

Unemployment

Cause and Cure

Second Edition

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With

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and Alison Sprague*

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Preface to the Second Edition

The first edition was prepared in 1982. Much has happened since that time – only two and half years ago. Labour laws have been passed, taxes and benefits changed, the Rent Acts have been somewhat modified, Wages Councils are being reviewed, and so on. These developments alone make it desirable to update this book and its recommendations.

But there have been intellectual developments also. Thinking has changed among both academics and practical men. Many have now begun to warm to the analysis set out in (though by no means unique to) this book, where first reactions were dismissive of an unfamiliar way of thinking. This too makes it desirable to restate the arguments and, if possible, make them more widely available.

Then there have been comments, criticisms and second thoughts which require response, rebuttal, or incorporation. The first edition was prepared at a furious speed to meet the urgency of the problem. Though the essential structure of the argument has not changed, there is much in the detail which could be, and to some extent has been, improved.

Finally, the policy canvas has been broadened in the last two years as some business has been concluded successfully and new areas of action have consequently opened up. Privatization – still controversial in 1982 – has now acquired unstoppable momentum. The principle is now seen to be extendable far beyond the obviously saleable nationalized industries into many areas of public sector activity that have been unquestioningly accepted as such in the post-war period. With the success too of union law reforms, the confidence has grown to tackle other legal minefields such as the Employment Protection (and related) Acts and the Rent Acts. These and other policy issues are highly germane to the topic of this book, and it seems right to include them in this edition.

Having said this, I have not altered the original text except where necessary to update, correct or add material. I have aimed to keep the book's original crusading spirit (together with its provocatively succinct title, suggested by Michael Hay). That spirit offended some, but it was an integral part of the book; it is not a dry-as-dust treatise but an attempt to communicate to as wide a public as possible the principles for understanding the problem of unemployment and to persuade them of its necessary cure. Those principles have been overlaid and obscured by fashionable economic and popular thinking for too long; their perception was painful and difficult for me, brought up as I was too with these fashions. My aim is to bring that same perception home to others, if possible with less pain and difficulty than I experienced.

One failing of the book is that, much as I would like it to communicate directly to the widest possible audience – so important is the problem – it does assume a certain basic knowledge of economic forces. Notably, it assumes an understanding of supply and demand. That may not seem an unduly harsh requirement, but experience has taught me that it is restrictive, though it ought not to be in a capitalist society with a properly functioning secondary education system. Be that as it may, I cannot escape from this restriction for there is an irreducible minimum of technical explanation required in what is, after all, a major area of social science.

In this second edition, Paul Ashton has joined my previous co-authors. He and Michael Peel have assisted me in rewriting this edition, respectively on the economic and the legal aspects. Longman's kindly gave permission to reproduce the material from *Economic Affairs* (Supplement to Vol. 4, No. 3, April–June 1984) which appears in chapter 3. The Economic and Social Research Council Consortium for Modelling and Forecasting the UK Economy has provided continuing financial support (under ESRC Grant No. B HG 2/64/3/5) for our research programme since the first edition was prepared. The Wincott Foundation also gave us support for research on housing, the results of which are briefly reported in chapter 6.

As ever, I have a debt to those who have argued with or commented on the practical and theoretical aspects of the previous edition. In particular, I would like to thank Michael Beenstock, David Peel, Arthur Seldon, Adrian Smith and Alan Walters. Finally, I am most grateful to Maureen Kay for preparing the ever-changing manuscript with her usual unflappable efficiency.

Preface to the First Edition

This book was written in response to demands from various quarters sympathetic to our previously published work, for a comprehensive account of the unemployment problem in Britain and a properly worked out programme of measures to combat it. It embodies the results of the research programme of the Liverpool Research Group in Macroeconomics over the past six years, as well as practical insights gained from periodic policy commentary and forecasts published in the group's *Economic Bulletin*. It has been published with all possible speed in order to promote public debate of the wide issues involved. Decisions on these require wide public understanding of the side-effects of measures whose obvious impact is socially popular and desirable; at the same time, people must take into account the social dimension of measures which would have substantial effects on the country's purely economic performance.

During the past decade increased understanding of the mechanism of inflation, due largely to the work of Professor Milton Friedman and those who have followed his pioneering research programme, has led to the political acceptability of apparently harsh measures to reduce and, it is hoped, eliminate inflation from many Western economies, and in particular, Britain. In Europe, and again particularly in Britain, unemployment has risen first steadily, then sharply. It has, however, been greeted with intellectual bewilderment on the part of the public and on the part of politicians, with a plethora of minor, cosmetic measures, as well as a refusal (correct in the authors' view) to abandon their anti-inflation programme. In our view, expounded in the following pages, there does exist a coherent anti-unemployment programme which could be embraced, though with a variety of different forms depending on the social preferences of the people in each given country. We hope that over the next decade there will be an increased understanding of the

unemployment mechanism, which in its turn will lead to the embracing of such a programme, politically unacceptable as it may seem at present to many observers conditioned by the post-war period. We hope too that this book will be a contribution to that process.

We gratefully acknowledge crucial assistance and support from a number of sources. First, that of our colleagues in the Liverpool Research Group, who have been involved over a number of years in the development of the Liverpool model used in this book: Chris Ioannidis, Satwant Marwaha, Kent Matthews and David Peel. Secondly, that of the Social Science Research Council, which has financed our research programme since 1977. Third, that of officials in this country and overseas who have patiently answered our requests for often detailed information and analysis of tax/benefit systems, and other institutions. Finally, we thank Paula Banks, assisted by Jackie Fawcett, Chris Nash and Vivienne Oakes, for typing this manuscript expertly within our exacting deadlines.

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Summary

INTRODUCTION

Unemployment in the United Kingdom fluctuated moderately within the range of 1–2 per cent of the labour force throughout the 1950s and early 1960s. From the middle of the 1960s it began a more or less steady rise, by 1970 to 3 per cent, by 1976 to 6 per cent, and by 1984 to 13.5 per cent. Part of the current higher unemployment rate is to be attributed to the extremely severe world recession, associated with US policies to reduce inflation, while insufficiently curbing public sector deficits. Another part is the effect associated with the Conservative Government's policies to reduce inflation in the UK. Both these effects are temporary in nature. In response to the Government's policies at home, and as a better balance in US fiscal and monetary policies allows world real interest rates to fall, recovery from the recession will continue to occur, though at a rate and with a timing that is inherently hard to predict as world events over the past four years have repeatedly demonstrated.

However, these elements account for a limited part of the unemployment total. Precise calculations are difficult, but, assuming none of the proposals made here were to be carried out, unemployment at the next peak of the economic cycle, whenever that comes, would seem unlikely to fall below 2–2½ million (8–10 per cent of the labour force). Some would regard even the upper end of that range as optimistic, a view that would leave even more of the rise in unemployment to be explained by factors other than the recession at home and abroad.

In this book, we focus on these 'underlying' factors and remedies for them, rather than on cyclical or 'demand-management' factors and policies. We fully accept the present framework of Government demand management and anti-inflation policy; and within that

framework, discussion of details for the money supply and Public Sector Borrowing Requirement targets lies outside the scope of the book.

THE CAUSES OF UNEMPLOYMENT

It is a widespread opinion among economists – and one which we fully endorse – that the proximate cause of unemployment is excessively high wage costs, produced either by high wages or by low productivity. We have identified this as a strong mechanism in the UK.

However, one cannot stop at this point in the analysis and proclaim, as has from time to time been done, that government can, by direct intervention in the wage-setting process, reduce real wages or increase productivity. Such direct intervention (or incomes policy) has repeatedly failed to achieve anything of the sort in the UK, besides being inconsistent with the economic freedom that is this Conservative Government's aim. The reason for this failure is that there are market forces and distortions of considerable power driving real wages and productivity to the levels we observe. In order to modify these levels and so the level of unemployment, we have to understand these forces and modify the market distortions.

This book identifies two major distortions in the UK labour market which prevent real wages and productivity from adjusting naturally to shifts in technology, demand, and industrial structure, and relocating those freed from one sector into other sectors.

The first, and the fundamental cause of unemployment, is the operation of the unemployment benefit system. The minimum flat rate benefit including any supplementary benefit 'top-up' is paid indefinitely to an unemployed man for as long as he remains unemployed. Such a man will very naturally expect to be re-employed at a wage after tax and work expenses which is at least as high as this benefit, and probably somewhat higher because he may not wish to 'work for nothing', whatever his personal attitude towards work. His work even at this wage may well be poorly motivated because of his lack of reward, so that productivity also suffers. Hence wages cannot effectively fall below this level for even the most unskilled worker. This level then acts as a floor under the whole wage structure, and working practices accepted at this unskilled level may similarly affect higher levels of the occupational structure. It follows that shifts in economic conditions which would

warrant a fall in real wage costs, will have only a limited effect on them and unemployment will result instead. This mechanism, in other words, substantially limits the wage flexibility of the UK economic system.

The second major distortion is the power of unions to raise wages relative to non-union wages. Given the way the benefit rate sets a floor below the non-union wage, as unions raise wages for their members, the workers who then lose their jobs cannot all find alternative work in the non-union sector because wages there do not fall sufficiently; the overall effect is increased unemployment.

Though union power is a major contributory cause of unemployment, it is not fundamental, in the sense that were benefits *not* to set a floor beneath non-union wages, it would not add to unemployment. There are other factors which play a similar contributory role. They include changes in taxation, shifts in technology, adverse movements in the terms of trade and in world demand for UK products, and changes in population size and structure. Many of these are frequently cited in press and other commentary on unemployment as 'reasons' for unemployment. They are so only in the limited sense we have defined. To repeat, if wages and productivity adjusted without constraint, these factors would not alter unemployment, but would instead have their effect on real wages. Nevertheless, *given* our benefit system, such alterations in these factors as lie within our power *can* help reduce unemployment, and we give some attention to them in what follows.

The explanation of the labour market we have just given is not to be tested by any very simple relationship such as, for example, one between unemployment and the ratio of benefits to work-income. There are a number of complex interactions which need to be disentangled. The book details some work of this nature that we have undertaken; some 1300 observations of post-war UK behaviour have been used in this work and the analysis given emerges unrefuted from these tests. These were supplemented by analysis of the post-war experience in four Continental countries, West Germany, France, Italy and Belgium. These provided economic support for the approach and useful institutional comparisons. In particular we found that the behaviour of Belgian wages and unemployment closely mirrored that of the UK, even in the size of its unemployment problem, because of its similar flat rate benefit system and powerful unions. In the other three countries with ratio systems, however, behaviour – as the approach predicts – was quite different. We also obtained estimates of the relevant relationships

for the UK. These, approximate as they must be, form the basis of the estimated effects of policy changes shown below.

POLICY PROPOSALS

Our proposals fall into three parts:

- (1) suggested changes in the benefit system;
- (2) supporting changes in tax and income supplements for those in work;
- (3) changes in the law and institutions regulating the labour and the closely related housing market.

Colloquially, (1) may be said to deal with the 'unemployment trap', (2) with the 'poverty trap', and (3) with union monopoly power and government regulation of wages, employment conditions, and rents. Taken as a whole, our proposals are capable of reducing unemployment very substantially over a five-year period. Politically we believe them to be well capable of implementation with public acceptance as a programme for reducing unemployment, though they will be strongly resisted by particular vested interests. They will increase incentives and get the labour market operating effectively once again.

The Benefit System

Wage flexibility is substantially reduced by the fixed ('flat rate') benefit level. This is because benefits do not vary with wage levels. Hence as wages fall, benefits do not fall in like proportion and act as a floor below wages, reducing their flexibility.

Our first proposal is therefore to introduce a maximum statutory ratio ('benefit capping') of 70 per cent for total unemployment benefits to net income in work. This is similar to the ratio used on the Continent, for example Germany where it is 68 per cent for family men. This cap would be widely seen as fair, in view of the need to maintain minimum work incentives. It would be simple to work (Continental practice shows it to be quite feasible), and it would, according to our estimates, bring about a sizeable reduction in unemployment – about $\frac{3}{4}$ million over four years. It would also of course greatly increase the flexibility of wages, since for many

workers (around 40 per cent) benefits would vary proportionally with wages.

We also propose the introduction of a jobs pool, consisting of all available vacancies and other community work specially organized, in each area (as in the US 'workfare' scheme), together with tighter procedures for denying benefit. Benefits should be conditional on acceptance of a job from the pool – after three months for workers under 25, after six months for other workers. In essence, this is an extension of the existing Community and Youth Training Schemes, but modified to increase substantially the pressure on people to take a job at lower wages, recognizing that there is help in work for the low-paid.

Tax and the Support of Work Income

The introduction of the above measures will increase work incentives substantially for those in low-paid occupations. But a further contribution to reducing unemployment can be obtained by raising tax thresholds. This will increase incentives for those a little further up the pay scale, whose benefits will not be affected by the cap. Furthermore it will also increase the social acceptability of the cap by raising the in-work incomes of those affected by it, so both mitigating the fall in their living standards when unemployed, and implying an absolute rise in living standards if they now choose to work even at a lower wage.

Our proposals here are for substantial falls in taxation, paid for by wide-ranging reduction in the responsibilities of the state through the privatization of virtually all state production, of state consumption of goods that are not 'public', and of some transfers (notably pensions). To protect the poor in work, we propose a negative income tax (health insurance, education and pension contributions would be compulsory). By 1990, the aim would be to double income tax thresholds and to abolish the national insurance scheme and its contributions, to raise child benefits to offset the cost of children's education and health insurance, to lower the standard rate to 25p and to eliminate the higher rates. The cost of this programme (net of tax revenue generated by higher activity) would be some £43 billion.

Laws and Regulations

Union power. With labour legislation currently in place, though rights to restrain union actions through the courts have been substantially strengthened, enforcement of these rights is still patchy. In many cases, the public sector is involved and the Government should ensure that public sector bodies enforce their rights fully. Nevertheless, private sector bodies may for various reasons, including intimidation and legal costs, be unwilling to pursue actions that it would be in the public interest to have pursued.

Furthermore, the law is by now extraordinarily complex and still fails in its original objective of eliminating labour market monopoly power. Closed shop practices are still permitted and unions still have immunity in respect of ‘primary’ actions. A bolder approach which goes all out to eliminate labour monopoly power is required. This should be seen to be even handed between workers and employers, for as such, charges of discrimination against workers – or ‘union bashing’ – would be turned aside.

Our proposals here are simple and threefold:

- (1) *to restore jurisdiction of the common law to all union actions* (i.e. withdrawal of all immunities);
- (2) *to legislate a ‘status’ provision* such that any contract contingent on the union status of the employee would be invalidated; this would render closed shop agreements, explicit or implicit, null and void;
- (3) *to institute a Labour Monopolies Commission* under the existing competition laws with independent power to investigate any apparent breaches of the public interest in labour market competition, and to bring actions under common law to obtain enforcement of the investigation’s proposed remedies.

Proposal (1) would make all union strikes actionable unless expressly covered by a negotiated strike clause in a collective contract; this would give a stimulus to collective agreements, provided these were permitted by the Labour Monopolies Commission. Proposal (2) would give freedom for any person to enter into a contract with any employer; evidence of employment or dismissal because of union membership or lack of it would be actionable. Proposal (3) supplies an active agent to ensure that monopoly positions are broken up, regardless of whether the parties wish it or not, and regardless of

whether the offence is by employers or unions. The activities of the Commission would build up a body of case law that should, over time, have the same effect in the labour market as the Restrictive Trade Practices Court and the Monopolies and Mergers Commission have had in the goods market under existing laws.

Minimum wages and employment protection. Wage Councils and laws to set minimum 'conditions' of work (such as restrictions on dismissal, on the work environment, and on discrimination) are extensions of union power largely brought about by the actions of unions in the political domain. Their effects are similar to union actions in raising wages in that they reduce employment. We propose here a series of steps that generally fall short of total abolition:

(1) *Wage Councils and wage regulations should be suspended as their terms run out.*

(2) *Small businesses should be effectively exempted from all employment protection laws* (where this does not violate treaties such as the Treaty of Rome).

(3) *The qualifying period for workers to enjoy their rights under the Employment Protection Act should be raised to five years; and workers should be allowed to contract out of these rights.*

(4) *Health and safety rules should be advisory, and industries should be self-regulatory on these.*

(5) *Benign neglect should be shown by the executive arm of the state towards other laws in this general area.*

Housing and the Rent Acts. Mobility between regions, which would reduce unemployment, is impeded by the Rent Acts interacting with subsidies to council house rents and 100 per cent rent rebates to the unemployed receiving supplementary benefit. It is usually prohibitively expensive for a worker to move from a high unemployment area where he has a council house to a low unemployment area where he would need to rent on the restricted private market. *The solution to this problem lies in simultaneously liberalizing the private rental market and eliminating council house rent subsidies*, while limiting (via benefit capping) the amount paid to the unemployed as set out earlier. Steps to deregulate private rentals are: include 'scarcity' as a factor in setting fair rents; allow landlords to designate *new* tenancies as being 'assured' or 'shorthold' or 'licences', effectively outside the Rent Acts; allow new tenants to contract out of their rights to go to a rent tribunal for a rent