the paper by Professor Burns and others cited earlier puts it: "The problem of British post-war inflation, compared to other countries, has been one of pursuing levels of economic activity relative to world activity which continuously weakens the balance of payments and tempts the Government to devalue in order to reconcile the unemployment target with external balance. This, in turn, generates inflation as incomes chase import prices upward, under free collective bargaining.....It follows... that it is not possible to pursue a simple policy rule of directing fiscal policy toward determining full employment while allowing the exchange rate to adjust the balance of payments. The refusal of the community to bear, or the government to inflict, the real income adjustment necessary following an exchange rate depreciation will simply not permit this." (emphasis added)

Post 1979

27. In the long run, this situation is clearly unsustainable without an improvement in real performance or greater acceptance of a reduced rate of growth in real incomes. But there exists great inertia in the system; the result of decades of indifferent productivity growth and an entrenched wage-price inflationary spiral. Thus the attempt after 1979 to reverse policies of cheap money and cheap factors of production - in particular, the reversal of previous accommodating movements in the exchange rate, leading to a severe loss of price/cost competitiveness - came as a severe shock (see paras 23-24 of main report). In retrospect, the considerable fall in manufacturing output and employment was hardly surprising.

COMMON INDUSTRIAL WORLD DEVELOPMENTS

28. The preceding paragraphs have presented an explanation of falling employment opportunities in manufacturing industry couched largely in terms of particular British problems.

29. This is undoubtedly too parochial. Manufacturing employment, both absolutely and as a proportion of the workforce, has been falling in other industrial countries, most particularly since the early-mid-1970s. Profitability has fallen elsewhere (Table B5), and inflation and unemployment have risen throughout the OECD area. The UK generally turns in the worst performance - hence our emphasis on the British disease as an explanation of unemployment - but there are clearly some common industrial world developments which also impinge upon the unemployment story, in particular the relative or absolute decline of manufacturing.

Table B5: Gross Rates of Return on Fixed Capital(1) in Manufacturing per cent

	Canada	USA	Japan	Germany	UK
1955	19	25	na	29	14
1960	15	20	na	26	14
1964	17	24	(28)[2]	20	12
1968	15	24	37	20	11
1973	15	19	37	15	9
1978	12	18	35	16	7
1979	14	17	34	na	6

1. Operating surplus (broadly equivalent to gross trading profit net of stock appreciation) as a percentage of gross capital stock (inventories excluded). Based on National Account statistics as returned to the OECD on internationally agreed definitions. Estimates provided by Department of Industry.

2. 1965 figure.

30. There is no completely satisfactory explanation of the causes of structural changes in employment or output but judged from an examination of UK developments and a still tentative analysis of trends abroad, we believe that there is an element in the declining fortunes of manufacturing industry (de-industrialisation) which results from the natural development of economies; a response to shifts in comparative advantage reflected in relative rates of return. To that extent, de-industrialisation in the UK may not be as pernicious as would appear at first sight.

31. There is some support for this view in the surprising buoyancy of "profit" share in a wide industry grouping in the UK including oil, services, public utilities and manufacturing, despite the continued fall in manufacturing profit share - Table B6. In particular:

- rates of return in private sector services have been far more buoyant than in UK manufacturing. It is a common feature of OECD economies that prices of services have tended to rise relative to manufactured goods prices - reflecting perhaps shifts in tastes as income grows. This shift in relative prices may have contributed to relative movements in profitability and thus output and employment, if only because manufacturers have to buy services during the process of production. The incursion of the newly industrialising countries into manufacturing activities especially since the late 1960s may also have influenced the re-allocation of industrial activity on a world-wide basis, consistent with movements in comparative advantage.

- the rise in real energy prices has caused a similar shift in relative rates of return. The manufacturing sector seems particularly hard hit. Table B7 shows the evolution of the real cost of materials and fuel bought by manufacturers and tentative calculations of the observable impact of higher material prices on profit share. (The data here do not discriminate between energy and non-energy inputs.) Although the figures are to be treated with caution, the impression is that the fall in profit share over the period shown is very largely accounted for by the

TABLE B6: Comparative "Profit"(1) Shares (%) in the UK

	Manufacturing Industry (1)	Production Industries Transport and Communication[2] (2)	Production Industries, Transport and Communication less Maufacturing Industry (3) = (2) - 1
1960	32.9	31.2	28.3
1964	31.4	31.2	30.9
1969	27.8	30.9	35.8
1973	28.1	31.7	36.9
1978	25.9	32.9	42.5

1. To enable comparison between industries, profit share in value added is defined to include income from self-employment which contains an element of income from employment as well as profit. The buoyancy of profit share may thus be overstated, particularly in column (3). Data are gross of capital consumption, net of stock appreciation.

2. Sectors included here are: petroleum and natural gas, other mining and quarrying, manufacturing, construction, gas, electricity and water, transport and communication. The aggregate is that used by Professor Hill in his international study of rates of return:Profits and Rates of Return, OECD, 1979.

Source: National Accounts, Table 3.1.

TABLE B7: Change since 1972 in Real Material Costs and Profit Share in UK Manufacturing

	Change in Real Material and Fuel Costs(1) %	Profit Share(2) Percentage points	Profit Share directly attributable to higher material costs (including services)(3) Percentage points
1972-73	+ 23.3	+ 0.2	- 1.2
1972-74	+ 48.4	- 6.5	- 6.7
1972-75	+ 39.9	- 8.0	- 2.2
1972-76	+ 51.4	- 6.8	- 4.2
1972-77	+ 44.9	- 2.5	- 7.0
1972-78	+ 31.9	- 2.1	- 4.5
1972-79	+ 36.3	- 7.2	- 7.6
1972-80	+ 40.5	- 10.5	- 6.6

Notes

1. Percentage point change in the ratio of the index of prices of materials and fuels purchased by manufacturing industry to the index of wholesale prices of goods sold at home. Source: Economic Trends.

2. Percentage point change in gross profit share (gross of capital consumption, net of stock appreciation) in value added in manufacturing industry. Source: CSO, National Accounts.

3. Estimated impact on profit share of increases in the real price of materials and services purchased inferred from movements in value added and the movements in the value of gross output in manufacturing. Source: National Accounts, Economic Trends.

sustained rise in the real cost of materials bought which, while reflecting a number of influences (eg exchange rate changes), is clearly related to the rise in real energy prices. Although data for other countries have yet to be examined, it would not be surprising if there were similar developments in other major economies, many of whom are far less fortunate in not having sizeable indigenous oil reserves.

Effect on Employment

32. Shifts in the pattern of activity, in the UK between manufacturing on the one hand, and services and energy on the other, create difficulties for employment if the labour shed from declining sectors is not suited to jobs available in expanding sectors or if the latter are relatively frugal in their use of labour. If relative pay levels do not move quickly enough to compensate or if demand for labour in the relevant sector is not especially sensitive to shifts in real pay, the result will be mis-match or structural unemployment.

33. An element in UK unemployment trends fits this pattern:

- the expansion of services was largely of benefit to females working more flexible hours, often part-time whereas the fall in employment in production industries was concentrated on males, often older males used to full-time jobs. Lack of flexibility in attitudes and skills and the relative cheapness of female labour probably contributed to the low rate of absorption of males into the service sector.

- the expanding energy sector is relatively capital intensive and, particularly in the case of oil production, unable to absorb labour shed elsewhere. The effect is reflected in relative movements in productivity and output growth at a national level: the annual average growth of output and labour productivity between 1973 and 1979 for the economy excluding oil is less than half that recorded for the economy including oil: overall rates of output growth have been associated with less employment growth.

Appendix to
ANNEX B

TECHNOLOGICAL DEVELOPMENT AND EXPLOITATION

1. The United Kingdom ranks below the United States, Japan, Germany and France in terms of gross expenditure on R and D and, despite a somewhat better performance in the late 1970s, has shown lower growth in this item compared with the last three countries since the late 1960s (see Table B8).

2. Overall, from the late 1960s growth in R and D expenditure in United Kingdom industry has not kept pace with that in France, Germany and Japan.

3. Whilst the United Kingdom employs about the same proportion of the total industrial work force as R and D scientists and engineers as Japan and Germany and more than France, the rate of growth of this employment category has been substantially lower since the late 1960s.

4. United Kingdom business spends less on R and D than Japan in all manufacturing sectors, except aerospace; less than Germany except in aerospace, food, drink and tobacco and miscellaneous manufacturing; and more than France in all sectors except transport equipment and basic metal manufacture (see Table B9). Moreover, compared to its main competitors, it is only perhaps in chemicals and electronic engineering that the United Kingdom can lay claim to a respectable R and D growth performance. Table C10 shows that growth rates of R and D expenditure have varied considerably between countries, sectors and time periods, but the United Kingdom is the only country where, for six of the eight industries identified in Table B10, R and D expenditure was lower in 1978 than in 1967.

5. United Kingdom government expenditure on R and D is lower than in France and Germany in all categories of expenditure by objective, except in defence. Its expenditure on R and D categorised by the objective 'industrial productivity and technology' is below that of France and Germany and the EC average and in current prices has failed to reach the levels of the early 1970s compared with the sustained and rapid growth rates in France and Germany.

6. Expenditure and employment figures are input measures of R and D activity, but the relatively poor United Kingdom performance is also reflected in the output measures available - eg patent data. Table B11 presents data on foreign patenting in the United States. Between 1963 and 1978 the share of the United Kingdom in foreign patenting in the United States halved whilst that of France remained constant, Germany's share fell slightly and Japan's grew dramatically. The United Kingdom's fall in share was much the same across the spectrum of industries, but with parts of chemicals holding their share or even increasing it (eg drugs and agricultural chemicals).

7. It is difficult to resist the conclusion from such international comparisons that, with one or two exceptions (ie chemicals and defence), there is some general sense in which the United Kingdom technological effort is relatively deficient. In addition the literature on innovation recognises that an important role is played in the development of technological sophistication of processes and products by what has been termed 'incremental innovation'. By this is meant gradual modifications and improvements to processes and products in ways and by means of expenditure which may not even be classified as R and D. The extent to which this goes on will depend on managerial, labour and organisational skills, attitudes and relationships. The Japanese, for example, seem to have particular strength in 'shop floor' initiated innovation.

8. Incremental innovation may also be a function of the speed with which experience is accumulated about the characteristics of the production processs and the market and about improvements that could be made. In other words, innovative capability in this sense may well be a function of the growth in the volume of output - the so-called 'learning curve' or dynamic scale economy effects. The cumulative effects of slow growth in the United Kingdom on this kind of hypothesis would have a self-perpetuating consequence.

9. Indeed, there is a body of opinion based upon anecdotal and some survey evidence that British technological weakness derives in large part from a failure to exploit technological advances commercially and to sustain

commercial success by continuous, incremental improvement rather than from a failure in the basic scientific and technology infrastructure. This view of a British 'development' or 'post-development gap' is consistent with evidence of a British deficiency in absorbing and developing foreign technology advances. The Germans and the Japanese, on the other hand, seem to thrive on foreign technology supplemented by their own incremental R and D efforts.

10. Studies of various industries (eg Prest on tractors, Rothwell on textile machinery and others in Pavitt (ed); Technical Innovation and British Economic Performance) have found that poor United Kingdom performance in radical innovations has been accompanied by relative deficiencies in incremental innovation. In other words, the relative technological weaknesses of the United Kingdom are a function not only of inadequate R and D investment but also of shortcomings in the other activities necessary for effective innovation such as production engineering, marketing and industrial skills and an awareness and absorption of foreign technological developments.

TABLE B8

GROSS EXPENDITURE ON RESEARCH AND DEVELOPMENT

	INDEX NUMBERS BASED ON $ 1975 PRICES (1975=100)		$m 1975 PRICES
	1968	1978	1978
US	110	114	41,868
JAPAN	52	119	11,794
WEST GERMANY	65	113	10,544
FRANCE	86	110	6,699
UK	94	113	5,439

Source: OECD

TABLE B9

INTERNATIONAL COMPARISON OF MANUFACTURING INTRA-MURAL EXPENDITURE ON R AND D, 1977

US $ million

	France	Germany, FR	Japan	UK [a]	USA
Electrical engineering	1,129	1,888	1,954	1,313	5,952
Chemicals	746	1,936	1,610	802	4,180
Aerospace	756	518	n.a	815	7,078
Other transport	482	879	1,394	284	3,419
Basic metals	152	203	675	126	915
Machinery	205	1,017	891	310	5,375
Chemical linked industries	226	143	457	245	1,035
Other manufacturing	89	58	516	137	1,005
Total manufacturing	3,786	6,642	7,496	4,034	28,959

a 1978

n.a - not available

EXPENDITURE ON R AND D AT 1975 PRICES. INDEX NUMBERS: 1975 = 100

	1967	1968	1969	1970	1971	1972	1973	1974	1975	1977*
TOTAL INDUSTRIAL INTRA-MURAL R & D										
Germany FR	69	–	78	–	97	–	94	–	100	107
France	85	84	89	90	93	97	97	98	100	108
Japan	53	67	78	94	97	104	106	102	100	108
UK	113	112	113	–	–	106	–	–	100	117
USA	110	111	112	104	101	102	105	102	100	111
ELECTRICAL ENGINEERING										
Germany, FR	62	–	81	–	85	–	91	–	100	104
France	65	–	–	81	87	87	89	98	100	100
Japan	50	70	88	110	104	116	117	107	100	113
UK	107	110	112	–	–	105	–	–	100	149
USA	123	124	127	119	118	123	125	119	100	105
CHEMICALS										
Germany, FR	70	–	85	–	88	–	88	–	100	109
France	84	–	–	90	89	98	99	97	100	110
Japan	65	77	89	105	111	106	101	102	100	110
UK	88	91	96	–	–	94	–	–	100	120
USA	89	92	92	93	91	88	91	97	100	110
AEROSPACE										
Germany, FR	38	–	63	–	116	–	100	–	100	89
France	120	–	–	98	104	103	101	98	100	106
Japan	..	..	..	..	..	..	..	..	..	..
UK	122	122	120	–	–	126	–	–	100	101
USA	161	156	152	128	115	112	108	103	100	112

CONFIDENTIAL

	1967	1968	1969	1970	1971	1972	1973	1974	1975	1977*
OTHER TRANSPORT										
Germany, FR	78	–	109	–	129	–	105	–	100	123
France	66	–	–	86	92	99	107	101	100	124
Japan**	36	46	50	63	71	95	102	90	100	111
UK	115	109	117	–	–	105	–	–	100	98
USA	90	95	94	91	96	104	121	110	100	127
BASIC METALS										
Germany, FR	198	–	141	–	109	–	102	–	100	110
France	92	–	–	–	–	–	98	98	100	106
Japan	60	65	74	91	86	91	95	97	100	108
UK	151	130	129	–	–	107	–	–	100	98
USA	87	89	86	88	89	85	88	88	100	108
MACHINERY										
Germany, FR	83	–	56	–	90	–	96	–	100	120
France	92	–	–	185	181	209	172	95	100	112
Japan	58	78	93	116	115	106	106	129	100	136
UK	146	144	133	–	–	100	–	–	100	117
USA	69	76	77	77	77	81	86	88	100	111
CHEMICALLY LINKED INDUSTRIES										
Germany, FR	76	–	71	–	62	–	118	–	100	119
France	83	–	–	98	102	103	100	103	100	104
Japan	65	87	82	90	104	99	106	94	100	109
UK	112	112	112	–	–	91	–	–	100	102
USA	80	82	84	85	84	88	87	85	100	110

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Table B10 (continued (ii))

	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976*
OTHER MANUFACTURING										
Germany, FR	96	-	148	-	178	-	94	-	100	102
France	105	-	-	105	99	96	122	112	100	109
Japan**	50	60	69	82	69	98	111	98	100	105
UK	169	166	159	-	-	114	-	-	100	137
USA	76	81	89	93	90	92	91	94	100	117

NOTES

*Based on 1978 figures for UK
**Includes aerospace

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TABLE B11 SHARES IN FOREIGN PATENTING IN THE UNITED STATES, 1963-1978

	1963	1967	1971	1975	1978
France	10	11	10	9	9
Germany	27	26	25	24	24
Japan	5	10	18	25	28
United Kingdom					
Chemicals					
Industrial	17	15	11	11	11
Plastics, etc	11	15	12	9	8
Agricultural	10	15	10	12	16
Drugs	9	15	10	13	15
TOTAL	**16**	**16**	**11**	**11**	**12**
Machinery					
Engines, etc	38	30	22	14	10
Farm, garden	17	20	18	12	11
Machine tools	23	18	15	13	9
Office	22	21	17	11	10
Other	22	19	16	12	10
TOTAL	**23**	**20**	**16**	**12**	**10**
Electrical Equipmemt					
Transmission, etc	21	22	18	9	11
Household appliances	15	17	15	9	7
Lighting, wiring	17	21	16	20	14
TOTAL	**22**	**19**	**18**	**12**	**11**
Electronic equipment					
Radio, TV	26	21	14	9	10
Communications	28	22	17	13	12
TOTAL	**28**	**22**	**17**	**13**	**11**
TOTAL UK	**21**	**19**	**16**	**12**	**11**

Source: Office of Technology Assessment and Forecasts, 7th Report, Washington DC, USGPO, 1977; and information supplied to Science Policy Research Unit, Sussex.

ANNEX C

UNDERLYING CAUSES OF WAGE STICKINESS

1. It has been argued that increasing unemployment in the United Kingdom has been generated by shifts in the structure of demand and by supply side "shocks". In commodity markets it is normally expected that excess supply will be removed by falls in prices. Why do not wages move in a similar way to clear the labour market? More specifically recent history suggests two related puzzles:

- First, when demand decelerates why do real wages drop so slowly?

- Second, when demand accelerates, even from (increasingly) high levels of unemployment, why do nominal wages rise so rapidly?

These questions are addressed in turn.

WAGE RIGIDITY IN THE FACE OF DECLINING DEMAND

THE EVIDENCE

2. When demand falls, firms can theoretically choose between reducing hours of work, reducing wages and allowing profits to be squeezed. The recessions of the last decade have been accompanied by pressure on manufacturing profits in virtually all Western economies, though the pressures may have been greater in Britain than in most other countries. (See Annex B). There is therefore casual evidence of difficulty in adjusting labour inputs in any way, either via quantitites or via prices. Indeed it has been suggested that in the 1960s and early 1970s Britain and Western Europe experienced unemployment rates that were only half the North American levels largely because of a greater reluctance to lay-off workers. The reluctance may have been motivated by job security provisions, including legislation.*

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* The same employment protection provisions may now be having an adverse impact on unemployment. Such provisions may discourage lay-offs in periods of mild recession, but at times of deep recession (and great uncertainty) they may well act mainly to inhibit new recruitment.

3. Once profits are squeezed firms initially attempt to reduce hours of work. If that proves insufficient they show a strong preference for reducing labour costs through lay-offs rather than through cutting real wages. In the post-war period nominal wages appear to have responded to decelerations in monetary demand, albeit with long and painful lags, but there have only been three periods, including the present, in which real earnings have actually fallen. The ground lost in the previous falls was recovered within three years.

4. Preliminary work on comparisons with other countries (carried out at the London School of Economics) suggests that real wages in the United Kingdom are more rigid that in most developed Western countries, the major exceptions being those with a high degree of indexation. This work is not yet in a form to be quoted. But there is evidence that unemployment on its own has only a limited impact on wage inflation (as distinct from real wages). Tentative OECD estimates of the short run impact of a percentage point rise in the unemployment rate are as follows; it will be noted that the United Kingdom shows the lowest figure (implying the most rigidity) and Japan much the highest.

TABLE C1: CHANGE IN THE SEMI-ANNUAL GROWTH RATE OF WAGES FROM A 1 PERCENTAGE POINT RISE IN THE UNEMPLOYMENT RATE

- (a) LOW UNEMPLOYMENT RATES

(Figures in parenthesis show starting level of the unemployment rate)

US	CANADA	JAPAN	GERMANY	FRANCE	UK
(4%)	(4%)	(1%)	(2%)	(4%)	(5%)
-0.47	-0.29	-3.77	-0.13	-0.14	-0.11

5. The same source suggests that excess supply in the labour market may have a smaller effect on wage inflation the higher the starting level of unemployment; the following figures, for higher unemployment levels, show much smaller adjustments in real wages (except for Canada).

TABLE C2: CHANGE IN THE SEMI-ANNUAL GROWTH RATE OF WAGES FROM A 1 PERCENTAGE POINT RISE IN THE UNEMPLOYMENT RATE

- (b) HIGH UNEMPLOYMENT RATES

(Figures in parenthesis show starting level of the unemployment rate)

US	CANADA	JAPAN	GERMANY	FRANCE	UK
(7%)	(7%)	(3%)	(4%)	(7%)	(10%)
-0.16	-0.21	-1.12	-0.04	-0.05	-0.03

6. Real wage rigidity - the failure of real wages to adjust rapidly to declines in demand - is not a new phenomemon*. In the Great Depression real wages generally rose in the United Kingdom, France, Germany (prior to Hitler's controls) and Sweden, even though money wages fell. In the United States real weekly wages did fall in the early part of the 1930s, before staging a strong recovery. But the initial fall largely reflected the

*In 1919 the Webbs wrote "If every artisan, without the slightest concert with his fellows, is possessed by an unreasoning prejudice that he and his family must consume wheaten bread, butchers meat, beer and tea, instead of living on oatmeal, maize, potatoes and water; the employer will find in useless to suggest that "any meal is better than none"".

adoption of a dramatically shorter working week; on an hourly basis real wages rose across nearly all United States manufacturing industries even over the period 1929-33. The buoyancy of real wages in Britain during the 1930s has been attributed to union bargaining. This may well have played a part. Analysis of the American experience shows that unionised sectors exhibited a smaller fall in money wages than non-unionised sectors. Nevertheless even the non-unionised sectors experienced stable or rising hourly real wage rates alongside unemployment much higher than in Britain and without the safety net of an unemployment insurance system.

EXPLANATIONS

7. For over 50 years attempts have been made to explain the downward stickiness of real wages. There are probably many mechanisms at work and the importance of each will vary across different sectors of the labour market and may change through time. They can be conveniently grouped in terms of influences on employees, influences on employers and influences on both parties.

a. INFLUENCES ON EMPLOYEES

8. One of the earliest explanations offered for the resistance of exployees to wage cuts was that they have profound convictions about appropriate relative wages among occupations and industries.* Relative wages are seen as defining status. Decentralised wage bargains can only determine the absolute wage in one occupation, industry or firm at a time. In a period of rising unemployment each worker resists offers below the going rate of wage increases, not because he or she would be unwilling to accept a universal reduction in real wages - "equal misery for all" - but because he or she sees only his or her part of the labour market and observes that to accept a lower rate is to accept a reduced relative wage by the normal standards of comparison. The net, though unintentional, result

* The rigidity of pay relationships was noted by Adam Smith 200 years ago. More recently a rank correlation co-efficient of +0.87 was found for earnings in 132 industries in 1948 and 1959. With a higher rate of pay increase the degree of correlation has fallen: for men manual workers in 124 industries in 1960 and 1975 it was +0.617.

is to preserve the general wage level or its trend. The great importance attached to starting recent wage rounds off on the right foot and to isolating and justifying aberrant awards suggests that this mechanism is very important in current circumstances. Its importance has probably been increased by the post-war growth of single-employer agreements and the declining importance of industry-wide agreements: for two-thirds of manual and three-quarters of non-manual employees in manufacturing the principal means of fixing pay is now through single-employer agreements concluded for individual companies or factories.

9. Another important influence on employee behaviour is the standard pattern of collective bargaining agreements. These agreements normally specify wage rates but not the amount of employment. Reflecting three decades of full employment, unions have placed much more emphasis on improving wages than on maintaining or increasing the number of jobs. The substantial growth of unions and the related extension of collective agreements over the same period have strengthened this source of rigidity. Old attitudes and objectives take time to change and unions have found it easier to accept redundancies than to relax their pressure for higher wages. Generous redundancy benefits may influence the choice, particularly where there is an ageing labour force.

10. For many workers the choice is not directly between a reduction in real wages and redundancy, even at current levels of unemployment. Over the post-war period a growing proportion of the United Kingdom labour force has come to work for large employers offering a high degree of job security. In manufacturing industry the hundred largest employers accounted for 27 per cent of all employment in 1958 and 34 per cent in 1978. Between 1961 and 1979 public sector employment rose from 24 per cent to 30 per cent of all employment. These types of employers often have highly developed "internal labour markets", ie administrative units where most jobs are filled by the promotion or transfer of workers who have already gained entry and which are therefore shielded from the direct influence of competitive forces in the labour market. Such markets may be believed to offer the protection of "lifetime employment". Recruitment with the implicit or explicit aim of

providing lifetime employment is by no means confined to the public sector. IBM, for example, only recruits people it expects to be able to employ on a permanent basis. Moreover, whatever the formal understanding, most people do experience very long attachments to one employer. While turnover rates indicate that there are many short jobs in the economy, the bulk of employment is spent in jobs of considerable length. A recent estimate is that in the mid 1970s men in employment could expect to spend an average of 20 years with the same employer, and employed women 12 years.* At that time the average length of job tenure in public administration appeared to be no higher than in manufacturing. One can readily see why redundancy is viewed as something that affects somebody else.

11. A further but related influence on employee attitudes is that the unemployed do not represent effective competition to most people in work. Those concerned with negotiating higher wages are not, on the whole, the ones that lose jobs as a result and even less are they the ones looking for jobs. As is noted in Annex A, unemployment has been concentrated on a relatively small segment of the labour force, with limited skills, low wages and poor work histories. Union members are under-represented: only four out of ten men and one third of the women becoming unemployed in 1980 were union members in their last jobs, and for most of these membership lapsed in the first few weeks of unemployment.** The concentration of unemployment on the disadvantaged is almost certainly greater than in some other countries, notably North America, and so far there is little sign that it is diminishing. A 1980 survey found that only 13 per cent of men in the labour force reported experiencing unemployment at any time in the previous year.

12. A final reason for expecting employees collectively to accept redundancies in preference to wage cuts is the availability of other sources of income. The obvious source is unemployment compensation, but redundancy benefits, occupational pensions, presence of a second earner, significant savings and various types of fringe activities may also reduce the costs of unemployment. All have greatly increased in the post-war period.

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*Average job tenures appear to be only slightly shorter in the United States. In US manufacturing seniority systems are thought to be more widespread than in Britain.

**For all employees the comparable figures were 72 per cent for men and 42 per cent for women.

b. INFLUENCES ON EMPLOYERS

13. While the reasons for employee resistance to real wage reductions are easily understandable, at first sight it is not so obvious why employers do not make greater efforts to take advantage of high unemployment to force wages down. Despite the obligations of job security provisions and the costs of redundancy payments, many employers apparently prefer to look for savings first through reducing the labour force and only secondly through curbing wage increases. Why?

14. One explanation is that employers find it more efficient to take a long-term view of the employer-employee relationship. Employers are concerned to minimise labour costs per unit of output over the long term. If employers believe that aggressive wage cutting in a buyers' market may antagonise the remaining work force, reduce productivity, and make it harder to recruit high quality workers when the labour market tightens, they will be less inclined to push their short-term advantage. Employers with large training investments - either formal or informal - in their work forces and with highly developed internal labour markets are particularly likely to take this view. In contrast to the situation in Japan, profit related bonus payments are not generally available to take the strain of fluctuations in demand. Given the prevalence of internal labour markets and the length of average job tenures, many employers can be expected to be more concerned about the impact of wage settlements on the expectations and motivations of their existing employees than about the ease of obtaining new recruits. This will be all the more true at a time when recruitment is depressed by demand conditions.

15. The extent to which employers can pursue a strategy of pay continuity in the interests of maintaining employee commitment will depend on the market structure. Employers in industries characterised by a significant degree of monopoly or oligopoly power and low sensitivity of demand to changes in prices and/or incomes clearly have the greatest scope for riding out recessions without altering their wage policies. Most of the public utilities and nationalised industries fall into this category but so, for

example, do the clearing banks. With the expansion of the public sector and the growth of concentration in private industry, an increasing share of the labour force have come to work for employers that can afford to (or believe they can afford to) pursue pay policies that disregard changes in the labour market.

16. A further factor influencing the employer's stance is the known attitudes of unions. For the reasons indicated earlier, redundancies and voluntary wastage are less likely to provoke strong opposition than attempts to make significant cuts in real wages. For most of the last ten years there have been 20 stoppages over wage rates and earnings levels for every stoppage caused by redundancy questions. Reducing staff numbers will therefore be seen as the course of least resistance. (However, behaviour is now changing: in 1981 work stoppages over redundancy questions were equal to one quarter of the stoppages attributable to wages and earnings.) In non-unionised sectors the floor set by Wages Councils may act as a similar incentive to opt for reductions in employment.

c. INFLUENCES ON EMPLOYEES AND EMPLOYERS

17. Underlying the wage responses of employers and employees to the difficulties created by rising unemployment are widely held notions of fairness, enforced by strong social pressures. These notions include the idea of a "fair wage", often interpreted as a "family wage"; ie the need for a wage sufficient to support a family. An equally important social convention is the concept of the "going rate", the belief that a particular kind of job carries a particular price tag. Related conventions include the reluctance of employers to take on new recruits at less than the rate paid to existing workers, and the unwillingness of the unemployed openly to offer themselves for wages that would undercut those in employment. These mores may be recognised (and underpinned) by Government regulations - for example, rules on suitable work for unemployment benefit recipients. There are two areas where the conventions do not apply: the "black economy" and the "household economy". But elsewhere these social conventions are possibly the single most important contributor to wage rigidities. It is not clear how the Government can influence them except at the margin.

18. Professor Minford has recently suggested that conventional ideas of a "fair wage" have been both stiffened and raised by the tax and social security system. He argues that the system effectively imparts a "floor" to wages. (This impact is separate from the long-recognised relationship between the level of benefits and the time taken in job search by the "temporarily" unemployed, though arguably it is an extreme form of this relationship.) There are two possible mechanisms. First, the tax and social security system may affect the behaviour of workers: when wages begin to fall people cease looking for work and de facto drop out of the labour force because they find flat-rate unemployment benefits more attractive than the jobs and wages on offer. Second, the tax and social security system may influence the behaviour of employers: even with very large declines in demand employers are unwilling to recruit at significantly reduced wages because they believe taxes and benefits define the minimum level of wage that it is socially acceptable to offer. Both mechanisms may operate together. Nevertheless it is worth reviewing the evidence in relation to each.

19. Until recently there has been very little hard evidence on the relationship between incomes in work and out of work for people experiencing unemployment. Most discussion has centred on illustrative family types and has, perforce, been based on a range of assumptions about the normal earnings levels, family characteristics, other sources of income and benefit take-up rates of the unemployed. In the last year or two the position has improved mainly because of the results coming out of the DHSS cohort study of the unemployed. Tables C3 and C4 draw on these results to provide a more comprehensive picture of "income replacement ratios" ie incomes out of work as a proportion of incomes in work -

Table C3 shows the position in November 1981 of the average man - in terms of earnings - experiencing unemployment in each family type, on the assumption first that there are no other sources of family income except his own earnings (when in work) and various social security benefits, and second that all social security benefits for which he is elegible are claimed. It therefore shows the 'theoretical' replacement ratio for an illustrative example within each family type.

Table C4 shows the distribution of actual replacement ratios for men of each family type becoming unemployed in the autumn of 1978. It takes account of the presence of other sources of family income, such as wives' earnings and occupational pensions, and of the incomplete take-up of social
security benefits.

20. With one important exception both tables take into account all the major elements relevant to comparisons of incomes in and out of work.* Allowance is made for all the main means tested benefits - housing benefits, free school meals, free welfare milk, family income supplement, as well as supplementary benefit. The tables exclude free prescriptions but their value is likely to be small and highly variable. (Moreover they are also available to low income families in work.) Both tables also include travel to work costs - the actual reported costs in the case of table C4 and national average costs for Table C3. They do not include the costs of special clothing required when in work or the extra costs of meals. On the other hand, no allowance is made for in-kind benefits provided to those in work; the DHSS cohort study found that about half of the men becoming unemployed received free meals or other in-kind benefits in their last job. It seems reasonable to conclude that the extra costs of work and the extra "perks" roughly cancel each other out. Finally, the calculations make no allowance for the effect of unemployment on tax obligations. They therefore understate replacement ratios prior to the taxation of benefits in June of this year. However, in practice only a minority of the unemployed appear to claim tax refunds before they return to work, suggesting that the majority are not fully aware of the tax advantages of the present position. After June tax rebates will generally be very small and will not usually be paid until the return to work. The tables are therefore a reasonable representation of the position that will obtain after benefits are brought into taxation.

For obvious reasons they do not incorporate earnings in the "Black Economy". The little information available suggests that these will be significant for only a small proportion of the unemployed (see Annex A). In some areas (eg moonlighting) the earnings may affect both sides of the comparison.

TABLE C3 ILLUSTRATIVE INCOME REPLACEMENT RATIOS FOR THE MALE UNEMPLOYED: NOVEMBER 1981

FAMILY TYPE	% of male unemployed (Nov 1980) (3)	Average Gross Earnings(1)	Total Income Support in work (4)	Total Income Support out of work on Sup Ben (4)	Replacement ratio (columnn 4 as % of column 3)
	1	2	3	4	5
	%	£	£	£	£
Single man, aged under 20(5)	15	66	44.6	21.2	47
Single man, aged 20+ (5)	39	107	70.1	38.1	54
Married man, 0 children	21	130	88.9	52.6	59
Married man, 1 child	8	125	91.0	65.4	72
Married man, 2 children	9	147	110.0	76.5	70
Married man, 3 children	4	139	110.3	90.6	82
Married man, 4 children	3	128(2)	114.6	107.2	93

Notes:

1. Based on 1978 DHSS Cohort Study figures, updated to November 1981
2. Based on men with 4 or more children in Cohort Study.
3. Males represented 72 per cent of the unemployed.
4. Illustrative values for householders (except single men under 20).
5. On the assumptions that single men under 20 are non-householders but receive the Sup Ben rate for men aged 18 or over, and that single men aged 20 or over are householders.

Total Income Support in Work: Gross Earnings, minus income tax, NI contributions and fares to work, plus FIS and Child Benefit, free school meals, free welfare milk, and housing benefits.

Total Income Support out of work: Total Supplementary Benefit payable including housing element and water rates, plus free school meals and free welfare milk.

TABLE C4 ACTUAL INCOME REPLACEMENT RATIOS* FOR MEN BECOMING UNEMPLOYED IN 1978 - EARLY PART OF SPELL**

	% of male unemployed stock (Nov 80)	Income Replacement Ratios				
		Up to - 50%	50% - 80%	80% - 100%	100% +	Total
Single men	54	67	28	3	2	100
Married couple no children	21	30	43	16	11	100
Married couple 1 child:	8	18	48	21	11	100
Married couple 2 children	9	22	46	22	9	100
Married couple 3 children:	4	13	47	25	14	100
Married couple 4 + children:	3	12	32	33	24	100
Total	100	45	36	12	7	100

* All sources of regular family income while out of work, including unemployment benefits, housing benefits, free school meals, wives earnings and occupational pensions expressed as a proportion of total weekly family income prior to unemploment.

** Ratios relate to the first three months of unemployment.

21. The main points to emerge from the tables are that-

- most of the male unemployed (about 75%) are single men or married men without children. Less than one in ten fits the stereotype of a wife and two children;

- taking account of the actual earnings of men experiencing unemployment, calculations of illustrative replacement ratios suggest that only for men with three or four children is the typical ratio high, ie over 75% (Table C3). For the great bulk of the unemployed without children the "typical" rato is 60% or lower;

- the actual income replacement ratios found by the DHSS cohort study are broadly consistent with the illustrative examples, though there is a wider dispersion than the simple averages might suggest. Early in their spells of unemployment about a fifth of all men had replacement ratios of over 80%, including 7% with ratios of over 100%. A little under half had ratios below 50%, (Table C4). While only 5% of single men had ratios of over 80%, the proportion rose to 27% for married couples without children and to 31% for married couples with two children.

22. A number of comments should be made on the significant proportion of men (20 per cent) with actual income replacement ratios of over 80 per cent. First, the main cause was a combination of low earnings - about half of the men with ratios over 80 per cent were in the bottom decile of the earnings distribution - and high benefits. Second, another contributing factor was the possession of other sources of income, apart from benefits and the man's earnings. The presence of working wives or occupational pensions serves to raise replacement ratios, particularly for married couples without children. In these circumstances the ratios exaggerate the implicit tax rates involved in a decision to return to work; a rough adjustment suggests that about 15 per cent of all men becoming unemployed in 1978 faced tax rates of 80 per cent or more. A third factor was the low receipt of means tested benefits in work, in contrast to the assumption of 100 per cent take up in the illustrative comparisons. For example, in the

DHSS sample less than a quarter of those eligible appeared to receive the housing benefits to which they were entitled while in work. A final point is that since 1978 the numbers and characteristics of the unemployed have changed and there have been important tax and benefit amendments, including the phasing out of earnings related supplement (ERS). On balance the proportion of men becoming unemployed for whom a return to work involves an implicit tax rate of 80 per cent or more is now probably less than 15 per cent, (assuming they can find work paying as well as their previous employment).

23. Apart from obtaining a comprehensive picture of current replacement ratios it is important to establish how the ratios are changing through time. Figure 7 in the main Report provides the best single indicator so far developed of the relationship between unemployment benefits (including payments for housing costs under supplementary benefit) and the average net earnings of manual workers. It may be possible to further refine this series. We would also propose to compare it with the time series used by Professor Minford, which is based entirely on the position of a family with two children.

24. The information on replacement ratios needs to be put alongside evidence on job search behaviour. Surveys of the unemployed have consistently shown that -

- most of the registered unemployed are actively searching for work, through there is a minority who, for a variety of reasons, do very little to help themselves; for example, a survey in 1980 of men and women who had been out of work for about four months found that four-fifths were using one or more of the "normal methods of job search" (as defined by the MSC), but about a fifth reported using none of them;

- many of the unemployed indicate a willingness to accept a real wage below their earnings in their last job, though again there is a minority who are inflexible; for example, in a 1979 survey of men who had been on the unemployment register for about four months, at least one half reported a willingness to accept a significant drop in their real pay. However a few required an increase in their real pay;

- in current circumstances few of the unemployed report turning down job offers. A national survey in mid 1980 found that 12 per cent of people unemployed for about a month had turned down a job offer, but the proportion rose with socio-economic group from 4 per cent of unskilled manual workers to 16 per cent of professional and managerial workers. Men in the same sample who had already returned to work reported a rather higher turn-down rate.

At the same time information on vacancies does not indicate that many low paying jobs remain unfilled for extended period. A 1977 survey found that 90 per cent of the unskilled vacancies that were notified to be filled by Job Centres were filled within 6 days. Since then there has been a large fall in the number of unskilled and semi-skilled manual vacancies on the Job Centre books, down from 90,000 in December 1978 to 35,000 in December 1981, and a large rise in the ratio of unskilled and semi-skilled unemployed people to such vancancies, up from 9 to 1 to 44 to 1. Studies of the residue of jobs that remain unfilled or are difficult to keep filled have usually identified low pay as only one among several contributing factors, including unrealistic qualification requirements, vacancies that are purely "theoretical", poor working conditions, unsocial or long hours, and difficult locations.

25. It seems reasonable to conclude that although a minority of the register show little active interest in finding work, current social security benefit levels are not causing large numbers of the adult unemployed to choose to remain permanently out of work. Hence this mechanism is unlikely to be seriously constraining wage flexibility. This is not, of course, to deny that benefits and taxes will influence the time taken over job search by the great bulk of the unemployed who regard themselves as temporarily out of work: in Annex 5 to MISC 14(82) 1 it was estimated that in present United Kingdom conditions a 10 per cent cut in social security benefits might lead to a fall in unemployment of some 100,000 in the short term.

26. The second mechanism through which benefits might act as a wage "floor" - by influencing the behaviour of employers - is more difficult to test. One possible approach would be to ask employers what determines their minimum wage levels and whether the tax and benefit system inhibits them from offering less. We are not aware of any surveys that directly address these questions, though some useful information should be obtained from monitoring the Young Workers Scheme and from forthcoming research on Wages Councils. In the meantime there is piecemeal evidence that employers see 'the going rate', 'collective agreements', 'the unions' and 'Wages Council awards' as the main explanations for their minimum wage rates. Social security benefits reportedly do enter into discussions about Wages Council awards from time to time. The ceiling on eligibility for Family Income Supplement (the 'prescribed amount') has been used by employees as an argument for larger awards. On the odd recent occasion on which supplementary benefit levels have been quoted they have apparently been referred to by employers as arguments for recommending smaller rises.

27. If any conclusion is possible from such impressionistic evidence it is that the benefit and tax system is just one of several elements that contribute to setting a 'floor' to employer wage offers. As we have seen, for most of the unemployed current minimum wage levels are well above the level of benefits. Moreover, in 1979, the latest year for which we have information, only 4 per cent of single people and family heads in full time

work were estimated to have incomes less than 40 per cent more than their supplementary benefit entitlement (and the proportion had fallen since 1975). Therefore if benefit levels do significantly influence wage offers it must be because employers are consciously or unconsciously aware of the benefit entitlements of families with children and assume the need to provide a 'family wage'. Directly attacking this notion, for example through an enhanced Family Income Supplement, might be a more efficient way of lowering a benefit-related "wage floor" than an across-the-board cut in benefits.

WAGE "PUSHFULNESS" IN THE FACE OF LIMITED EXPANSION

THE EVIDENCE

28. While wage rigidities have long been a feature of periods of recession, fears of high wage inflation at a time of limited expansion have become widespread relatively recently. Table C5 below illustrates the basis of these fears. It shows the relationship between real growth and growth in nominal GDP in the main OECD countries in the two decades since 1960. All countries have experienced a deterioration in the relationship between the 1960s and the 1970s, a reflection of both higher inflation and lower growth. However it is not clear how far this is due to a fall in "supply responsiveness", the trade off between inflation and growth, and how far it is the result of unfavourable supply shocks (for example higher oil prices).

29. But some economies fared worse than others. In particular in the United Kingdom the ratio between real growth and nominal GDP fell fourfold (twice the OECD average), the result of adding a dismal performance on inflation to a longstanding poor performance on growth. Bearing in mind the upward trend in unemployment this comparative deterioration suggests some increase in wage pushfulness. Of the other countries, Japan put in the best performance, even though particularly badly hit by the 1973-74 oil shock. Canada, United States and Germany were also considerably less inflation - prone that the United Kingdom.

TABLE C5: INFLATION AND REAL GROWTH: AVERAGE ANNUAL CHANGES, 1960-1980

	1960-1970			1970-1980		
	Inflation %	Growth % in Nominal Incomes	Growth - Increase	Inflation %	Growth % in Nominal Incomes	Growth - Increase
US	2.9	4.1	0.6	6.9	2.9	0.3
Canada	3.0	4.9	0.6	8.7	4.0	0.3
Japan	4.7	11.4	0.7	6.8	5.3	0.45
Germany	3.5	4.8	0.55	5.3	2.8	0.35
France	4.4	5.7	0.55	9.4	3.6	0.25
Italy	4.5	5.6	0.55	14.7	3.1	0.15
UK	4.2	2.8	0.4	13.8	1.8	0.1
OECD	3.7	5.0	0.55	8.4	3.3	0.3

Source: OECD National Accounts

Notes: (i) Growth - annual average rate of growth of real GNP, per cent
(ii) Inflation - annual average rate of growth of GDP deflator, per cent
(iii) Increase in nominal incomes - the sum of (i) and (ii)
(iv) Growth - increase in nominal GNP rounded to nearest 0.05

30. Assuming that the whole of the growth of inflation cannot be put down to the direct impact of supply side shocks, there are two questions to explain:

First, why has wage inflation at any given level of labour market slack worsened across nearly the whole of the OECD?

Second, why has the deterioration in the United Kingdom apparently been greater than in most other countries?

EXPLANATIONS

31. At this stage explanations can only be tentative. Many of the mechanisms that appear to make nominal wages "springy" when constraints on monetary demand are loosened are the same as those preventing real wages falling when demand declines. There are, though, additional factors at work. It is again useful to order the arguments in terms of influences on employees, influences on employers and influences on both parties.

a. INFLUENCES ON EMPLOYEES

32. A widely held view is that since the late 1960s there has been an "aspirations gap" - a desire for a growth in real living standards in excess of what the economy can deliver in the form of rising productivity. The gap could be caused by a spontaneous increase in aspirations, perhaps the result of societal changes towards materialism; or by a supply shock reducing productivity growth. In the latter case, aspirations based on a projection of past increases in living standards will create a divergence between desired and attainable real income. Several commentators see the slow-down in productivity growth in the early 1970s and the deterioration in real incomes inflicted by high real oil prices as the sparks which set off the prairie fire of inflation across the major economies.* In time, the problem should resolve itself as aspirations are gradually brought into line with reality. But there may be a protracted learning period, especially if real

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* A possible indicator of this aspirations gap was the strike wave that affected many Western countries, including the United Kingdom, after 1968. Most of the extra days lost were over pay issues.

wage demands are met partly out of lower profits, thus sustaining the illusion of a bottomless pint pot. The last time during which Britain experienced a fairly similar situation - a sharp downward turn in the trend of real earnings - was at the turn of the century.

33. Aspiration gaps can only be translated into inflationary wage settlements if employees exert strong bargaining power or employers offer weak resistance. Provided Government policy is accommodating there are three ways in which trade unions can cause the average level of money wages to rise:

i. by increasing the share of the labour force organised into unions or subject to union wages, so that an increased portion of the labour force are paid the union rate;

ii. by increasing the union/non-union wage differential, provided there is not an offsetting shift in employment from the union to the non-union sector;

iii. by causing the non-union wage to rise more rapidly than it would in the absence of trade union activity; for example because non-unionized employers fear encroachment by unions if they do not compete with wages in the unionized sector.

There is a good deal of United Kingdom evidence on the first two of these channels of influence.

34. Measured by union coverage there is no doubt that union bargaining power has increased in the United Kingdom over the last twenty years, both in absolute terms and relative to the position in most of our main competitors. Between 1960 and 1979 union members rose from 44 per cent to 55 per cent of employees plus the unemployed. (In 1980 the figure fell back to just under 54 per cent)*. The same period saw little or no increase in union

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* As a proportion of employees only membership has risen more dramatically, from 44 per cent in 1960 to 59 per cent in 1979. It remained at 59 per cent in 1980

penetration in Germany, France, the United States of America and Canada, although in 1960 all four had membership rates that were lower than our own. (The four EEC countries with the highest unionisation rates are Denmark, Italy, Belgium and Ireland but only in the last two has there been a substantial increase in coverage in recent years.) There has also been a significant rise in closed shop arrangements in the United Kingdom. Currently at least one third of blue collar and about one in ten white collar employees are involved in closed shop policies.

35. Evidence on the size of the union 'mark up' (ie the union/non-union wage differential) is harder to interpret. There also appear to be few studies of the mark up in other countries, outside North America, to place the British experience into perspective. Putting together a number of British studies the overall picture is that the union differential rose significantly over the period 1968-73 but has since remained roughly constant. The failure generally to rise after 1973, thought the average position masks different patterns across industries and occupation, is surprising given the usual expectation that the union mark up increases with unemployment. It may be that incomes policies modified the impact of unionism.

36. The absolute level of the mark up is a matter of some debate. A number of studies using industry cross-section data had suggested a differential of around 25 per cent in the early 1970s. However the most recent work using richer data on individuals indicates a mark up of less than 10 per cent for male manual workers in manufacturing industry. For the time being this must be regarded as the most reliable estimate. What is important for Government policy is the sources of the power to produce a mark up. Although there are a large number of theories about the determinants of union bargaining power we have been unable to find any empirical work that convincingly links the size of the union differential to particular legal rights and privileges.

37. Variations in union bargaining power, and employer toughness, across sectors will ensure that the wage structure that emerges from a period of restrained monetary demand will exhibit considerable inequities in terms of traditional industrial and occupational relativities. The problem will

probably be most acute if the constraints on demand have been accompanied by an effective incomes policy. Attempts to restore relativities as soon as the controls are loosened have been among the most pernicious causes of wage inflation in the last twenty years. However, it is not clear whether concern with relativities is greater in the United Kingdom than elsewhere or whether British periods of restraint have left behind larger perceived inequities in the wage structure.

38. The presence of one and a half million unemployed acted as no inhibition on wage demands in 1979. There are reasons for doubting whether three million will be a more effective dampener once output and profits begin to increase and fears of redundancy decline. As has already been noted, because of the segmentation of the labour market, the growth of internal labour markets and the concentration of unemployment on the unskilled, those in work do not by and large see the unemployed as competitors for their jobs.

b. INFLUENCES ON EMPLOYERS

39. Surveys of management negotiatiors in the United Kingdom private sector have consistently shown that ability to pay (or profitability) is employers' first consideration in drawing up wage offers. In circumstances of depressed demand this consideration will place downward pressure on wage settlements. But once profits begin to rise the same factor may rapidly lead to large wage rises. Recent history suggests that when the general economic situation is seen as improving, the size of profits will be a far more important influence on employer wage offers than the state of the local or national labour market. In times of rapid structural change it is particularly likely that high wage settlements will co-exist with large scale unemployment.

40. As demand rises, expanding firms need to attract new employees. Even with high unemployment there are several reasons why this may lead to the bidding up of wages -

i. The unemployed are relatively unskilled and where they have skills they are primarily those of declining industries or occupations rather than of expanding ones.

ii. A legacy of recession and high unemployment is a contraction in both the stock of skilled workers and the flow of new skills: firms cut back on training (for example, apprenticeships) and displaced skilled workers move to unskilled or semi-skilled jobs in other sectors.

iii. More speculatively, a further legacy of depressed demand is a decline in mobility. Recessions have long been known to reduce labour turnover through discouraging voluntary job changing. What is now particularly worrying is that the upward trend in unemployment over the last fifteen years appears to have been associated with a secular decline in labour turnover in maunfacturing industry (and possibly elsewhere).

The force of these three arguments taken together is that without strong offsetting action the higher the unemployment the higher will be the level of unemployment at which skill bottlenecks begin to emerge and consequently the earlier the point in the recovery at which wages are bid up by competitive pressures.

41. Inflationary pressures created by shortages in even a narrow range of skills can quickly be diffused over wide sectors of the economy. One mechanism is the rigidity of wage structures in many large organisations in both the public and private sectors; to avoid upsetting internal relativities an increase in pay for one skill in short supply may have to be extended to the whole workforce. Another mechanism is the preveiously noted rigidity of wage relativities between industries and occupations.

c. INFLUENCES ON EMPLOYEES AND EMPLOYERS

42. A history of inflation creates expectations of further inflation. Because the United Kingdom has had a worse inflation record than most of its competitors, employers are probably more ready to assume that high wage settlements can be recouped in higher prices. This assumption may be encouraged by the high degree of concentration in many product markets, higher than in many of our competitors. For the same reasons employees and their representatives are probably more ready to believe that employers can find the money to fund substantial wage claims. They may also be more aware of the danger of being leap-frogged by other bargaining groups should they set their own claims "too low".

ANNEX D

THE MINFORD THESIS

1. In its unemployment study the CPRS was asked to give particular attention to the work of Professor Minford on this subject. Accordingly we have had discussions with him, and studied his paper on "The Problem of Unemployment" an article in "Economic Affairs" of January 1982. The result is embodied at relevant points in our interim report. This annex sets out specifically our views on his main propositions.

2. There are some key propositions, central to Minford's thesis, which we have already built into our own work -

i. A useful approach to the problem of unemployment is to consider the labour market as like any other market in that supply and demand are balanced by relative prices - that is, in this case, by real wages. On this approach, the fact of unemployment entails that real wages have not fallen to market-clearing levels.

ii. It follows that if real wages could be lowered (in a closed economy, or in an open economy relative to real wages elsewhere) employment would be increased and unemployment reduced. In practice, employers have generally responded to a fall in demand by cutting back their work-force rather than by cutting real wages - the phenomenon of (downward) "real wage stickiness".

iii. One cause of "real wage stickiness" is that social security benefit levels effectively set a floor to wage bargains, so that employers cannot expect to fill jobs offered at wages below benefit levels. The effective "minimum wage" for unskilled manuals tends to hold up the wage structure for skilled workers, by the operation of traditional wage differentials and employers' needs to keep trained workers in skilled jobs. Higher benefits also encourage those who lose jobs to spend longer unemployed while they search for a suitable new job.

iv. Another important cause of real wage stickiness is the monopoly power of some trade unions. This pushes real wages higher than they would have been otherwise, and to the extent that the non-union sector does not adjust to offset this it reduces the demand for labour and increases unemployment.

v. Other costs of employing labour, direct and indirect, again reduce the demand for labour - Minford mentions social security contributions, redundancy payments, industrial tribunals, health and safety regulations.

vi. The rigidity of the labour market is also increased by the imperfections in the housing market, so that those wishing to move from regions of high unemployment to look for suitable jobs elsewhere face costs and difficulties in finding somewhere to live.

3. On the other hand, there are some further propositions advanced by Professor Minford which in the CPRS's view need some qualifications -

i. He suggests that if constraints were removed so that real wages could fall far enough, all those capable of working could find jobs of some kind - and hence that their unemployment is in this sense "voluntary". In the extreme this may be true, in that without any social security benefits those who could not find work (or support themselves in some other way eg by begging or crime) would starve. But the question is how far real wages and social security benefits would need to fall, and how quickly the new jobs would be generated. The international dimension is relevant here. Minford recognises the importance of the "increasingly tough world environment", and points to increasing competition from the newly industrialising countries, which have maintained rapid growth rates by efficient working at low wages in labour-intensive industries. In our view, a reduction in real wages on any feasible scale is unlikely to bring about a substantial increase in labour demand in the trading sector, unless entrepreneurs and innovators can be encouraged to identify new competitive opportunities; and it must be doubtful whether low-paid jobs in the non-trading sector

alone would be created in sufficient numbers (or how quickly life-styles would change to make this possible). This question of the elasticity of demand for labour is of course a crucial one, and more is said in our interim report about the prospects as we see them.

ii. Minford implies that real wage stickiness is the result of union power and social security benefits. Even in theory, it seems to us questionable whether these factors provide a complete explanation. There is evidence that downward adjustment of real wages has been difficult to achieve even before the present degree of union power and benefit structure had been built up, and even in places such as the United States non-unionised sector in the 1920s. In our view real wage stickiness results from a broader range of economic and social factors - for example, the employer's interest in maintaining a trained work-force; social pressures (backed by international conventions and legal sanctions) to provide workers with a "fair" rate for the job which should be enough to support a family; and so on.

iii. Minford offers a quantification of the effects of the two main factors highlighted - that the rise in union power since the mid-1960s is responsible for 1 million of current unemployment- and that a 10 per cent rise in real social security benefits would raise unemployment by some ½ million. To evaluate these estimates requires a technical examination of the model, which we have carried out in some detail. A worrying feature is the sensitivity of the estimates to small changes in the original formulation of the equations. Professor Minford himself accepts that the evidence so far is not conclusive, and that his model might usefully be tested on data from other countries than the United Kingdom. We agree with him that the level of social security benefits has an important effect on unemployment, and this was analysed in Annex 5 to MISC 14(82) 1, which estimated that in the current state of the United Kingdom labour market a 10 per cent cut in social security benefits might lead to a fall in unemployment of some 100,000, with further falls in the longer term as the result of downward

pressure on real wages. To estimate the effect of "union power" on wages and unemployment is even more difficult. It operates primarily through increasing the union/non-union wage differential. But the results of recent direct studies of this differential are not consistent with Professor Minford's original estimate that since 1963 it has risen from 10 per cent to 74 per cent. Instead they suggest much lower mark-ups - possibly as low as 10 per cent in the second half of the 1970s - and no significant rise since 1973. Minford has since withdrawn the 74 per cent estimate, but it is still implicit in his estimate of the unionisation effect.

iv. Minford suggests that these two main factors are "largely the responsibility of Government", and that in particular there could and should be "further legislation to ... eliminate the ability of unions to raise relative wages". Obviously the extent to which Government action can in practice be taken to curtail the effect of these two factors is limited and there are difficult matters of political judgement. But any suggestion that either union power or social security benefits could be abolished by legislation would seem highly unrealistic.

4. None of these qualifications disturbs the central Minford thesis, as summarised in paragraph 2 - that in considering remedies for unemployment it is right to look first at ways of increasing the demand for labour by reducing its price, in terms of real wages; and that union power, and the level of social security benefits, are both important factors in this. But Professor Minford acknowledges that what matters essentially is real unit labour costs in relation to our competitors. Given the difficulties in practice of getting any sizeable and rapid reduction in real wages, it is also worth looking at other possibilities for improving productivity and competitiveness so that the demand for labour at a given real wage level can increase. This again is not an easy area in which to propose promising new remedies, given the history of past failures to reverse the United Kingdom's relative decline in competitiveness. An important part of the problem is that organised labour has insisted on restrictive practices which have

diverted management effort and discouraged innovation. The CPRS has therefore indicated in its employment study, as well as the factors given prominence by Professor Minford, an examination of other ways in which employers might be enabled to increase their demand for labour.

5. We also propose to commission some further work, in which Professor Minford has agreed to help, to apply his recent work as embodied in his computer model to comparable data for some other European countries. This should enable us to make a better assessment of the magnitude of the factors on which he has focussed attention. It is proposed to complete this work in time for our later report.