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**A STUDY OF THE STATE MONOPOLIES**

Introduction

1. At the request of the Prime Minister, the CPRS has carried out a study of the nationalised industry monopolies, with a view to identifying ways in which their power could be reduced.

2. It was agreed that the study should examine how monopoly power has in practice been exploited, and how it could be curtailed through improved competition, privatisation, structural changes and regulatory pressure. It was further agreed that consideration should be given to ways of constraining union power in these key industries.

3. The CPRS began this study by carrying out brief reviews of the coal, electricity, water and telecommunications industries. These were based on discussions with officials in the Sponsor Departments and others, and a review of the published material and of the manner in which these industries are organised in other countries, notably the USA and Germany.

4. Last year the CPRS carried out a study of the relationship between Government and the nationalised industries, to review how they might be better controlled within the existing governmental framework. We have not sought in this study to duplicate any of this earlier work. Instead we have examined those more fundamental changes which might reduce the power of the state monopolies. We would like to re-emphasise however that the successful operation of any organisation depends on the quality of its management and we recommend that incentives should be improved to attract the best people to run these large corporations.

5. This report does not contain a blueprint for action in respect of the industries chosen for study, but rather general themes and principles which might be considered for application to each of the state monopolies. The CPRS recommends that as a next stage Sponsor Ministers should undertake a review of the industries for which they are responsible and make detailed proposals, based on the general conclusions reached in this report and options put forward for change.

6. We have structured this report as follows -

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Findings following our review of regulatory agencies in the United States and also in the United Kingdom are set out in the annex.

**I - The Nature of State Monopolies**

Monopoly - Natural or Created?

7. Monopoly exists where there is a single supplier of a commodity or service. The extent of monopoly power depends on whether the entry of competitors into the market is restricted, either by economies of scale or by legislation, and whether there is any close substitute for the commodity.

8. In the United Kingdom many of the state monopolies supply products and services which are not strictly "natural monopoly" products, defined as those where a second supplier would face prohibitively high costs (including costs of entry), because of the nature of the market and technical economies of scale. Corporations have typically been established by statute as sole suppliers of certain products, and their monopoly position has thus been created. Examples of activities where competition has been prevented and monopoly situations created include -

- a. electricity generation;
- b. telecommunications services;
- c. coal production;
- d. local bus transport;
- e. collection of water;
- f. sewage treatment and disposal;
- g. postal services.

9. On the other hand nationalised industries also provide some services which it is less easy to envisage being duplicated by other suppliers. These natural monopoly activities include -

- a. transmission and distribution of water, gas and electricity;
- b. sewerage;
- c. possibly the provision and maintenance of railway tracks.

Thus the list of genuine "natural monopoly" activities is not a long one and it is shrinking. Services which were at one time thought to be necessarily provided by only one supplier are now being opened up to competition - for example long distance telecommunications services, electricity generation, gas supply and bus transport. This shows that the boundary is not absolute, and competition may become possible as perceptions change, technology develops and costs of entry decrease. Common carrier infrastructures are possibly the only operations of a strictly natural monopoly nature.

10. During the first half of this century, in many developed countries, monopolies were tolerated and even encouraged for certain activities. In such industries as electricity, water, gas, telecommunications, air and surface transportation, it was often considered that the "public interest" was best served by having a monopoly supplier. Competition was typically considered wasteful and monopoly rights were granted in return for a statutory duty to supply, sometimes in uneconomic circumstances.

Regulation of power

11. However the creation of a monopoly implies a concentration of power, particularly over pricing (and profits) and over the service provided. Governments appreciated the need to control this power and either set up a regulatory system where the industries remained in private hands, or alternatively brought them into public ownership.

Rationale for state ownership

12. In addition to the need to regulate monopoly industries, certain utilities were nationalised because -

- a. the provision of the product or service to the whole population was considered to be of vital importance to society;
- b. the industry was of special significance to the economy and to employment;
- c. public funds could more easily be provided to guarantee provision of services;
- d. the industry needed controlling for technical reasons, for example to control the hydrological cycle or to create a national grid for gas or electricity;
- e. the industry had not fared well under private ownership, for example the coal industry or the railways, and needed reorganising "in the public interest".

## II - THE PROBLEM AND THE RATIONALE FOR CHANGE

### The consequences of creating monopolies

13. There have been many benefits from the creation of monopolies. Duplication of facilities, for example the pipework, grid or common carrier infrastructure has been avoided and economies of scale have resulted. But there have also been disadvantages. Some of these arise from the creation of monopoly itself. Others arise through state ownership.

### Adverse features of monopoly

14. Although some of the following features might apply to British industry generally, it appears to us that they are worse in those industries which are monopolies -

- a. failure to innovate, to respond to market signals, and to take account of consumer and local interests. Because monopolies do not face competition, they are less market-oriented;
- b. inefficiency of operations, deficiencies in management practices and inward-looking management. Monopolies have no incentive to remove inefficiencies because their additional costs can be passed on to the consumer in increased prices;
- c. cross-subsidisation of uncompetitive and loss-making operations. Monopolies often subsidise peripheral activities where they face direct competition or main activities where they are under threat from close substitutes (this may be necessary for a time, to shield new products, but is distorting and inefficient if it continues indefinitely);
- d. greater union power through threat of industrial action and disruption of monopoly (and often essential) supply. This power has long been latent, but since the early seventies unions have shown a greater willingness to use it. In the last few years there has been resistance to demanning in certain industries, and lack of flexibility in the use of labour to meet changing economic and technical conditions;
- e. a failure to encourage innovation and competitiveness in suppliers. As monopsony buyers, the industries have been inflexible in their requirements and have often overspecified the product in the interests of greater security of supply.

### Adverse features of state ownership

15. The original Morrisonian concept was to appoint a board of directors who would ensure that the industry was being properly run in the nation's interest. However this concept of an arm's length relationship between Government and the nationalised industries has been difficult to maintain and Ministers have been drawn into intervening in industries' affairs. There are several reasons for this -

- a. Parliament has considered Ministers accountable for the well-being of these industries and their actions;
- b. it may appear to Ministers that national economic objectives can be achieved by influencing nationalised industries' behaviour;

c. the threat of labour disputes and union demands has led to intervention, in the short term interests of the public;

d. some industries have needed heavy external (state-guaranteed) borrowing for investment, and others have been judged to need Exchequer subsidies to maintain output and employment.

16. State ownership has had a number of adverse features -

a. prices have been artificially constrained, for example in the early seventies, resulting in inefficient pricing policies, customers receiving incorrect pricing signals, and incorrect forecasting and investment decisions;

b. investment has been artificially constrained at times as a means of deflating the economy;

c. there has been a failure to establish objectives and monitor the performance of the industries properly;

d. there has been a failure to deal with structural decline in certain industries, in particular the railways and (recently) the coal industry;

e. Government financial backing and the absence of the threat of bankruptcy has led to complacency and inefficiency as the industries have been protected from market disciplines;

f. hidden cross-subsidisation of services has been encouraged. This has exacerbated the supply-oriented approach of the industries by shielding them further from market forces. Hidden cross-subsidisation has made it difficult to identify those services the Government would wish to see continued and to determine whether it has been getting value for money.

17. A major problem has been the inevitable conflict which Government has faced in trying to reconcile the following responsibilities -

a. manager of the economy;

b. owner of the business;

c. banker to the business;

d. regulator of monopoly, including protector of the consumer;

e. provider/subsidiser of social services (rural telephone kiosks, railway lines etc)

18. State ownership has also sometimes enhanced union power, because the industries are interdependent (eg coal and electricity) and the Government as owner has presented a common target to union negotiators in the various industries.

Rationale for change

19. The existence of past and potential abuses of monopoly power and of state ownership, together with the real threat of union power, present cogent reasons for seeking to change the status quo. The climate for change is right: the traditional arguments in favour of large monopoly utilities and public ownership are being questioned; there is increasing criticism of the

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industries by consumers; what would have been considered unthinkable a few years ago is now happening, for example there are private sector refuse collectors and a rival telecommunications company is starting to develop. Above all there is a political will to change.

20. In the remainder of this report we consider options for change. These options are not mutually exclusive, and could be complementary. Not all of the options will be applicable to each industry.

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**III - A REVIEW OF POSSIBLE REMEDIES**

21. The distinction between "created" and natural monopolies, though not absolute, is useful in considering remedies. For those industries or parts of industries where cost structures are such that alternative suppliers could compete, the problem is to remove obstacles in their path. But for natural monopolies, other means have to be found to restrain and control monopoly power. In this section we first consider the manner in which competition can be encouraged in those industries where monopoly has been created; where natural monopolies will remain, we consider ways of restructuring and regulating these so that abuses are diminished. Finally we review ways of reducing union power and other steps to change the context in which state monopolies operate.

**Increase Competition**

**Remove the statutory bar on entry**

22. For those industries where monopoly has been created, it is necessary to provide a suitable environment for competitive and innovative enterprise. The first essential is the removal of the statutory bar on entry and this may be enough in some instances to allow competition to develop. Legislation has been introduced to encourage competition in the long distance bus transport, industrial gas and trunk telecommunications markets. Further legislative steps are to be taken to facilitate the private generation of electricity as a main business and its supply using the national grid as a common carrier. Only a few years ago competition in most of these industries would have been regarded as unthinkable.

23. However the practical difficulties facing potential new competitors are significant and there must be doubts about the willingness of the private sector to invest in industries where the costs of entry are likely to remain high. The decision to enter the market is bound to be a risky one, not least because of the political risk that the statutory role of the state industry as sole supplier might be reimposed. And any new competitor, facing the state monopoly's dominant position over a wide range of products, must be vulnerable at least for a time to cross-subsidisation and "predatory pricing" in his chosen markets. There may also be regulatory problems, for example over interconnect arrangements and equipment compatibility as in the BT case. Union pressure may prevent competition. The removal of the statutory bar on entry may not be enough on its own to achieve the objective of greater competition. At least protection, and perhaps even some forms of positive discrimination, may also be needed until new competitors are established.

**Regulate the terms of competition**

24. Regulation is primarily thought of as a way of controlling monopoly and this is comprehensively dealt with in paragraphs 49-56 below. However regulation is also necessary to protect emergent competition. The Government needs to provide some assurance to potential competitors that the competition will not be unfair. This means taking away the power of the state monopoly to impose unreasonable pricing or regulatory burdens. In principle the Sponsor Department may be in a good position to back Government assurances by detailed supervision of the state industry's behaviour. But in practice we consider that Sponsor Departments are likely to be less effective in this role than an independent regulatory agency.



Prevent the expansion of state monopolies

25. Any expansion of a state monopoly into a new area is bound to increase its market power. If successful, it will increase the scope for cross-subsidisation of other less profitable activities. We have also noted in our study that nationalised industries abuse their monopoly power when they become involved in activities that are not truly monopolistic. Inefficiencies and other malpractices are carried over into the non-monopolistic activities. Unprofitable and inefficient operations are typically subsidised by the monopoly activities and the industries compete unfairly. We are sceptical about the effectiveness of regulatory mechanisms to neutralise this power. In addition the extent of union power will be increased if the industry is permitted to expand its activities; this will be further enhanced if cross subsidisation occurs and there is a lack of any threat of bankruptcy. It is arguable for example that the National Union of Seamen would have taken a less militant stance in the recent Sealink dispute if that company had not been owned by British Rail.

26. We start therefore with a strong presumption against allowing state monopolies to integrate vertically or to expand into other areas of business, except where this is to reduce their dependence on other monopolies. We recognise that in some instances it may be beneficial to a state (or private) monopoly to expand its operations but consider that the onus of proof must be on the industry itself. Thus we have a presumption against allowing British Telecom to manufacture its own products and to enter new markets involving cable systems and information technology, unless it can be demonstrated that these are essential to the efficient supply of a telecommunications service or to the preservation of competition. It could be argued that if an alternative telecommunications company could be found to enter the interactive cables market, this would create competition for British Telecom.

Require the industries to sell off parts where competition is possible

27. Reliance on new competitors entering the field in the case of many of the state monopolies will be a slow method of introducing competition. A faster method will be to break up the monopolies by selling off parts where competition is possible. The present Government has already taken some steps in this direction, but these have mainly been confined to peripheral activities. Over time this could be taken a good deal further, and extended to the main businesses, for example electricity generation, to reduce industries down to the core of natural monopoly activities. This will require clear political will, with a high priority for privatisation above other industrial objectives such as the preservation of particular jobs and activities. It will also require expertise to translate the objective into practical proposals for individual industries and parts of industries.

28. Confining the industries to their natural monopoly activities might result, for example, in -

- a. electricity generation being first regionalised and then sold, electricity showrooms being sold (or closed), and area boards transmitting and supplying electricity as monopoly suppliers. Consideration might also be given, as a second stage, to confining the state industry to a common carrier role;

b. British Gas Corporation being reduced to a pipeline carrier only. Its exploration and production activity, together with its consumer services, would be hived off;

c. splitting up British Telecom into area monopolies, a trunk telecommunications company and an international telecommunications company. BT Enterprises and Martlesham would be sold separately.

29. In cases where immediate privatisation is not possible, it may be worth considering the establishment of a separate state corporation (eg Sealink separate from British Rail) with its own separately accountable management, as a half-way house. Or regional corporations might be set up and allowed to compete. This is considered further in paragraph 43 below.

### Restructure and regulate to improve efficiency

#### Privatise state monopolies

30. Efforts have been made by the present Government to return industries from the state to the private sector. To date no state monopoly has been privatised although plans have been announced to sell shares in British Telecom in the next Parliament.

31. The main advantage of privatisation appears to us to be the likelihood of removal of many of the adverse features of state ownership described in paragraph 16 above. We have sought to examine the evidence available on the relative performance of monopoly industries in private and state ownership. Many of the inefficiencies which occur in the water industry apply as much to the private water companies as to the water authorities; however the mechanism in this industry for regulating the companies is deficient and provides no incentive to efficiency. Some of the research in the United States and Australia indicates that monopolies in the private sector operate more commercially and efficiently than comparable state owned monopolies. In our view there is a general presumption that private ownership will lead to better results than state ownership.

32. Privatisation of state monopolies in their entirety will not however resolve the difficulties (referred to in paragraphs 15-18 above) which are inherent in any monopoly whether state or private. We consider that apart from selling off operations where competition is possible privatisation is likely to be more beneficial if the industry is fragmented into regional companies which are subjected to independent regulation, and later privatised.

33. It is difficult to privatise loss-making operations. However with few exceptions it should be possible for each of the state monopolies to be made profitable. It is likely that those parts of the rail system which are judged socially desirable will always require public financial support and remain in public ownership. The other large loss-maker, the National Coal Board, should be capable of being made profitable in the longer term, regionalised and then privatised.

#### Expand franchising and contracting out

34. Franchising and contracting out introduce "competition for the field" as opposed to "competition in the field". If parts of the industry's operations are franchised or contracted out, this will reduce the size of the state monopoly and thus its power; in particular union power will be fragmented. It

should also introduce benefits of private sector involvement. At one extreme a franchise could be granted for supply of the monopoly service. At the other there could merely be an extension of the present practice of contracting out. Thus where privatisation of activities is ruled out for any reason, franchising and contracting out may be adopted as "second best" solutions. An example of franchising is television where independent television companies are granted licences to broadcast for eight years; examples of contracting out include refuse collection and bureau computer services.

35. One of the criticisms of state monopolies is that the technical specifications for construction of plant and the supply of services are too high. In the case of franchising and contracting out, responsibility for ensuring that the services are provided to a given standard rests with the franchisor. However the franchisee is actually responsible for the service. Franchising activities to the private sector will create an incentive to reduce technical specifications to the extent that this is consistent with the standard of service required.

36. Franchising and contracting out are likely to be easier to introduce in labour intensive situations, where the initial investment is not high. However franchising in capital intensive industries should not be ruled out. Normally in order to make it attractive to a potential investor the length of the franchise would need to be sufficiently long for him to recover his investment. However if the franchise is too long, this could result in the franchisee developing all the adverse features of the monopoly industry in which he is operating. This could be avoided if franchising was widespread in an industry since there might be frequent competition for franchises which would provide an incentive to efficiency. Alternatively the management of operations only could be franchised for shorter periods with the assets continuing to be owned by the franchisor.

37. Franchises should be arranged to place the financial risk on the franchisee. It will also be necessary to provide safeguards when the activity remains a monopoly supply and the franchisee fails to perform adequately. The right to appoint an alternative franchisee or to acquire the assets and take over the operation should be retained in exceptional circumstances, which will need to be clearly spelled out in advance so as to avoid termination subject to political whim.

38. If industries are acting efficiently, they should be continually reviewing the relative costs of providing services themselves and of contracting them out. However there are pressures against this practice, for example from unions who see an erosion of their membership and power base, and from management because of the loss of status in a smaller organisation, and because of entrenched attitudes. Indeed over the years the industries have tended to take on themselves functions previously performed by others. This probably reflects a general tendency among large organisations in the UK, as opposed to Japan where contracting out is seen as a useful way of preserving flexibility and avoiding long-term commitments to employees. Where contracting out has been introduced it has mainly been confined to peripheral activities such as maintenance of vehicle fleets and catering. However we consider that the state monopolies should consider this more imaginatively and investigate the contracting out of mainline activities such as power station maintenance, the provision of postal services and meter reading - possibly jointly with other nationalised industries.

Regionalise state monopolies

39. By regionalisation, we mean the fragmentation of state monopolies into discrete independent companies based on geographic rather than functional lines. This is different from decentralisation, which is the devolution of decision-making and responsibility to subsidiary regional organisations, under central ownership and control.

40. Where it proves difficult to encourage new competitors to enter an industry and where an industry cannot easily be confined to a common carrier role, regionalisation may help. Apart from breaking up large national monopolies, regionalisation may also be a prelude to and facilitate privatisation.

41. Regionalisation of state monopolies appears to us to have the following advantages -

- a. it brings the supplier closer to the customer and should result in greater attention to consumers' interests and complaints;
- b. it facilitates comparison between monopolies and should therefore encourage competition between managers and greater consumer pressure for change;
- c. it is more likely to lead to innovation in the industry because of the absence of centralised control and single culture, which are typical of national organisations;
- d. it will facilitate regulation by a regulatory agency because of the comparisons available and reduced likelihood of "agency capture", referred to further below;
- e. it will facilitate regional wage bargaining and local productivity schemes, referred to in more detail below;
- f. it may reduce the likelihood of national disruption and therefore the bargaining power of the unions;
- g. it may facilitate privatisation since it may be easier to sell smaller regional units;
- h. it is less likely to lead to monopsony purchasing and uncompetitive suppliers;
- i. smaller organisations are easier to manage.

42. Decentralisation on the other hand is unlikely in our view to result in the same benefits. Inevitably a large measure of control will remain with the central organisation and regional freedom of action will not be present to the same extent. We do not believe for example that decentralisation will result in the benefits identified under items c to h above being achieved.

43. Regionalisation of those industries where the monopoly position has been created could be used to facilitate competition. Examples of this are electricity generation and coal. However in the case of the coal industry any major change is difficult at the present time because of the strong militant union. In this industry we consider that decentralisation now may represent a step towards regionalisation at a later date when individual prosperity appears more relevant to miners than NUM unity.

44. Although the gas and electricity industries are decentralised in varying degrees, they are not structured into independent regional organisations. In addition it is generally accepted that the current structure of the electricity industry is unsatisfactory. The separation of a centralised generation authority from regional distribution and supply boards does distance the consumer from the dominant sector of the industry, the CEGB. In consequence, the potential for both inefficient and non-market oriented behaviour is inherent in the current organisation.

45. Our discussions in Germany have indicated that a regionalised electricity system, largely made up of separate power-boards, appears to allow a greater degree of market response and the potential for limited competition. There is evidence that the different approaches of the various authorities in Germany encourage more innovation and allow individual authorities to learn from others. This combination of innovation and imitation is more likely to lead to an efficient and responsive system than the approach of a single centralised organisation. We recommend that this model should be considered alongside proposals mentioned earlier for reducing the electricity monopoly to a common carrier role.

46. In the case of British Telecom, the lack of separate internal commercial relationships and adequate financial information makes regionalisation difficult at present. However we consider that the monopoly power of this corporation is more likely to be reduced by fragmentation into regional areas (with privatisation later) and by the separate sale of trunk, international and other activities rather than by privatisation as a whole.

47. One of the industries we studied, namely water, is already organised on a regional basis. However this has not produced the benefits we believe possible for several reasons. These include -

- a. the regulatory function has traditionally not been adequately performed;
- b. until recently the political will has not existed to remove inefficiencies in the structure of the industry.

48. We formed the view particularly following our visit to Germany that more could be done to stimulate competition between the management of different regions by means of inter-regional comparisons of price and performance. These comparisons could be made by a more effective form of regulation at national level.

Improve regulation

49. Whether monopolies remain in the public sector or become privately owned there is a need to regulate them to prevent monopoly abuse. In particular there is a need to ensure that -

- a. they do not charge unreasonable prices and so make monopoly profits;
- b. they act as efficiently as possible, in the absence of competition;
- c. they do not concede excessive wage increases, with a knock-on effect throughout the economy, and finance them by inflationary price increases;
- d. the consumer is protected, complaints are dealt with satisfactorily and the product or service is of a reasonable quality;
- e. they do not engage in anti-competitive practices;
- f. where they are dominant purchasers of other industries' products they encourage healthy competitive suppliers in the interest of the economy as a whole.

50. In addition to controlling monopolies better; there is also a need for regulation where competition is being introduced, in order to protect smaller operators from the dominant suppliers and ensure that competition is fair.

51. At one time it was believed that a board appointed by the Secretary of State could be relied on to see that state owned monopolies were properly run "in the public interest". Thus they were expected to ensure that the above adverse features would not occur. Last year's CPRS report recommended a key role for non-executive directors. However this will not be enough on its own, since -

- a. the industries cannot be properly directed and managed in the absence of strong boards with executive as well as non-executive directors;
- b. these directors have to resolve conflicts of interest between what is best for the corporation and what is judged to be in the public interest;
- c. it is difficult for non-executive directors alone, being part-time and reliant as they are on the organisation for information, to ensure the efficient running of the industry.

52. Other mechanisms have been introduced. The Sponsor Departments have increased the extent of their monitoring of the industries. Nationalised Industry Consumer Councils (NICCs) have been established to represent the consumer and advise on consumer policy. The Monopolies and Mergers Commission (MMC) is being used on a periodic basis to investigate instances of inefficiency, monopoly abuse and anti-competitive practices. However in our view these organisations in their present form are unlikely to fulfil the regulatory function defined above for the following reasons -

- a. Sponsor Departments will continue to have to attempt to resolve the conflict of interest described in paragraph 17 above. They are likely to go on giving low priority to regulatory responsibilities where these cut across political concerns and relations with the industries. In addition despite agreement to improve monitoring following the CPRS report on relationships with nationalised industries last year, it will be difficult for them to attract appropriate staff with business expertise to perform these tasks;

b. the NICCs rely heavily on voluntary support. They are often ignored by their industries. Without considerable expansion in their resources, rights and powers, their regulatory role will be limited. We consider that additional resources would be better employed elsewhere;

c. while the MMC is able to investigate subjects in depth, it remains an ad hoc review body visiting industries on a four to five year cycle. Sponsor Departments may not follow up recommendations with sufficient vigour for the reasons given above.

53. We have reviewed the experience of regulatory agencies in the United States and here. Our detailed findings are set out in the attached annex. Although these agencies have some adverse features, we are attracted by the benefits that could result from independent regulation of state monopolies. There is a need for continuous regulation of monopoly activities which we do not believe the present framework is capable of providing. A separate regulatory agency is likely to be more effective if -

a. the industry is first fragmented into regional operations. This will facilitate comparison, for example of prices and performance, and is less likely to lead to agency capture;

b. the agency is given wide powers of access to information and powers to ensure implementation;

c. it has a maximum degree of independence from Government thus making political decisions and actions affecting the industry more transparent;

d. there is complete or partial privatisation and there is provision for removal of monopoly rights. Where the regulatory agency has the ultimate sanction of withdrawing the monopoly licence, or at least recommending its withdrawal, there will be greater incentive for both public and private sector operations to refrain from monopoly abuses.

54. The appropriate mechanism for regulation will depend on the nature of each industry, and there are a number of issues needing to be examined, including -

a. the precise definition, in statutes or more informally, of the responsibilities of the agency, the Sponsor Minister and the Board of the industry itself;

b. the nature and funding of the agency;

c. which Secretary of State should be responsible for it;

d. whether there should be one agency for all the industries or one for each;

e. the relationship with MMC and the OFT.

55. We consider, in particular following our study of the German regulatory arrangements, that the scale of activities and degree of intervention should be less where there is competition for the field or an effective base for

regional comparison. We appreciate that the establishment of regulatory agencies will lead to additional expenditure although this could be offset to some extent by the abolition of the NICCs whose duties might be assumed by the agencies. However we consider that if the monopolies cannot be broken up by competition as advocated earlier in this report, then their power should be constrained by better regulation. It is arguable that this will produce expenditure savings which will more than offset the additional costs involved.

56. Accordingly we recommend that regulatory agencies should be established where the industry can be fragmented into independent regional organisations. Where regionalisation is not the best course, for example in the case of a common carrier role, and the monopoly remains in the public sector, then we recommend that rather than create an agency, regulation through Sponsor Departments should be improved. In order to achieve this, we consider that the recommendations in the 1981 CPRS report on the relationship between Government and the nationalised industries should be implemented. Where a monopoly is to be privatised, then we recommend that a regulatory agency is established to ensure regulation independent of Government and therefore as far removed from political pressures as possible.

57. The creation of regulatory agencies will involve a fundamental change in the relationship between Government and the state monopolies. Such a change is presently in hand in the case of British Telecom. We consider that the establishment and experience of the Office of Telecommunications will provide valuable lessons for regulation in other industries. A suitable candidate for early regulation would be the water industry.

#### Reduce union power

58. Union power in a monopoly industry stems from the following conditions -

- a. the service is indispensable;
- b. there is no close substitute;
- c. there is no possibility of the service being provided in some other way.

The trade unions are more conscious than they were of their power to demand excessive pay increases and job protection at the expense of their industries, the Government and the consumer. During the seventies the balance of power in the nationalised industries swung towards trade unions and away from management. In recent years wages in state monopolies have increased faster than average industrial wages, restrictive working practices have remained, no-redundancy agreements have spread, and in some cases union power has become more centralised and more co-ordinated. There has also been some evidence of increased militancy. If wages are too low and out of line with other industries, as had happened in the coal industry by the early seventies, this can cause problems.

59. We consider that union power can be reduced in a number of ways -

- a. by privatising potentially competitive activities. Privatisation directly introduces the threat of bankruptcy into those parts concerned, and at the same time reduces the size of the remaining organisation and therefore the power base;



- b. by introducing competition wherever possible. The existence of competition coupled with the possibility of bankruptcy and therefore loss of employment is likely to result in a more commercial environment;
- c. by expanding franchising and contracting out;
- d. by regionalising the organisation.

These options have been examined in the earlier part of this report.

60. Both the 1980 Employment Act and 1982 Employment Bill have sought to reduce union power by reducing unions' and individuals' immunities for unlawful acts. Further proposals for changing the legislative environment are being pursued by the Secretary of State for Employment following consideration in E Committee; we have not sought to duplicate this work by putting forward detailed proposals in this report. However, two legislative measures, the provision of statutory 'cooling off' periods and powers to make strikes unlawful, are particularly relevant to the reduction of union power in state monopolies. These measures were discussed in detail in the 1981 Green Paper "Trade Union Immunities" (Cmnd 8128). We believe that making strikes unlawful would be ineffective because of the difficulty of taking sanctions against strikers, but that the introduction of 'cooling off' periods may be a useful move at an appropriate time.

#### Standing up to union power

61. There is a growing realisation that it is possible to stand up to union power, at least in the short term. During postal strikes alternative methods of postal delivery develop. Even in telecommunications, where the chances of action are higher than in the past, it is likely to involve selective withdrawal of staff rather than an all-out strike and this would probably lead to a progressive deterioration of service in areas affected. Stockpiles of coal at power stations may be used to weaken the resolve of miners to strike. We consider that where studies have not already been carried out consideration should be given to ways in which union power can be reduced through self-sufficiency, including -

- a. reducing consumers' dependence on the state monopolies, for example by removing barriers to collection of water by private industry, generation of electricity and telecommunications;
- b. reducing the interdependence of state monopolies, for example by allowing the CEGB to develop its own water sources and by encouraging water authorities to develop stand-by generation of electricity;
- c. stockpiling and building in redundant capacity.

Above all, management needs to be persuaded to take a resolute line when dealing with unreasonable union demands.

#### Changing union attitudes

62. In many cases the unions are single industry unions so that union officials, as well as management, have been sheltered from external market forces. Trade union negotiators are often more militant than the members they represent. A strategy to increase the influence of moderate elements should be pursued, for example by better and more consistent management

communications both to union leaders and directly to members, and by introducing private sector management through joint ventures, competition and privatisation. This is likely to create new loyalties and break down existing prejudices.

Decentralising wage bargaining

63. It is claimed that decentralised bargaining exposes weak local management to militant union power. In addition one area can be played off against another by a strong cohesive union, with a consequent risk of wage settlements leapfrogging each other. While we recognise these risks, we consider that where an industry is regionalised then decentralisation of bargaining may be advantageous since -

- a. it should bring bargaining closer to local realities;
- b. it should lead to regional pay differentiations reflecting local conditions;
- c. it could reduce the power of the unions who will be stretched and less likely to be cohesive as a national group;
- d. it should lead to an increase in local productivity agreements.

Linking wages to performance

64. We consider that wages and salaries should be linked more closely to productivity and performance since this is more likely to lead to employees being less inclined to threaten disruptive action and sanction restrictive practices. Their livelihood and prosperity become more closely allied to the success of the organisation for which they work. Accordingly we recommend that efforts should be made to introduce more well-designed productivity and incentive arrangements where appropriate.

Change the financial and statutory environment

65. We have outlined above methods of reducing the respective powers of the state, the monopolies and the unions in trying to resolve the problems identified in Section II. All these involve significant changes to the operating environment. There are other changes which might be made which would help to create a new climate. These are described in the remainder of this section.

Encourage private finance and joint ventures

66. Private finance can make a contribution to the problem if it brings with it new pressures for greater efficiency. It is clearly irrelevant if private money is protected from loss. A recent development was the BT Bond, though this has been overtaken by plans for privatisation. The principle behind the proposed BT Bond was that its return was related to BT's performance: essentially it was a form of equity. The intention was that this form of financing would bring about pressure for improved performance, because the borrower would wish or need to raise further finance on a similar basis.

67. However the effectiveness of this option should not be exaggerated. Investors have no sanction against the Board if performance is inadequate and if the Board has other sources of future finance. Thus the holders of the London Transport Passenger Board's C Stock in the 1930s became defenceless victims of that Board's inadequate return.

68. Alternatively the private sector can play a role in a particular activity within a corporation. This may either be simply a financial involvement, or it may be a joint venture. We believe that such joint financial frameworks introduce private commercial practices and disciplines, and that, provided they are reasonably free-standing, they should be encouraged, even in cases where it is hard to demonstrate immediate and tangible benefits. We consider that, even where the public stake exceeds 50 per cent, Government should make it clear that it accepts no implied commitment to guarantee the finance.

Remove the guarantee against bankruptcy

69. It is at present considered unthinkable that a utility monopoly should be permitted to become insolvent. Even where private monopolies exist, for example in the water industry, there is no ultimate sanction against inefficient management and unions contemplating extremist action. This has created the cosy and complacent thinking that currently exists in these industries. There is an absence of commercial disciplines.

70. Morrison's original conception for nationalised industries was that they should stand on their own without a guarantee of Government funding. However, Ministers would find it difficult not to support state industries and the legislation has often been interpreted accordingly.

71. We regard the guarantee against bankruptcy as part of the framework which encourages the abuse of monopoly power and inhibits the pursuit of efficiency. We therefore consider that removing the guarantee against bankruptcy may have benefits, in changing attitudes within monopolies and also in eliminating loss-making activities where restructuring has proved difficult by other means. This would be best achieved by creating Companies Act companies, to emphasise that the Government sees them as businesses specifically with limited liability and not as distinct public corporations. It might for example be easier to close down excess capacity or to introduce new manning practices by taking the drastic step of appointing a receiver rather than operating through the existing or even a reconstituted board. The receiver would restructure the business and dispose of those parts which are viable or for which the state is prepared to make explicit subsidies. At some stage in the future restructuring of the coal industry involving closure of uneconomic mines might be capable of being carried out more easily through the appointment of a receiver.

72. It is less easy to envisage decisive advantages from removing the guarantee of bankruptcy in the case of activities where the business is a national natural monopoly, since insolvency could be avoided by price increases unless a regulatory authority or Government prevented this. Within a regional framework insolvency could lead to another regional company taking over the operation.

73. We recognise that without Government backing, external loans to nationalised industries would cost more. In addition we accept that the first large public bankruptcy may have adverse knock-on effects on future trading arrangements by the monopolies and on the financial markets. However the decision to appoint a receiver for one of the state monopolies would not be taken lightly and would not happen often. We consider that when it did occur it would have major implications in "encouraging the others" to maintain commercial disciplines despite the monopoly power. As a result, we see net advantages in removing the guarantee of Government funding.

Remove the statutory duty to supply

74. We have referred to the supply-oriented approach of most of the nationalised industries. Employees in the state monopolies typically consider themselves as providing a public service rather than carrying on a business and selling a product. To some extent this attitude has acted as a brake on abuse of union power. The threat of termination of a public service was until recently unacceptable to many employees. However in the last decade, as employees have become more conscious of their ability to achieve objectives by holding the public to ransom, the beneficial effects of the "public service" attitude have diminished.

75. The dominant consideration has been to supply, not necessarily at least cost, rather than to ascertain what the customer wants. This has typically been used as an excuse, for example in the electricity industry, for excessive planning margins.

76. Now that the bulk of the population is connected to essential public services, we consider that the statutory duty to supply may be an anachronism and also irrelevant. It has diminished the importance of consumer choice and led to surplus capacity. Its removal could encourage a change in attitude.

Make cross-subsidisation explicit

77. Many of the state monopolies have a statutory duty not to discriminate between customers. Initially this was designed to prevent monopoly profit and result in "fair" pricing. However the industries have taken this to mean standard pricing for consumers regardless of cost. Thus many services are provided at uneconomic prices and subsidised by more profitable activities. Typically rural consumers are subsidised by urban consumers.

78. Hidden cross-subsidisation of this nature may achieve social objectives, as well as being politically convenient, but it has many adverse features -

- a. it increases the ability of the monopoly to hide inefficiency;
- b. it makes the prices of profitable services higher, thus restricting demand, and confusing market signals;
- c. it results in the funding of loss-making services being questioned only on an irregular basis, if at all.

79. We recommend that the monopoly industries should be required to cost separately their services and products so that cross-subsidisation is not hidden but either explicit between consumers or eliminated by separate subsidy of social loss-making activities. The latter course would add to public expenditure, but it is the only way of avoiding economic distortions while meeting social objectives.

#### IV - CONCLUSIONS AND RECOMMENDATIONS

80. We have examined in our study the development of state monopolies and shown that in many instances monopoly has been created and is not inevitable. The core of natural monopolies, where a second supplier would necessarily face prohibitively high costs, is narrower than is generally perceived. We have also examined the evidence available on the performance of the state monopolies, and have listed the adverse features which arise partly because they are monopolies and partly because they are in public ownership. The power of the unions stems mainly from the indispensable and monopoly nature of the products and services provided.

81. We suggest that the scope for change should be examined in detail for each industry. For various reasons the climate for change is right. The options discussed are not mutually exclusive; in many cases they are complementary. Not all are applicable to each industry. The overriding need is to break up the existing national monopolies.

##### A. Increase competition

82. The first objective should be to increase competition wherever possible. This means removing obstacles, and creating the right conditions for competition to develop -

a. remove the statutory bar on entry - necessary, but often not enough by itself;

b. regulate to ensure fair competition - we consider that an independent regulatory agency will provide the best assurance to potential competitors, against unreasonable pricing or regulatory actions by the state monopoly;

c. require industries to sell off parts where competition is possible - a quicker way to promote development of effective competition than waiting for new private sector entrants to appear;

d. as a step to privatisation under c, split industries into separate state companies, either by function (eg Sealink) or by region (eg regional electricity generating companies);

e. presumption against allowing state monopolies to expand - moving into new areas may sometimes increase efficiency or reduce dependence on another monopoly, and may increase competition short-term, but it increases market (and union) power.

##### B. Restructure and regulate

83. The process of stimulating effective competition will take time, and there will still be a core of natural monopolies. For the remaining monopolies, ways must be found to improve their performance. Last year's CPRS report made proposals within the existing framework of government/industry relations. This report reviews more radical options -

a. Privatise - this will remove the adverse features of state control, but not those of monopoly power (and union power); hence regulation and/or regionalisation should generally come first;

b. set up an independent regulatory agency - this should be an effective means of preventing monopoly abuse, but depends on Government willingness to hand over some of its powers to the agency (otherwise it merely adds another layer of supervision); hence we recommend that the experience of regulating British Telecom should be taken into account before regulatory agencies are established for other industries;

c. split the industry into regional corporations - in a natural monopoly these will not compete directly, but will enable management performance to be compared, so that a regulatory agency can be more effective; this will be strengthened if regional corporations borrow on their own credit without guarantee against bankruptcy, and if the possibility exists of a monopoly licence being withdrawn and the licence transferred ("competition for the field" as opposed to "competition in the field").

d. extend franchising and contracting out - much wider opportunities exist than have been considered so far, and should be pursued, even within the present framework, to promote efficiency by introducing private sector management and to reduce union power.

C. Reduce union power

84. There is a need to redress the imbalance of union power that currently exists. We believe that the options described above should all help to reduce monopoly power and therefore union power. Proposals for further general legislation on unions will be considered following a consultative period. The proposal for statutory cooling off periods may be useful in the state monopoly context. However we consider that other action might also be taken -

a. further studies should be undertaken where necessary to see how best to stand up to the ransom threat, for example by stockpiling;

b. union attitudes need to be changed; this should be tackled through management action;

c. where an industry is already structured on regional lines there may be advantages in developing decentralised wage bargaining;

d. linking wages more to performance will help to develop a relationship between effort and reward and hence lead to more responsible action.

D. Change the statutory and financial context

85. Other changes might also be made in order to change the context in which the state monopolies operate -

a. encourage private finance and joint ventures;

b. remove Government's guarantee against bankruptcy;

c. remove the statutory duty to supply;

d. make cross-subsidisation of classes of business including uneconomic social services more explicit.

Conclusions

86. The problems of monopoly power, and alternatives to state ownership, have baffled numbers of people for many years. We do not claim to have found any simple solution, for example in the model of a regionalised and regulated industry. In some industries or parts of industries where it proves impossible to introduce competition, the costs of splitting into regional organisations may turn out to be greater than the benefits, and Ministers may decide against handing over their powers to an independent regulatory agency. In such cases there may be no better course than the present system, with better business management along the lines proposed in last year's CPRS report. But we believe that the more radical options in this report need to be seriously and imaginatively examined in relation to the particular circumstances of each industry.

Recommendations

87. In order to effect changes wherever possible, we recommend that Sponsor Ministers should be invited to review the industries for which they are responsible and make detailed proposals, based on the general conclusions reached in this report and options put forward for change. Departments are already considering opportunities for privatisation and a separate exercise is being carried out to ascertain if nationalised industries could contract out more of their activities. A certain amount of ground will therefore already have been covered. We recommend that these efforts should now be extended to consider those more fundamental changes which might be made to break up the state monopolies and reduce their power.

88. We recommend that Treasury Ministers should be invited to consider the proposals for removing guarantees against bankruptcy and for encouraging joint ventures.

89. We further recommend that Sponsor Ministers should be invited to consider the proposals aimed at reducing the power of the unions in their industries.

A REVIEW OF REGULATORY AGENCIES

1. As part of our study we have considered the experience of regulatory agencies in the United States where there is a long history of private sector ownership of monopoly industries and also of regulation. We have also examined regulation in the United Kingdom of broadcasting, air transport, local stage carriage bus services, private water companies and pharmaceutical companies. Where a monopoly exists, there is a need to regulate its activities in the interests of consumers, primarily in order to prevent excessive prices and therefore monopoly profits or excessive costs.

2. However in the United States in particular in the past it is competition as much as monopoly that has been restricted and regulated. In certain industries, mainly transport, monopolies and limited competition have been tolerated on the grounds that this best serves the public interest. A period of de-regulation of potentially competitive industries began under the Ford administration with some resistance from the operators who had previously been protected from competitive forces and effectively guaranteed a steady stream of profits. Experience has shown that regulation has had many unsatisfactory features, referred to further below, and we therefore recommend that regulatory agencies are only established where necessary. We consider that regulation is essential -

a. where, despite the introduction of competition, a created monopoly will exist for some time and there is a need to ensure that the monopolist competes fairly with new entrants to the market;

b. where natural monopoly cannot be avoided.

3. Regulation in the United States dates from the last quarter of the 19th Century where it was thought necessary in order to protect customers from exploitation by private monopolists. Regulators have been mainly concerned with ensuring a secure supply, at a fair price, and partly as a result of these and other considerations, mentioned below, regulatory agencies have suffered from the following defects -

a. they are too bureaucratic and legalistic. This is partly a reflection of the relative dominance of lawyers in United States commercial life and also of the difficulty the regulators and regulated have experienced in agreeing a "fair price" and "fair rate of return";

b. hearings are too formal and applications for price increases too burdensome;

c. the commissions have been too slow to respond. There have been delays in granting price increases, in periods of inflation. Such delays are referred to as the "regulatory lag";

d. many agencies have developed a cosy relationship with their industries and have failed to be sufficiently questioning and investigative in their approach. This is referred to as "agency capture".

e. economic efficiency has not been encouraged. Agencies have been more concerned with ensuring that a rate increase is reasonable;



- f. they have responded too much to local political pressures and have tended to favour short term interests, and present rather than future consumers;
- g. some commissions are underfunded and understaffed and lack good quality staff;
- h. in order to increase their return, utilities have artificially expanded their "rate base" or capital employed;
- i. agencies have condoned and even fostered unimaginative tariff structures and pricing policies.

Perhaps the most damaging effect has been the regulatory lag which, coupled with adherence to historic cost accounting, has resulted in low rates of return. This has affected bond and credit ratings. As a result regulated industries have had difficulty in expanding their funding at economic rates and have been loath to make new investments.

4. Despite these defects, the clamour for de-regulation has not extended to the monopoly industries such as telecommunications and electricity. Indeed in the former, the United States can claim, under the regulation of the Federal Communications Commission (FCC), to have developed one of the world's better telephone systems. The FCC has to some extent stimulated competition to AT and T and required that company to make interconnection facilities available. More recently it has been agreed with AT and T that it should divest itself of its local regional telephone operations in return for permitting it to retain its interests in telephone equipment.

5. Experience in the United Kingdom of regulation of private sector monopolies has not been encouraging. However as in the United States, this has mainly been the result of the methods of regulation used. Thus -

- a. it is claimed that the Independent Broadcasting Authority (IBA) has failed to make the independent television companies operate more efficiently and economically. However the IBA has no direct responsibility for efficiency and the companies have little incentive to reduce costs, because monopoly profits are constrained by a levy which results in a marginal tax rate of 82 per cent above a certain level;

- b. private water companies have had no incentive to improve their performance, other than from the threat of nationalisation, because profits earned in excess of a maximum rate of dividend must be ploughed back into the business or returned to water ratepayers.

6. Regulatory agencies can however claim certain advantages -

- a. they act as a surrogate for market forces and aim to prevent abuse of monopoly power;

- b. they are a better method of regulation than a Government Sponsor Department since they will not have the other conflicting responsibilities of manager of the economy, owner of the business, banker and subsidiser of social services;

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c. they are likely to be more professional and can present a better method of highlighting inefficiency and promoting efficiency. Staffing is less likely to be constrained by Civil Service terms of employment and remuneration - they can more easily employ staff with expertise and knowledge of the industry concerned, accountants and economists;

d. there is greater transparency of decision making. The pricing mechanism will be divorced from Government and subsidies for loss-making and "social" activities are likely to become more explicit;

e. there is increased public accountability on the part of the industry being regulated;

f. they are essential if the monopoly is to be privatised, in order to reduce uncertainty and potential interference which would exist under Government regulation;

g. they will be able to assume the responsibility of the NICCs whose duties they will be able to carry out more effectively;

h. they offer the prospect of continuous regulation of monopoly.

7. We consider that regulatory agencies can be an effective method of reducing monopoly power and are essential if state monopolies are to be privatised and remain monopolies. They are likely to be most effective if accompanied by regionalisation, since this will facilitate comparison and is less likely to lead to agency capture. The deficiencies noted above are less likely to arise if the following conditions exist -

a. the agency should be divorced from Government in order to reduce the possibility of political intervention;

b. the agency should be managed by a small number of members who are full-time appointees of the Government. Terms of office should be at least 5 years, with cyclical rotation in order to minimise political interference. The members should be properly remunerated;

c. the agency should have statutory investigative and judicial powers. These will include rights of access to information and premises, to subpoena directors and staff, to conduct audits and reviews and to request the MMC to investigate the monopoly;

d. care should be taken to ensure that appellate arrangements will not result in political interference; we consider that the MMC should be able to fulfill this appellate function, with its experience of examining "public interest" questions;

e. uncertainties are created in the US system of regulation because agencies attempt to determine each year when approving price increases a fair rate of return based on the monopoly's relative efficiency. Major reviews of rates of return and of efficiency should only take place periodically, for example every 4 or 5 years. The results of efficiency reviews should represent a major input to the determination of permitted maximum rates of return, so that past effort and achievement are rewarded. However some flexibility should also be permitted to the agency in the intervening period as an added stimulus to efficiency;

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f. permitted rates of return should be established by the agency (or the MMC as the appellate) rather than by Ministers, in order to reduce the possibility of political interference;

g. the agency should have powers to ensure that the monopoly is constrained and abuses are remedied. In the longer term the permitted maximum rate of return can be varied to meet this need. In the short term, price restraint could be used where maximum rates of return are likely to be exceeded;

h. the agency should be adequately funded and should be permitted to recruit those staff appropriate for the task, from outside the Civil Service where appropriate, at market rates of remuneration;

i. the agency should be permitted to examine all aspects of the business, including profits, efficiency, pricing, extent of market and services provided, standards of service, consumer protection, investment and possible abuses of monopoly power such as cross-subsidisation to keep out competitors and pressure on suppliers;

j. current cost accounts should be used primarily as the financial basis for regulation. However we would point out that for many industries there is a high degree of subjectivity involved in the preparation of CCA accounts. As a result we consider that for the time being at least it will be necessary for agencies to have regard to and even regulate by reference to historic cost accounts, as well as CCA accounts.

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H I G H E R   E D U C A T I O N

Report

by the

Central Policy Review Staff

CABINET OFFICE

July 1983

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## HIGHER EDUCATION

A Report by the Central Policy Review Staff

### PART I: SETTING THE SCENE

#### Chapter One

#### Introduction

1. At the end of last year, the Prime Minister invited the CPRS to carry out a study of higher education with particular reference to its response to market forces and employment needs, its efficiency and its financing. This report fulfils that remit.

2. Higher education contributes to the attainment of a wide variety of economic and social aims. We decided to focus on the three main objectives of our higher education system, which we have called the economic, the academic and the educational. We began our work by examining the extent to which our present higher education arrangements meet each of these objectives. On the basis of this review, we concluded that there is scope within present public expenditure provisions for improving the extent to which our higher education system meets the needs of the economy (its "economic" objective) and promotes personal and citizenship qualities in individuals (its "educational" objective) without threatening its concern for high standards in either research or teaching (its "academic" objective).

3. The second part of this report contains our proposals for improving the extent to which our higher education system meets each of these objectives. These recommendations are based on the belief that the system itself can and will develop a new balance between its objectives if and only if two fundamental changes are brought about in the conditions under which it works. First, the system must be more exposed to market forces and more able to react to them. (These forces must, in turn, be improved). Second, the government must be willing to use such levers, mainly financial, as it already has to encourage the system to adapt in ways which are better suited to the needs of the economy. Our detailed proposals are aimed at these ends.

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4. Finally, a caveat. Although we believe that the general thrust of our analysis and proposals is applicable to the higher education system of the United Kingdom as a whole, this report is concerned principally with higher education in England and Wales. We have not considered in any depth the particular arrangements which operate in Scotland or Northern Ireland and many of our detailed comments and recommendations may therefore not be applicable to the conditions which apply in those parts of the United Kingdom.

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Chapter Two

An Outline of Higher Education

Universities

5. The British system of higher education is made up of universities, polytechnics and a variety of other institutions such as the Colleges of Further Education and of Higher Education which offer a more or less limited range of advanced courses of the 'higher education' type. The Universities are the oldest and most prestigious part of the system. They are independent institutions established by Royal Charter. The oldest can trace their origins back to the great mediaeval establishments in England and Scotland; the newest (the University of Buckingham) received its Charter earlier this year. There are now 45 universities in Great Britain. All, except Buckingham, receive almost all their income from the public purse, principally in the form of a block grant from the Secretary of State distributed by the University Grants Committee (UGC). Other 'public' funds received by the universities include 'fees' for home students (a book-keeping transfer payment) and research income from the Government-funded Research Councils. In addition, universities have a certain amount of private income, including genuine fees from overseas students and funds from endowment and other private sources.

6. Universities are self-governing. Their form of government is normally stipulated by their Charters and statutes. A typical pattern consists of a largely ceremonial Court, a Council with substantial lay representation, a Vice Chancellor appointed by and responsible to the Council and a Senate composed largely of members of the academic staff. The Council is formally the highest governing body of the institution and is responsible for all non-academic matters, including finance. The Senate has responsibility for academic issues. Each institution determines its own academic policy and grants its own qualifications. Most academic staff at universities are "tenured"; that is, "established", and are removable only for a limited range of narrowly defined causes specified in their contracts of employment.



7. The University Grants Committee, the main conduit of public funds from the Government to the universities, was established in 1919 as a way of reconciling the independence of the universities with the need to demonstrate accountability for public funds. In addition to a full-time Chairman, it normally consists of about 20 members; at present, all but 4 are academics. The Committee's principal task is to allocate to individual universities the funds which have been provided for them by the Secretary of State. Although the UGC is formally independent of the DES, it operates in close contact with the Department and from time to time the Secretary of State issues letters of guidance to the Committee asking it to pay particular attention to specific policies. Nevertheless, neither DES Ministers nor officials attend the grant allocation meetings of the Committee, nor does the Government or the UGC interfere with the way in which individual universities actually spend their block grant funds.

#### Public Sector Higher Education

8. We have grouped together all the remaining institutions offering higher education into what we call the "public sector of higher education". Like the universities, the institutions in this group vary in size, structure and origins. They include, in England and Wales, 30 polytechnics, 95 institutions providing mainly (over 60 per cent) higher education and about 80 others providing some (10-60 per cent). They range from small Colleges of Further Education which offer only a few advanced courses to the major polytechnics in which most of the student body are reading for 'university-type' degrees. In addition, there are numerous smaller Colleges of Higher Education, many of which grew out of local authority teacher training colleges or local advanced technical colleges.

9. The polytechnics and most of the other public sector institutions are local authority institutions, owned by them and subject (with wide variations) to their controls on staffing, conditions of service, recruitment, capital expenditure and the retention of income. Their instruments of government normally provide for governing bodies containing equal proportions of local authority representatives, academics and representatives of local industry and commerce. The Further Education Regulations and the Education Acts together establish a system that controls both the funding and provision of

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courses. This report is concerned only with Advanced Further Education (AFE) courses, which in the public sector are the equivalent of what is loosely called higher education. These courses include degree and degree equivalent work, Higher National Diplomas and Certificates and the Diploma of Higher Education. The funding of AFE is through a pool to which all local authorities contribute through adjustments to their entitlement to Rate Support Grant. An individual local authority may, however, decide to increase the funding of its own institution(s) by "topping up" the pool with direct funding from rate income.

10. The rest of what we call the public sector is made up of the so-called "voluntary colleges" many of which owe their origins to religious foundations. These institutions are governed under a wide variety of arrangements but all are funded directly by the DES, which stands in relation to them much as a local authority does to its colleges.

11. Unlike the universities, which are free to determine their own curriculum and degree standards, every course offered by a public sector institution must be approved by the Secretary of State. In practice, he delegates this task to Her Majesty's Inspectorate of Education which works within the framework of policy guidelines set out in DES circulars and is advised by Regional Advisory Committees consisting mainly of academics but including some industrialists. In 1982, the National Advisory Body for Local Authority Higher Education (NAB) was established to bring together the interests of central and local government in public sector higher education and to advise the Secretary of State on its provision. In addition to these controls, the academic content of most courses in the public sector is "validated" by bodies external to the institutions, principally the Council for National Academic Awards (CNAA), the Business and Technician Education Council (BTEC), and the universities.

## Students

12. The number of students in higher education has expanded dramatically over the past twenty years. The number of full-time students increased from about 180,000 in 1960 to some 450,000 in 1982/83. This represents a doubling of the proportion of the population in higher education, or "participation rate", to some 13% of 18-21 year olds. Nevertheless, our full time

participation rate remains low by some international standards; the UK rate is less than half that in either Japan or the USA, two-thirds that in France or Italy and about the same as in Germany. (In the USA and Japan the rate is nearly 40 per cent). In part, this difference is offset by our large number of part-time students - now about 260,000. Only the USA has an equivalently high proportion of part-timers.

13. Most students make their way to higher education by way of 'A' level courses which they take in 6th forms or, to a lesser extent, in Colleges of Further Education. Some apply on the basis of BTEC or other Further Education qualifications. A relatively small proportion of higher education students have had some post-school experience; only about 16% of full time undergraduates are over 21 when they enter the system, and only about 6% are over 24.

#### The Costs of Higher Education

14. Despite our low participation rate, however, we devote a comparatively large proportion of our national resources to higher education. Public expenditure on higher education was about £3 billion in 1982/83. This represents about 25 per cent of the total education budget and a little more than one half per cent of GDP. In part, our relatively high cost per student reflects our method of student support. The vast majority of UK higher education students pay no fees. These are paid for them by their local authorities who receive a 90 per cent Exchequer grant for the purpose. In addition, all resident students receive a maintenance award, the size of which depends on parental income. In most other countries, loans as opposed to grants are the most common form of student maintenance. Students are charged tuition fees on a significant scale only in the USA and Japan, where there is a substantial number of private institutions; but even in these countries fees account for only about half of the total income received by higher education institutions as a whole.

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15. But our student support arrangements do not explain the whole of the difference in the cost of keeping a student for a year in higher education in the UK as opposed to in many other countries. Our lower staff-student ratio is also relevant. In broad terms, our system operates on the basis of one member of staff to each 10 students, whereas the ratio is about 1:20 in both Japan and Germany. It is interesting to note that the University of Buckingham, the only private university in the UK, has chosen to operate at the general UK level. (In large part, our high cost per student is offset as far as public expenditure is concerned by the fact that our degree courses are shorter than those offered in most other countries).

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Chapter Three

The Objectives of Higher Education

16. We believe that the most useful way of examining our present system of higher education is in terms of three main objectives:

- an "academic" objective - the achievement of high standards in both extending knowledge and transmitting it.
- an "economic" objective - the ability to supply to employers in all sectors of the economy the range of manpower required (from the generalist to the specialist) and to generate new knowledge and skills which in turn produce marketable and profitable products.
- an "educational" objective - the provision of the widest possible opportunity for the promotion in individuals of those personal qualities which will enable them to lead more satisfying lives and to play a fuller part in society.

17. As we shall show, these three objectives are often mutually reinforcing; sometimes, however, they conflict. The overall shape of the system is determined by the balance between them.

18. The primary emphasis of our present system of higher education has traditionally been on the pursuit of "high standards" in both research and teaching; ie, the "academic" objective. As a result, many of our researchers are universally accepted as the best in their fields; we have won more Nobel Prizes in science than any other country of comparable size. As for teaching, there is no easy way of judging quality, but in most fields our graduates are regarded as being at least as well educated as those of our competitors.

19. But this overriding concern for high academic standards (as these are perceived and pursued by the universities themselves), has left other, less desirable, marks on our institutions of higher education. It has meant that when considering the value of a subject for study (either as research or by students) too little weight is given to relevance or usefulness to the outside

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world. It has led to the development of courses which are almost always based on early subject specialisation and the assimilation of great detail, rather than on acquiring knowledge of a number of disciplines as building blocks from which later specialisation can be constructed. Most significantly, perhaps, it has encouraged the belief that academic freedom in the widest sense is the sine qua non of academic achievement so that, notwithstanding the fact that higher education is almost entirely publicly funded, academics must be free not only to pursue their own academic interests but also to determine their own conditions of employment, what courses are to be offered, how much research as opposed to teaching they should do and when they should do it. As a result, our universities are under little external pressure to achieve efficiency and are almost uniquely unaccountable for the public funds they consume.

20. Taken together, these features of our university life are what we call the "university ethos". It has largely determined admission policy, course structure and content, grading standards, criteria for appointing and promoting staff, and even the way in which public funds are allocated to universities. As we shall show below, we believe that this ethos accounts to a large extent also for the failure of our universities to achieve a better balance between their three main objectives.

21. Nor has this ethos been confined to the universities. It has permeated the public sector, too, despite the fact that many of those institutions were originally established to pursue objectives more closely related to the economic needs of their localities and are more closely connected to central and local government. An example of its effects is the steady drift which has taken place in the public sector away from part-time courses and sub-degree work towards courses of a university type.

22. As for our secondary schools, their curriculum also reflects the "university ethos". It has helped to create a highly specialised curriculum which makes the last two years of school in this country (although less so in Scotland) a significantly more academic experience than in any other Western nation so that comparatively few students enter higher education with qualifications other than 'A' level certificates.

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23. A successful economy depends on trained manpower. The most valuable skill is the ability to adapt and change to meet new circumstances. As higher education is a main supplier of highly qualified and trained manpower and a central mechanism by which these qualifications and this training can be updated and adapted, it is clearly crucial to economic performance. As we move towards an economy which is even more service and information based, and in which change occurs even more rapidly, this contribution of higher education to economic success - the "economic" objective of higher education - will become increasingly important.
24. The higher education system contributes to the economy also by performing most of the fundamental long term research needed to underpin industrial advance; in this sense, it is the nation's research laboratory. The extent to which this research is coupled to industry is of great importance and is a matter on which the Advisory Council for Applied Research and Development has recently reported to the Prime Minister.
25. It is difficult to judge how well or badly a particular higher education system meets the needs of an economy; the evidence is inconclusive. Commonsense would seem to indicate, however, that, all other things being equal, the higher the "participation rate" the better the performance of the economy. (As we have noted above, our full-time participation rate is lower than that of our principal competitors, although the figures are more equal if part-timers are included). But there does not appear to be any conclusive evidence of a direct link between participation rates and economic performance, either as between different countries or over time.
26. In addition, participation rates are only a partial measure of the contribution which higher education can make to economic success. Other factors which must be taken into account include the quality and relevance of the courses on offer, which must keep changing as the economy changes, as well as the extent to which the system permits educational "topping up" later in life. The latter may be significantly affected by government action and we make proposals about it below.

27. It is not reasonable, however, to expect "the centre" to be able to determine with any success which courses - and how much of each - should be provided at any particular time to meet the needs of a technologically developing economy. The only really effective way of securing the sort of course mix which the economy needs is through the market. Employers must be encouraged and assisted to send clear and consistent signals about their present or future needs to the higher education system. They can do this through the labour market (most unambiguously through the initial salaries which they are prepared to offer), through their corporate organisations such as the CBI and the professional institutions, through links with particular higher education institutions and through their representation on the national bodies which allocate funds to the higher education system; ie, the UGC and the NAB. To be effective, these signals must be received and understood by potential and actual students and by those responsible for managing the system. Finally, the institutions themselves must be flexible enough to be able to adapt to them. Unfortunately none of these aspects of an effective market mechanism works well in our present higher education system and, as a consequence, our system is failing to a large extent to achieve its economic objective.

28. The "educational" objective of higher education focuses on the individual, not on the economy or on some abstract notion of knowledge for its own sake. It aims to help people to lead fuller, richer lives and to play more effective roles in society. Primary and secondary schooling make major contributions to this end, too, and heredity, family and an individual's social environment all have a determining influence. But higher education has its own distinctive role. Whether taken immediately after school or later in life, perhaps through the Open University or other part-time adult education courses, higher education offers personal development through exposure to the most advanced knowledge. The wider the access to higher education, therefore, the more effectively can the "educational" objective be achieved. From this point of view, higher education should not be too costly. Entry requirements should be flexible enough to allow those of all age groups to participate. The courses on offer should include part-time and modular courses which make it possible to complete a higher education degree course over a prolonged period. On many of these counts, our system of higher education appears to be less effective at meeting its "educational" objective than it might be.



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29. A system of higher education can and should aim to meet all three objectives. The extent to which each is met will vary between different institutions and will be the subject of public debate and perhaps even of political controversy. But each is essential to justify the £3 billion per year in public funds devoted to higher education; none is an optional extra.

30. Our analysis of the present British system of higher education leads us to believe that because of the dominance of the so-called "university ethos" (as discussed in paras 19/22 above) the economic and educational objectives of higher education are not being pursued as effectively as they should. We believe also that, paradoxically perhaps, the "university ethos" has hindered the full achievement of even the purely academic objective. In our view, this situation can be put right without significant new injections of public money and without sacrificing the high academic standards which have been achieved. What is required is substantial change in the practice of our higher education institutions and the government. We describe the necessary changes below.

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PART II: OUR PROPOSALS

Chapter Four

Our Approach to Change

31. In this section of the report, we make proposals for changes in our system of higher education which we believe will help to overcome the most important weaknesses identified above. We map out the desirable pattern of change and suggest particular ways in which these changes might be achieved. Most of what we propose is not novel; it accords with the views of those who have been studying the system longer than we have. There is plenty of room for argument about detailed ways of achieving the desired goals. What matters, however, is that these goals should be adopted and actively pursued.

32. The general aim of our proposals is to achieve a new balance between the academic, economic and educational roles of higher education. Each of these is important, but we believe that our higher education system has given too much attention to academic concerns and not enough to the contribution which it could make to our economic performance or to widening educational opportunity. Our aim is to shift the balance so that higher education plays a more effective role in meeting economic needs while safeguarding and, if possible, even enhancing its educational role and without lowering academic standards or threatening important academic freedoms.

33. Our approach is through the market. We do not advocate a significant increase in the role which the government plays in the planning and management of higher education. We do, however, suggest that the government should take steps to improve the flow and quality of information essential for any market to work effectively. In addition, we believe that the Government should use the financial levers available to it more positively with a view to giving the institutions of higher education greater incentives to respond to the need to change. This would, of course, mean increasing the extent to which the Secretary of State is concerned with affairs of particular institutions, but we believe both that such an extension of his role is necessary in order to ensure that the Government's preferred balance between objectives is achieved and that it is consistent with respecting the fundamental academic freedoms on which our system of higher education rests.

34. We reject the idea that what is required is a significant increase in public spending on higher education. As we pointed out above, there is no clear evidence of a direct link between investment in higher education and economic performance such as would justify a major publicly funded expansion of the system. In addition, we doubt that the structure of our system is well enough adapted to meeting the needs of the economy for us to be confident that simply increasing our participation rate would contribute significantly to improving our economic performance unless it were accompanied by changes in funding, course provision and entry qualifications. It is questionable, therefore, whether higher education should have first claim on any extra resources for raising the general educational attainment of the labour force. It is at least as important to increase educational participation between 16 and 18 and among adults who have had no post-compulsory education.

35. Increasing our higher education participation rate would, however, be desirable in terms of widening educational opportunity. But we believe that this could be achieved within present public funding levels by increasing the effectiveness and efficiency of our system and by attracting more private finance. We make proposals below to both these ends. The first step, however, must be to move away from the present controls on student numbers which discourage universities from, and in some circumstances penalise them for, accommodating extra home students even within the same public budget. Similarly, we advise against the imposition of such controls in the public sector.

36. The main message to emerge from our consideration of the present United Kingdom higher education system is that it is dominated by what we have called the "university ethos" and that this is reflected in almost every aspect of the system. It is even underwritten by Government in the "hands off" way in which it finances the system. The main thrust of our proposals is directed at tackling this problem by making the system more capable of responding effectively to its non-academic objectives, particularly the economic. To this end it needs to have a diverse product range (different courses), it needs to

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draw its raw material (intending students) from a range of backgrounds and it needs to be responsive to demands for its final products from a wide range of customers (society as a whole, the academic world, employers, individuals). It is likely that these needs will be met most effectively if there is considerable diversity of producers (higher education institutions).

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Chapter Five

The Binary Line

37. It is largely for this reason that we do not recommend eliminating the so-called "binary line" between the universities and the public sector institutions. We recognise, of course, that the "binary line" does not separate two different and homogenous groups of institutions and that by treating each sector differently the view is perpetuated that predominantly academic institutions are superior to those which direct themselves also to wider educational and economic objectives. We believe that the binary line has thus encouraged the dominance in higher education of purely academic values and reinforced the "university ethos". The ownership by local education authorities of important parts of higher education also raises problems in terms of extending the accountability and responsibility of the Secretary of State.

38. There would clearly be advantage in treating all institutions providing higher education on the same basis; ie freeing the public sector from the operational controls of local authorities. But there are problems. Such a change would be politically controversial and would require complex transitional arrangements. In addition, as long as Non-Advanced Further Education (NAFE) remains a local authority responsibility, removing Advanced Further Education (AFE) from local control would make it more difficult to maintain the bridges between the two which we believe are important and should be strengthened. Nor should one underestimate the contribution made to diversity in higher education by the involvement of local authorities in it.

39. The proposals which we make below for changes in the way higher education is funded, for enhancing peer review in the universities and for providing more and better advice to the Secretary of State, will in practice lead to a considerable blurring of the "binary line" and to the emergence of a co-ordinated and consistent approach by government to both sides of it. This is fully in line with the Secretary of State's guidance to the NAB and UGC to promote "transbinary" co-operation and should lead to a considerable reduction in the number and intensity of the problems commonly associated with "the binary line". We therefore see no pressing need to alter the

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present position in relation to the ownership of higher education institutions by local authorities. But we think that there is much to be said for permitting a major public sector institution which has a critical disagreement on future policy with its LEA to petition the Secretary of State for independent status and we make allowance for this in our other proposals.

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Chapter Six

Funding Institutions

40. As described above, we believe that new arrangements are required for funding higher education teaching, particularly in universities. At present, the block grant allocated by the UGC to each university is meant to cover both the educational needs of students (i.e. teaching, scholarship and administration) as well as a basic "floor" of research. (The Research Councils provide the rest of the support for research). The size of this block, although it is intended to be used principally for teaching, is in practice determined largely by considerations related to an institution's research performance. We believe that this militates against the achievement of some of the wider economic and educational objectives of higher education and even against the achievement of high standards in teaching. We therefore propose that the total block grant for each institution should be separated into its research and teaching components so that the size of each part can be determined according to criteria most appropriate to it.

41. For research, for example, a greater degree of selectivity may be appropriate. There is certainly no prima facie reason why it is right to assume, as the UGC does, that the ratio between the amount of funds required for research and that for teaching should be the same across all subjects or that research funds should be spread evenly throughout the system. Similarly, some formal mechanism might be evolved within each institution for ensuring quality control and accountability as suggested by the Working Party on the Support of University Scientific Research chaired by Sir Alec Merison (Cmd. 8567).

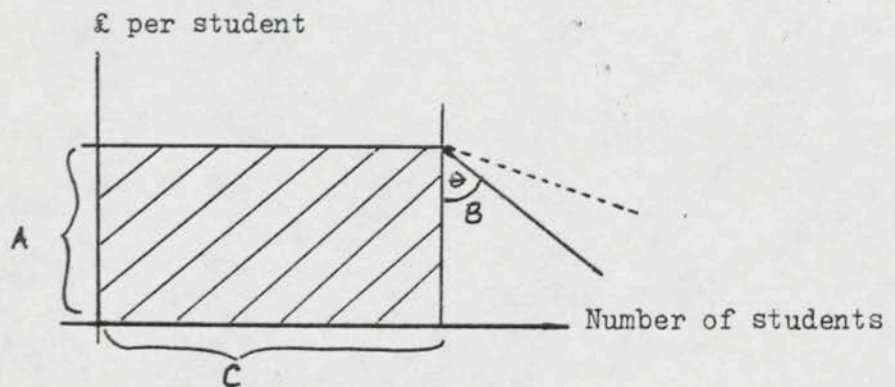
42. As for that portion of the block grant distributed to universities to support teaching and related activities, we have a number of proposals about how it should be allocated and monitored.

43. The allocation of resources for teaching and course development requires a judgement to be made about the balance between, on the one hand, academic considerations and, on the other, wider economic and educational goals. We think that this is a judgement which should fall to the Secretary of State. We recommend that in making this judgement, he should be advised by two national bodies, one concerned with academic matters, the other with economic (including employment) considerations. The former, which might evolve from the UGC, would be composed of academics and would be concerned principally with academic and educational matters. It would take a system-wide view of provision in particular subjects, much as the UGC does at present. It would advise on the future growth or decline of particular disciplines and departments, recognising the importance of quality in teaching and course development as well as in research. Equally, it should be constituted so as to be able to give advice to the Secretary of State on ways of meeting the wider educational objectives of higher education. The second body, which might evolve from the Professional and Industrial Liaison Group now advising the National Advisory Body (NAB) would have a much more broadly based membership. This is because it would not be able to do its job as the Secretary of State's advisor on employment and economic matters if, for example, it ignored the position of the public sector as a major employer or represented only a relatively narrow spectrum of industrial interests. It would be the Secretary of State's role to reach a judgement as between the advice provided by each body and thus take a co-ordinated view of the higher education system as a whole. We believe that the advice provided by these bodies should normally be published so that the public debate about the shape and content of our higher education system can be as informed as possible.

44. As one of its first tasks, the academic advisory board should be invited to undertake a study of ways of evaluating the quality of university courses and how they are taught. Such a study might be expected to consider, among other things, the possibility of the advisory body appointing its own corps of independent external examiners. Such an initiative would not be popular with the universities, but we believe that in the long term it would help to raise the quality of teaching and course development and encourage the universities to respond more quickly and effectively to new demands from employers and students.



45. Finally, we suggest that the teaching grant should give each institution a degree of flexibility to respond to the pressure of demand while allowing the Government to retain central control over the total public expenditure earmarked for higher education. This might be done by applying to actual student numbers, up to a centrally determined student base number in each subject category, standard amounts per head to reflect the acceptable costs of teaching these subjects. Institutions would, however, be allowed, indeed encouraged, to accommodate more than the base number of home students and would receive a somewhat smaller (tapered) per capita amount for each student above their base. The total grant for each institution would thus reflect these three factors, as illustrated:



46. These arrangements would provide the Government with levers with which to influence the behaviour of individual institutions much as the factors which underlie the Rate Support Grant settlement permit the Government to exert influence on individual local authorities. For example, by altering the size of the standard amount per head (A on the figure), the steepness of the taper above the student base number (B) and the level of the student base number itself (C) the same total budget could be used to strike a balance between different objectives. A squeeze on basic per capita amounts coupled with a gradual taper would encourage greater efficiency as institutions would seek to spread their fixed costs over larger numbers of student; it would also encourage considerable competition among institutions for students. A steeper taper (perhaps compensated for by a higher base number), would give the Government greater control and give institutions an incentive to raise finance other than from the government. This mechanism could be used also to achieve other aims such as encouraging part-time and sandwich courses.

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47. There should be no difficulty about introducing this system for universities straightaway. The same principles should apply to the financing of the public sector, but it may be that the way in which these institutions are funded at present cannot be adapted to meet these ends without significant adjustment. The DES should be invited to consider this matter, without ruling out the possibility of transferring to central government the responsibility for this part of the financing of public sector institutions.

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Chapter Seven

Statements of Educational Policy (SEPs)

48. We believe that our funding proposals would help to achieve the diversity and flexibility which the higher education system requires. They would also give the Secretary of State a much more active role in the financial affairs of individual institutions than he has at present. To assist him, we propose that every 3 years each publicly funded higher education institution should be invited to submit to him a statement of its objectives. These Statements of Educational Policy (SEPs) would be prepared within national guidelines issued by the Secretary of State after consulting the two new advisory bodies referred to in paragraph 43 above. The guidelines would describe how the Government perceives the present balance between the various objectives of the higher education system and whether it wished to see that balance shifted in any particular direction; for example, away from academic to economic considerations. Each institution would be encouraged to strike a balance of objectives of its own in the knowledge that centres of excellence of different kinds would be encouraged within the overall balance indicated by the Government. Once an institution's objectives had been agreed, its subsequent performance and hence claim for public funds would be judged against yardsticks which reflected its own objectives as set out in its SEP.

49. The SEP, which would be published, would describe the institutions' policies on such matters as subject mix, the balance between teaching and research, training of teachers, course length, breadth and content, links with industry, entry qualifications, continuing education, credit transfer and arrangements for monitoring quality. It might even be used to encourage institutions to play a larger role in their local or regional economies.

50. In the public sector, SEPs would have to take account also of the views of LEAs. In most cases, the institution and its LEA would agree on the terms of the SEP. If, however, there were a serious difference of opinion between them on the direction which an institution wished to take or on the amount of LEA resources required to achieve its ends, the SEP might be the vehicle for the institution to petition for independent status. (See paragraph 39 above).

51. Each SEP, except an institution's first, would contain also a report on the extent to which the objectives it had undertaken to pursue in its last SEP had been met. The Secretary of State, on the advice of his two advisory bodies, would use the SEPs, particularly the reports on past performance, in deciding about the allocation of funds to individual institutions. For example, in deciding on the number of students in each subject category for which an institution would receive the standard amount per head (see para 45 above), he might take into account how well that institution had met its commitment to wider access.

52. In the university sector, SEPs would, to a large extent, simply replace and systematise the present inter-change of information between institutions and the UGCs. They would be similar to the five-year academic plans which universities had been required to submit to the UGC under the system of quinquennial funding. In the public sector, the SEP process would gradually absorb the tasks presently performed through course approval; there would be no need to maintain the present system of HMI and RAC advice on Advanced Further Education. What distinguishes SEPs from existing arrangements, however, is the degree of independence which they would give to institutions to negotiate their own objectives and the extent to which they might be used to monitor the achievement of those objectives. In this latter respect they offer the prospect of a considerable improvement on the present arrangements for the accountability of the public funds allocated to higher education.

#### Encouraging Innovation

53. It is important to stress that the SEPs provide a link between the Secretary of State's policy for the higher education system as a whole and each institution's perception of what it does, or could do, best. We believe that the aggregation of these statements of objectives would produce, over time, a balance of emphasis in the system which was consistent with the Government's policy. But we recognise that there are strong forces of inertia which now act to preserve the status quo. To help to overcome these by encouraging those proposals in SEPs which appear to offer the best prospect of achieving the changes in the higher education system which the

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Government would wish to see, an Educational Venture Fund (EVF) of, say, £25 million a year should be established. This money would be used by the Secretary of State to fund the testing and development of new ideas. Higher education institutions, voluntary organisations and others who wish to innovate would be eligible for EVF support. The kind of developments which might be funded are credit transfer, open access programmes, the development of shorter and modular courses, new forms of teaching, teacher training and the monitoring of teaching performance and new methods of involving industry in an institution's activities. In administering this fund, the Secretary of State would be advised by his two new advisory bodies. (This approach is similar to the new Technical and Vocational Education Initiative (TVEI) for 14-18 year olds.)

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Chapter Eight

Course Structure, Content and Access

54. In the technologically based society of the next century, higher education institutions will be called upon to provide a whole new range of courses; courses which will be broad enough to enable individuals to cope later with rapid changes in particular fields of knowledge and to acquire and exercise completely new areas of expertise. We believe that the most effective way of doing this is by the "core plus modules" approach in wide use in the USA and currently being developed here in the system of training for manual workers and technicians. In short, the "core plus modules" approach requires candidates for a degree to complete a number of "core" or essential courses as well as a number of other (supplementary) courses or "modules" from a list of those available in their institution or, in a credit system, also from other institutions. We advocate this approach principally as a way of meeting economic needs, but we believe that it would also serve wider educational objectives by providing the opportunity to introduce a broad "core" curriculum which would meet the needs of those who are not well suited to the highly specialised nature of traditional courses.

55. If a degree based on "core plus modules" is to be introduced without any major increase in the resources and time which the State and individuals devote to higher education, the "core" must be shorter than the current standard three-year degree so as to provide room and time for specialisms of adequate quality to be built onto it. We believe, largely on the basis of experience in other countries such as France, Japan and the USA where such courses have been in operation for some time, that two years of study on the basis of carefully developed complementary core courses would be enough time to justify awarding a university degree to the student who had completed it.

56. Experience in other countries also reinforces our belief that if two-year general courses are to be accepted by employers as useful screening devices for potential employees, they must be certificated and graded on the same basis as the present three-year honours degree. (This is the normal practice abroad). In addition, they must be offered by our 'best' institutions and attract the ablest students. The proposals which we make for funding institutions and students should provide incentives to the former to develop and offer such courses and to the latter to opt for them. In addition, we think that the Government, if it wishes to encourage such courses, should accept them as the basis for entry to the "fast stream" of the Civil Service.

#### Credits

57. Implicit in the "core plus modules" approach is that the facility should exist for people to add to their basic higher education core later in life, after they have entered employment. A prerequisite for this is a system of transferable credits which would permit a student who had successfully completed a core or module course in one institution to get "credit" for that course as part of the requirement for a degree awarded by another institution. This would permit students to choose courses with a degree of independence from their institution, recognising that it is unrealistic to expect all institutions to offer all courses. This has long been recognised as a desirable development, but progress, especially in the university sector, has been slow. The Education Credit Transfer Information Scheme (ECTIS) is a good start, but exchanging information on courses is not enough. We recommend that the Government should press for more rapid development of credit transfer.

#### Widening Access

58. As well as encouraging higher education to offer a more diverse product range, we believe that the Government should use the leverage of its funding to persuade institutions to open their doors to a more diverse student body by accepting a wider range of entry qualifications, including qualifications in vocational education. 'A' levels, now overwhelmingly the most commonly

offered qualification, meets the needs of the academically gifted child who has a clear idea of the interests he wishes to pursue, but should be only one element in a broad sixth form curriculum. The much discussed 'I' level should now be introduced. Given the existence of a well tried Scottish model (the 'H' grade) to build on, introduction of 'I' levels should take years rather than decades.

59. At least as important is the need to develop an additional path from school to higher education via courses and qualification in vocational education. If higher education is to be more effective in providing a corpus of highly educated but practical people motivated to work in the productive sectors of the economy it needs to tap a higher proportion of the young people whose minds have a practical bent. A path of sorts to higher education exists at present via NAFE but it lacks status and there is no clear and simple progression from school to Further Education courses or from Further Education to university, because schools do not prepare pupils for Further Education and because higher education institutions (especially universities) do not gear their entry requirement to the products of CFEs.

60. Several other approaches to developing alternative forms of entry to higher education have recently been tried and are worth noting. The Open University, is of course, the best known. In the North West, a group of universities and colleges have set up an Open College Federation which steers unqualified students through units of tuition, often while at work, on the successful completion of which they can enrol for a degree at one of the participating institutions. We think that a study should be undertaken of various entry criteria, including the use of aptitude tests and credits for relevant work experience, as a way of helping those who leave school at 16 but who would benefit from higher education later in life.



Part-time

61. In this connection, we believe that higher education institutions should be encouraged to provide more flexible study arrangements so as to attract students who are paying their own way; eg part-time and evening courses which enable people to combine study with employment. The Open University, Open Tech and Pickup programmes all have important parts to play in encouraging these developments. Their continued co-operation, straddling the division of responsibilities between DES and MSC, will be a crucial factor in their success.

62. Working adults, particularly those with families to support, face a considerable financial sacrifice - in the short term at least - if they take time away from work to study full time. We therefore think that they should be assisted to study part-time and this end, we recommend that a programme of grants for part-time study should be considered. The level of grants available for mature students should also be reviewed and extended to a wider range of sub-degree courses.

63. We do not, however, propose that adults should be given a statutory right to education leave, with or without pay, from their employer. This would increase the burdens on employers and could help to destroy jobs. The negotiation of any such right is a matter for (individual or collective) bargaining between employer and employees, who between them must decide what their enterprises can afford and what priority educational leave should have as compared with pay, job security, etc. If the government were to introduce any general fiscal incentive to encourage training, then company expenditure arising from any education leave might be an admissible expense. But, generally, we believe that the right approach is to encourage flexible patterns of learning that minimise the time away from work.

Chapter NineNew Funding Arrangements for Students

64. As we pointed out in paragraph 14 above, this country treats its students exceptionally generously. All UK resident students on a recognised degree course, no matter what the subject, receive a maintenance grant, the size of which is dependant on parental income, and free tuition. We believe that the government should consider using this aspect of its spending on higher education as well as its funding of institutions to effect any shift it might wish to bring about in the balance between the various objectives of the system.

65. If, therefore, the Government accepts that an initial two years of higher education based on carefully planned general "core plus modules" courses is a useful way of producing manpower of the quality required to meet the needs of the economy as well as for meeting more general educational needs, it should consider adjusting its student support system accordingly; that is, by providing maintenance grants and free tuition to all qualified students only for the first 2 years of higher education. For the third and subsequent years, however, students should have to meet their own maintenance and tuition costs, although they should be eligible for Government-guaranteed loans for both.

66. We recognise that this represents a radical change to our system of student support and appreciate that any proposal which appears to treat students less generously and thus to limit educational opportunity is likely to generate strong opposition across a wide spectrum of political opinion. We therefore recommend that our proposal should be introduced gradually, perhaps over 10 or more years. At first students should be required to meet their own maintenance costs but should continue to be provided with free tuition. Gradually, fees should be introduced for all courses in such a way that at the end of the transitional period the fee payable for each course would reflect the full cost of providing it. Charging full cost fees would expose the costs and benefits of tuition beyond the second year to the test of the market so that courses which do not meet this test would decline. It would be up to employers to pay for special core qualification which they value, either by setting salary levels so that the courses attract students

or, if rigidities in their pay structure prevent this, by sponsoring courses and/or students which meet their needs. Charging for tuition would also encourage institutions to compete for students and would give students an incentive to choose carefully which of the many specialised options and post-graduate courses on offer were likely to be most relevant to their future employment prospects. By their third year, they should be in a position to do this.

67. The Government should be aware, however, that to produce the benefits claimed for them, full cost fees require a labour market which is capable and willing to adjust to take account of new circumstances. This is because unless salary levels, etc, move to reflect the cost differences between courses, the effect of full cost fees would be to threaten seriously the more expensive science and technology based courses. The Government must therefore use the transitional period to monitor carefully the behaviour of the labour market. If it appears that rigidities in it are preventing the necessary adjustments from taking place, it may be necessary to reconsider the phasing programme. But the Government must not make too much of its intention to keep a close eye on developments. If it wishes the market to make the necessary effort to adjust to full cost fees, it must present its commitment to them as firm and settled.

68. DES has previously considered a half grant/half loan system in place of existing maintenance awards. For a typical student on a three-year course, this scheme would result, assuming the loan is fully taken up, in a debt of about £2,500 per typical student on a three-year course. Under our scheme, a student on a two-year general course would face no financial burden. A student on a three-year course of the traditional kind would be required in the early years of our scheme to take a loan to cover the cost of his maintenance during this third year; typically, about £1,600. But once our scheme was fully operational, he would have to raise a much larger amount as he would have to pay also for the full cost of his tuition. The likely size of his tuition bill is difficult to assess at this stage as we make other recommendations aimed at improving the efficiency of teaching; i.e. at reducing costs. On the basis of current cost levels, however, the recurring expenditure costs for universities are estimated to be about £3,500 for classroom based subjects

and £5,500 for laboratory based subjects. For advanced courses in polytechnics, the comparable costs are about £3,000 and £4,000. In the first year of our scheme, therefore, the third-year student would have to take a loan for £1,600; ultimately, the burden on the student on a specialised three-year course could be of the order of between £4,000 and £7,000. (These sums are significantly higher than the costs now faced by students in other European countries, but not out of line with fees in Japan and the USA).

#### Scholarships for the Brightest

69. These funding arrangements should exert considerable pressure on the higher education system to move in the direction of meeting its economic and, through its encouragement of two-year general courses, also its wider educational objectives. We must not, however, run the risk of throwing the baby out with the bath water in the sense of going so far that the highest academic standards and, in particular, the research base, of our system are seriously threatened. To protect high standards, the academically most able students in all disciplines should be eligible for a limited number of bursaries or scholarships to cover their full-time maintenance and tuition costs beyond the second year, including post-graduate study. These should be awarded by a body largely comprised of academics, perhaps a sub-committee of the new academic advisory body proposed above. It is essential to limit the number of these scholarships, if the inevitable tendency for standards to be devalued progressively to the point where these new arrangements come to replicate the present grant system is to be resisted.

Chapter Ten

Improving the Information Flow

70. The proposals set out above have been aimed at increasing the responsiveness of the higher education system to the needs of the economy and to the more general educational needs of the country. We hope that they will have the effect of making students, too, more responsive to these needs. But responsiveness is a two-way relationship; if the higher education system is to respond as we wish it to, we must ensure that the messages it receives are clear, consistent and in line with the ends we seek to achieve.

71. As far as wider educational aims are concerned, it is mainly for the Government to ensure that the flow of information is adequate. As for the needs of the economy, employers, including the Government as a major employer, must take the lead. More particularly, they must act through the market by ensuring that initial salaries, promotion prospects and other conditions of employment reflect their assessment of the relative value of various skills. They must also express their needs clearly through the general statements issued by their trade associations, professional institutions, the CBI and other bodies. They must seize the opportunity of membership of the UGC, the NAB and other national bodies to put the employer's case on teaching, course development and other matters as forcefully as possible. Finally, they must forge close links with particular institutions by serving on governing bodies, seconding staff as managers and part-time visiting lecturers and by sponsoring courses designed to meet special needs.

73. Central to our proposals is the need to ensure that relevant information passes freely between potential students (in school and elsewhere), between institutions and employers (broadly defined) and between employers and schools. There are at present serious deficiencies in all these areas but, to some extent, our previous recommendations should improve the quality and flow of information. In particular:

- (a) SEPs will provide public information to intending students and employers about the objectives and achievements of each institution and give details of the contacts which that institution has with outside bodies;
- (b) Our proposals for student financing will provide incentives to industry and commerce to enter the market for loans or sponsorship in a cost-effective way;
- (c) The combined operation of our new economic and employers' advisory body and the Educational Venture Fund will enable best practice on information to be disseminated and, occasionally, funded.

74. But more needs to be done. One of the most important problems is the strength of the link between the traditional sixth form and higher education and the way in which this link encourages academic interests almost exclusively. In order to develop alternative links between young people and the higher education system, we propose the following:

- (a) The MSC should ensure that those on YTS and TVEI receive complete, up to date and comprehensible information on opportunities in higher education (including FE courses leading to higher education); they should use the numbers progressing to higher education as one of the criteria for judging the success of these schemes;
- (b) DES should ensure that School-Industry link programmes build bridges to appropriate higher education courses;
- (c) DES should consider exploiting the unique position of tertiary colleges. The mixing of academic and vocational streams within them can create a climate in which all pupils are aware of a wider range of possible next destinations.

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75. In addition, the provision of careers advice to those intending to enter higher education requires substantial overhaul. Among the proposals which we believe should be considered are the following:

- (a) The Government should fund the publication of a national compendium of information, similar to Occupational Outlook in the United States, which lists up-to-date information on graduate destinations, employment rates and salaries by degree course and institution. DES should ensure that publicly funded institutions collect this information for publication. The SEP might be used for this purpose. We commend the practice of some universities of sending to schools a report on the progress of their former pupils after their first year;
- (b) Local Careers Services should be encouraged to provide all schools with details of further education courses available to their pupils, scores needed for admission to them and the destinations of local children leaving them. We have seen some excellent examples of this;
- (c) In schools, enthusiastic and well informed careers teachers are the key to good advice. They should have clear responsibility for advice, over and above that of departmental heads. They should be appropriately graded and be encouraged to visit higher education institutions in the area and beyond. DES should consider issuing a strong circular to LEAs along these lines;
- (d) In Colleges of Further Education the quantity and quality of advice depends crucially on the Careers Service. Exhortatory efforts to increase the number of specialist officers in further education have failed. We recommend that DE considers directing each LEA to designate a certain proportion of its officers as further education specialists.

76. We are conscious that the points made in (b), (c) and (d) above may appear secondary to the problems that youth unemployment poses for careers teachers and advisors. For that reason, we would see merit in considering them in the context of a wider investigation of the place and role of careers teaching and advice to young people.

77. We mentioned the role which would be played by our new economic and employers' advisory body and by the Educational Venture Fund in improving the quality of information about the world of work coming from employers. The Occupational Outlook exercise would also help. In addition, we propose the following:

- (a) DES and DE should commission further research into the qualities which employers require of graduate recruits with a view to assisting with the interpretation of the confusing signals which are sometimes given by individual recruitment decisions;
- (b) The NEDC Sector Working Parties, as part of their continuing task of promoting best practice in British industry, should disseminate information to industries on the detailed manpower effects of technological change. The Engineering Council should undertake a similar task;
- (c) SEPs should be used as a method of increasing the importance accorded by higher education institutions to the contribution that their Appointments Boards can make to the planning of courses, etc. There is far too little feedback from employers to academics through these Boards.



Chapter Eleven

Improving the Quality of Management

78. By making higher education institutions more responsive to nonacademic considerations, our proposals would place substantial burdens on the management structure of institutions. The Government should encourage systematic management training for those with management responsibilities in higher education and should consider using public funds for this purpose. In addition, we believe that the following proposals would also encourage better management and a heightened concern for efficiency:

- (a) Government support towards the teaching costs of higher education should be based on the estimated reasonable costs of providing a particular type of course. Institutions with higher costs should have to make charges or raise private finance to cover the extra cost or make savings elsewhere; institutions with lower costs should be able to keep the "profit", provided that they can prove that their "quality" has not been lowered;
  
- (b) The Government should use the power implicit in setting the level of publicly funding teaching costs to exert pressure on institutions to achieve more efficient use of teaching staff and overheads; eg, lower staff/student ratios. The Public Accounts Committee in 1980 pointed out the scope for such savings in the universities when it drew attention to the range of staff/student ratios and to the fact these can vary by as much as a factor of 3 even within a single subject. In the public sector, the HMI are now specifically looking at productivity and have concluded that in many subjects a 25-30 per cent tightening of the staff/student ratio within 3 years is feasible without loss of quality;

- (c) The Exchequer and Audit Department should be encouraged to conduct a rolling programme of value for money audits of publicly funded institutions. In addition, institutions should be required to publish costs and performance indicators on an annual basis.

Easing Change

79. Better managed institutions should be able to change the mix of courses they offer more rapidly than at present. This should enable them to meet more effectively the changing course preferences of loan/financed students responding to market signals and to cope better with the effects of the greater choice of courses and institutions which our proposals should produce. To put on new courses within limited resources, they will have to be able to discontinue existing courses at relatively short notice. (Credit transfer would enable them to send students to other institutions to undertake courses which are discontinued). This will inevitably mean redundancies. These are costly in any organisation but are particularly so in universities because of tenure. We therefore recommend that the DES, when considering applications for new charters and at other times, should continue its present policy of discouraging conditions of employment such as tenure which impede restructuring so that in due course institutions will not offer tenured posts except where these are funded entirely from private sources.

80. In addition, we recommend that the Government should set up a restructuring fund to cope with the "one-off" costs of retraining surplus staff or for compensating them. The fund should have a limited life of say, 5 years; the case for extending its life should be subject to review without any presumption that it should continue. More permanent arrangements are needed also to permit DES (or some agent) to act as a kind of academic receiver for departments which, in the view of their institution, are no longer viable. This would ensure that students were able to transfer to other institutions to complete courses on which they had already embarked. (Credit transfer would help here too). The funds realised by disposing of part of an institution's assets could be used to re-finance restructuring.

Chapter Twelve

Implications of our Proposals for Public Expenditure

81. Our proposals for improved careers advice in schools, in further education and in higher education, together with our proposals for extending the coverage of maintenance grants to part-time students and in other ways all have implications for public expenditure. So do our suggestions for an Educational Venture Fund (EVP) and a Restructuring Fund. The size of the Restructuring Fund is difficult to assess, but we are inclined to be suspicious of some of the wilder estimates of the cost of restructuring. Mitigation of damages will account for much of the projected earnings of lecturers. Our best guess is that a staff reduction in the region of 15 per cent over 5 years would cost some £50 million a year. Assuming an EVP of about £25 million a year, we estimate that our proposals would in total add less than £100 million a year to public expenditure in the initial five years. The sums involved thereafter would depend largely on the success of the EVP proposal and whether it becomes a permanent and significant part of the higher education scene.

82. Our proposals for student support involved the replacement of maintenance grants beyond the first two years by loans and the phased introduction of tuition fees which would also be covered by loans. If these loans were financed by Government, public expenditure would be reduced as repayment built up. In addition, to the extent that commercial or employer sponsorship developed, expenditure savings would emerge immediately. The exact size of the public expenditure reduction would depend on the number of bursaries/scholarships awarded, but ultimately the savings would be of the order of £½ billion per year. Our proposals for reducing costs and improving efficiency should also result in savings in public expenditure.

83. In short, we believe that in the longer term, once the restructuring and adjustment costs have been incurred, the effect of our proposals, by reducing student support and lowering unit costs, would be to reduce the pressures on Government finance for higher education.

Postscript

84. Our present system of higher education has become hallowed by generations of tradition, personal loyalty, memories and myths. There is thus tremendous inertia in it, further buttressed by the mutual reinforcing links which have been forged between it and the specialised school curriculum. Overcoming this inertia so as to be able to implement the changes necessary to make the system more responsive to changing needs will require far more than exhortation. It will require sustained and strong pressure from the Government over many years. But given the almost total dependence of higher education institutions on public money, the Government has a powerful lever by means of which to exert this pressure. Many will argue that to use public funds in this way is to threaten "academic freedom". We accept that this is a test to which our proposals must be put, but we are confident that they can pass it successfully.

Summary of Main Recommendations

85. The general aim of our proposals is to achieve a new balance between the academic, economic and educational objectives of our higher education system with a view to increasing the contribution which the system makes to our economic performance and to widening educational opportunity. To this end, we propose the following:

(a) Funding institutions:

- (i) The total block grant distributed to each institution in both the university and the public sector should be separated into its research and teaching components so that the size of each part can be fixed according to criteria most appropriate to it (paras 40-41);
- (ii) The judgement as to the balance between academic considerations and wider economic and educational goals which must underlie the decision about how much money should be allocated to any particular institution should be made by the Secretary of State (para 43);
- (iii) To advise the Secretary of State in making the judgements referred to in 85(a)(ii) above, two new bodies should be established; viz, a group of academics to advise on academic and educational matters and a more widely based group of employers and others charged with advising on employment and economic matters. The advice provided by each body should normally be published (para 43);
- (iv) As one of its first tasks, the academic advisory board should be invited to study ways of evaluating the quality of university courses and how they are taught (para 44).

(b) Statements of Educational Policy (SEPs)

- (i) Every 3 years each publicly funded higher education institution should be invited to submit to the Secretary of State a statement of its educational policy of objectives (we call this an 'SEP'). SEPs should be prepared within national guidelines issued by the Secretary of State after consulting his two new advisory bodies (para 48);
- (ii) Each SEP should contain a report on the extent to which the objectives which the institution had undertaken to pursue in its last SEP had been met. SEPs would inform the Secretary of State's judgement about the allocation of funds to individual institutions (para 51);
- (iii) To encourage innovation, an Educational Venture Fund (EVF) of say, £25 million a year should be established out of which the Secretary of State would be able to fund the testing and development of new ideas (para 53).

(c) Course Structure, Content and Access

- (i) The "core plus modules" approach to course development should be developed as a way of meeting economic needs and increasing educational opportunity (para 54);
- (ii) Institutions should be encouraged to develop, and students encouraged to take, two-year "general" courses, based on the "core plus modules" approach, leading to a certificated and graded degree (para 56);
- (iii) The Government should press for more rapid development of credit transfer (para 57);
- (iv) The Government should use its financial leverage to persuade institutions to accept a wider range of entry qualifications, including qualifications in vocational education (para 58);

- (v) A study should be made of various entry criteria, including the use of aptitude tests and credits for relevant work experience as a way of helping those who leave school at 16 but who would benefit from higher education later in life (para 60);
- (vi) Institutions should be encouraged to provide more flexible study arrangements so as to attract students who are paying their own way; eg, part-time and evening courses (para 61); a programme of grants for part-time study should be considered (para 62);
- (vii) The level of grants available for mature students should be reviewed and their availability be extended to a wider range of sub-degree courses (para 62).

(d) Funding Arrangements for Students

- (i) To encourage the development of two-year general "core plus modules" courses, students should have to meet their own maintenance and tuition costs beyond their second year of higher education, although they should be eligible for Government-guaranteed loans for both (para 65). This change in our present arrangements should be introduced gradually, perhaps over ten years or more, and should be carefully monitored to ensure that the labour market was reacting appropriately (paras 66-67);
- (ii) To protect high standards, the academically most able students in all disciplines should be eligible for a limited number of bursaries or scholarships to cover their full-time maintenance and tuition costs beyond the second year, including post graduate study (para 69);

(e) Improving the Information Flow

- (i) A number of steps should be taken to develop new links between young people and the higher education system as a way of supplementing the traditional links through 6th forms (para 74);
- (ii) The provision of careers advice to those intending to enter higher education should be substantially overhauled and we make a number of proposals for consideration (para 75);
- (iii) The quality of information coming from employers about the world of work should be improved and we offer suggestions for doing this (para 77).

(f) Improving the Quality of Management

- (i) The Government should encourage systematic management training for those with management responsibilities in higher education and should consider using public funds for this purpose (para 78);
- (ii) In order to increase the ability of institutions to respond quickly to changing needs, the DES should continue its present policy of discouraging conditions of employment such as tenure which impede restructuring (para 79);
- (iii) The Government should set up a restructuring fund to cope with the "one-off" costs of retraining surplus staff or for compensating them (para 80);
- (iv) Arrangements are necessary to permit DES (or some agent) to act as a kind of academic receiver for departments which are no longer viable. This would enable students who have embarked on courses in such departments to complete them (para 80).



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**THE BLACK ECONOMY**

A report by the CPRS

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CHAPTER 1 - INTRODUCTION

**Structure of report**

1.1 In commissioning this study of the black economy, the Prime Minister asked for as thorough an assessment as possible of the facts; and she referred particularly to the relevance of the black economy to enterprise, the will to work and unemployment. In this report we look at the nature of the black economy (this Chapter); at its composition and the mostly quixotic attempts which have been made to quantify it (Chapter 2); and at its worth (Chapter 3). We also consider how some at least of the energy manifested in it could be harnessed to the white economy (Chapter 4). Finally we examine ways of controlling its size through enforcement (Chapter 5). A summary of our conclusions is provided in Chapter 6 along with a list of our recommendations.

**Definition**

1.2 First we need to make clear what we mean by the phrase 'black economy': it is commonly used as if it denoted something obviously separate from normal economic activity, but on closer examination the boundaries turn out to be imprecise and shifting.

1.3 By 'black economy' we mean that part of the production of goods and services in exchange for money (or money equivalent) which is not declared to the authorities, and where there is underpayment of tax or overpayment of social security benefits. We thus include for example -

- a. The full-time self-employed window-cleaner who earns enough to be liable for income tax but is unknown to the Inland Revenue: he is a 'ghost'.
- b. The ambulance driver, paying tax on his regular income, who also undertakes building work in his spare time, and avoids tax on his income from that source: a 'moonlighter'.

- c. The self-employed businessman who understates his earnings and overstates his expenses in his tax return.
- d. The prosperous company director who charges some of his living expenses to the company.
- e. The immigrant garment worker for whom no income tax or national insurance contributions are paid.
- f. The restaurant waitress who declares only a fraction of the tips she receives.
- g. The 'unemployed' worker who works to increase his family's income above the level of social security benefit he receives, and does not declare the extra income: 'working and drawing'.
- h. The owner of a large house who does not declare rent income from letting some of its rooms.

1.4 There is no received definition of the black economy and we have drawn the boundaries of this study in the way which seemed most sensible to us. So our definition excludes some activities that others might have included - for example the huge amount of unpaid work that takes place within households, families or communities. All this adds to the national product, in some unquantifiable sense, but is not taxable. We have devoted some considerable space to tax evasion, none to tax avoidance (which is legal). We have not made a special study of pilfering and other criminal activities although taxability may be an issue. We have not looked at certain types of social security fraud (such as giro cheque fraud) where paid work is not involved.

1.5 The Inland Revenue believe that the bulk of tax evasion is committed by moonlighters (example b in paragraph 1.3 above) and by the self-employed (example c); together these groups may be concealing between £8 bn and £12 bn of their income, or between 4 per cent and 6 per cent of GDP in 1981. As we see later the other components of the black economy are relatively small; for instance the 'working and drawing' component (example g) may amount to no more than £½ bn or ½ per cent of GDP (see paragraph 2.14).

1.6 The examples in 1.3 by no means exhaust the variety of people and trades involved, or laws and regulations broken. They do however illustrate an important point. The black economy is not the prerogative of one section of society. Its practitioners (and its customers) are to be found in the pages of 'Who's Who' as well as on the unemployment register. If, in current usage, the typical member of the black economy is the man providing cheap house maintenance services in return for cash, it is perhaps because he is the newest and most visible recruit. What is new is not the service he performs, but the fact that, with the lowering of the level at which income tax is paid compared with the average wage, he has in recent years become liable to tax. (In 1938-9 fewer than 4 million people were assessed for income tax; today the figure is over 20 million). The black economy is as old as taxation itself. But it is only since the second world war that, by bringing the vast majority of the working population into income tax, the Government has itself widened enormously the scale of potential tax evasion. (The introduction of VAT has had a similar effect, by increasing the number of taxable transactions.) Thus the single handed house painter or plumber has, for the first time, the chance to join the much older ranks of the tax evaders and the welfare scroungers.

#### **The two faces of the black economy**

1.7 If an essence can be distilled from the wide variety of black economy activities, it is that of challenge to the state, not only as grinding tax-collector but also as faceless bureaucrat, mindless regulator and hostile purveyor of charity. In classical economics, efficiency depends on a free market bringing the wishes of producers and consumers into concordance. A worker will work hard and long to the extent that the wages he obtains make up for his effort, and the employer will pay them up to the point where they equal his marginal product. Taxation, or loss of benefit as earnings increase, make this concordance impossible, since the worker brings home less than the employer pays. Distortions to the free market are also imposed by regulations, by form-filling, by employment protection and general interference. From this point of view, the black economy is in a sense a pure economy, freed from the trammels of the state; the archetypal entrepreneur is the 'ghost'. Nor are these advantages merely theoretical. Anecdote, for want of a better source, suggests that at least some black economy workers

do a better job, more quickly and more cheerfully, than their tax-paying competitors. Part of this may be due to satisfaction at beating the system, but part also to the fact that 100 per cent of the extra amount earned can be kept. It is not the case that the only good work is done in the black economy, but some of it is. Even 'working and drawing' shows that some people are prepared to go out and market their services successfully in bleak conditions of high unemployment.

1.8 Seen from this point of view, therefore, the black economy reminds us of how (in certain respects only) economies once worked, and of where the state may have gone wrong. Perhaps the extreme example of this is the Soviet Union, where the economic regime is so oppressive, complicated and inflexible that a large black economy must flourish if the economy is to work at all. In the West, much of the vigour and resilience of the Italian economy is said to come from the 'black' manufacturing sector. In this country the black economy is unlikely to be crucial to our economic survival, but it might be a nursery of human resources for economic resurgence. And if it helps to make formal unemployment more bearable it may have an important social function.

1.9 But there is another side to the story. Few people would be prepared to see the state wither away. Most people would agree that we need defence forces, even though there is argument about their nature and extent. Similarly, we need law courts and police; and most people want some provision of education, health care, and financial support for the very poor, and some regulation, eg of child labour. There is disagreement about the extent of state activities, and pressure to push them back after the growth of earlier decades. But again there is general acceptance of our democratic system and the laws of the land as the framework for arguing over the extent of state responsibility, and hence there is also acceptance of taxation as the means to pay for it. In other words, most people who want, for example, adequate defence forces are also in principle willing to contribute their fair share of the cost of defence through taxation. Tax evasion and welfare fraud both increase the tax burden borne by honest members of the community, thus making them poorer and increasing market distortion. Moreover, a trader

who is evading tax can charge a lower price for his goods than is possible for his honest competitor. The latter's resentment is well founded, and he may find himself forced to choose between curtailing his business or evading tax himself, thus further increasing the burden on honest tax payers.

1.10 There are thus two fundamentally different approaches to the black economy. One sees it as a useful antidote to state interference, with useful side-effects; the other as a fraudulent attempt to slide out of paying a fair share of taxation while continuing to enjoy its fruits. Most people's attitudes probably contain elements of both approaches. For example, it seems to be a fairly common view that tax should be paid on ordinary earnings in the day-time, but that there is not the same obligation to declare income from overtime and second jobs. Actual behaviour is affected not only by moral beliefs but also by the perceived likelihood of getting caught and paying a penalty. People may find their way in to the black economy through sheer inertia or ignorance and then stay in for fear of being caught coming out. They may nevertheless resolutely condemn other parts of the black economy. Contrariwise, citizens who are entirely honest in their own tax affairs may condone or encourage dishonesty in others, for example when asked to choose between a higher price for a service including VAT, or a lower price, payable in cash, no questions asked. And while there is often strong antagonism to 'working and drawing', not least from honest neighbours who do not have the benefit of two incomes, there is also sometimes opposition to the 'snooping' and other methods of enquiry which may be necessary for its detection.

#### **A way forward**

1.11 This public ambivalence, sometimes verging on muddled thinking, about the black economy is an important political fact, since it is likely to limit the Government's freedom of action in the area. It is tempting to suggest a way out of the ambiguity. The present Government, it could be argued, has gone a long way in its attempts to cut down the unnecessary burden of the state. Maybe there is more to be done; but now people should obey the law and pay their taxes honestly so that the total tax burden can be spread as widely and therefore as lightly as possibly. But this argument on its own will have little effect on people's behaviour. Other means at the Government's disposal for

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tackling the black economy are also likely to affect the problem only at the margin. We believe therefore that it would not be useful to try to reach a firm conclusion whether the black economy as a whole is a good or a bad thing. Instead our approach will be to look at particular facets. Where they have potential value, are there ways in which the benefits can be transferred to the regular economy? Will they then do better, freed of the constraint of concealment? Where there are harmful features, can a simplification of the structure or a rearrangement or strengthening of controls lessen the damage, or would the costs outweigh the benefits? It would be wrong to expect instant solutions. Equally, it would be wrong to decide in advance that no policy changes can be made, not least because the black economy is in effect a creation of government itself.

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## CHAPTER 2: WHO PARTICIPATES IN THE BLACK ECONOMY? HOW BIG IS IT?

2.1 The black economy is to be found everywhere: we cannot here do justice to its width and complexity. We shall briefly outline some characteristics of the main groups operating within it.

2.2 The self-employed and small owner-run companies frequently evade taxes - for example by underdeclaring their profits and turnover, by drawing on the takings for personal use and by use of property belonging to the business. These enterprises are largely in the services sector (eg retail distribution and household services such as plumbing) and in construction. Preliminary results from an Inland Revenue study of a sample of self-employed traders are that up to 20 per cent of them give clear indications of significant evasion, 40 per cent show weak indications and the remaining 40 per cent show no indication of evasion. After investigating suspected traders the Inland Revenue obtain settlements in which the amount of under-declared profits agreed with tax payers is, on average, about £2,000 pa, or 40 per cent of declared profits, but the true amount of under-declaration is likely to be significantly larger. On this basis Inland Revenue estimate that the total amount of under-declared profits by the self-employed may be as much as £2.5 bn pa (see paragraph 41 of Annex A for details of their calculation). They will be able to provide firmer estimates in 1983 when their sample study will be complete. Customs and Excise have a similar experience. They discover under-declaration of VAT by over 37 per cent of registered traders, with cash traders being particularly prone (eg 46 per cent of pubs); the average amount of VAT under-declaration in these cases is in excess of £1,000; they believe that the total amount of VAT evaded is in the region of £200m to £400m a year.

2.3 Inland Revenue believe that there is relatively little evasion by employees in relation to the earnings from their primary employment because most employers meet their obligation to deduct tax and national insurance contributions through the PAYE system. Evasion is limited mainly to cases where employer and employee collude, eg by paying wages in cash and not reporting them, and by abusing the provisions that allow casual workers to be paid without deductions. Other examples are waiters under-reporting tips and employees inflating their expense accounts.

2.4 By contrast moonlighters (people doing a second job) constitute a large part of the black economy. Some moonlighters do of course pay their taxes, but many of them conceal part or all of their secondary earnings. The Family Expenditure Survey reports that about 9 per cent of the employed population have a second job and the true proportion may be much higher. A very high proportion of these second jobs, perhaps 90 per cent, are in the services sector, and they are mostly done for a few hours a week or irregularly. The majority of moonlighters work for somebody else (eg as a barman or petrol pump attendant) but a third or more are running their own business on a part-time basis - anything from hairdressing to servicing cars. Some will be using this as a trial period before setting up in business full-time.

2.5 'Ghosts' are mainly people who trade on their own account but manage to keep their activity secret from the Inland Revenue, often for many years. This may be quite widespread. For example the Inland Revenue recently discovered that nearly 20 per cent of the taxi drivers in one city were ghosts, many of them earning around £8,000 a year but paying no tax. Some ghosts are likely to be registered as unemployed and claiming social security benefits. Others, especially those with substantial earnings, may feel that claiming benefits exposes them to unacceptable risks of being detected; they will be among those who are classified as unregistered unemployed. A third group of ghosts will be among those classified as economically inactive; many of these will be married women and pensioners with concealed earnings, often on a small scale from part-time or casual work. The numbers of ghosts falling into these three categories are unknown but many of them probably evade national insurance contributions, as well as income tax, by concealing their activity from the Department of Health and Social Security (DHSS).

2.6 An Inland Revenue list of the more commonly found activities of ghosts and moonlighters is given in Table 2.1. Very little of their activity seems to fall in the manufacturing sector. This is probably because it is difficult to conceal a manufacturing activity in this country. Small manufacturers usually have to sell to other firms who are registered for VAT and the VAT procedures will lead Customs and Excise from the latter to the former. Thus small manufacturers will become known to Customs and Excise and they

Table 2.1: Some examples of 'ghosts' and moonlighters encountered by the Inland Revenue

Hawkers  
Driving Instructors  
Mobile caterers  
Ice cream vendors  
Newsrounds  
Building repairs etc  
Back garden nurseries, poultry  
Private garage car maintenance  
Printers  
Pub/Club entertainers  
Collectors' fairs  
Saturday markets  
Mobile discos  
Fairgrounds  
Mobile hairdressers  
Franchisemen - Hometune etc  
Canvassers - Double glazing, wall insulation etc  
Contract cleaners  
Car traders  
Carpet fitters  
Professional football clubs - agents, scouts, turnstile stewards  
Football referees - local leagues  
Wholesale news deliveries  
Sub-contracting monumental masons  
PSV license holders - private coach operators  
Out workers, especially in garment trade  
Private medical care, including fees for certificates  
Professional services, eg architects  
Draughtsmen  
Taxi and mini-cab drivers

probably assume, wrongly, that Customs and Excise will automatically inform the Inland Revenue of their existence. Also the use of premises and the employment of labour are likely to attract attention. So small manufacturers are unlikely to try to operate completely underground although they can much more easily evade tax by under declaring their profits.

2.7 One tax where evasion is very small is rates. In 1979-80 the outstanding bills for domestic and non-domestic rates amounted to £95m, which is only about 1½ per cent of the total rate bill, and some of this arose from bad debts rather than evasion.

2.8 Working and drawing is a rather different form of black economy activity in which an individual conceals earnings from the Department of Health and Social Security (DHSS) or the Department of Employment (DE) in order to masquerade as unemployed and fraudulently to claim social security benefits. The scale of the fraud varies widely from those who are running highly profitable businesses (eg a roofing contractor) to those who occasionally earn a few pounds (eg as a gardener). The large scale defrauders are probably cheating in other ways by not paying income tax, VAT and national insurance contributions. But the small scale defrauder presents a problem to DHSS or DE only since his earnings are likely to be below the tax and national insurance thresholds (but above the levels that are disregarded in assessing benefits).

#### **The size of the black economy**

2.9 By definition the black economy consists of activities which are unrecorded by the authorities. There can therefore be no official accurate and comprehensive statistics of its size.

2.10A direct approach to measuring the black economy would employ survey methods. The obvious problem is that most people who are active in the black economy will wish to conceal their activities and will therefore refuse to participate in surveys or will give false information. For this reason most of the analytical studies in this field have used indirect methods based on indicators such as -

-the gap between income and expenditure-based measures of GDP in the National Accounts;

-the amount of currency in circulation;

-the value of transactions in the economy.

2.11 A summary of these studies is provided at Annex A. There we conclude that none of the studies (which give widely different estimates of the size of the black economy) provides a reliable answer. Each study is based upon one or more crucial assumptions that cannot be checked independently; different, but equally plausible, assumptions lead to quite different answers. Furthermore some of the studies cover only part of the field.

2.12 Some conclusions are however possible. In brief they are -

a. The black economy probably accounts for between 5 per cent and 10 per cent of GDP. Greater precision is impossible.

b. Just as there is no reliable measure of the size of the black economy so there is no reliable indicator of how it has developed over time. It seems probable however that it has grown gradually over the last 30 years as the tax system (direct and indirect) has embraced more people and more transactions.

c. There is no convincing evidence that the black economy is more (or less) likely to grow during periods when the official (white) economy is expanding than in periods when it is shrinking.

d. Public awareness of the black economy has grown sharply in recent years but this does not imply a major change in its size.

2.13 Even on this rather tentative basis it is clear that there is a huge loss to the Exchequer from tax evasion, although views differ about its precise nature and extent. Much depends upon the assumptions to be made about whether,

and how, the tax burden on the white economy would be lightened if the black economy were to pay its proper taxes. Also assumptions have to be made about the size of the black economy, the tax rate it would face and the consequent disincentive effects, its propensity to spend and other factors. One approach is to assume that the present average effective rate of income tax in the white economy, which is about 25 per cent, would also apply, on average, to the black economy. If we further assume that the size of the black economy is in the middle of the range we consider plausible, ie  $7\frac{1}{2}$  per cent of GDP, or about £16bn in 1981, the first-round tax loss would be about £4bn. But there are quantities to be offset against this figure. First some black economy income already finds its way to the Exchequer: that portion of black economy income that is spent on consumption will incur indirect taxes and will increase earnings in the white economy which will then be subject to direct taxation. One analysis\* has suggested that this second-round tax gain might amount to one quarter of the first-round tax loss, or £1bn on our assumptions. This leaves us with a net tax loss of about £3bn. Another important offsetting second-round effect, which is much more difficult to quantify, is on the supply side; if the black economy faced the disincentive effect of full taxation some of its activity would reduce. But similar second-round effects apply, in a reverse direction, if we assume that tax collected from the black economy would be used to finance a general cut in tax, with effects on the white economy. If the Government could ever capture the tax evaded by the black economy, then it could consider a general tax cut of £4bn - which is about one seventh of the present income tax burden on the white economy. Some of this, perhaps £1bn, would find its way back to the Exchequer through taxes arising from the extra expenditure on consumption. The improvement in incentives would increase activity and thereby broaden the tax base. We discuss the second-round effects more fully in Chapter 3.

2.14 Information about the size of the 'working and drawing' component of the black economy has improved recently as a result of the work of DHSS's newly formed Specialist Claims Control (SCC) teams. These teams visit local offices

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\* A Peacock and C Shaw, 'Calculating the Revenue Loss from Evasion' Journal of Economic Affairs, July 1982

and typically investigate perhaps the most suspicious 5 per cent of the unemployed who are receiving benefit in that area. Typically between 30 per cent and 70 per cent of the people investigated withdraw their claim or have their benefit stopped or reduced; strong evidence of fraud, of the undeclared earnings variety, is obtained in most of these. In some cases the amount of revealed earnings is small but in the majority of cases it exceeds the total amount of benefit entitlement. A minimum estimate of the registered unemployed who are secretly working is thus around 2½ per cent of the total.\* The full extent of 'working and drawing' is unknown but it is likely to be larger than this minimum, and probably much larger, due to activities among the 95 per cent of unemployed benefit recipients who are not investigated by the SCC teams. It is quite plausible that, say, 10 per cent of those receiving benefit as unemployed are not entitled to it. In this case the annual loss to the Exchequer might be about £500m and the unemployment register would be inflated by some 300,000.

#### Could we find out more?

2.15 The only way to obtain reliable estimates of the size of the black economy would be to carry out widespread random checks on the honesty of the citizens. (At the moment checks are confined to cases where there are grounds for suspicion). The United States Internal Revenue Service (IRS) carries out a Tax Compliance Measurement Programme which does involve both random checks on the innocent and passing IRS information to other organisations - both of which actions would be illegal here\*\*. However we do not believe that a comprehensive system like the American one would be justified here because we do not believe that the Inland Revenue, or government generally, needs to know, to such a degree of precision, the size

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\*The Rayner scrutiny on Payment of Benefits to Unemployed people suggested a minimum estimate of 8 per cent on similar grounds but this was based upon the more limited data that was available then.

\* The US authorities can justify the methods of their Tax Compliance Measurement Programme because they have a system of self assessment and it is accepted that this needs some form of audit. Using their methods they have estimated that the US black economy represents between 6% and 8% of the GDP, excluding illegal sources of income.

of the black economy. Operationally it is enough for the Inland Revenue to know, as they do, that the extent of tax evasion is considerably larger than the amount they discover by their investigation work; thus, as we describe in Annex B, they can be reasonably confident that any extra effort or improved technique that they apply to their investigation work is likely to prove worthwhile. This confidence is confirmed by their experience that the point of diminishing returns from investigation work has not yet come into sight.

2.16 As for social security fraud, the Rayner scrutiny on Payments of Benefit to Unemployed People recommended that measurement of the incidence of fraudulent claims be conducted as a matter of urgency in 1981. Ministers accepted this recommendation in principle, but a direct approach would have to include the investigation of random samples of benefit recipients displaying no prior evidence of fraud; many of these would be completely innocent. The objections are obvious and DHSS Ministers have been understandably cautious; they have not yet sanctioned a direct measurement study. But there are good reasons why Ministers should ascertain, roughly, the incidence of 'working and drawing', in particular to assess the adequacy of the current anti-fraud procedures in the processing of benefit claims. The only really reliable way to do this is by the direct approach mentioned above. A less controversial method, though giving less reliable results, would be to extend progressively the scope of SCC investigations in experimental areas so as to include an increasing proportion of the cases giving some grounds for suspicion whilst still leaving untouched those cases where there are no grounds at all for investigation. From the proportion of these additional cases that were found to be fraudulent it would be possible to calculate a much improved estimate of the size of the fraud problem; if the incidence of detected fraud was found to decrease sharply as more cases were brought progressively into the investigation net then we could be more confident in assuming a negligible incidence of fraud in the apparently innocent cases not now investigated. We recommend that Ministers sanction an experiment along these lines if they judge the direct approach to be unacceptable.



CHAPTER 3:

THE EFFECTS OF THE BLACK ECONOMY ON THE WHOLE ECONOMY AND ON SOCIETY

3.1 If there is a lack of hard information about the size of the black economy, even more do we lack firm data about its economic and social impact. But some progress can be made by arguing from first principles.

3.2 The black economy is not a separate ghetto. There are, it is true, some trades where tax evasion and 'working and drawing' are particularly extensive: for example the building industry, scrap metal dealing, taxi driving, and catering and hotels. But there are also honest people in these trades: and black economy practices are far more widespread.

3.3 Starting from the existing tax burden and tax and welfare systems the black economy can be regarded as receiving a subsidy, equal to the amount of tax it should but does not pay plus the amount of benefits it should not but does receive.

3.4 One possible effect of the subsidy is that the black economy operator charges a lower price to the customer. In the extreme case, all the benefit may be passed on to the latter; if for example no VAT is paid a service can be offered for 13 per cent less than the regular price. More often part of the subsidy will go to lowering prices and part will be retained as increased earnings. A restaurant, for example, whose casual employees pay no tax or national insurance contributions, can undercut the prices of honest competitors and still retain more profit. The honest competitors may then be forced to lower their prices. In turn lower prices will bring two kinds of benefit. Sometimes they will increase customers' demand for, and consumption of, the product; sometimes they will enable them to spend more on other goods as well, with a multiplier effect.

3.5 Alternatively black economy operators may keep all the subsidy as extra income, eg taxi drivers who are constrained to charge a fixed tariff. They may then save more; they will almost certainly spend more. They will pay Value Added Tax on many of their purchases; and through multiplier effects other people's incomes, and the taxes they pay (if they do), will also increase.

3.6 The likely outcome, considering only the results of the subsidy, will be to increase real national income by more than the amount of the subsidy, to increase somewhat the incomes of black economy operators, and to decrease somewhat the prices of their products and thereby increase the consumption of these products.

3.7 But the subsidy has to be paid for. Let us assume that public expenditure and the PSBR are held constant and that the cost is borne by honest taxpayers paying more tax. As a result of the extra tax, net money incomes and expenditure in the white economy will be lower than if there was no black economy, and prices higher. Here too there will be multiplier effects, this time working in a constricting direction.

3.8 The negative consequences for the white economy of having to shoulder the tax burden of the black economy may not exactly cancel out the positive consequences of the latter's subsidy. Elasticities of demand, propensities to save etc may vary between the two sectors. But there is no a priori reason to expect that national income will be higher or lower nor that the overall rate of inflation will be affected. The distribution of disposable income between individuals will be different and to the extent that it diverges from the distribution envisaged in the tax legislation, and is contrary to what Parliament intended, it will be inequitable. The composition of expenditure and output will be different; roughly speaking, sectors where the black economy is more pervasive will be larger at the expense of sectors where it is not.

3.9 Some of these effects may be illustrated by looking at an individual case. Let us imagine a self-employed 'ghost' plumber. He earns £15,000 a year, and saves himself tax and other contributions amounting to say £5000, his subsidy in the terms described above. Part of this is passed on to his customers in the form of lower prices, undercutting his white economy competitors.

3.10 Now let us suppose that the Inland Revenue catch up with him, after he has advertised in a local paper to attract more custom. In future he will have to pay tax; and he will have to work harder to pay his arrears and any penalties levied; (Inland Revenue usually set penalties at levels that are not so great as to bankrupt traders). He therefore becomes part of the white economy, losing his subsidy. To the extent the market allows, he will raise his prices to help pay tax, and demand for his services will somewhat fall. He will be worse off, and so, from the point of view of plumbing, will his customers. For some of them his services will be too expensive and they may forego them altogether. But if they spend less on plumbing, they will spend more on something else. And the white economy will have slightly less tax to pay, and will therefore be better off. If, as is less likely, the plumber gives up in disgust, rather than work and pay taxes, he may become unemployed and start drawing benefit. But some demand for plumbing will remain. Thus some new employment and (perhaps) another job will be created. Whether it will be filled by someone leaving the unemployment register, or out of the black economy, will depend partly on local sentiment about the likelihood of getting caught. Furthermore to the extent that demand for plumbing falls because of higher prices demand for something else will rise.

#### **Dynamic effects**

3.11 The black economy also has dynamic effects, on the ease with which small businesses may be set up, and possibly on company size and efficiency.

3.12 The "subsidy" which the black economy offers may prove a powerful incentive to set up one's own small business - whether as a part-time moonlighter or whole-time. (We do not suggest that the scope for tax evasion is the only lure of the black economy; there may also be a psychological attraction, as well as an aversion to form filling and other aspects of bureaucracy.) Small black economy enterprises fulfil many useful functions, and not only for their customers. Individuals are given opportunities to exercise qualities of responsibility, enterprise and industry, which are denied them when employees. The black economy worker may indeed develop his business to the point where he wishes to employ others. The black economy could be seen as a nursery for small vigorous firms. Freed of bureaucratic interference, form filling, and employment, health and safety regulations as well as tax, the black economy 'ghost' is a one-man enterprise zone.

3.13 On the other hand, the black economy's freedom from the normal burden of taxes may lead to serious distortions. The moonlighter may put lots of effort into his second job to the detriment of his main employer. And he may close off a job opportunity for one of the unemployed. He may resist changes in working arrangements sought by his main employer, eg in rosters or shifts, because of his moonlighting commitments. In some fields - eg building - larger firms in the white economy may, despite their overheads, in principle be able to operate more cheaply and efficiently than small firms. But the gains from specialisation and economies of scale can be more than offset by the black economy firm's ability to evade taxes. By patronising or tolerating the black economy we may be discouraging efficiency.

3.14 Indeed some sectors such as small scale building services may become so deeply penetrated by the black economy that the white - whether the small, honest firm or the larger firm which would find it much more difficult to evade taxes - is driven out. Small scale electrical work or plumbing, for example, may well become the exclusive preserve of the black economy firm. But the small black economy firm which wants to grow may be imprisoned by its need for secrecy: if it becomes too large detection becomes certain. The black economy may therefore impose unnecessary rigidities on the market. There may develop a gap between larger white economy firms and smaller black economy ones; a customer may not be able to find an established firm willing to do a small contract, yet he may not want - or know how to find - a black economy firm. There may be similar harmful effects on employment: small, black economy enterprises may not be able to expand their workforce without risking detection, while large firms do not take on workers to do small contracts.

3.15 We do not intend to suggest that there is always competition between white and black economy firms or that the former are always at a disadvantage. Sometimes there is no clash. The lady who runs a black economy business providing home hairdressing for old age pensioners may be rendering a useful service which her clients could not otherwise afford. Her and her customers' gain is not the loss of the High Street hairdresser.

3.16 Another kind of distortion occurs when workers who are on strike during a dispute in their official employment are able to compensate for their loss of wages by working in the black economy, either temporarily or as an intensification of regular moonlighting work. Anecdotal evidence suggests that this can sometimes be a factor in determining how long workers hold out in a prolonged strike.

3.17 The black economy might also be thought to have a useful dynamic effect on the level of prices and wages in the economy generally. Black economy prices can be lower, and non-tax paying workers should be willing to work for lower wages. On the other hand, we point out in paragraph 3.7, these effects will be counterbalanced by higher prices and wages in the rest of the economy. The black economy is likely to be less prevalent in manufacturing and in internationally traded services, given its need for unobtrusiveness and small-scale operations. Hence, a growth in the black economy may raise prices and wages in the internationally traded sectors of the economy (thus reducing international competitiveness), while lowering them in other sectors, which will be encouraged to expand.

3.18 Interestingly the effect of the black economy in Italy is rather different, favouring the internationally traded sector. Compared to the situation here the Italian black economy appears to be much more active in the manufacturing and trading sectors but less so in services, especially household services\*. Often, it seems, black economy firms and individuals act as suppliers and sub-contractors to larger white economy manufacturing and assembly firms. Thus a major effect of the black economy 'subsidy' is to make Italian traded goods more competitive in international markets. Moreover the small black economy manufacturers operate outside the social security, safety, and labour regulations; the workforce may consist of the members of

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\* By contrast to the United Kingdom, most urban Italians live in apartments in large blocks, usually rented. Thus at least some of the household services that would be bought here by individual house owner-occupiers and supplied by black economy operators would, in Italy, be bought by property owning companies who could engage registered white economy contracting firms and record the transactions, as tax-deductible costs in their accounts.

one family and the 'factory' may be in someone's home. Thus their overheads are low, there are no trade union restrictive practices and they can respond flexibly and efficiently to changing patterns of demand for their products. This in turn benefits their customers - the larger white economy firms - who, if they had to undertake the work of their black economy suppliers themselves, would have to bear more of the pain of adjusting to changing demand and would cope less well.

#### **National statistics and economic policy**

3.19 The figures for Gross Domestic Product in the national accounts are lower than would be the case if the whole of the black economy were included, although the Central Statistical Office is able to adjust for part of its effect. Unemployment is overestimated because of the working and drawing problem. These inaccuracies are sometimes politically harmful, presenting the state of the nation as worse than it really is. Unfavourable international comparisons can be made. But other countries' figures may be no less misleading than ours on this account (some, eg Italy's, will be more so); and there are many other factors distorting such comparisons (eg differences between countries in the extent of unpaid household work). For practical policy decisions the inaccuracies probably do not matter much because the most relevant statistics are those describing the movements in output, unemployment etc, over the short and medium terms, rather than their absolute values. The black economy will not seriously distort the statistics on movements unless it grows or shrinks rapidly over the same period and out of phase with the white economy, which we do not believe; in any case other errors are likely to dwarf those arising from the black economy.

#### **Social effects**

3.20 Little is known about the non-economic effects of the black economy, either on its members or on society as a whole. They are likely to be as disparate as the black economy itself. Some researchers have pointed out the beneficent effects for social cohesiveness. Some black economy goods and services are provided not only or even mainly for profit, but are part of a network of mutual obligation and helping out. On the other hand, the black economy may lead to harmful secretiveness, or to laying oneself open to blackmail. It may sometimes have its own moral code, but it is not likely to foster respect for the law. And it often harms and annoys honest citizens, who may blame the government for not taking action to bring it under control.

3.21 Working and drawing is a form of black economy activity with a rather different social effect. It is probably much smaller, as a total, than tax evasion (see paragraph 2.14). It can be regarded as more immoral than tax evasion because it often requires more deliberate acts of deception, because it appears to be closer to direct theft from the state and because it represents abuse of a quasi-charitable welfare benefit. On the other hand it can be regarded as more excusable, or at least understandable, because the amounts of money involved are often much smaller and because if benefit recipients declared their earnings many of them would experience effective tax rates of 100 per cent or worse; these high tax rates occur because, as earnings increase above the (very modest) disregard levels, Supplementary Benefit is abated £ for £, other benefits may be lost entirely and national insurance contributions and income tax become payable. Moreover, at a time of high and growing long-term unemployment, concentrated in particular areas and groups, undeclared odd jobs or more regular work in the black economy may alleviate poverty and so provide a useful safety valve for the pressures which may build up, as well as an introduction to work and perhaps to particular skills. It would be better still if these jobs could be provided in the regular economy, but this may be difficult, not least because of benefit rules such as low disregards. More clamping down on offenders without other changes in the system would be likely to lead to increased social pressures.

3.22 Potentially, there would be a much more serious negative social effect if the black economy grew so much that more and more of the white economy was unable to compete, gaining a momentum that could be stopped only by the most drastic measures. We might then be in danger of suffering the kind of social damage experienced by Italy. There the tax subsidy in the black economy is so large and tax and social security payments bear so heavily on the white economy that honest private sector firms find it hard to thrive and a large portion of the white economy is dominated by large, heavily subsidised, state-owned enterprises. The government machine itself cannot function properly. Civil servants are forced to supplement their meagre incomes by moonlighting, to the extent that their main jobs are often entirely neglected, and corruption is encouraged. All this increases the pressure on honest firms to cheat before they are driven under. Ironically, if the black economy

were to expand greatly in this country we might suffer the same kind of social damage as in Italy but because the structure of our black economy is so different we would probably not enjoy the compensatory economic benefits, especially to the trading sector, that occur in Italy and which we described at paragraph 3.18.

3.23 In chapter 5 we describe how the revenue and benefit departments are improving their ability to enforce compliance and we offer some suggestions of our own for further improvement. In these circumstances we doubt that there is a real threat of a black economy take-over in this country. We do however see one cause for concern. While most people may have strong moral beliefs on some matters, tax honesty apparently comes rather low on many people's scale of values. (This attitude, so far from being a reflection of a decline in values, may be as old as taxes themselves.) What keeps many people on the path of tax probity, therefore, is less moral beliefs than lack of opportunity and the fear of being found out. For tax liable to collection by PAYE the opportunities for evasion are small, unless the employer colludes, and the system is policed by the Inland Revenue auditors. But the scope for employees to evade tax on secondary earnings, moonlighting, is enormous and they need have little fear of detection in most cases. The opportunities are also good for the self-employed. They can understate income, overstate expenses, delay and obfuscate. They can find accountants who will help them. And provided they keep their misstatements within reasonable limits, the likelihood of their being found out is small, and they know it. Some of them, 'ghosts', can even go to the extent of keeping their entire activities secret. Even if they are found out, the penalties are generally so pitched as to be bearable. Working and drawing has also appeared to be a fairly safe activity, at least until recently. This climate of deception is not a healthy one, nor necessarily a stable one. Accordingly we return to this subject in Chapter 5.



### Conclusions

3.24 Our conclusions about the economic and social effects of the black economy are -

- i. its short term economic effects are to stimulate some activity in sectors pervaded by the black economy but to depress activity in other sectors (which are effectively bearing the tax burden evaded by the black economy) and there is no good reason for believing that the net effect on national income and inflation will be good rather than bad;
- ii. it redistributes income between individuals in a way that was not intended by Parliament in the tax legislation, and that is regarded by many people as unfair;
- iii. in the longer term it has a number of dynamic effects on the economy, both good and bad: it can facilitate enterprise and the creation of small business but it can also distort market forces, inhibit the development of firms and favour parts of the service sector at the expense of the manufacturing sector;
- iv. although black economy activities will sometimes have good social effects, the moral attitudes involved are not healthy ones;
- v. national statistics understate output and overstate unemployment but not to an extent that matters much for practical economic policy decisions;
- vi. although there appears to be no immediate prospect of the black economy taking over the white, if such a takeover were to occur, the negative effects would outweigh the positive ones.

## CHAPTER 4: HARNESSING THE ENERGIES OF THE BLACK ECONOMY

4.1 Thus the black economy represents a large amount of economic activity, in itself for the most part desirable, that becomes anti-social and even harmful because it escapes the taxation that it should bear. In this chapter we consider how far it may be possible by policy changes to legitimise black economy operators or to encourage them to enter the white economy. In the next chapter we discuss possibilities for better enforcement of the tax and benefit laws.

**The tax and benefits systems**

4.2 The present levels of earnings that are disregarded in assessing benefits for the unemployed are low. No Unemployment Benefit is paid for days when earnings exceed £2. For Supplementary Benefit the amount of weekly benefit is reduced £ for £ for earnings (net of certain in-work costs) above £4 a week. These rules are consistent with the view that the benefits are intended to compensate for loss of earnings. But they provide very little incentive for someone to take up and declare part-time work where the earnings would be above the (very low) disregard level but less than or equal to the benefit level. Consider, for example, a married man with two children on Supplementary Benefit who receives about £60 a week. He has little monetary incentive to take a part-time job paying, say, £40 a week (net of in-work costs) since £36 would be deducted from his benefit. Worse still, since part-time work can sometimes lead to full-time work this lack of incentive causes people who might otherwise progress to full time employment to remain on benefit and to be inactive. Thus honest people will be discouraged from seeking work. Meanwhile less honest people will choose to work and conceal earnings so as to maintain their benefits at maximum value, thereby entering the black economy.

4.3 In the long term these and similar problems could be alleviated by reform of the tax and benefit systems so that loss of benefit and payment of tax increase smoothly in relation to gross earnings so that at all points the effective marginal tax rate is at a tolerably low level. But the scope for change in the short term is limited. Nor may the reform prove attractive even in the long-term; there are a number of difficulties including the necessity to increase the burden on some taxpayers.

4.4 A feasible short term change, which we favour, is to increase the earnings disregards for benefits. This and several other changes were considered by a working group of DHSS and DE officials on "Benefits for Unemployed People". The Working Group concluded that the case for raising the disregard for Unemployment Benefit is not strong at present because there appears to be a lack of awareness of the full scope of the present disregards and the availability of in-work benefits. Accordingly the group recommended that steps be taken to increase this awareness.

4.5 The Group concluded that there is a good case for increasing the Supplementary Benefit disregard for unemployed people who have been on this benefit for a year or more to the lone-parent level (£4 completely disregarded plus half earnings between £4 and £20). The Group also favoured paying the long term rate of supplementary benefit to the long term unemployed. They decided that it would be wrong to adopt both measures together and they preferred paying the long-term rate, mainly on welfare grounds. On black economy grounds the latter measure is not particularly attractive; the improvement in benefit might be sufficient to entice a few benefit recipients to forego their black economy earnings, but for many more the main effect will be to extend the range of earnings which are worth concealing and thereby increase the attraction of the black economy. Thus on black economy grounds we would prefer the proposal to increase the earnings disregard to the proposal to pay the long-term benefit rate. (In the CPRS report on Unemployment we commend the disregard proposal on employment grounds.) We recognise that increasing the disregard would increase Exchequer cost considerably because those who currently declare their earnings and have their benefit abated £ for £ would receive more; but there would be offsetting savings, which are very difficult to forecast, from the reduction in working and drawing and from the increase in the number of unemployed who would seek and ultimately obtain part-time and possibly full-time work.

4.6 Some other reforms of the tax and benefit systems are considered in the CPRS Report on Unemployment. They would improve work incentives by reducing the sharp peaks in effective marginal tax rates that occur in the present system. They should also have a useful, though limited, effect on the

black economy since some people would have less incentive to conceal marginal earnings at points where the effective tax rate is very high. People who would fall into this category are mainly the 'unemployed' who are working and drawing. Most black economy operators, however, would not fall into this category and would continue to gain considerably by evading some or all of their tax liability.

4.7 The changes referred to in paragraphs 4.5 and 4.6 are desirable but they would make only a minor contribution towards legitimising the black economy. More progress in this direction could be made in the short term by raising income tax thresholds. Unfortunately a major impact could be achieved only by very large changes, massively reducing the income tax yield, which are unlikely to be affordable at least in present circumstances. In the longer term a smoother rise in marginal tax rates, as described in paragraph 4.3, is the more effective reform. We have considered whether there is a case for specific tax concessions, directed at the trades most pervaded by the black economy. But we can see no good economic or social reason for favouring these trades. Although it might at present be easier for household plumbers to evade tax than, say, haulage contractors, this is not a reason for taxing them less.

4.8 The sector of the economy comprising small firms and self-employed traders - part of the "secondary sector" of the economy described in the CPRS Report on Unemployment - is, we believe, particularly prone to penetration by the black economy. Growth of the secondary sector could well lead to a larger black economy and loss of tax revenue. But, as the Government has recognised in its adoption of a wide range of policies to help small businesses, growth here is desirable for a number of reasons. In the Report of Unemployment, the CPRS develops the theme that a larger secondary sector will be particularly beneficial for overall growth and jobs in the economy as a result of increased flexibility to respond quickly to market opportunities and to absorb shocks.

4.9 The moral is not that we should hold back in our efforts to develop small businesses but that policies in this field should as far as possible be tailored to producing a secondary sector which is not only vigorous and expanding but also legitimate.

4.10 We can distinguish two separate elements in the burdens which the state imposes on small business - particularly at the formative stage. The burdens in themselves may actually be relatively tolerable. (Little tax may be payable; the health and safety requirements, for example, may be quite reasonable and not expensive to implement). It may be the process of compliance - the form filling, the negotiation with the bureaucracy, and so on - that seems to present the greater problem. Many newly established businessmen will find this side of the business particularly daunting (because unfamiliar) and a diversion from more rewarding and productive tasks. The very prospect of such contacts with the bureaucracy may well encourage traders to go underground.

4.11 The simplest route to reducing the lure of the black economy is to reduce the burdens imposed by the state. This is being done in Enterprise Zones. The CPRS Report on Unemployment proposes several ways of reducing the regulatory burden on small firms more generally, for example in the field of employment protection. We believe that any measures that lighten the burden of running a small business will also lessen (perhaps only slightly) the temptation to run such a business clandestinely.

4.12 It is also important to help the emerging small businessman over the initial hurdles in dealing with the bureaucracy. The DoI Small Firms Advisory Service has a good record in this field, and further help is now available from the growing number of local enterprise agencies. The CPRS Report on Unemployment argues also that local organisations, particularly enterprise trusts drawn from the local business community, are probably more flexible and better suited than national bodies to provide help to small businesses.

4.13 Finally, it is relevant to draw attention here to the MSC's experimental Enterprise Allowance Scheme. This scheme provides a grant of £40 a week for one year to people on the unemployment register who want to start their own business and who can raise £1,000 of capital by their own means. This scheme almost certainly attracts some people who now claim to be unemployed but are trading, or who are about to trade, in the black economy. One of the implications of participating in the scheme is that the business is reported to

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the Inland Revenue and DHSS and will then pay at least some of its tax and national insurance liabilities; also the working and drawing problem will be reduced. This linkage between help from the tax payer and compliance with the law seems to us one of the most attractive features of the scheme.

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## CHAPTER 5: ENFORCEMENT AND MONITORING

5.1 We say (paragraph 2.12) that we think that the black economy accounts for between 5% and 10% of GDP. The potential yield to the Exchequer from better enforcement is thus very large. But the proportion which is detected amounts to roughly 0.3% of GDP. In other words the authorities are successful in catching up with 6% or less (possibly as little as 3%) of the total of the black economy.

5.2 Tax evasion, which constitutes most of the black economy, is a rather low risk enterprise. Nor is it generally regarded as being in the same moral category as many other forms of law-breaking and dishonesty. For these reasons among others the black economy may tend to grow. We set out in Chapter 4 some ideas for encouraging the transfer of activities from the black to the white economy, but these are likely at best to have a small effect.

5.3 In recent years the Government Departments most concerned with the black economy have put increasing efforts into detection and enforcement. (In Annex B we describe very briefly the resources and methods used.) We believe they have been right to do so and that in general these increased efforts have been amply justified. At the risk of repeating the analysis in Chapter 3 above, we emphasise that all direct taxes have disincentive effects and all indirect taxes reduce demand. While therefore tax evasion may raise incentives or increase demand in the sectors where it is practised, the evasion merely shifts the tax burden, with its penalties in terms of disincentives or reduced demand, on to someone else.

5.4 For these and other reasons, we consider that Government Departments should aim greatly to improve the rate of compliance with the tax and benefit laws. We think this can be done cost effectively and without unacceptable changes in the conventions and rules governing privacy. Our discussion covers the following main areas -

- i. review of recent important developments (5.5-5.13)
- ii. deterrence, including publicity (5.14-5.22)
- iii. declarations of secondary earnings by moonlighters (5.23-5.24)
- iv. information exchange between Departments (5.25-5.31)
- v. co-ordination of work between Departments (5.32-5.38)
- vi. monitoring the effects of enforcement (5.39-5.43)

#### **Present Enforcement Work**

5.5 In Annex B we describe briefly the resources and methods used by Departments to detect and deal with tax evasion and benefit fraud. There we note that the Departments are developing more cost effective techniques and are concentrating their attention more selectively onto the more serious evaders, where the yield is greater. We commend these developments and mention some of the more important ones below.

#### **The Inland Revenue's Enforcement Work**

5.6 The main recent developments in Inland Revenue's enforcement work are -

- The Black Economy Experiment in which extra staff have been deployed to detect ghosts and moonlighters by looking for signs of their activity in the economy (eg advertisements in newspapers, local authority registers of traders), (see paragraph 7 of Annex B).
- A more selective approach to investigating the self-employed using prior subjective judgements of the likelihood and size of evasion in individual cases (see paragraph 3 of Annex B).
- Extra staff deployed on PAYE Audit work with 'at-risk' employers being visited more often and investigated more thoroughly (see paragraph 6 of Annex B).

5.7 Although it is too early to evaluate the results of the Black Economy Experiment we draw attention to it because it could prove a very important guide for future action. The results so far suggest a very high incidence of ghosts working full-time in certain trades (eg taxi driving). Applying the



type of analysis given in Chapter 3 above, we think there is a very strong case for pursuing such people. The returns in tax collected will be high in relation to the cost of collection; and there is likely to be little public sympathy for such wholesale evasion. To judge from Inland Revenue's experience of them, most ghosts operate in trades where there are white economy operators also; in effect the black economy ghosts are competing against the white economy but with a hidden advantage. In some cases, eg taxis, the price to the consumer is fixed and all the benefit of evasion goes to the ghosts; in other cases some of the benefit may pass on to the ghosts' customers in lower prices. Either way there is a distortion of market forces which enforcement removes. Furthermore enforcement is unlikely to have the effect of suppressing the ghost's economic activity since, in most cases, his income net of tax will comfortably exceed the social security benefits he could claim if he became unemployed; also Inland Revenue normally arrange for the payment of tax owed and penalties to be spread out over a sufficiently long time to avoid bankruptcy. We would therefore expect the Inland Revenue to be able to plan an enhanced programme of work on this front when the results of their black economy experiment are available.

5.8 The experiment was in fact aimed primarily at moonlighters and initial reports suggest that it is succeeding in identifying a number of these, by new methods. The tax yield from catching an average moonlighter is much smaller than from ghosts and the case for deploying additional resources against moonlighters is therefore weaker. Moonlighters are however very numerous so that, although average earnings are small, the total at issue is perhaps the largest single component in the black economy. It is therefore necessary to preserve a credible deterrent against moonlighters.

5.9 We conclude that the recent improvements in Inland Revenue's enforcement work are wholly welcome. By concentrating on the more cost-effective forms of investigative work Inland Revenue are improving their performance against the more serious evaders, such as ghosts, where the case for enforcement is strongest.

**DHSS Fraud Work**

5.10 The DHSS have improved the cost-effectiveness of their work on social security fraud (see Annex B, paragraphs 11 and 12). The DHSS's concern to obtain high yields from fraud work, in terms of benefit savings, will tend to encourage fraud investigators to concentrate more of their effort on the more serious cases, where the amount of undeclared earnings, and benefit overpayments, are larger. We believe this emphasis would be right. Although the benefit claimant with small concealed earnings cannot be condoned, he is responding to a tax and benefit system that confronts him with an effective marginal tax rate of 100 per cent or worse. Accordingly we endorse the efforts that DHSS are making to improve the cost-effectiveness of their fraud work and we suggest that the cost-effectiveness principle should apply right down the management line so that investigators are encouraged to concentrate more on cases where the concealed earnings are likely to be larger.

5.11 DHSS's most striking success recently has been achieved by the Specialist Claims Control (SCC) teams (described briefly in paragraph 2.14 above). When the most suspicious 5% of those receiving benefit as unemployed are investigated, about half of them are found not to be entitled. The technique is therefore highly effective; but it needs to be handled with care. By definition it involves investigating considerable numbers of people who are innocent and the DHSS is rightly concerned about public opinion. Also it attracts opposition from the civil service trade unions. Nevertheless DHSS plan to extend the scope of SCC progressively; we support this plan.

5.12 If half of the most suspicious 5% of the unemployed on benefit are not entitled to it, there is a powerful case for investigating the next 'most suspicious' group. If the return there is also good, the number to be investigated should be increased again, and so on, until diminishing returns indicate a halt. The Department estimates that its yield from SCC work at present is about 5 times the cost, which is a better ratio than any other of its enforcement activities, and so there is probably scope for considerably more SCC work.

5.13 Moreover the programme is new. By careful monitoring of the results, the Department should be able to build up a much better picture of fraud - who is likely to commit it, the likely numbers, and so on; and so further increase the effectiveness of the drive against fraud.

#### Deterrence

5.14 Prevention is better than cure; we have therefore looked at the question whether more could be done by Departments to deter people from entering the black economy in the first place.

5.15 The Departments concerned believe that the best deterrent is a high detection rate. We agree that striving for high detection rates is a correct operational objective for the Departments but it does not go far enough, because:

- Detection rates are quite low in many areas of the black economy and there may be no practical and socially acceptable ways in which they can be raised more than marginally; to the extent that would-be offenders perceive this, the deterrent effect is poor and will remain so.
- Deterrence depends upon the public's perception of Departments' success in enforcement, which may be quite different from actual detection rates.

These considerations lead us to offer some suggestions for action which the Departments might take, in addition to their current efforts to improve detection rates. These suggestions have the merit of being relatively easy to try out and low in cost. If they do not succeed, little will have been lost.

5.16 Several of our suggestions could not be implemented without changes in the very stringent statutes under which the Inland Revenue operate or, in one case, without modifying Ministerial undertakings given at the time of legislation. However we note that the Keith Committee on the Powers of the Revenue Departments is expected to report soon, probably in October this

year. The Committee's recommendations may also point to statutory changes. We therefore suggest that if Ministers are attracted to our suggestions they should consider the case for making any statutory changes that are required in the context of their consideration of the Keith Committee's report.

5.17 We believe that there could be advantage in local publicity for successes in countering the black economy. The Inland Revenue are bound under their statutes to treat information about individual taxpayers' affairs as strictly confidential. But the statutes would permit a form of local publicity in which detected evaders were not identified by name but information was released on the types of activity they were engaged in, the amounts of evasion, and the nature of the settlement (tax, interest and penalties). Publicity could be given both to individual cases (with news value) and to groups of cases (eg 5 pop music groups in city x). The publicity should be designed, and the cases selected, with the aim of achieving the greatest increase in perceived detection rate. The Inland Revenue could experiment with different types of publicity in different areas and evaluate their effects. We recommend that the Inland Revenue consider giving local publicity for some of their successful investigations.

5.18 A potentially much more powerful form of publicity would be for Inland Revenue to divulge individual details of some of their most serious cases of evasion including the identities of the offenders. This would be controversial and would require statutory change. But such information would attract considerable media attention and so gain publicity. Also the deterrent effect might be strong, at least among those would-be black economy operators who would feel a sense of shame at being exposed publicly. We suggest that such publicity should be considered only for people who evade large sums, who make determined and persistent efforts to conceal income, who are demonstrably obstructive during investigation and who have attracted heavy penalties. We note that in Australia and New Zealand the tax authorities, operating under a different statutory regime, publish the identities of large numbers of detected tax evaders.

5.19 We have examined whether an equivalent form of publicity could be achieved by means of prosecution in the courts. At present Inland Revenue prosecute very few tax evaders, (only 204 cases in 1981/82 and most of these were complex company cases). The problem here is that income tax evaders would have to be prosecuted under the laws of criminal fraud and in nearly all instances it is very difficult, if not impossible, to establish a sufficiently strong case for deliberate fraud as opposed to negligence (which is not prosecutable).

5.20 Accordingly we recommend that the Inland Revenue should devise for Ministers' consideration a scheme for publishing individual details, including identities, of some of the more serious cases of tax evasion and should indicate what statutory changes it would require.

5.21 It is far easier to establish a case of criminal fraud for VAT evasion or for working and drawing than for income tax evasion. Consequently the proportions of detected VAT evaders and benefit offenders prosecuted by Customs and Excise, DHSS and DE are much higher than the proportion of detected income tax evaders prosecuted by Inland Revenue. Thus the former three departments already obtain good publicity for their enforcement successes through media reports of the results of their prosecutions. We believe that little, if any, extra publicity is needed. However we note that Customs and Excise do not normally prosecute cases involving less than £10,000 of VAT evasion; in these cases they offer the offender an alternative procedure, 'compounding', under which he pays an extra sum fixed by the Commissioners on top of the amount of VAT owed. We suggest that Customs and Excise consider the case for greater publicity for compounding cases (though not necessarily identifying individual offenders).

5.22 The DHSS has attracted, and continues to attract, much media attention for its present campaign against fraud. Rightly the DHSS is careful to minimise the amount of adverse publicity, particularly concerning the methods of the SCC teams (described at paragraph 2.14 above). At the national level we believe that there is little the DHSS could usefully add to this publicity for the purpose of raising perceived levels of risk; it is sufficient, we believe,

for DHSS Ministers to refer, from time to time, to the high success rates of the new methods, particularly the SCC teams. But at the local level some more publicity might help, although it would require careful and sensitive handling. Because of the existing public awareness of the effectiveness of the SCC teams we believe that the mere knowledge that an SCC team was about to visit an area might have sufficient of a deterrent effect to cause some fraudulent claimants to cease their claims, before waiting for the investigations to commence. We suggest that DHSS consider giving some advance local publicity to the impending arrival of SCC teams in selected areas on an experimental basis so as to assess the effect. Should the deterrent effect prove to be significant we suggest that DHSS might exploit it in two different ways:

- i. giving advance publicity to genuine full-scale SCC team visits;
- ii. giving advance publicity to 'token' SCC teams visits, in which the teams visit only briefly to conduct a small number of investigations.

A judicious mixture of i. and ii. would obtain the maximum deterrent effect from a limited amount of investigation.

#### **Moonlighter declarations**

5.23 Many moonlighters could, with some reason, claim that they are not deliberately concealing their secondary earnings from the Inland Revenue because the Inland Revenue have never asked them about secondary earnings. Only a minority (about a third in 1981) of taxpayers is asked to complete a tax return, in which they have to declare all sources of income. To save staff time the Inland Revenue do not normally send tax returns to people whose tax affairs appear to be sufficiently simple to be treated adequately by PAYE alone. Thus a moonlighter is unlikely to be sent a tax return if his primary employment is in the PAYE system and if there are no indications of complicating factors such as mortgage interest. Thus he will not have signed any declaration, such as that on the front of a tax return, that he has disclosed all sources of income to the Inland Revenue.

5.24 To some moonlighters who receive no tax return or other enquiry it might come as a genuine surprise to learn that they are under a legal obligation to take the initiative and inform Inland Revenue of their secondary earnings. Conceivably some moonlighters might declare some or all of their secondary earnings if they were given more encouragement to do so and if they were made more aware of their obligations. However we accept Inland Revenue's argument that sending tax returns to everyone would probably be far too costly a remedy in relation to the anticipated yields. A much cheaper step would be to include with the Notice of Coding or the P60 notice sent to PAYE taxpayers a very simple form, on which taxpayers would have to declare whether they did or did not have secondary earnings in the previous year. The form could be included at intervals of 5 years. Those returning forms which declared secondary earnings would need to be followed up. A possible sanction against people who failed to return forms after reminders would be to apply temporarily an emergency coding number on current PAYE deductions. Such a scheme could concentrate on primary employments known to be conducive to moonlighting (eg those with shift working). We understand that statutory changes would be required to underpin a scheme of this type. We recommend that Inland Revenue should devise a scheme for Ministers' consideration indicating the statutory changes required.

#### **Exchange of information between Departments**

5.25 Different departments often find themselves investigating the same people. Many traders who evade VAT also evade tax and some may also evade NI contributions. Probably most of the 'unemployed' who claim benefit and conceal their earnings from DHSS also conceal the earnings from Inland Revenue. Thus the Departments stand to gain considerably by exchanging information about their successful investigations. Yet very little of such information is exchanged. The Departments tend to regard the information they hold about individuals as confidential to themselves, including information gained from their investigations.

5.26 The Inland Revenue are under strict statutory obligations to keep their personal information about taxpayers to themselves; every member of their staff signs an undertaking to this effect. Their statutes permit Inland

Revenue to exchange such information in only two specific areas - some PAYE information with DHSS and some information with Customs and Excise. Customs and Excise staff treat the information they obtain from businesses as confidential although they sign no undertakings. In the course of taking benefit claims, DHSS and DE staff often acquire a great deal of personal information but the claimant is given an understanding that this will be treated as confidential.

5.27 It might seem natural that when citizens supply detailed information about their personal circumstances to these departments, on their tax returns and benefit claims for the normal purposes of assessing tax liability and benefit entitlement, the Departments should then treat the information as confidential.

5.28 But while we could accept the current limitations on exchange of detailed personal information supplied by citizens about themselves to the Departments we suggest that the same limitation need not apply to basic non-sensitive information (such as name and address and whether the citizen is economically active) nor to information gained by Departments solely from their investigation work. It seems odd, for example, that DHSS fraud investigators who establish, from their own work, that an 'unemployed' benefit recipient is concealing earnings and evading tax can then complete their work on the benefit aspects of the case in the fairly sure knowledge that the Inland Revenue will not find out about the tax aspects. Equally it seems curious that when the Inland Revenue detect ghosts, who probably evade National Insurance contributions as well as tax, they are not permitted to inform DHSS. To the public, even to the tax evader and benefit defrauder, it might seem strange that officials of one government department protect offenders in this way from their liabilities to another government department.

5.29 Since the introduction of VAT in 1973 Customs and Excise and Inland Revenue have been empowered to disclose information to each other but, as a result of undertakings given by Ministers at the time of the legislation, it has been limited to exchanges between their Head Offices about serious evasion. The only exception to this restriction is an experimental scheme for exchange



at the local level which has been operated at Leeds since 1977. The experiment has brought a significant amount of tax evasion to the attention of the departments; from the experience (and assuming that Leeds is representative) they estimate that the benefit to them of nationwide exchange of information would be a yield of the order of £5 million per annum. Ministers have said that they will consider extending the scheme nationwide in the light of the conclusions of the Keith Committee. We would go further and suggest that Ministers then consider the case for much wider exchange between the revenue and benefit departments, particularly the information gained in the course of their investigation work.

5.30 Exchange of information between Inland Revenue and DHSS would be particularly valuable in preventing, or inhibiting, the ability of ghosts to conceal themselves from one or other department. A ghost is likely to fall into one of the following categories:

- i. possesses a NI number and currently pays Class 2 contributions (self employed);
- ii. possesses a NI number and claims Supplementary Benefit by claiming to be unemployed;
- iii. possesses a NI number but currently pays no contributions;
- iv. does not possess a NI number and is unknown to DHSS.

Someone in category i. displays clear evidence of self-employment earnings and the DHSS would usually have a correct record of his address; if this information were passed to Inland Revenue they would be well placed to bring the ghost to light. A ghost in category ii. presents more difficulty since there is no outward indication that distinguishes him from a genuine unemployed benefit claimant; his true nature will only be revealed by successful fraud investigation by DHSS, at which point the information could be passed on to Inland Revenue to their advantage. Category iii. presents

two main difficulties. First there are a number of legitimate reasons why people (other than ghosts) may pay no contributions - they may have no earnings or their earnings may be below the national insurance thresholds. Secondly, DHSS face severe practical difficulties in tracing non-contributors many of whom have no good reason for informing DHSS of a change of address. So this category is unlikely to prove a fruitful field for investigation if information flow occurs in one direction only, from DHSS to Inland Revenue. But DHSS might stand to gain considerably if information also flows from Inland Revenue to them since some people will be self-employed, gaining income which they declare to Inland Revenue under Schedule D but which they conceal from DHSS in order to evade Class 2 national insurance contributions. DHSS suspect that very few people born and bred in the United Kingdom are likely to fall into category iv. but there may be a number of recent immigrants who do, including illegal immigrants. There are severe practical difficulties in identifying such people, although it is conceivable that some submit Schedule D returns to Inland Revenue.

5.31 If Ministers decide to implement statutory changes to permit exchange of information between the Inland Revenue and other departments then DHSS and Inland Revenue could explore the scope for co-operation in this area. The first step would be to analyse a sample of ghosts detected by Inland Revenue and a sample of their Schedule D cases to discover their social security status. The analysis, which itself depends upon information exchange, would indicate the value of conducting the exchange on a routine basis, ie for DHSS routinely to inform Inland Revenue of the cases it identifies in category i. and the detected fraud cases in category ii. and for the Inland Revenue to inform DHSS of Schedule D taxpayers.

#### **Co-ordination of PAYE and national insurance work**

5.32 Employers have cause to be surprised at the present procedures under which they are visited by staff from two government departments who independently inspect their records of deduction from pay:

- 600 Inland Revenue PAYE Auditors look at tax deduction

- 1,800 DHSS Inspectors look at deductions for national insurance

5.33 Although their concerns differ the two groups of staff examine much the same records. Employers who are deducting insufficient amounts of tax are also likely to be deficient on national insurance, and vice versa. It would therefore seem logical to employ one group of staff to check both types of deduction on a single visit, 'higher risk' employers being visited more frequently. Within a given total number of staff this should lead to a more effective programme of enforcement. Indeed this is one area of enforcement where we believe that the Departments, especially if they pool their resources, should be able to achieve a sufficiently high level of success to deter employers who are contemplating evasion.

5.34 A working group of Inland Revenue and DHSS officials has examined the scope for co-ordinating the work of NI Inspectors and PAYE auditors. They recommend a co-ordinated work scheme in which there are two levels of inspection:

i. by DHSS Inspectors: they would check both PAYE and NI deductions and correct irregularities of both kinds; they would attempt to visit all employers over time but the more 'at risk' employers would be seen more frequently;

ii. by PAYE Auditors: they would visit only a small proportion of employers, mostly those more technically difficult cases referred to them by the DHSS Inspectors and cases revealed to be more 'at risk' by the DHSS visits.

The effect of this scheme on employers is that 'good' employers would be visited by only one group of staff instead of two as at present and that 'bad' employers will be seen by two groups and, in some cases, more often than now.

5.35 We recommend that the Working Group's proposals for a co-ordinated work scheme for NI Inspectors and PAYE Auditors be accepted and implemented swiftly.

5.36 The Working Group also considered the more radical step of merging the two groups of staff to create a unified body of inspectors under either DHSS or Inland Revenue. The Group rejected this step because they considered that most of the benefits of joint working could be obtained from the scheme outlined above and that the (small) additional benefits from a fully merged staff group would be outweighed by the costs of bringing all the staff under either Department.

5.37 We believe that in the longer term the additional benefits from a fully merged staff group would outweigh any problems-probably transitory-inherent in the merger. We feel that a logical continuation of the co-ordinated scheme is the eventual merger of the two groups of staff under one or other department. We suggest that the case for a merger be re-examined when there has been sufficient experience of the new scheme.

#### **Overlap of Fraud Work by DE and DHSS**

5.38 We observe in Annex B (paragraphs 15 and 16) that the responsibilities of DE and DHSS overlap in cases of fraud by those who receive both Unemployment Benefit and Supplementary Benefit. We consider that the demarcation of work between the two departments needs attention and we recommend that they examine it.

#### **Monitoring the Effects of Enforcement**

5.39 We think it is important that the Inland Revenue should monitor the effects of their enforcement work upon taxpayers and, in particular, should identify cases where enforcement appears to lead to a reduction in economic activity. Although one's first reaction might be to restrain enforcement work where it appears to suppress economic activity, we suggest that a more appropriate reaction is to monitor the effects and then to consider the case for adjusting the tax burden by formal means.

5.40 An example of the kind of monitoring we have in mind is provided by a pilot study in which the Inland Revenue compared the profit performance of two groups of traders over a 3-year period. One group consisted of traders who had been investigated before the start of the period and for whom evasion had been established and settlements made. The other group consisted of similar traders who had not been investigated (and had given no cause for suspicion). Over the 3-year period the declared profits for the first group tended to keep up to the levels established by the investigation and were comparable with those of the second group. This suggests that enforcement did not suppress the activity of traders in the first group.

5.41 We recommend that the Inland Revenue should monitor the effects of improved enforcement in order to assess how far it leads to a reduction in activity by the taxpayers and to consider the implications, if any, for taxation policy.

5.42 The pilot study mentioned above also shows that during the 3 year study period 'recidivism' was low, ie that once found out the traders in the first group continued to declare profits and pay taxes at (reasonably) honest levels. Enforcement work of this kind, leading to (apparently) lasting reform is particularly cost-effective. The monitoring procedure we propose should, as a by-product, throw more light on this subject and thereby assist Inland Revenue to improve the cost-effectiveness of their work still further by developing procedures that elicit durable, rather than temporary, compliance.

5.43 In Annex B we mention other examples of the revenue and benefit departments using studies of this kind to assess the effects of their compliance work on offenders' future behaviour. We commend this approach and suggest that it could be more widely exploited to improve the overall value of enforcement work.

## CHAPTER 6: SUMMARY AND LIST OF RECOMMENDATIONS

6.1 In Chapter 1 we describe the variety of the black economy and point out how widely it is active within our society. Although the black economy is as old as taxation itself, the scope for tax evasion has widened greatly over the last 30 years with the vast increase in the number of taxpayers. One view of the black economy is that it is a pure economy, undistorted by taxes and regulations, where entrepreneurs flourish - often to the customer's advantage. The opposing view points out that the black economy fails to pay its share of taxation despite enjoying the benefits; and the extra tax burden is passed to the white economy. White economy traders have good cause to resent their black economy competitors who enjoy an unfair advantage. We point out that many people sympathise with both points of view; there is much ambivalence on the subject. This ambivalence limits the Government's freedom of action. We eschew a blanket approach; our aim is to try to build on the black economy's good points (or at least learn its lessons) while improving worthwhile controls.

6.2 In Chapter 2 we look at the composition and size of the black economy. Most of it consists of tax evasion, mainly of income tax. Much of the evasion is done by companies and self-employed traders who under-declare their profits and by moonlighters who conceal earnings from second jobs. An extreme form of evasion is practised by 'ghosts': people who manage to conceal their trades entirely and so pay no income tax, and often no VAT or national insurance contributions either. Another smaller part of the black economy comprises people with undeclared earnings who claim social security as 'unemployed' - the 'working and drawing' phenomenon. Much black economy activity appears to be in services (eg retailing and household repairs) and in construction.

6.3 Of its nature the black economy defies direct measurement. Several indirect methods have been employed, using a variety of more or less tenuous assumptions and giving a wide range of answers. However we conclude that the black economy probably accounts for between 5 per cent and 10 per cent

of GDP, or between about £10bn and £21bn in 1981. It has probably grown gradually over the last 30 years, both in absolute terms and as a proportion of GDP, as the tax net has embraced more people and more transactions. As to whether the black economy as a whole moves counter-cyclically, prospering when the white economy is in recession and suffering when it expands, or pro-cyclically, there is no convincing evidence; we suspect that some components of it react in one way and others in the opposite way. If the black economy were to pay its full taxes there could be a reduction in the tax burden on the white economy of the order of £4bn.

6.4 To measure the black economy much more precisely would require an elaborate and controversial programme of random checks on the honesty of citizens which we do not consider justified. The working and drawing component is a special case where we believe better measurement is needed and could be obtained by less controversial methods.

6.5 In Chapter 3 we look at the good and the bad effects of the black economy on the whole economy and on society. In the sectors where it is active it can lead to lower prices and increased output; but on the assumption that the cost of the black economy's tax evasion is reflected in higher taxes on the white economy, the latter suffers higher prices and lower incomes. On this basis there is no reason to expect that real national income will be higher or lower as a result of the black economy, or that the overall rate of inflation will be affected either way.

6.6 We point out that because of its very freedom from taxes, form filling and bureaucratic interference the black economy could be regarded as a nursery for small vigorous firms. But these freedoms create distortion in competition because they are not enjoyed by all. Honest traders may be forced out of business by black economy competitors even if they work harder and more efficiently. The manufacturing sector as a whole is penalised (to the benefit of the services sector) and that part of it that faces international competition is disadvantaged. And profitable firms, starting up in the black economy, may choose not to expand in order to evade detection. Finally, and most obviously, disposable income is redistributed between individuals in a way that differs from that intended by Parliament and is regarded by many as unfair; and a unhealthy climate of deception is fostered.

6.7 In Chapter 4 we look at ways in which the energies of the black economy might be diverted to the white. Part of the black economy could be legitimised by changes in the tax and benefit system that would remove people from tax or reduce the marginal rates they face. But the scope for change here is limited. Large tax concessions aimed deliberately at sectors most deeply penetrated by the black economy would obviously have much greater effects but there is no good economic or social reason why these sectors should enjoy such favourable treatment, which would be at the expense of other sectors.

6.8 The black economy will also be affected by actions that the Government could take to increase the numbers and activity of small businesses and self-employed traders. Sometimes the effect will be to shift activity from the black economy to the white, eg when traders come out into the open as a result of the regulatory burden being lifted or in order to benefit from Government-financed schemes. More often the effect will be a net growth in the black economy, by virtue of the greater numbers of small businesses and self-employed traders who, as a group, are prone to evasion. Thus there need to be adequate measures to limit tax evasion but without stifling enterprise.

6.9 In Chapter 5 we look at the steps taken by the revenue and benefit departments to improve the effectiveness of their enforcement work. We suggest that further desirable improvements could be made at little or no cost, by action in four areas:

- a. deterrence by means of publicity;
- b. declarations of secondary earnings by moonlighters;
- c. exchange of information between Departments;
- d. co-ordination of work between Departments.



Our specific recommendations are listed in 6.11 below. The main aim of the suggested action is to improve the Departments' ability (both real and perceived) to detect evasion so that would-be black economy operators may be deterred at the outset and may choose to enter the white economy instead. In two of the areas (b and c) the suggested action would, among other things, remedy some situations in which some people may at present be evading tax or national insurance contributions more by accident than by design.

6.10 Sometimes better enforcement of the tax regime will suppress economic activity (though this will be offset by greater activity elsewhere, in the white economy, if its tax burden is lightened). This is an inevitable feature of any tax regime. Of their nature direct taxes reduce incentives to work and indirect taxes reduce demand. The question for government is how to spread the burden between different parts of the economy, having regard to incentive effects, among others. We note that Inland Revenue have studied the effect of enforcement on a small sample of self-employed traders where evasion had been revealed by investigation; in these cases there appeared to be no sign of a subsequent reduction in trading activity. We suggest that Inland Revenue conduct more studies of this kind, over a wider range of their enforcement work, in order to assess its disincentive effects and to consider the implications, if any, for tax policy.

#### Recommendations

6.11 Our recommendations are listed below; the paragraphs where they appear in the report are shown in brackets.

- a. Ministers should sanction an experiment to measure the extent of working and drawing either by a direct survey approach or by extending progressively the scope of Specialist Claim Control investigators (2.16).
- b. On black economy grounds increasing the earnings disregard for Supplementary Benefit for the long term unemployed is to be preferred to paying them the long term benefit rate (4.5).

c. Recent and continuing improvements in the enforcement work of Inland Revenue and DHSS are to be endorsed and the cost-effectiveness principle should apply down the management line so that effort is concentrated on 'ghosts' and more serious benefit fraud where the concealed earnings are greatest (5.9 and 5.10).

d. DHSS's plan to extend the scope of Specialist Claim Control work should be endorsed (5.11).

e. In order to improve the deterrent effects greater publicity should be given to the Departments' successes in detecting cases of non-compliance; in particular consideration should be given to:

i. Inland Revenue giving local publicity for some of their successes but without identifying offenders (5.17);

ii. Inland Revenue devising a scheme for publishing the identities of some of the more serious cases of tax evasion (5.20);

iii. Customs and Excise giving greater publicity to compounding cases (though not necessarily identifying individual offenders) (5.21);

iv. DHSS giving advance local publicity to the impending arrival of Specialist Claims Control teams, on an experimental basis (5.22).

f. Inland Revenue should devise a scheme, for Ministers' consideration, in which moonlighters not now receiving tax returns would have to make a declaration about secondary earnings on a simple form (5.24).

g. Ministers should consider the case for increasing the exchange of information between Departments, particularly information gained from investigations and routine national insurance and Schedule D data (5.29 and 5.31).

- h. If Ministers are attracted to any of the recommendations e. ii., f. and g., which would require changes in the statutes under which Inland Revenue operate, they should consider the case for these changes in the context of their consideration of the report of the Keith Committee, due later this year (5.16).
- i. The recommendation of the official Working Group for co-ordinating the work of national insurance Inspectors and PAYE Auditors should be accepted and implemented swiftly (5.35).
- j. The case for a full merger of national insurance Inspectors and PAYE Auditors should be re-examined after sufficient experience of the co-ordinated work scheme, (5.37).
- k. The Departments of Employment and of Health and Social Security should examine the demarcation between them of benefit fraud work (5.38).
- l. Inland Revenue should monitor the effects on taxpayers of its improved enforcement in order to assess how far it leads to a reduction in their activity and to consider the implications, if any, for taxation policy (5.41).
- m. The revenue and benefit departments should conduct more studies that assess the effects of compliance work on offenders' future behaviour and should exploit the results to improve the overall value of their enforcement work (5.43).

## ANNEX A: STUDIES OF THE SIZE OF THE BLACK ECONOMY

A.1 Several attempts have been made to estimate the size of the black economy in this country. This annex describes and reviews them. Our conclusions are at paragraphs 48 to 52. The various methods used can be grouped as follows -

- macroeconomic
- microeconomic
- informed guesswork

**Macroeconomic Methods****Estimate based on National Accounts**

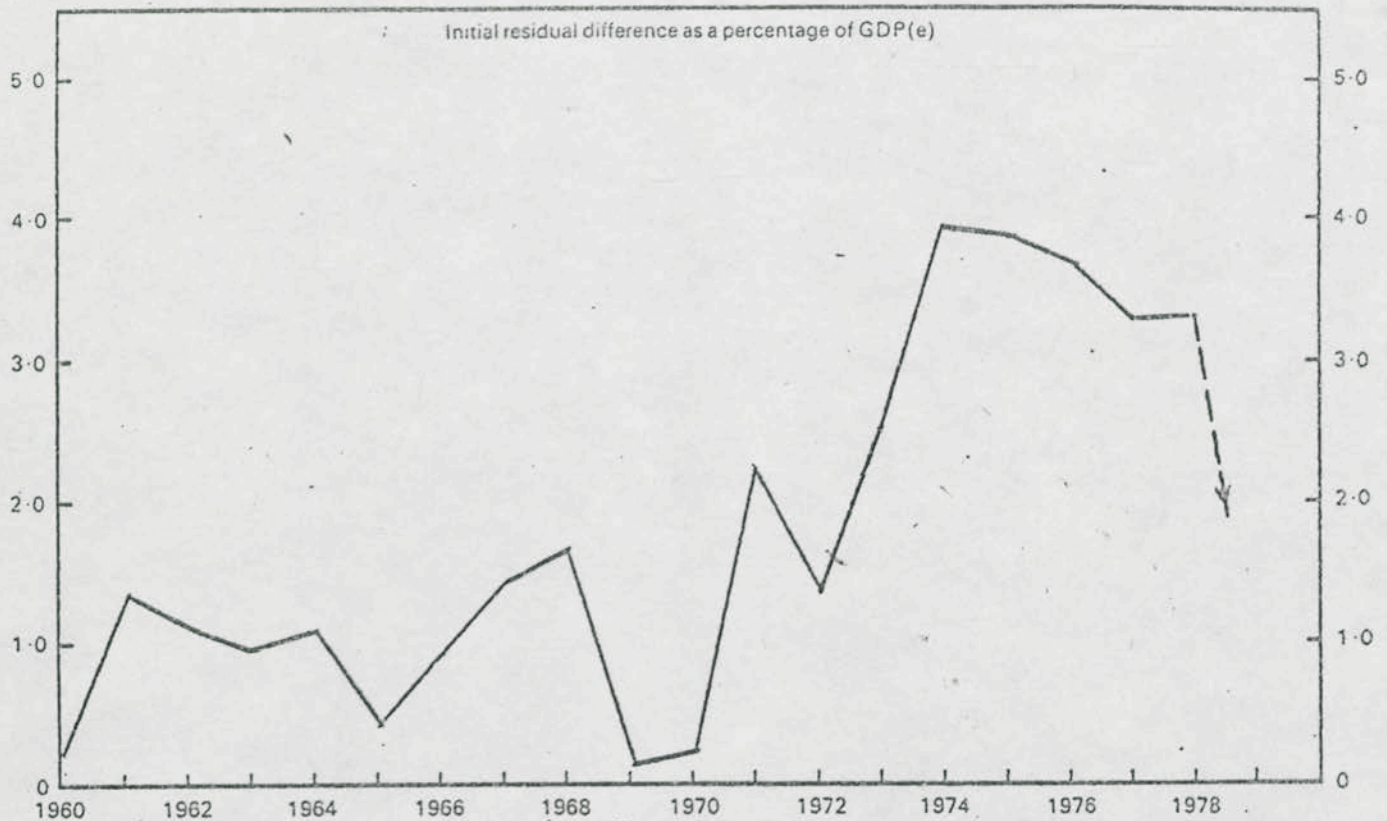
A.2 The Central Statistical Office (CSO) have attempted to use the different measures of GDP in the National Accounts to estimate the size of the black economy\*. One measure of GDP uses **income** data from official sources, mainly Inland Revenue. Income which is not declared to Inland Revenue will therefore not, in general, be included. The other measure uses **expenditure** data from surveys such as the Family Expenditure Survey (FES). A key assumption is then made that while people often understate their income to the Inland Revenue, participants in the FES will have no reason to under record their expenditure. In most years the expenditure-based measure of GDP exceeds the income-based measure by a small amount, which is called the Initial Residual Difference (IRD). It can be argued that the IRD tells us how much income is concealed from the Inland Revenue and thus how large the black economy is.

A.3 The IRD has varied considerably over the last 20 years, from close to zero in 1960, 1969 and 1970 to nearly 4 per cent of GDP in 1974 as shown in figure A.1 below. In their 1980 publication the CSO concluded that the size of the black economy in 1978, the last year for which they then had data, was around 3½ per cent of GDP.

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\*K Macafee, 'A Glimpse of the Hidden Economy in the National Accounts' Economic Trends, February 1980.

Figure A1: Initial Residual Difference (CSO Estimates)



A.4 The main weakness of this method is that it derives from a small difference between two large numbers each of which is prone to wide margins of uncertainty and measurement errors. The uncertainty is demonstrated by the number and size of revisions that CSO make to the National Accounts as new data become available and as different assumptions in the GDP calculations become more plausible. Since they published their 1980 paper CSO have revised their estimate of the IRD for 1978 from 3½ per cent of GDP down to 1.6 per cent; their latest estimate for 1981 is 2.2 per cent. Unfortunately it seems that the degree of uncertainty in the estimates can be almost as large as the quantity being measured; -thus very little reliance can be placed upon the end product. We do not believe that the size of the BE could have been close to zero in 1969 and 1970 and yet as high as 1.5 per cent of GDP in 1968 and as high as 4 per cent of GDP in 1974, which is what the IRD figures suggest; much of this volatility must be ascribed to measurement errors.

A.5 The CSO have recognised this problem and have attempted to make adjustments for likely estimating errors. This exercise produces a much more stable series of 'corrected' estimates of unrecorded income: close to 2 per cent of GDP for each year since 1972.

A.6 The CSO have also pointed out that some parts of the black economy will be reported in neither the income-based nor the expenditure-based measures of GDP; examples are payments in kind, and undeclared private use of goods and services that are charged to business or trading accounts.

A.7 There is a further problem, that the expenditure-based measure of GDP under-records a significant amount of money expenditure. The main source for the expenditure-based measure of GDP is the FES. The FES collects data on the expenditure recorded by a sample of families over a 2-week period. There must be room for doubting that even the families whose incomes are entirely above board will correctly record items of their expenditure that they suspect, or know, have gone to participants in the black economy. The buyers of black economy products often have close personal relations with the providers and will therefore tend to collude with them to keep the transactions secret. Moreover respondents to the FES are asked to record their income as well as their expenditure. It seems unlikely that families with undeclared income (from black economy sources) will faithfully record all their expenditure with the result that the total would exceed their declared income. Yet another problem is that about 30 per cent of the families whose participation in the FES is sought do not respond either because they refuse to be interviewed or because they cannot be contacted. One significant group of 'uncontactable' people are those who have recently moved home: such people are likely to be major customers for black economy services in their new homes (for house repairs and decorations). Thus participants in the black economy, both producers and consumers, are likely to be more heavily represented in the 30 per cent who refuse to take part than in the 70 per cent who do. This again would result in the FES understating expenditure.

A.8. These considerations have led the CSO to conclude that the true size of the black economy is likely to be significantly larger than that indicated by their published IRD estimates. On their (confidential) judgement of the amount of expenditure not revealed by the FES and of other sources of error in the IRD approach the CSO conclude that the true size of the black economy is about 5 per cent of GDP or more. We would endorse their conclusion and regard 5 per cent as a plausible minimum for the size of the black economy; however, we note that different but equally plausible judgements about the errors in the IRD approach lead to considerably higher estimates.

A.9 The CSO believe that the size of the black economy, relative to the rest of the economy, probably grew in the post-war years up to the middle of the 1970s and that since then it has grown only slowly or may even have fallen (in relative size). There are two particular sectors where the CSO has evidence for a less rapid growth or even a decline, in the black economy in recent years. The first is agriculture where the estimates of sector income from tax returns can be checked against estimates calculated from statistics from the Ministry of Agriculture, Fisheries and Food on sale and costs; this suggests that farmers under-declare a considerable proportion of their income (possibly as much as 18 per cent in 1981) but that this proportion has remained fairly steady over the last ten years and may even have decreased. The second sector is construction, long considered one of the largest areas of black economy activity. The attack on the 'lump' system since 1975 is likely to have reduced the amount of evasion and there is some indirect evidence to confirm this: the number of self-employed in construction grew at a rate of about 8 per cent a year between 1961 and 1973 but between 1973 and the last boom year for construction (1979) it has declined at about  $1\frac{1}{2}$  per cent a year.

#### The 'big bill' method

A.10 This approach starts from the observation that the use of large denomination currency notes has increased far faster than currency holdings in total. Blending this observation with anecdotes about furtive tradesmen with wads of large denomination notes in their back pockets has led some commentators\* to conclude that the black economy is booming.

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\*Ross, Fortune, October 1978, and Freud, Financial Times, April 1979

A.11 Unfortunately for this method, there are other more plausible (and more mundane) explanations of why people's holdings of large denomination notes have increased. It is most unlikely that people respond to inflation by holding a greater number of notes of all denominations, in constant proportions. They are more likely to respond by keeping the same number of notes but substituting high value ones for low value ones. A number of researchers have shown that such a substitution effect is more than enough to account for the growth in holdings of large notes.

A.12 We conclude that this method has nothing useful to tell us about the size of the black economy.

#### The transaction method

A.13 The starting assumption here is that there is a stable relationship between the value of total transactions in the economy, derived from multiplying currency and bank deposits by average velocity, and national income. Other things being equal an increase in the ratio between the value of transactions and recorded national income would suggest a growth in unrecorded income, the black economy.

A.14 Feige\* has employed this method in a calculation which suggests that the black economy has increased substantially (though not regularly) since 1960 to a level of about 15 per cent of GDP in 1979.

A.15 Feige admits that his results depend strongly upon a number of assumptions in areas where empirical data are lacking and concedes that his 'estimates should be regarded as preliminary'. For example his assumptions for currency velocity are derived from estimates of the number of transactions which banknotes can bear before they are recalled by the banks as unfit for further circulation. Unfortunately a wide range of estimates of banknotes' lifetimes are plausible, leading to quite different conclusions.

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\*E Feige, 'The UK's unobserved Economy', Journal of Economic Affairs, July 1981



A.16 We conclude that until better methods are available for measuring the number and values of transactions in the economy this method will not produce reliable estimates of the size of the black economy.

**'Cash in the money supply' estimates**

A.17 This method, developed by Gutmann in the USA, starts from the assumption that black economy transactions are usually conducted for cash payment. Hence an increase over time in the ratio of cash to a narrow measure of money supply indicates, other things being equal, a growth in the black economy as a proportion of GDP. In the USA the ratio of cash to narrow money stock, M1, increased during World War 2, then declined slowly until 1961, and then grew again until by 1976 it reached the World War 2 level. Gutmann suggests that the black economy grew during wartime as a reaction to higher taxes, controls and rationing, then declined up to 1961 and then grew again. Assuming, among other things, that the pre-war ratio of cash to narrow money supply corresponds to an economy with a negligible black component, Gutmann estimates that the increase in the ratio since 1961 implies a black economy in the USA which increased as a proportion of GDP up to a level of over 10 per cent by 1976.

A.18 O'Higgins\* has applied the Gutmann method to United Kingdom money supply figures. The ratio of cash to M1 has gone through several periods of increase and decrease since 1963, making it difficult to formulate a plausible hypothesis about changes in the size of the black economy. In relation to a slightly broader measure of money supply, which includes United Kingdom private sector sterling time deposits and which we denote M\*, the cash ratio moved quite differently, declining fairly steadily to 1974 and then increasing. This measure suggests that the black economy grew steadily from a nadir in 1974. Taking this as a working hypothesis O'Higgins performs Gutmann-type calculations which suggest that the black economy in the United Kingdom rose to a level of between 3 per cent and 5 per cent of GDP by 1978.

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\* O'Higgins M, 'Measuring the Hidden Economy: A Review of Evidence and Methodologies', Outer Circle Policy Unit, July 1980.

A.19 Several writers, including O'Higgins himself, have identified serious weaknesses in this methodology -

- quite different answers flow from employing different but plausible measures of money supply, (as we saw in relation to M1 and M\*, above);
- quite different answers come from different choices of base year; (repeating the O'Higgins calculation with 1963 as base year reveals a negative black economy in 1978);
- the ratio of cash to money supply is strongly influenced by changes in the velocity of circulation of currency and of demand deposits. These effects were not estimated in the Gutman and O'Higgins calculations; in any case independent estimates of changes in velocity of circulation are difficult to obtain and subject to wide margins of error.
- people's holding of cash is influenced by factors other than their propensity to purchase from the black economy, (eg increasing use of cheques and credit cards, increasing proportion of income spent on non-essentials).

A.20 We conclude that no reliance can be placed upon estimates using this method, at least until there is a far better understanding than now about the factors, other than the black economy, governing people's holdings of cash. The next method we look at attempts to remedy this deficiency.

#### An Econometric Method

A.21 Matthews employs econometric techniques in a study\* that can be regarded as a more scientific version of the cash ratio method described above. He starts by formulating a hypothesis about what influences people's

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\*K Matthews: 'The demand for currency and the rise of the Black Economy 1973-79', Liverpool Research Group Economic Bulletin (No 2)

choices in the holding of cash as an alternative to bank deposits (all sterling sight deposits including certificates of deposits held by United Kingdom residents). The hypothesis states that the cash ratio will be -

- negatively related to 3 factors that make deposits attractive: inflation, interest rates and the efficiency with which deposits can be used (assumed to increase with time);
- positively related to the size of the black economy which, he assumes, is itself positively related to 3 further factors: unemployment, average effective household income tax rate and sales tax rate.

The hypothesis is then expressed in the form of a mathematical model relating the cash/deposit ratio to these 6 factors. The credibility of the hypothesis is then taken to depend upon how well the model fits with data from recent years.

A.22 Matthews attempts to fit his model to quarterly United Kingdom data from Q3 1973 to Q2 1979. He decides, reasonably in our view, not to use data from earlier years on the grounds that the large (downward) movement in the cash/deposit ratio over the period immediately preceding 1973 is heavily influenced by the effects of the relaxation of credit controls, which are not catered for in his model. He found that the model fitted his data fairly well, explaining 94 per cent of the variation in the cash/deposit ratio. But only 2 of the 6 independent variables - unemployment and income tax - bore the hypothesised relationship to the currency/deposit ratio. Nevertheless he concluded that 'given the crudeness of our black economy variables it is heartening that 2 out of the 3 appeared correctly signed and significant'. Matthews then calculated the size of the black economy from the parameters of the unemployment and income tax variables in the fitted equation and a further assumption of a zero black economy in 1973. He offers a lower estimate (using the income tax parameter only) of 3.3 per cent of GDP and a high estimate (using both parameters) of 11 per cent of GDP, both for the year 1979.

A.23 We believe that although this is a potentially fruitful approach\* it will require considerable refinement and better data over a longer time period before it can yield reliable estimates. As noted above, Matthews himself demonstrates the widely differing estimates that come from employing two different assumptions in the calculation. The assumption of a zero black economy in 1973 is both implausible and arbitrary; Matthews concedes that quite different conclusions would flow from using other 'base' years. Also the failure of 4 of the 6 independent variables to bear the hypothesised relationship casts some doubt on the correctness of the equations' specification; other factors may exert greater influence on currency and deposit holdings and their inclusion in the equation might radically alter the tax and unemployment parameters.

#### **Is the black economy counter-cyclical?**

A.24 Some of the macro-economic studies provide series of estimates that purport to show how the black economy has changed over time: CSO's 'corrected' series (see paragraph A.5) and those of Feige (A.14) and Matthews (A.22). It is tempting to use these series to examine whether the black economy is related to observed macro-economic variables. In particular is the black economy counter-cyclical, ie moving in the opposite direction to 'official' GDP and in the same direction as official unemployment? This would be expected on the theory that rising unemployment increases the supply of black economy workers and their 'product' is not recorded in official GDP calculations.

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\*A more successful application of this approach is the study in the USA by Tanzi, ('The Underground Economy in the USA Estimates and Implications', Banco Nazionale del Lavoro Quarterly Review No 135, December 1980.) His model was similar to Matthews' but he had more and better data available and obtained a better fit. His results for the USA, are of a similar order to those obtained by Matthew for the size of the UK black economy.

A.25 An alternative, pro-cyclical, theory says that a fall in GDP and an increase in unemployment decreases the demand for goods and services, including those produced in the black economy. Also the self-employed might be tempted in boom years to declare a smaller proportion of income to the Inland Revenue so as to avoid arguments in lean years when their income would decline.

A.26 The three series portray somewhat different pictures of the development of the black economy over the late 1970s. To some extent these may arise because lagged effects are captured to differing extents by the different methods. More likely, we fear, the estimates in the series may be more artefacts of the assumptions in their respective methods than measures of the 'real' black economy. Nevertheless, for what it is worth, the main movements in the three measures can be summarised thus -

- the CSO 'corrected' estimate increases steadily during 1969-73 and remains fairly stable during 1973-80 with a small peak in 1978-1979.
- Feige's estimate increases sharply during 1971-74, declines sharply during 1974-75 and is stable during 1975-79.
- Matthews' estimate increases swiftly during 1973-76 and is fairly stable during 1976-79.

A.27 These movements are to be compared with -

- GDP, which grew relatively swiftly in 1970-73, declined a little in 1973-75, grew slowly during 1975-79 and decreased in 1979-80.
- Unemployment, which decreased during 1971-73, increased during 1974-77 and increased again during 1979-80.

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movements in GDP and in unemployment during 1971-

estimate and Feige's estimate tend to move pro-

wards to move counter-cyclically.

That all 3 series show periods of relative stability in the 1970s. In each case these periods cover a time when unemployment increased so that the two macro-variables have been pulling in opposite directions on either an empirical or theoretical theory. Thus without a more refined analysis of the magnitudes (which we do not think would be justified for the measures), we have to conclude that the periods of stability are no more than the other. Unfortunately the period 1979-81 which could provide a good test-bed for the theory, unemployment rose and GDP fell, ie on the counter-cyclical path which should have grown strongly.

Official household surveys offer another approach to the problem. It is suggested that at least some of the moonlighters who are reported in the earnings from the Inland Revenue may report them to the surveyors on a rather shaky basis the reported level of double-jobbing is an indicator of the level of tax evasion from which we can examine whether it moves pro or counter-cyclically. There is conflicting evidence from the two main surveys that we have looked at - the FES and the General Household Survey (GHS). A comparison of the results reveals a quite strong positive correlation between double-jobbing and unemployment at the national level over the period 1967-75. There is also a positive correlation between the regional rates of double-jobbing and unemployment in a particular year (1970). The same study however also shows a positive correlation between the GHS regional rates of

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and nature of double job holding in Great Britain',  
Journal, Vol 8, No 3, 1977

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double-jobbing and unemployment in 1971. More recently the FES reports a gradual increase in double jobbing in each of the years 1977-81 but the GHS reports no such increase except for a modest one in 1980. The two surveys do appear to agree on the relationship with income - regions with low average household incomes in 1971-72 showing higher rates of double-jobbing. On the whole the evidence from this (rather dubious) source gives more support to the counter-cyclical theory than to the pro-cyclical one.

A.31 We conclude that in relation to the pro and counter-cyclical theories there is some evidence on each side. But we believe that the uncertainties in the measures are too great to draw any confident conclusions about how the black economy has responded to movements in macro-economic variables.

#### Micro-economic methods

##### Expenditure and income of individual households

A.32 Dilnot and Morris\* examined the discrepancies between individuals' income and expenditure as reported to the FES during the survey period (2 weeks). They identified as potential black economy households those where reported expenditure exceeded income. They then devised procedures (which they called 'traps') to try to eliminate households where the excess expenditure could reasonably have arisen for reasons other than black economy activity, eg the purchase of a large item during the survey period, heads of households temporarily out of work who might have been running down savings or incurring debts. Realising that these 'traps' might be too strong, in the sense of inadvertently eliminating some black economy cases, the authors generated two derived samples of apparent black economy households:

- a minimum sample derived using all the traps and also eliminating pensioners;
- a maximum sample derived using only the less contentious traps.

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\* Dilnot and Morris, 'What do we know about the black economy?', Fiscal Studies, March 1981

The excess of expenditure over income was regarded as black economy income, except in cases where this excess was less than either 20 per cent of income or £3 per week (such small differences being regarded as insignificant or the product of recording errors).

A.33 Their minimum estimate suggested that 9.6 per cent of households had an average weekly income from the black economy of £31, implying that the black economy represented 2.3 per cent of GDP in 1977. The maximum estimate suggested 14.8 per cent of households earning an average £30 per week from the black economy, implying that the black economy represented 3.0 per cent of GDP.

A.34 Although this is one of the more careful and detailed attempts to study the black economy it is open to the same general objection as all the others, namely that it employs assumptions which can plausibly be altered to give quite different results. One such assumption concerns the correctness of the 'traps' employed, where the authors exercised considerable subjective judgement. A second assumption is the arbitrary cut-off of excess expenditure less than 20 per cent or £3 per week. A third assumption is that black economy households will correctly report to FES their expenditure, even when it is considerably in excess of reported income. A fourth assumption is that the amount of income reported to the FES corresponds to the amount declared to Inland Revenue for tax purposes. A fifth, and probably most crucial, assumption is that the 30 per cent of households who decline to participate in FES are no more inclined to black economy activity than the 70 per cent who agree. We suggested earlier (paragraph A.7) that this last assumption may lead to a serious underestimation of the size of the black economy. O'Higgins has demonstrated the sensitivity of Dilnot and Morris' results to changes in this last assumption; by applying subjective but quite plausible assumptions about greater black economy activity by the decliners, he shows that Dilnot and Morris' minimum estimate rises from 2.3 per cent to 6.7 per cent of GDP and the maximum estimate from 3.0 per cent to 8.2 per cent.



Income-Expenditure discrepancies for the self-employed

A.35 Many commentators have suggested that tax evasion is particularly prevalent among the self-employed. Certainly it is much easier for them to conceal income than it is for employees under PAYE, and it would not be surprising if they succumbed to temptation.

A.36 Some evidence for the phenomenon appears to come from the FES. An analysis by O'Higgins\* of the survey results over a 7 year period showed that the ratio of reported expenditure to reported income was consistently higher for self-employed households, both in general and at particular income levels, than employee-headed households in a variety of occupational groups; the discrepancy was greatest for self-employed households reporting relatively low levels of income. Based on these discrepancies O'Higgins estimated that the extent of under-reporting of income by the self-employed might amount to about 18 per cent of their total income, or about 2 per cent of total national income.

A.37 Unfortunately for this method there is a serious problem relating to the measurement of self-employment income in FES. Because of the week by week fluctuations that often occur in self-employment income the FES does not attempt to record the income in the two week survey period; this would be too volatile. Instead they ask those of their respondents who are self-employed to assess their income over the most recent 12 month period for which figures are available; the FES then apply this rate of income to the survey period without adjustment. The greater the rate at which nominal earnings are increasing the more this procedure will underestimate income for the survey period. O'Higgins has conceded, in a later paper, that the effect of this time-lag could, on its own, be sufficient to account for the apparent discrepancies in the FES analysis as between self-employed and employees. It therefore seems that no useful result can come from this method.

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\*O'Higgins, 'Measuring the Hidden Economy', Outer Circle Policy Unit, July 1980

**Inland Revenue 'Guesstimates'**

A.38 The Inland Revenue, unlike their counterparts in the USA, do not have the power to undertake random investigations which would, inter alia, permit them to arrive at more reliable measures of the black economy than any of the methods reviewed above. Instead Inland Revenue have made judgements of the plausibility of different levels of evasion, extrapolating from their experiences in investigation work. This approach led to the statement to the Public Accounts Committee by their Chairman that a figure in the range of 6 per cent to 8 per cent of GDP was not implausible.

A.39 Inland Revenue base this view on judgements of the sizes of 5 components of evasion as shown in Table A.1 below. They concede that their judgement on 3 of the components - moonlighters, unearned income and ghosts - are little more than informed guesses; the judgements on the other 2 - companies and self-employed, and PAYE - are firmer because their enforcement work in these areas provides information that is more representative of taxpayers' behaviour in these fields. Inland Revenue regard their judgement as representing a plausible range for the size of the black economy but not lower and upper limits. In reviewing their judgements below we attempt to suggest, on a purely subjective basis, where the limits of plausibility might lie, and we list these in Table A.1.

TABLE A.1: JUDGEMENTS OF THE SIZE OF THE BLACK ECONOMY

	Inland Revenue plausible range		CPRS subjective limits of plausibility (% of GDP)	
	£bn (1981)	% of GDP	Low	High
Moonlighters	5 - 7	2½ - 3½	1	3½
Company and self- employed profits	3 - 5	1½ - 2½	1½	2½
PAYE	½ - 1	½ - ½	½	½
Ghosts	1½ - 2	½ - 1	½	1½
Unearned income	2	1	½	2
<hr/>				
Total (to nearest whole number)	12 - 17	6 - 8	4	10

A.40 In Inland Revenue's judgements the largest component is moonlighting - between  $2\frac{1}{2}$  and  $3\frac{1}{2}$  per cent of GDP, or between £5bn and £7bn in 1981. The upper end of this range would be consistent with a population of about 6 million moonlighters (nearly one-third of all employess) earning, on average, about £1,200 per year from undeclared secondary employment. In our view, and that of other commentators, this appears to represent an upper limit of plausibility; (some have said it is implausibly high). Although this is a purely subjective judgement we find it hard to believe that the number of moonlighters is more than 6 million; and whilst some moonlighters certainly get away with more than the suggested average of £1,200 per annum (eg those with full-time second jobs) there are many more who get much less (eg occasional work). Looking in the other direction we believe that the moonlighting component could be much smaller than  $3\frac{1}{2}$  per cent of GDP and smaller than Inland Revenue's lower judgement of  $2\frac{1}{2}$  per cent of GDP. In our view, and again this is purely subjective judgement, the moonlighter component might be as small as 1 per cent of GDP, or £2bn in 1981, and we regard this as the lower limit of plausibility.

A.41 Inland Revenue's judgement of the second component - companies and self-employed - is based partly on preliminary results from the pilot study of evasion by the self-employed, which we mentioned earlier (2.2). In this study a sample of self-employed case files was examined by Tax Inspectors who classified the taxpayers, subjectively, into 3 categories -

- |  |     |
|--|-----|
| a. clear indications of significant evasion: | 20% |
| b. weak indications of possible evasion:     | 40% |
| c. no indications of evasion:                | 40% |

The cases in category a. and some of those in category b. are now being investigated; the results will throw light on the reliability of the Inspectors' categorisation judgements and will also indicate the probable amounts of evasion by people in these categories. (Of the investigations completed so far in category a. significant evasion has been established in 87 per cent of cases.) For the present Inland Revenue proceed by assuming -

- i. that the judgements are reliable;
- ii. that the proportionate split between the categories is applicable to the general population (1.8 million) of self-employed;
- iii. that the proportion of declared profits that is concealed by those in category a. and would be revealed by investigation is the same as the average proportion agreed in settlements following current investigations, namely 40 per cent.

Given that the average reported profits in category a. are about £6,000 a year the total of under declarations by this category is calculated as 20 per cent x 1.8m x 40 per cent x £6,000 = £860m. For category b. a smaller degree of concealment, 15 per cent, is assumed although there is a higher level of declared profits, £7,000; this leads to an estimate of under declaration of £760m. Combining these two figures and assuming no evasion in category c. leads to a figure of £1,620m. Allowing for the fact that the true extent of profit under declaration will be greater, perhaps much greater, than that established by investigations Inland Revenue arrive at the view that the total of under declarations by the self-employed is of the order of £2½bn.

A.42 Inland Revenue do not yet have equivalent information (of the sample study type) for evasion by companies. They consider it plausible to assume that the total extent of evasion by companies is about one-third of that by the self-employed, or £½bn (one-third of £2½bn). Hence they arrive at a figure of £3bn for evasion by companies and self-employed, which is the lower end of the range quoted in Table A.1. We doubt whether the true extent of evasion could be much less than this.

A.43 The higher end of Inland Revenue's range for this component, £5bn, can be justified by assuming a degree of evasion in category b. much closer to that assumed for category a., (and by assuming a pro rata increase in the company element). This would require those in categories a. and b. to be under-declaring by about £3,500 on average, which is about one half of their average declared profits. This seems to us to represent a reasonable

figure for the upper limit of plausibility. We would enter one caveat. An even greater figure could be advocated if some of those in category c. are significant evaders despite their outward appearances. Unfortunately the Inland Revenue, will not be able to test this argument since their statutes prohibit them from investigating people giving no outward sign of evasion. We believe that there is likely to be a sizeable proportion of the self-employed who do not evade to any significant extent, either because they are completely honest or because the nature of their trade makes evasion difficult. But we are not able to judge whether this proportion is as high as the 40 per cent assumed by Inland Revenue.

A.44 Inland Revenue are on firmer ground with PAYE non-compliance. As we describe later (paragraph 6 of Annex B) their auditors visit all employers over a period of time and so obtain a representative view. We see no reason to quarrel with Inland Revenue's judgement that this component of the black economy could amount to  $\frac{1}{2}$  per cent of GDP.

A.45 We are back in the realm of guesswork with the fourth component, ghosts, which Inland Revenue judge to be up to about 1 per cent of GDP, or £2bn. This would be consistent with, say, a population of around 300,000 ghosts earning an average of £7,000 per year (roughly the national average wage of employees). Whilst we consider that this is a plausible view we note that preliminary results from the black economy experiment (see B.7) are revealing considerably larger numbers of ghosts than Inland Revenue anticipated, many of whom appear to be earning £7,000 or more. But, even now, very little is known about this, the most obscure component of the black economy. Thus although we would not quarrel with Inland Revenue's judgement that 1 per cent of GDP is a plausible figure for its size we believe that any figure in the range of  $\frac{1}{2}$  per cent to  $1\frac{1}{2}$  per cent is equally plausible.

A.46 Very little is known about the size of the fifth component - unearned income - which Inland Revenue judge to be of the order of 1 per cent of GDP; we understand that they would not regard figures as low as  $\frac{1}{2}$  per cent or as high as 2 per cent as totally implausible.

A.47 To conclude we agree with Inland Revenue that it is not implausible that the size of the black economy lies within the range of 6 per cent - 8 per cent of GDP. But we suggest that the limits of plausibility suggested by their approach are somewhat wider than this; our subjective judgements mentioned above and listed in table A.1, suggest a range of 4 per cent - 10 per cent of GDP. An extreme view of evasion by the self-employed would permit a figure still greater than 10 per cent.

**Conclusions (i) - how big is the black economy?**

A.48 The estimates of the size of the black economy from the studies reviewed in this Annex are summarised in table A.2 below. They vary very widely, between 2 per cent and 15 per cent of GDP. None of the estimates is reliable; each study is forced to make crucial assumptions about factors where empirical evidence is lacking and, as many of the authors concede, alternative (but equally plausible) assumptions lead to quite different results.

A.49 We have argued that the CSO IRD measures (both the crude version 3½ per cent, and the corrected version, 2 per cent) and the Dilnott and Morris measure (between 2 per cent and 3 per cent) are all likely to be under estimates. We noted (paragraph A.8) that confidential CSO information points to a size of at least 5 per cent; this is slightly large than the plausible lower limit (4 per cent) we arrived at above using Inland Revenue's component judgements approach but is based on independent sources.

A.50 The highest estimate, 15 per cent of GDP, is provided by Feige, but we noted that his method employed some very arbitrary assumptions. We have a little more confidence in the approach of Matthews who provides the next highest estimate: his upper estimate is 11 per cent of GDP (though subject to wide margins of error). This is close to the plausible high limit of 10 per cent of GDP, which we derived above using the Inland Revenue approach.

TABLE A.2

<u>Author/Method</u>	<u>Estimated Size of Black Economy as % of GDP</u>
(i) CSO: IRD (published version)	3½%
(ii) CSO: 'corrected' IRD	2%
(iii) Feige: Transactions	15%
(iv) O'Higgins: Cash/Money supply ratio	3-5%
(v) Matthews: econometric	3.3-11%
(vi) Dilnot and Morris: Income/expenditure discrepancies in FES	2.3-3%
(vii) As (vi) with O'Higgins correction for FES bias	3-8%
(viii) Inland Revenue: informed guess	6-8%

A.51 We conclude that the true figure for the size of the black economy is likely to lie in the range between 5 per cent and 10 per cent of GDP but that within this range there is no good evidence for favouring any one figure rather than any other.

#### Conclusions (ii) Is the black economy getting bigger?

A.52 We considered above (paragraphs A.24-31) whether the black economy might be counter-cyclical, growing when the 'official' economy was in recession and falling back when it was growing. We noted that there is evidence both for and against the counter-cyclical theory and that there are no empirical grounds for believing that the black economy has grown or shrunk much since about 1976. But three general points can be made -

- a. Various official statistics suggest (but no more) that if a trend is occurring, it is a relatively gradual one.

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b. Nevertheless, it is very probable that over a longer time scale (say since 1950) the problem has grown as people have come into tax, and as public attitudes (eg to receipt of social security benefit) have changed.

c. The last few years have seen a growing awareness of and interest in the problem by the media, academics, government and the public. But this does not mean there is more black economy activity.

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ANNEX B: THE ENFORCEMENT WORK OF THE REVENUE AND  
BENEFIT DEPARTMENTS

B.1 Under the heading "enforcement" we consider the anti-evasion work of the Inland Revenue and Customs and Excise, the work of DHSS in compliance (ensuring proper payment of National Insurance Contributions) and the work of DHSS and the Department of Employment (DE) on benefit fraud. In this Annex we review briefly the enforcement work of these departments with particular regard to their recent success in developing more cost-effective methods.

B.2 The front line of the Inland Revenue's enforcement forces consists of the Tax Inspectors in District Offices to whom are submitted company accounts and personal tax returns. Some of the time of these Inspectors and their support staff is devoted to investigation, usually of cases where there are positive indications of evasion. The amount of time available for investigation is limited. Normally the aim is to secure the taxpayer's co-operation in establishing a reasonable figure for his tax liability; this figure may often be less than the true amount of liability but the latter figure would often be impossible or very time-consuming for the Inland Revenue to establish with conviction. Inland Revenue encourage the taxpayer to co-operate in an investigation (ie to remedy previous non-declarations) by offering to treat him more favourably when assessing penalties if he does so. (Penalties are an administrative fine which the Inland Revenue are empowered to levy for tax evasion; a typical settlement of a case when significant tax evasion is established would lead to a yield made up of 3 elements: the amount of tax due for current and previous years, an interest charge, and a penalty of between 25 per cent and 100 per cent of the tax due).

B.3 Traditionally Districts selected cases for investigation mainly on the strength of the indications of evasion, enough of them to fill the available staff time. Recently more weight has been placed in the selection of cases on the likely yield; at the same time investigation procedures have been streamlined. The majority of the work is concerned with the self-employed and companies. In 1981 the whole time equivalent of about 1,150 staff were employed on this work which yielded about £92 million - a yield-cost ratio of about 4:1. There are already signs of higher yields in 1982, partly due to improved procedures and the selection of higher yielding cases.

B.4 The Inland Revenue also employ staff on specialised enforcement functions; these are summarised below along with approximate staffing and yield figures for 1981 (where appropriate):

PAYE Audit - to check that employers correctly operate the PAYE system and deduct tax and national insurance contributions; yield £20 million, 400 staff, ratio 4:1;

Special offices - mainly to investigate areas of widespread evasion and avoidance where large amounts of tax are at risk (eg employment in Fleet Street of casual labour under fictitious names); yield £29 million, staff 102, ratio 19:1;

Enquiry Branch - to investigate cases where there is a large amount of evasion or serious fraud; yield £23 million, staff 144, ratio 13:1;

Board's Investigation Office - mainly concerned with administering a special scheme for collecting tax from sub-contractors.

B.5 Special Offices and Enquiry Branch obtain high yield ratios, by comparison with those of mainstream District work and PAYE Audit, mainly because they are intended to deal almost exclusively with particular types of cases where the yield is high.\* We have already noted that the yield ratio of District work seems to be increasing as they adjust their selection of cases. But there is a limit to how far Districts can become more selective; they will always need to investigate cases where the yield may be only moderate, not least to maintain a credible degree of deterrence against people contemplating evasion on this scale.

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\* The number of Special Offices has been increased in recent years to improve their geographical coverage; a high yield ratio has been maintained.

B.6 PAYE Audit has undergone some substantial changes in the last two years. Until 1981 the average employer was visited once every 20 years although the cycle was geared so that larger employers or those in trades prone to evasion were visited every 10 years. Since then the visits have been re-organised so that more time is spent on cases showing significant irregularity. In addition the number of staff is being doubled so that employers meriting most attention will be visited more frequently. Inland Revenue consider that the scope for improving compliance in this area is sufficiently great that the present yield ratio (4:1) can be maintained even with double the number of staff.

B.7 Inland Revenue's most recent innovation is the 'Black Economy experiment' in which about 75 staff are being redeployed onto investigation work in 50 District and Special Offices. Their remit is to discover 'moonlighters' and 'ghosts' by looking actively for signs of their activity in the economy (advertisements, local authority registers etc). This approach contrasts with the traditional approach to District investigation work which starts with information coming to the Inland Revenue's files during the normal course of work; evidently the traditional approach is unlikely to catch ghosts and moonlighters. The 75 staff have no special training and were only posted in November 1981. It is too early to draw many firm conclusions from the results of the experiment to date. Nevertheless, from what we have seen, we believe that the experiment will prove successful, in that new and highly cost-effective methods for detecting moonlighters and ghosts will be identified. Already quite striking results have been achieved, for different types of target and by different methods, by the 50 offices involved in the experiment. Inland Revenue are arranging for information on these successes to be collated centrally and distributed back to the participating offices so that each office can learn from the experiences of the others, which should lead to further successes.

B.8 We commend the Inland Revenue's progress in improving the yields from their investigation work. We would suggest that they consider the balance of effort to be directed against ghosts and moonlighters. We suspect that most members of the public would be surprised to learn about the ghost problem, ie

a significant (but unknown) number of people are able to earn a good living, working on their own account, but completely unknown to the Inland Revenue and without paying any tax at all. There might be strong public support for deploying extra staff, better methods and greater powers to get these people to pay up. Added to which ghosts are likely to be cost-effective targets for extra investigation work because they will usually offer high yields. By contrast the case for extra effort against moonlighters may be harder to sustain. This type of evasion, though illegal, is probably more widely accepted by the public. The amounts evaded are often small and hard to detect, which makes moonlighters a less cost-effective target. Nevertheless the total loss of tax through moonlighting, though unknown, is likely to be large because many people are at it. Thus the Inland Revenue needs to achieve sufficient success in this area to provide a credible deterrent and to prevent the problem getting out of hand. At a time of high unemployment there is also a strong economic case for trying to reduce moonlighting because moonlighters are servicing consumer demand that might otherwise support jobs for other people in the white economy.

B.9 Persons supplying goods and services subject to VAT are not required to register and charge and account for VAT unless their annual taxable turnover exceeds £17,000. This high threshold excludes most of the moonlighters and some of the ghosts and restricts significant evasion to suppression and misdeclaration of transactions by established businesses. Customs and Excise seek to limit evasion by a computer-based programme of visits to registered traders. These visits protect the expected yield from the tax by deterring evasion and pick-up large amounts of additional tax from under-declarations discovered. 3500 visiting officers are employed; they obtained a total yield of about £160 million in 1981-2. The yield/cost ratio, ignoring the deterrent effect of the visits, is 3:1. Operational Research techniques have been employed continuously over the last 6 years to refine visit selection to enable a smaller visiting staff to concentrate greater effort on those of the 1.3 million traders where the risk of evasion is perceived to be greatest. In addition Customs and Excise employ 380 specialist staff who deal with VAT fraud. Most of their cases are in the catering and allied trades and in the second-hand car trade where compliance is very poor. Some cases involve

large sums, (occasionally in excess of £1 million), and others involve professional criminals. The total VAT yield from this work was £13 million in 1981-2; information on the more serious cases is passed on to the Inland Revenue (through the head offices of the two departments) and leads to recovery of large sums of income tax.

B.10 In seeking to ensure compliance with national insurance contributions obligations DHSS employs a force of about 1800 Inspectors. Compliance work represents about two thirds of their duties. It involves visiting employers at intervals to check that Class 1 contributions from employers and employees are properly deducted and then paid via Inland Revenue's PAYE collection system. It also involves checking that self-employed people pay Class 2 contributions. In 1981 they recovered a total of about £70 million unpaid contributions, a yield ratio of about 4:1. Traditionally the normal visits to employers have been conducted in a regular cycle so that each employer is visited in turn over a period of about 5 years. It is becoming increasingly clear that certain types of employer are more likely to be non-compliers and will repay more frequent visiting. Accordingly DHSS is developing a more selective approach to achieve this.

B.11 In its normal work on countering benefit fraud DHSS fraud officers used to investigate cases only where there were positive indications of fraud. Proven cases were often taken to prosecution in the courts. More recently DHSS has modified its approach in two ways so as to improve the cost-effectiveness of this work and we commend these developments. First the emphasis has been shifted away from prosecution, except for the more serious cases, and towards getting fraudulent benefit recipients to agree to stop claiming benefit and, if they have the means, to pay back the benefits they received but were not entitled to; this approach is much more economical of staff because it saves the considerable amount of time required to prepare a case for prosecution and appear in court. Secondly a new method of investigation - Specialist Claims Control (SCC) - has been employed, as described at paragraph 2.14. Cases are selected for investigation on the grounds that they fall into types which have been found by experience to be prone to fraud rather than because there is firm evidence in each individual case.

B.12 Since April 1980 about 300 extra staff have been deployed on benefit fraud work. In the year from April 1981 the total of DHSS fraud work yielded £95 million, using 2,281 staff, a yield ratio of about 3:1; the yield ratio for SCC work was about 5:1. These yield figures require some qualification before being compared directly with those from the work of Inland Revenue, Customs and Excise and DHSS Inspectors. They are based largely on the expected future benefit savings from current detection of fraudulent benefit recipients; it is assumed in the calculation that one year's worth of future benefit is saved, ie that if the average fraudulent benefit recipient were not detected he would continue his claim for benefit for one more year. Although DHSS have some evidence to support this assumption it intends to conduct a controlled experiment shortly to test its validity by comparing the outcome of cases subjected to SCC investigation with similar cases which are not. We welcome this kind of experiment which provides results that permit proper estimates to be made of the cost-effectiveness of enforcement work.

B.13 The Department of Employment employs about 600 staff (whole time equivalents) in their 800 Unemployment Benefit Offices (UBOs) to investigate fraud. In the past their field of concern was limited to (a) people claiming Unemployment Benefit (UB) only and (b) those claiming both UB and Supplementary Benefit (SB) where the UB portion is larger; this left DHSS to deal with (c) those claiming UB and SB where the SB portion is larger and (d) those claiming SB only. Due to the abolition of Earnings Related Supplement and the abatements in the 1980 and 1981 upratings the value of UB has fallen relative to SB; this has led to a substantial increase in the proportions of claimants in category (c) at the expense of categories (a) and (b). As a result DE have spread their investigation field into category (c), where they supplement the work of DHSS.

B.14 Out of about 5 million new UB claims in 1981/82 DE investigated about 42,000 or 0.8 per cent. Evidence of fraud (undeclared earnings) was obtained in about 20,000 cases, ie half of those investigated; there were about 4,000\* prosecutions. DE do not collect routine statistics on the benefit savings

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\* This figure was exceptionally low because of the civil service dispute; in the previous year DE prosecuted about 7,000 cases.

achieved from their fraud work. (Their yield ratio is likely to be lower than that of DHSS because for many of their claimants benefit ceases, or is greatly reduced, when the spell of UB is exhausted after 12 months; in such cases fraud work saves less than one year's worth of full benefit).

B.15 DE have been taking steps to improve the cost effectiveness of their fraud work. First they are attempting to concentrate the work so that about three quarters of their 800 UBOs have one member of staff working full-time on fraud; at present most UBOs have one member of staff working on fraud for only part of his time. Secondly, somewhat like DHSS, they have adopted a more selective prosecution policy; whereas they used to prosecute nearly all cases where there was sufficient evidence of fraud they now confine prosecution mainly to cases when the amount of benefit defrauded exceeds £50. Thirdly, they are adopting, on an experimental basis, a more active style of fraud work using peripatetic teams that operate rather like DHSS's SCC teams; early indications suggest that these teams achieve much higher yields than traditional DE fraud work.

B.16 We commend the DE's efforts to improve their fraud work. We suggest that they should collect sufficient routine statistics to be able to measure the yields (benefit savings) from this work, which will in turn assist them to develop more cost effective methods (and to assess the value of experiments such as the one they are conducting on the SCC style teams). We consider that the demarcation of the field of investigation between DE and DHSS needs attention; we consider unsatisfactory the present arrangements in which both departments investigate claimants receiving a majority of SB and a minority of UB. An argument for making DE responsible for all such cases is that their staff can observe suspect claimants when they make their fortnightly 'signing-on' visits to UBOs; the same claimant may visit his local DHSS office no more than once. On the other hand the DHSS have an advantage in that they probe claimants' personal circumstances more deeply when taking an SB claim than do DE with a UB claim. Ideally perhaps there might be a joint body of fraud investigators dealing with claimants of all types. We recommend that DE and DHSS consider jointly how their separate fraud activities could be better co-ordinated.

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26.8.82

CPRS REPORT ON UNEMPLOYMENT

CHAPTERS

1. Introduction
2. Origins of Unemployment
3. The Outlook for Unemployment
4. Approach to Remedies
5. Improving the Economy's Supply-side Performance
6. Encouraging Efficient Ways of Generating More Employment
7. The Tax and Benefit Systems
8. New Patterns of Working Time
9. Other Measures to Cope with Unemployment
10. Summary and Conclusions

ANNEXES

- A Categories of the Unemployed
- B The Social Security System and Unemployment
- C Labour Intensive Public Works

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CHAPTER 1: INTRODUCTION

1.1 The seeds of the present phenomenon of unemployment were sown in the prosperous years of the 1950s and 1960s. This post-war boom continued for an unprecedented time and led people to believe that economic growth would continue indefinitely as a normal feature of life and that living standards would always be rising. This came to be regarded not just as a hope, nor even a target to be worked for, but an entitlement. With this went the view that no-one should ever fall behind, let alone accept a lower living standard - any adjustments could always be made by creating more wealth. The expectation of ever rising living standards led to <sup>demands</sup> increasing ~~pressure~~ <sup>matched</sup> for higher wage increases which could not in time be ~~fulfilled~~ in terms of higher real output and resulted in inflationary pressures that later proved difficult to control. At company level, it led to a fall in profitability and, at the national level, public expenditure rose as a proportion of GDP because of commitments entered into in the prosperous years.

1.2 These problems arose to some degree throughout much of the industrialised world. But in Britain they came on top of long standing weaknesses in industrial performance including the failure to invest in new products, skills and processes. And in Britain for various reasons we were slower and less successful in adjusting to the changed circumstances. The pervading attitudes and resistance to change were reinforced by the accommodating policies of Governments of which one ~~further~~ example was the reluctance to adjust to the effects of the first oil price increases in 1973. Even when Governments preached austerity, they appeared to accept a duty to maintain everyone's living standards. Small wonder that beliefs in the existence of a basic right to improved living standards remained unaltered.

1.3 The present Government came to power with a mandate to achieve the long delayed adjustments necessary to create a stable and growing economy. There have been two main thrusts of policy: to squeeze out inflation and to remove "supply side" deficiencies which constrain British businesses from producing efficiently and competitively. The timing of these policies coincided with a world recession which put extra strains of adjustment on the economy.

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The sudden shift away from policies which accommodated inflation and inefficiency, together with other upward pressures on the exchange rate, caught both businesses and workpeople unprepared. Their belief in the policies' ability to cure inflation came too slowly. Hence the wage agreements reached proved far too high <sup>for</sup> compared with businesses' capacity to pay. The net result of all this was a massive rise in unemployment.

1.4 The policies to squeeze out inflation have had considerable success and there are hopeful signs of some long term improvements in productivity and efficiency. But more needs to be done to improve the efficiency of response of the economy overall, notably by reducing the size of the public sector, lowering taxation and changing the tax structure, reducing rigidities throughout the economy and increasing competition in product markets in both public and private sectors.

1.5 Recovery in competitiveness and increasing national wealth are prerequisites for success in tackling unemployment. Nevertheless the fact must be faced that economic growth achieved through competitiveness, brought about by productivity improvements and new technologies, cannot in itself guarantee full employment. The level and pattern of employment generated by such growth will be markedly different from that of the past. In a totally free labour market, adjustments would be made smoothly to bring the supply and demand for labour into line. But no labour market is totally free and Britain's is particularly rigid. As obstacles are removed so the situation over time should improve. But the rigidities are strong and the process of adjustment could be <sup>prolonged</sup> ~~uncomfortably~~ long. Despite the safety net now offered by the social security system (one of the inevitable obstacles to a totally free labour market) unemployment is a serious problem for society and for the individuals affected. Many of the effects of the current unemployment have still to show through, for prolonged worklessness reduces people's long run capacity to make a productive contribution to society.

1.6 The primary need is to remove the many deficiencies in market mechanisms which prevent unmet wants in society from being translated into jobs for the unemployed. As a nation we are not prosperous enough to look to

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the sharing of existing work as a cure-all solution; but we do need to remove the rigidity of thinking about jobs only in terms of the standard working week or career span. We could contemplate a prosperous society with much less work across the life cycle - most people work much less hard than their forebears did and our greater leisure is a bonus on top of higher material standards. But we could not accept a society in which people are unwillingly without paid work throughout their lives. Flexible patterns of working time would help translate the fruits of higher productivity into more leisure rather than into unemployment.

1.7 Given an expanding and competitive economy, and flexible adjustment of the labour market, there is no reason why full employment should not return. But the time span is uncomfortably long and it will be difficult to gain public acceptance for many of the steps along the path. Progress will be gradual. There are no easy answers. In the transitional period/ ~~which may be prolonged~~ it will continue to be necessary to take measures to ease the pain of unemployment and reduce its cost to society whilst ensuring that the measures taken do not subvert the longer term reforms and indeed where possible support them. At the same time they need to be as cost effective as possible in reducing the adverse effects of unemployment. This will mean reducing its concentrated impact (notably on the long term unemployed, the young and the worst affected geographical areas). It also calls for increasing emphasis on ways of using the resources currently available to enable people who are unemployed to use their time constructively.

1.8 This report cannot, and does not aim to, do equal justice to all these themes, but seeks rather to provide a basis of analysis - of causes, prospects, and possible courses of action - which will help the Government to formulate its future policies for employment. The report starts with a discussion of the causes of the increase in unemployment (Chapter 2) and its composition (Annex A). Prospects and consequences are considered in Chapter 3. Chapter 4 suggests an approach to the reform of the labour market (and product markets) which tries to combine the need for greater efficiency of supply side response (Chapter 5) with an increase in employment opportunities (Chapter 6). Possible changes in the tax and social security

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systems to support these objectives are tackled in Chapter 7. The report then discusses the development of more flexible patterns of working time (Chapter 8). This is followed by a discussion in Chapter 9 of ways of coping in the shorter term with the impact of unemployment. The report concludes by presenting a range of measures for discussion. A continuing theme of the report is that many of the steps that can be taken to reform markets will have their major impact among the more flexible, smaller employers (which we call the secondary sector) rather than the large, well established employers (the primary sector) where changes will occur more slowly.

1.9 In preparing this report, the CPRS has received help from other governing <sup>ment</sup> departments, notably the Treasury, Department of Employment, Department of Health and Social Security and also from a number of individuals.

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## CHAPTER 2: ORIGINS OF UNEMPLOYMENT

**Unemployment Trends**

2.1 Rising unemployment in the United Kingdom is a long-standing feature of the economy. Unemployment rose even during the prosperous post-war years of the 1950s and 1960s, though the pace of increase worsened in the 1970s (figure 1). In 1955, nearly 240,000 people (excluding school leavers) were registered as unemployed; in 1973, over 600,000; in 1979, 1.3 mn. These figures are for years of peak activity in the business cycle and reveal a strongly rising trend in unemployment. Since 1979, unemployment has more than doubled, partly as a result of recession. In August 1982, nearly 3mn people (3.3mn including school leavers) were unemployed, 12½ per cent of all employees.

2.2 Unemployment in the OECD area as a whole also rose sharply from around 1973. In the European Community, the increase was from 3 per cent to over 9 per cent between 1973 and 1982. Of the major EC economies, West Germany had the lowest levels but <sup>just recently has</sup> suffered a faster-than-average rate of increase in unemployment (figure 2). The United Kingdom continued to experience rates of unemployment higher than in France and Germany after 1973, and, since 1979, its relative position has deteriorated sharply against all major economies. In the 1960s the United States and Canada had higher rates of unemployment than Europe but in the 1970s the pace of increase was less marked: unemployment in the United States, in particular, was only slightly higher in 1979 than in 1973. Japan experienced consistently low levels of unemployment: the rate rose from around 1½ per cent in 1973 to 2½ per cent in June 1982.

2.3 Labour force growth increased in the OECD area as a whole between 1973 and 1979. Employment growth slackened a little, though less than would have been expected on the basis of past experience: the near halving of the OECD rate of output growth after 1973 was associated with a reduced growth of productivity. Across economies, there was no general relationship between rising unemployment and labour supply growth. A sharp increase in unemployment was recorded in France where there was no marked shift in the

FIGURE 1

Registered unemployment in United Kingdom, 1961-1981  
 Registered unemployed, excluding school-leavers

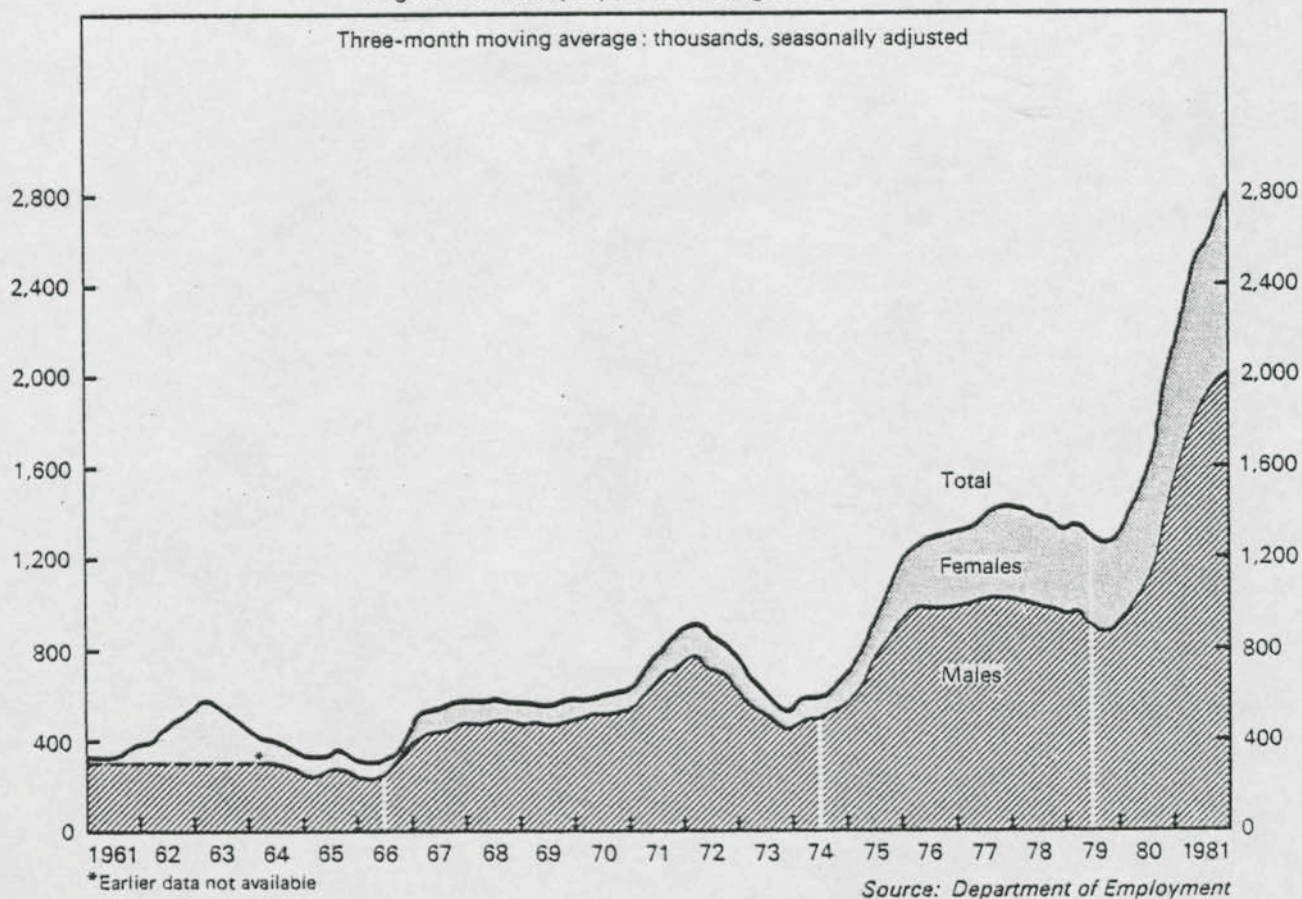
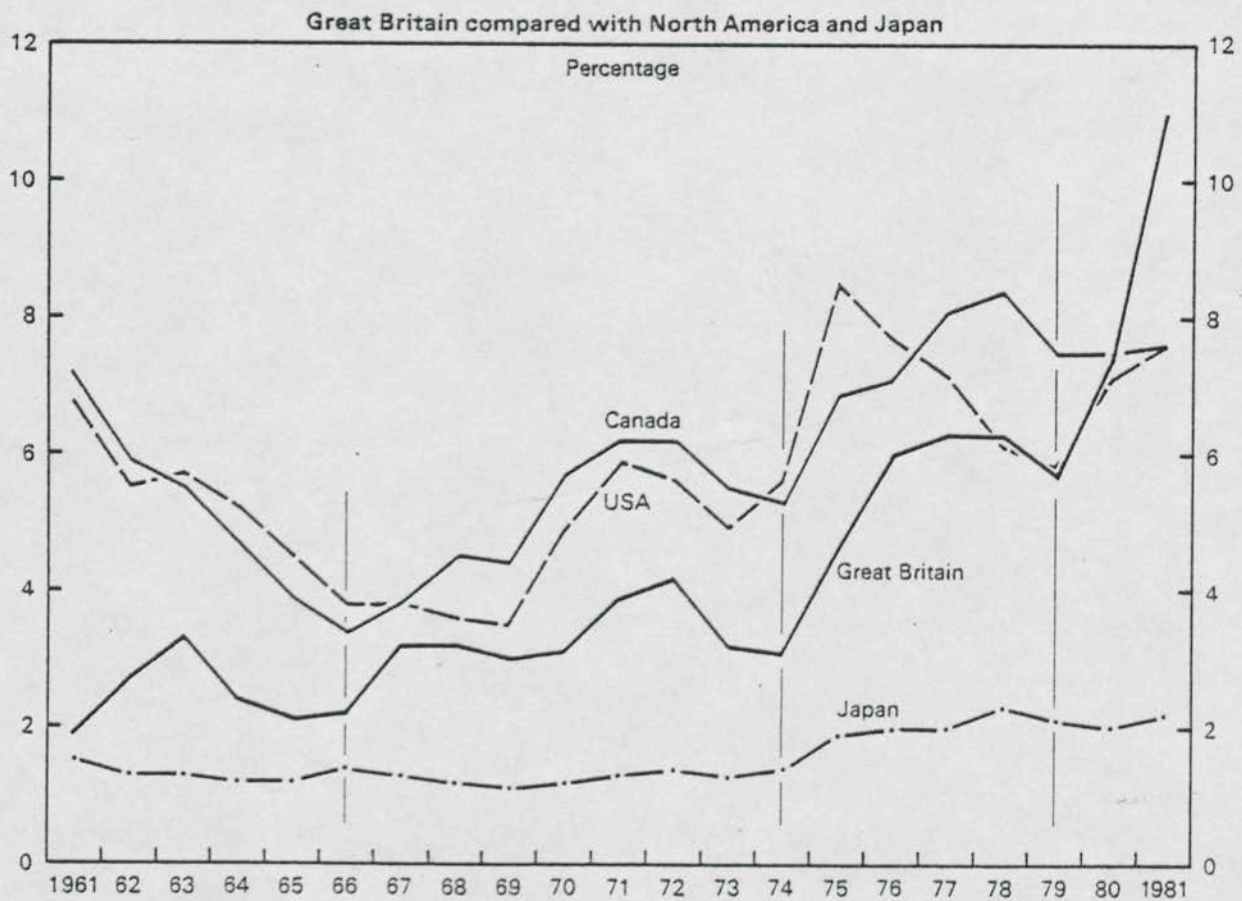
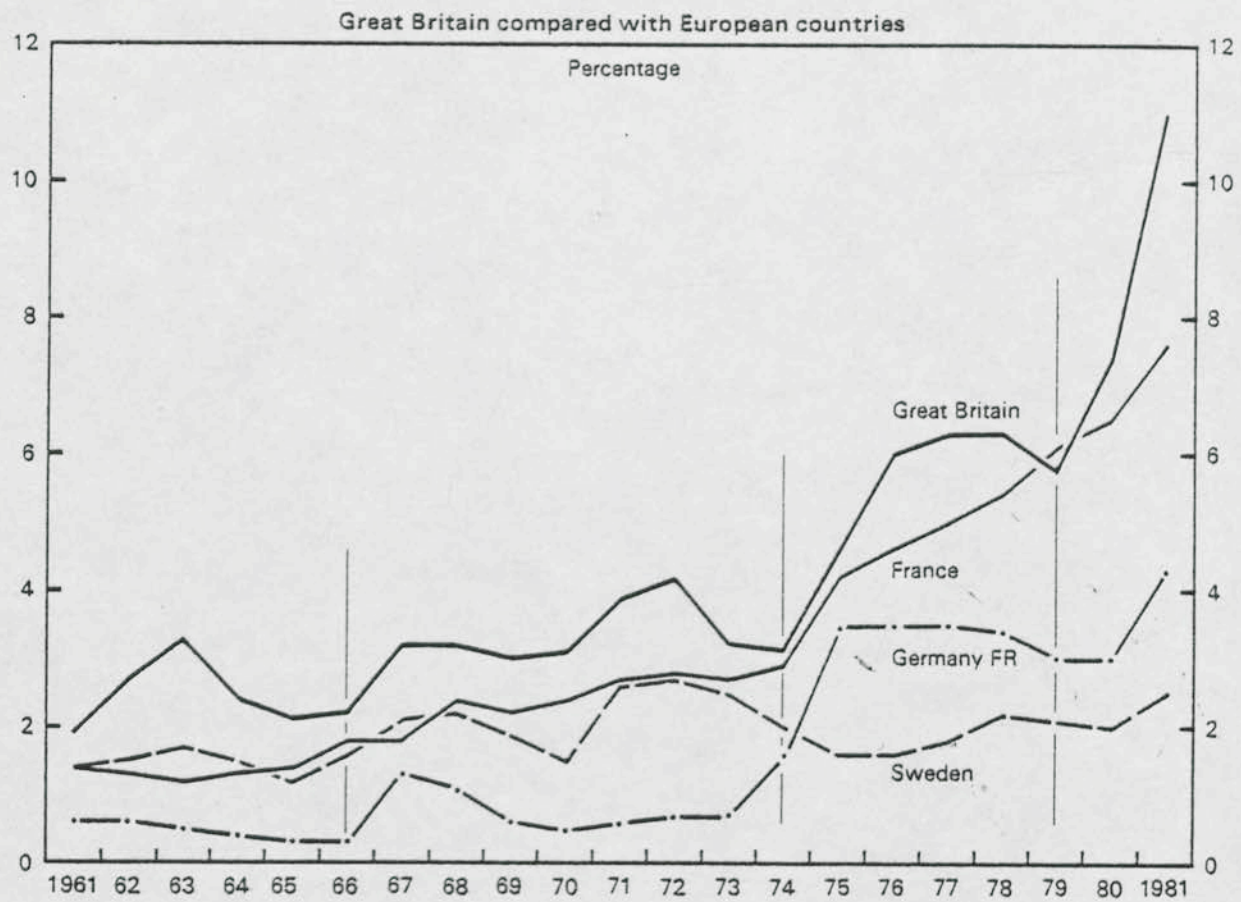


FIGURE 2

International trends in unemployment, 1961-1981  
 Unemployment rates adjusted to US concepts



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

growth in the labour force after 1973; in Germany, the labour force fell as "guest-workers" were made redundant and returned home. The United States was notable for the strong growth in both its labour force and employment after 1973.

2.4 In the United Kingdom, between 1973 and 1979, the rise in unemployment was associated with a somewhat faster increase in the labour force (figure 3), reflecting the high but subsequently declining birth rates of the early 1960s. These led to an influx of young people in the mid 1970s. Moreover, there was a further rise in the participation rate of women in the labour force. Total employment remained flat between 1973 and 1979, though manufacturing employment continued to fall (figure 4).

2.5 Since 1979, OECD employment growth has fallen, particularly sharply in Europe, with the onset of recession. At the same time, the labour force has continued to grow in most economies. In the United Kingdom, however, both employment and the working population (ie the employed plus registered unemployed) fell after 1979, the latter by 600,000 between early 1979 and early 1982. As a result of recession, there was a sharp decline in the participation rate of men in the labour force (particularly for those in the 60-65 age group) and an end to the rise in female participation. Participation rates, which were relatively high in the United Kingdom, consequently fell back towards the levels experienced overseas. Had this not happened, the rise in unemployment here would have been even steeper.

#### **Unemployment in the Industrial World: Some Common Causes**

2.6 Immediately after the first oil price rise and the severe inflationary problems which followed, slower industrial world growth and poorer job prospects were due in part to a deficiency of demand. The build up of unspent OPEC oil revenues had a deflationary effect on the rest of the world. This effect came on top of a normal reversal of the previous boom conditions and attempts by governments to squeeze out inflation by fiscal and monetary



FIGURE 3  
 Employment, labour supply and unemployment, Great Britain, 1961-1981

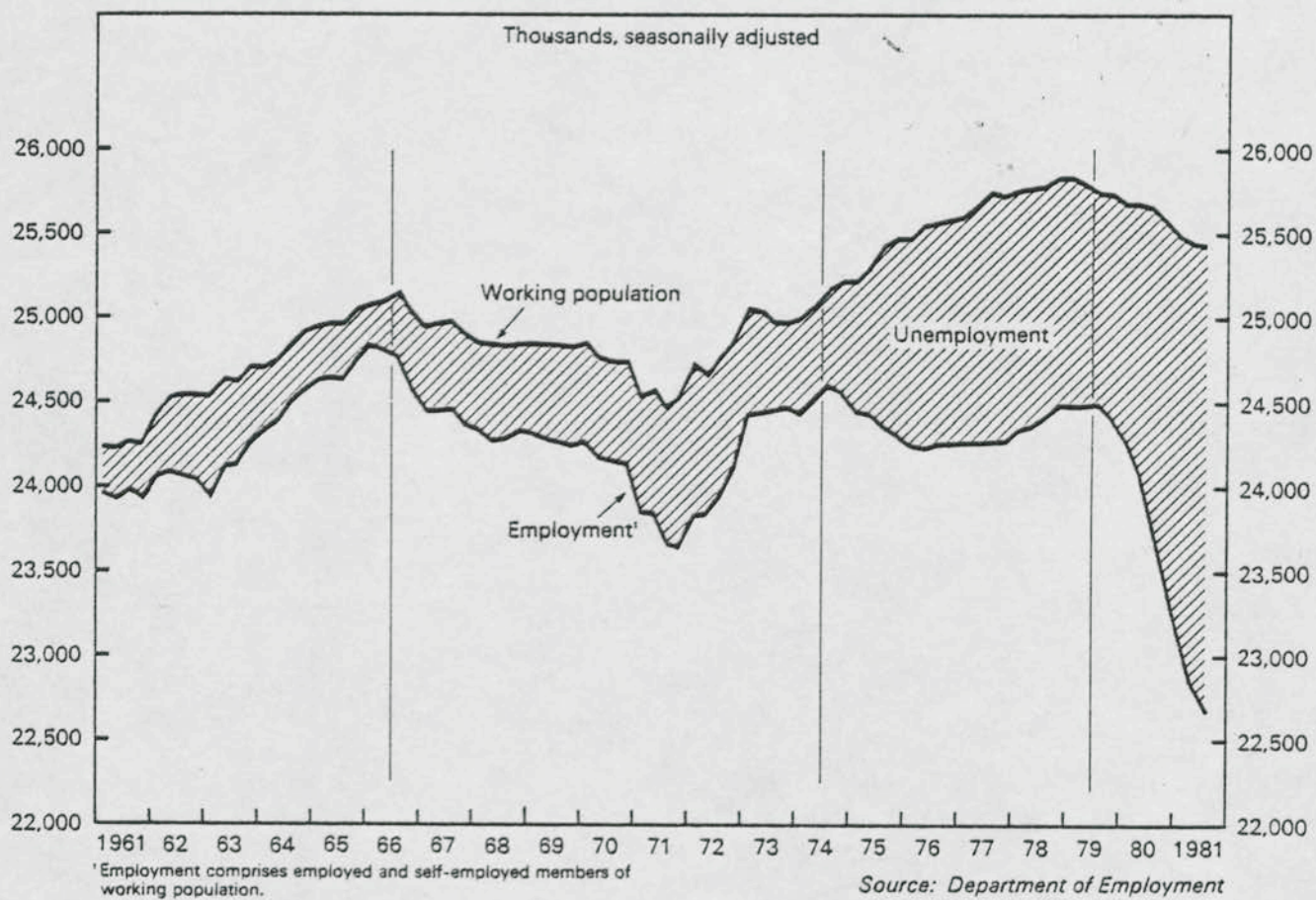
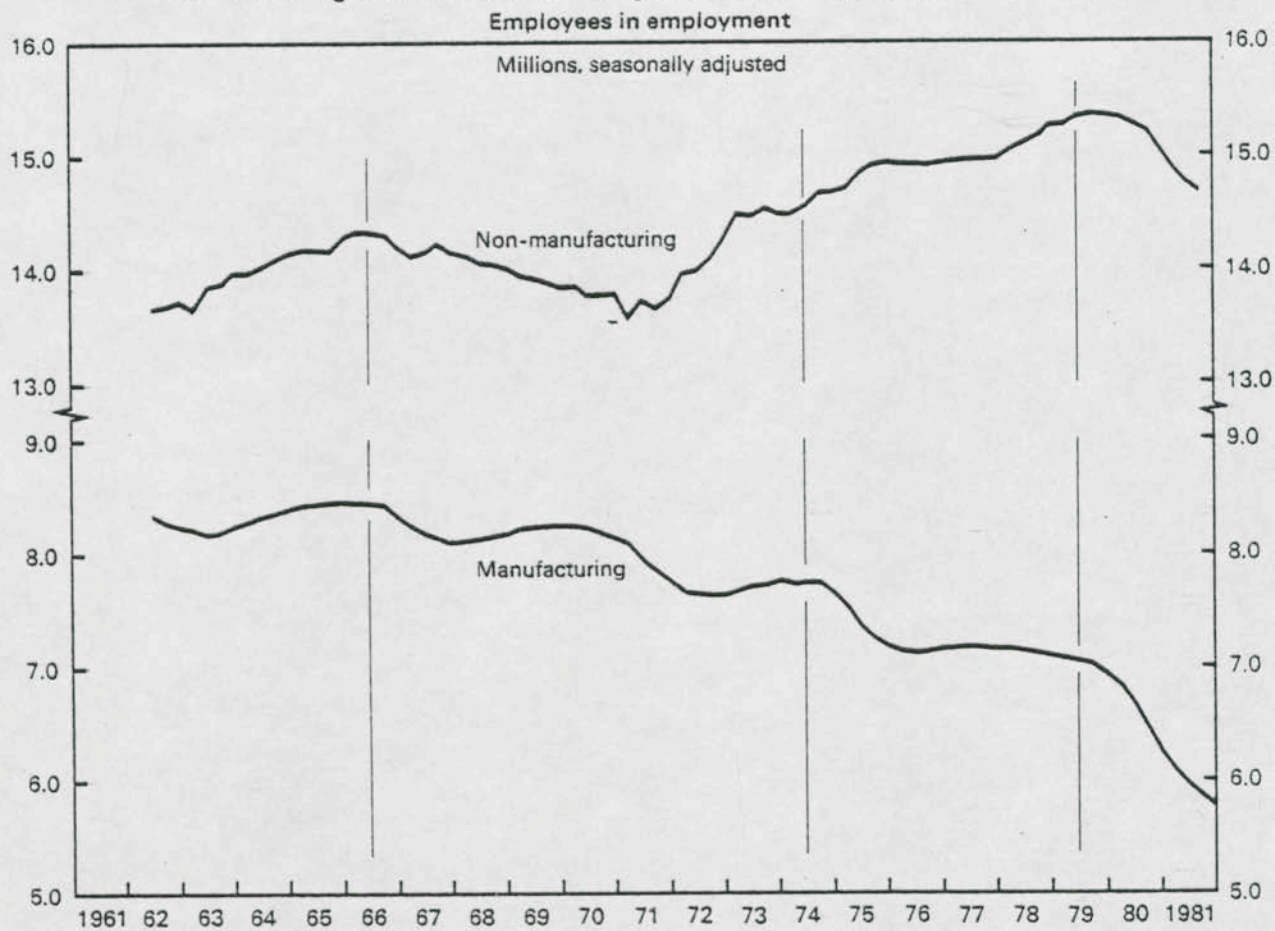


FIGURE 4

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



Source: Department of Employment

policies. The United Kingdom response was slower with the result that the economy went into recession later and inflation was higher. The deflationary effects in individual countries were transmitted to others through reductions in imports and a general slackening of international trade.

2.7 The general expectation at the time was for a medium term recovery. OPEC would, after a while, spend more of its swollen revenues. Even if it did not, the revenues re-cycled in the world's capital markets would provide a source of cheap money which could sustain higher activity in the industrial world. The problem of squeezing out inflation would cause a temporary, if substantial, fall in real demand and output. But once inflation had been conquered, it would be possible for industrial world growth to return to previous levels.

2.8 It did not. Trend rates of growth were lower even in economies (like Japan and Germany) which succeeded in squeezing out inflation after 1973/74. In several economies, at different times, attempts at domestic reflation were prejudiced by a resurgence of inflationary pressures.

2.9 Furthermore, despite slower growth, the amount of spare productive capacity in several economies by the late 1970s was surprisingly small. In 1979, the level of utilisation of capacity in manufacturing in the United Kingdom and the proportion of firms facing skilled labour constraints were at about the average level recorded in the 1960s and early 1970s. Recent estimates by the OECD Secretariat also suggest that, like the United Kingdom, the United States, Germany and Japan (though not France or Canada) were getting back to levels of capacity utilization enjoyed in the early 1970s.

2.10 These observations imply that the slowdown and persistence of slower industrial world growth reflect growing supply-side deficiencies in industrial economies. In many cases, the main constraints on expansion and creation of new jobs appear to turn on a lack of suitable productive capacity which is profitable at prevailing levels of real wages and a fear that renewed growth would stimulate a resurgence of inflation.

2.11 The reasons for these developments are undoubtedly complex and not fully understood, but it is possible to identify some of the more obvious causes.

Supply Shocks

2.12 A variety of "supply shocks" in the 1970s rendered economically obsolete certain industrial plant and the jobs which went with it. Such obsolescence occurs quite naturally as a result of technical progress but, in the 1970s, the rate of obsolescence and thus scrapping of existing industrial capacity and jobs in the advanced economies probably accelerated on two counts -

a. There were increasingly strong pressures from newly industrialising countries as suppliers of competitive manufactured goods. The share of OECD imports of manufactured goods supplied by the NICs rose from 4½ per cent in 1970 to 8 per cent in 1977. The impact was concentrated in particular sectors: not only traditional ones like clothing but also newer activities like consumer electronics. The associated scrapping of plant and jobs (particularly unskilled jobs) probably added to unemployment, given the difficulties of re-allocating the labour thereby released to new product areas, often requiring higher skills.

b. the rise in the oil price, which quadrupled in 1973/74 and nearly trebled 5 years later, and the associated rise in real energy prices also rendered prematurely obsolete some proportion of existing industrial capacity and jobs. In some cases, plant which had been installed and operated profitably in an era of cheap energy was scrapped immediately; in other cases, the scrapping of energy-intensive capacity occurred more slowly as the investments concerned ceased to make any worthwhile contribution to overhead costs. These adjustment problems, which are continuing, are illustrated in the United Kingdom by the decline of the energy-intensive, basic industries like steel and chemicals.

Unrealistic Pay Demands

2.13 Some jobs and productive capacity were also lost in the 1970s as a result of an unwillingness of labour unions in a number of economies to accept a lower rate of advance of real wages, despite the reduced ability of economies to deliver such advances.

2.14 The attainable real growth in personal incomes, particularly of tax payers, declined after 1973 for a number of reasons -

a. A fall in productivity growth. This fall was partly induced by recession, but its origins also go back to the late 1960s. At that time, there were signs of weakening in the forces which had nurtured the historically unprecedented growth rates of the 1950s and 1960s. For example, there was an abatement to the prolonged post-war investment boom and reduced scope for productivity improvement by shifting labour off the land or, in Europe and Japan, by catching up with United States technology.

b. The continued rise in public expenditure. Long term commitments on public provision had been undertaken by Western governments in prosperous years when demands for better and more health care, education and support for the needy and disadvantaged seemed affordable as well as socially desirable. But when growth fell after 1973, the public expenditure share of GDP rose rapidly throughout the OECD area. By 1980, total outlays of governments represented nearly two-fifths of the GDP of OECD economies; this compares with a figure of a third in 1973. The rise in public spending created severe public finance problems and further increased the tax burden. Taxes in the OECD area rose from 32½ per cent of GDP in 1973 to 36½ per cent in 1980. Higher taxes probably reduced work incentives and, by frustrating the desire of workers for increasing personal living standards, reinforced the pressure for higher wages.

c. The rise in real oil prices. More goods in real terms had to be traded to pay for a given quantity of oil, leaving less for personal consumption. This "terms of trade" deterioration reduced OECD real income by about 2 per cent in both 1973 and 1979 though the United Kingdom was to some extent cushioned from this effect.

2.15 Generally, expectations for growth in real living standards did not attune quickly to what was feasible after 1973. The reasons include: the sheer complexity of modern industrial economies and the associated difficulties of understanding the economic implications of major changes; the belief that post-war growth rates would continue indefinitely and therefore that growth in the 1970s would return to previous levels; the unwillingness of leaders in political life and in industry to spell out the unpalatable message that real living standards had to adjust and grow more slowly; the (by then) established practice of effectively indexing pay to the rise in consumer prices in many economies; and deeply ingrained aspirations, befitting affluent societies, to own a home, at least one car, a TV and the latest luxury gadget. In short, aspirations for a fast rise in real incomes made possible by the growth in productivity in the 1950s and 1960s were generally extrapolated into a period when such aspirations were no longer realistic.

2.16 Our assessment is that unrealistic real income aspirations adversely affected capacity growth and jobs, if not immediately, then over a period of time. Experience differed between countries -

a. Pressure for higher real wages in excess of underlying productivity growth, or when oil prices had risen, in some cases succeeded but only at the expense of profits and jobs. A number of economies - notably, but not exclusively, in Europe - experienced sustained reductions in profit shares during the 1970s. A fall in actual and prospective profitability probably led, in turn, to accelerated scrapping of capacity and therefore jobs and a gradual substitution of machines for too expensive labour.

b. In addition, in some economies such as the United Kingdom, producers granted high nominal wage increases but attempted to pass them on in price increases in order to preserve profit margins. This

frustrated the desire for higher real wages. In principle, this process, repeated, would have led to hyperinflation. Government attempts to contain inflation, even at some stable level, led in the face of wage claims out of line with reality to an increase in spare capacity and labour market slack. In cases where pay aspirations adjusted very slowly, the end result may have been a scrapping of capital equipment and an atrophy of human skills.

#### Experience Across Economies

2.17 While the importance of these mechanisms remains a matter of debate, the flexibility or lack of it in the evolution of real wages helps to explain some of the differences between economies after 1973. The following examples illustrate this with particular reference to the different extent and pace of adjustment to the rise in oil prices:

a. The comparative buoyancy of employment in the United States may be partly ascribed to its real wage moderation in the face of the oil prices rises and a depreciating dollar, the latter partly reflecting reflationary policies. Real wages fell following both oil price rises and profit share in the United States remained reasonably stable. This moderation in real wages might be put down to union weakness and the rather low rate of unionization in the United States but also to its wage contract system which typically fixes cash wages 3 years in advance, *though increasingly these contracts include* ~~with limited scope for cost of living adjustment.~~ Hence, ~~an upward movement in prices immediately reduces real wages.~~

b. Despite its oil import dependence, the Japanese economy absorbed the second oil price rise comparatively smoothly because of moderation in nominal and real wage demands. This contrasts strongly with behaviour after the first oil price increase: GDP in Japan fell (by 1 per cent) in 1974 (following 9 per cent growth in 1972/73) and inflation rose to nearly 25 per cent. Nominal wages also rose very rapidly and although real wage growth began to moderate, there was nevertheless a severe squeeze on profits. Continued moderation in real wage growth thereafter and the more favourable adjustment to the second oil shock may be partly ascribed to monetary restraint but also to the underlying

flexibility of labour costs in Japan. This reflects the high degree of social consensus and commitment of workers to the long term viability of their companies, themselves subject to considerable competition, Japan's bonus payments system, and the extensive use of sub-contractors and small firms (which act as a buffer during economic downturns).

c. The absorption of the oil price increases by the German economy provides an example of more serious problems of real wage adjustment. After the first oil shock, there was a strong wage push in the face of a slowdown of economic activity. Unions - despite early warnings - appeared to disregard the fact that the rise in consumer prices resulting from the worsening of the terms of trade as oil prices rose represented a real income loss for which compensation could not be demanded from domestic firms without employment losses. Unlike in Japan, precisely the same kind of adjustment problem appears to have occurred in 1980. Professor Giersch (of the Kiel Institute), in particular, ascribes much of the heavy loss of jobs in Germany precisely to the pressure from unions for advances in real wages.

#### United Kingdom Experience

2.18 In the United Kingdom, there is evidence (notably in the very low rates of return on capital) of sluggish adjustment of aspirations. One estimate is that the effect of the fall in sustainable real income growth and the rise in the tax burden in the face of inflexible real wage aspirations increased permanently the unemployment rate consistent with merely stable inflation by 1½ percentage points in the mid 1970s. A number of factors (some of which apply with equal force in other economies) explain sluggish adjustment of pay aspirations in the United Kingdom despite heavy unemployment:

##### a. Unions

Unions have placed much more emphasis on improving wages than on maintaining or increasing the number of jobs, possibly as a result of the experience of full employment in the prosperous post war years and the commitment of governments at that time to manage demand in order to secure jobs. Old attitudes and objectives take time to change and



unions have found it easier to accept redundancies than to relax pressure for higher pay. Thus for most of the last ten years, for every stoppage caused by redundancy questions, there have been 20 stoppages over wages. Old attitudes and objectives have been reinforced by increased industrial muscle. The bargaining power of unions has been strengthened over the years by extensive legal immunities, by developments of modern technology which have increased the potential disruptive power of key groups of workers and by increases in membership. Union membership rose from 44 per cent of the labour force in 1960 to 55 per cent in 1979, one of the highest levels of union density by the standards of the major industrial economies. Some estimates suggest also that the "union mark-up" (ie the wage differential between union and non-union workers) rose significantly between 1968 and 1973 though it has since remained fairly constant.

b. Less Competitive Product Markets

Despite competition from imports, some product markets may have become less competitive as the result of the increased concentration of output in the hands of fewer large firms (discussed further in chapter 5). In addition, some industries, particularly in the public sector, are monopolies. The resistance of employers to pay claims may have weakened since they were able to pass on higher pay in the form of higher prices. This point is allied to a. in the sense that unions often have the greatest market power in companies/industries where competitive forces are weak.

c. Internal Labour Markets

In the United Kingdom, and in other major economies, a number of people have long term job security in the public sector and within large companies. These employers often have highly developed "internal labour markets" where most jobs are filled by the promotion or transfer of existing staff and not by new entrants. The purpose of these arrangements is to motivate and to encourage loyalty amongst experienced and well-trained employees. The extent of internal labour markets is reflected in the length of job tenure enjoyed by many in

employment. A recent estimate is that, in the mid-1970s, men in employment in the United Kingdom could expect to spend an average of 20 years (and women 12 years) with the same employer. At that time, the average length of job tenure in manufacturing appeared to be as high as in public administration. The effect of these developments is to shield substantial numbers of those in jobs from the direct influence of competitive forces in the labour market. Unless accompanied by specific agreements to promote pay flexibility (like profit sharing as in Japan), the growth of internal labour markets will therefore have reduced the responsiveness of wage increases to changes in economic conditions.

d. Employment Protection Legislation

In the United Kingdom and elsewhere, the general effect of the development of internal labour markets on wage responsiveness was reinforced by employment protection legislation.

e. Employers' Attitudes

There are strongly entrenched notions of "fairness" which make employers reluctant to push down the pay of employees and cut their living standards, and to pay below the local "going rate". Employers are also averse to sacking people in order to take on, at a lower wage, someone formerly unemployed and willing to work for lower pay. This partly explains the difficulty of the unemployed pricing themselves into jobs.

f. Wages Councils

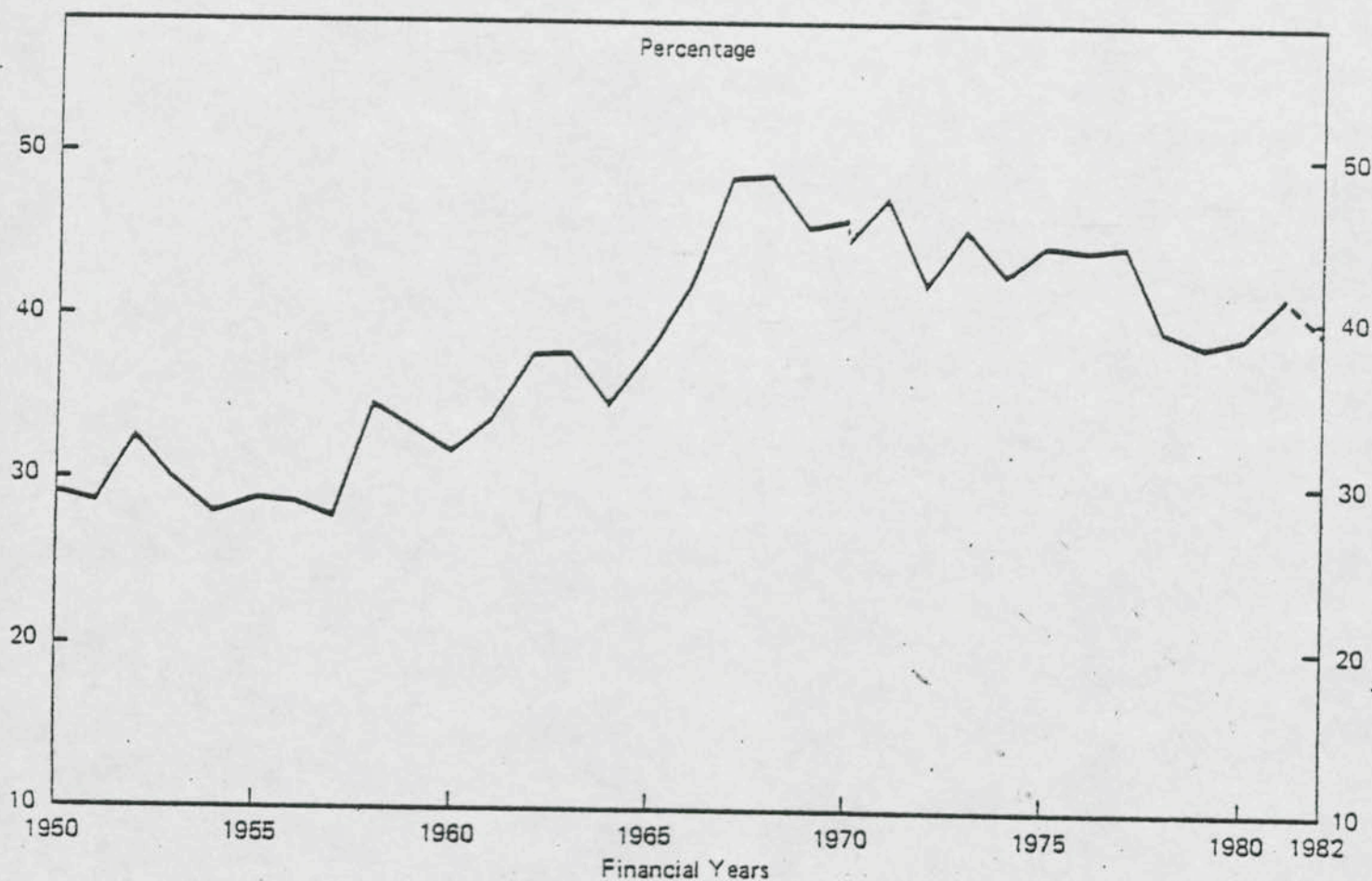
Wages councils may have made it difficult to adjust the wages of the lower-paid and largely unskilled workers.

g. Benefit levels

Figure 5 shows how social security benefits rose sharply in relation to earnings in the late 1960s before falling gradually in the 1970s. The increase in benefit in the late 1960s probably caused people to take up existing vacancies more slowly, adding to registered unemployment. A

URE 5

## Replacement rates for unemployed, Great Britain



## Notes

1. The replacement rate is total benefit received out of work divided by total net earnings in work.
2. Total benefit paid is total expenditure on Unemployment Benefit, Supplementary Benefit and Child Benefit/family allowances for the unemployed divided by the average number of registered unemployed people. For 1982/83, the estimated increase in income tax revenues due to the taxation of Unemployment Benefit and Supplementary Benefit has been deducted from the PESC estimate of benefit expenditure.
3. Total net earnings is a weighted average of the estimated net earnings of the various age, sex and family groups represented on the unemployment register. Net earnings are gross earnings plus Child Benefit/family allowance (where appropriate) less income tax and employees' national insurance contributions. The earnings of the groups has been adjusted in the light of the findings of the 1978 DHSS Cohort Study on the actual earnings of men experiencing unemployment. To calculate net earnings, various simplifying assumptions were made but from 1970 onwards the tax calculations allow for change in the main family characteristics of the unemployed. This accounts for the small break in the replacement rate series in 1970.

more powerful effect on employment may have come through the influence of benefits on the "wage floor". Although there is no strong evidence, employers may be reluctant to be seen to be paying less than the "family wage" (eg supplementary benefit level payable to a family man with two children). Hence benefit may hold up the going level of low pay. The effect on the total range of pay rates is not clear. Further details are given in Chapter 7 and Annex B.

### **The United Kingdom's Industrial Weakness**

2.19 In the United Kingdom the problems just described come on top of domestic supply weaknesses and generally poor industrial performance. This combination of adverse factors created additional problems for jobs.

2.20 The most obvious symptom of industrial weakness in the United Kingdom is its low productivity growth, although labour productivity is only one aspect of industry's overall competitiveness. Productivity growth has been persistently worse in the United Kingdom than abroad, with the inevitable result that there has emerged an ever-widening gap in levels of productivity. The National Institute, for example, estimated that, even in 1955, manufacturing output per man-hour was higher (by a margin of 8-18 per cent) in some major European countries. By 1980, estimates on a similar basis put the level of productivity in the United Kingdom at less than half that in the United States, the Netherlands, Japan and Germany; little more than half that of France and Belgium; and around two-thirds of that of Italy.

2.21 The long-standing malaise in British industry is only partly explained by economic factors. Relative to the level of output, productive investment in the United Kingdom does not compare too unfavourably with abroad; studies have shown that capital productivity - the increment to output achieved from investment - is, like labour productivity, a major weakness. Misdirected R and D expenditure, over-diversified product ranges, high marginal tax rates, excessive capital subsidies and uncertainty created by stop-go macro-economic policies have all contributed something to the explanation, but not the whole story.

2.22 A pervasive factor, which has been identified by commentators for over a century, is the lack of adaptability of British 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, has often been said to derive from management weakness - an "entrepreneurial failure". British managers have often been found to be less well educated or trained and lacking the animal spirits evident in their peers overseas. Part of the problem here may stem from institutional factors such as Britain's failure to develop a comprehensive technical education system.

2.23 Another pernicious influence has been the United Kingdom's system of collective bargaining and industrial relations. Labour militancy in the United Kingdom probably reflects not only union intransigence and greed but also the weakness of management in handling industrial relations and underlying class conflict. As a result, industrial performance and productivity have suffered. In a comprehensive study, Prais (of the National Institute) notes the greater frequency of short, small, "wildcat" strikes in Britain compared to abroad. Whilst harming the workers little in the short run, these are particularly disruptive to production. Moreover, the increased incidence of strikes with increasing sizes of plants is much more marked in Britain than in Germany or the United States. The result is a "comparative disadvantage for Britain in this respect in those industries in which production is required for technical reasons to be carried out on a very large scale". The highly decentralized, locally-based nature of collective bargaining, combined with the defensive strength of unions, inhibits long term planning and co-ordinated decision making, encourages restrictive labour practices, delays the adoption of new techniques and militates against quick responses to changes in the organisation of work. This disadvantage, allied to the degree to which trade unionism has penetrated the workplace, appears to be particularly pronounced in the United Kingdom.

2.24 A further effect of unions which represent the great masses of unskilled workers in the United Kingdom has probably been to reduce pay differentials between the skilled and unskilled. For example, the differential between pay for skilled workers and labourers in engineering narrowed by 10

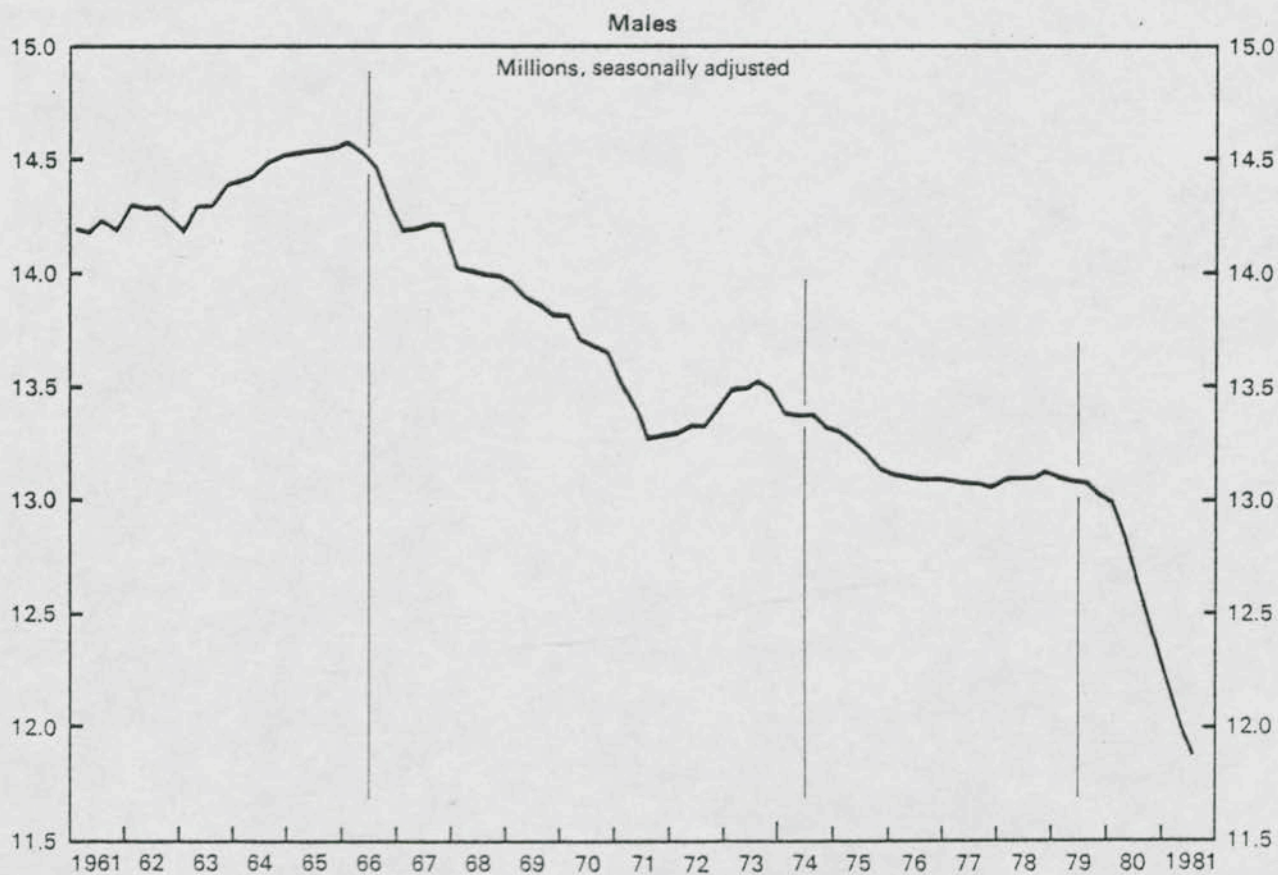
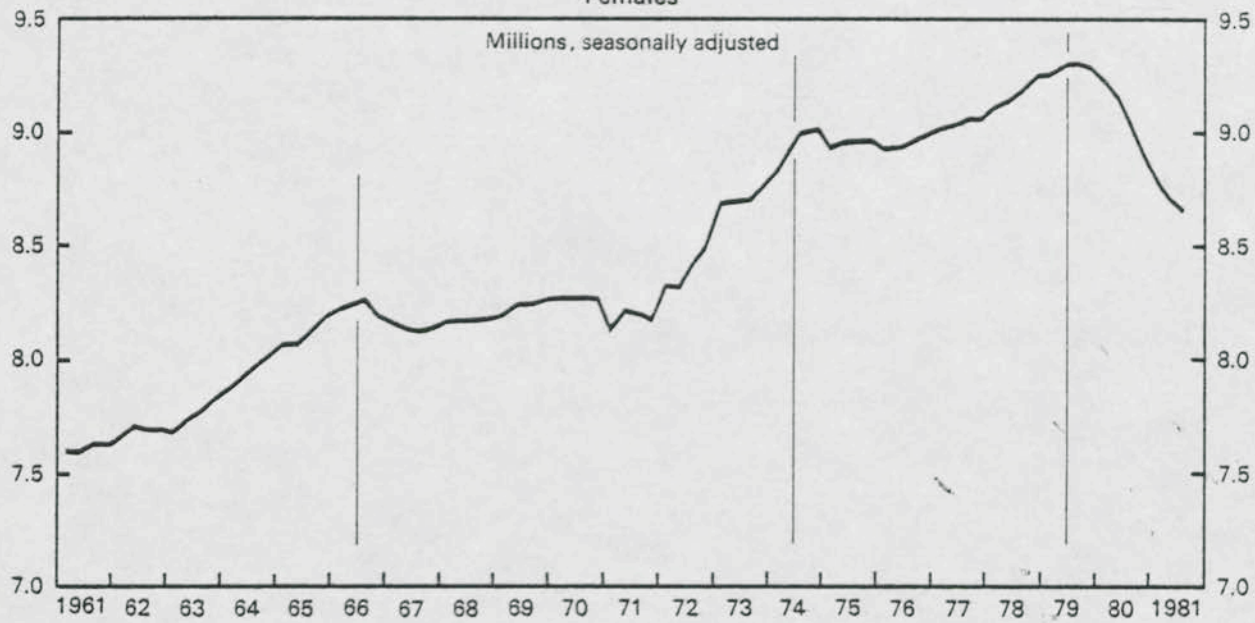
per cent between 1970 and 1980. Apart from undermining the job prospects of the unskilled, an important effect has been to reduce the rewards to investment in labour skills by individuals and companies. This may have added to the skill shortages which have plagued British industry.

2.25 Such fundamental industrial deficiencies prejudiced trading performance in terms of non-price as well as price competitiveness. In fact, (imperfect) measures of price/cost competitiveness indicate broad stability if not improvement between 1960 and 1978. It is the quality and reliability of British goods which have proved particularly deficient. As a result, there has been a tendency for imports of manufactures to rise disproportionately to increases in domestic output while exports fail to tap the strongest growing overseas markets.

2.26 The general impact of these weaknesses has been two-fold:

a. The inability to compete effectively in international markets has undermined the manufacturing sector's ability to generate jobs directly. There is a close association over time between jobs (especially male jobs) lost in manufacturing and the rise in unemployment in the United Kingdom (figures 6 and 7). The causal link is, however, unlikely to be a simple one: for example, while the older, less adaptable redundant steelworker may remain unemployed, others displaced from the manufacturing sector but with more marketable skills may succeed in finding jobs elsewhere and may thereby "bump down" others into unemployment. The fall in manufacturing employment in the United Kingdom appears particularly severe judged by the experience of other major economies. The fall preceded by a substantial margin the decline in manufacturing jobs in Europe and Japan seen in the 1970s. In the United States, manufacturing employment continued to expand until the latest recession. Moreover, while in other major economies manufacturing output rose between 1973 and 1979, the United Kingdom was unique in experiencing an absolute fall. (Part of this can be attributed to the diversion of resources into the development of the North Sea.)

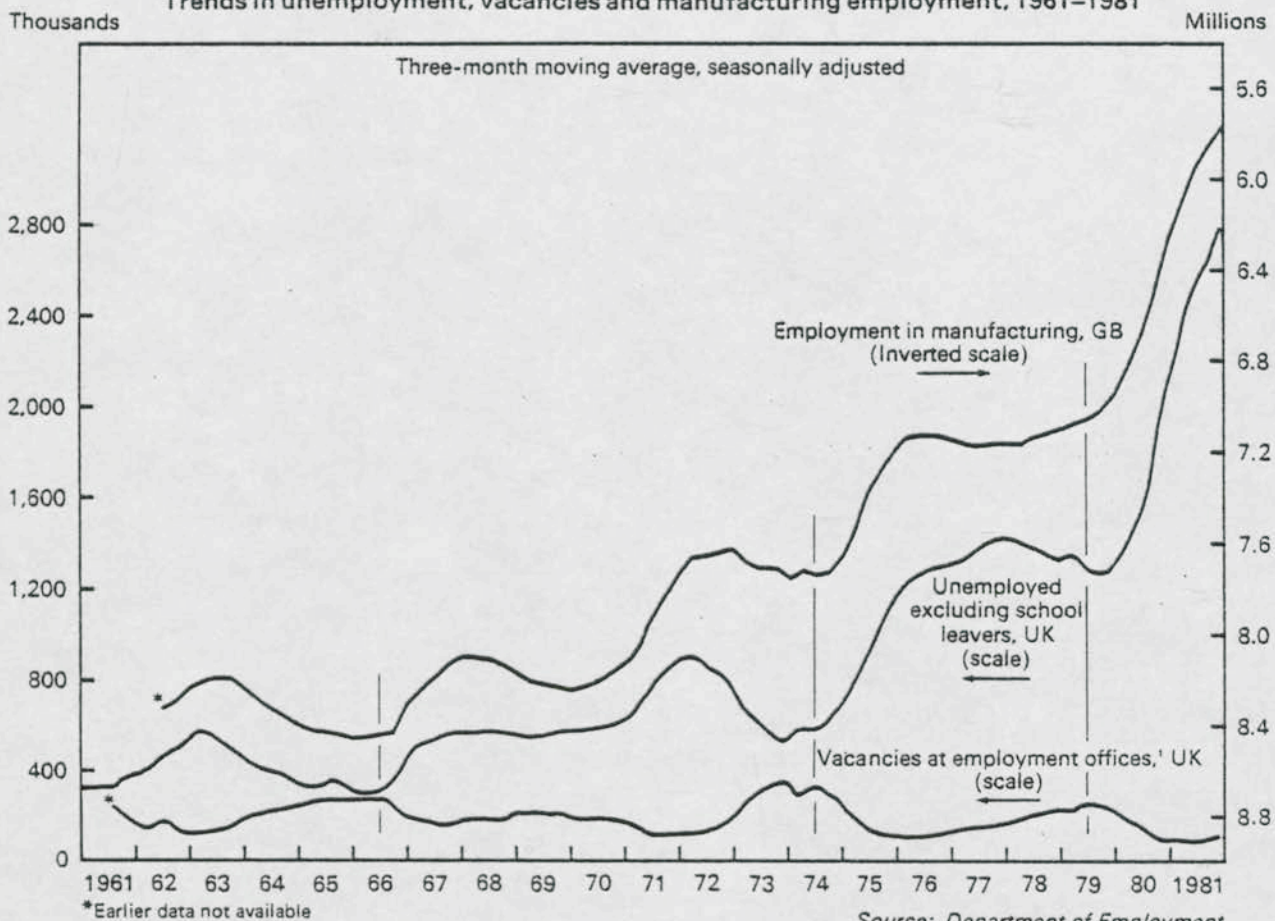
**FIGURE 6** Trends in male and female employment, Great Britain, 1961-1981



Source: Department of Employment

FIGURE 7

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





b. The high import propensity of the economy has meant that it fails to respond adequately when domestic demand increases. Extra spending often simply leaks into imports, creating balance of payments and exchange rate difficulties, and ultimately higher inflation. More generally, the United Kingdom, by its industrial weakness, has been constrained to grow at a rate less than that achieved by competitors abroad. This, in turn, has reduced the achievable growth of real income and employment in all sectors of the economy.

#### **United Kingdom Experience Since 1979**

2.27 After 1979, the last peak year of the cycle, a downturn in activity, here and abroad, added a cyclical component to the trend rise in unemployment caused by the various supply weaknesses described above.

2.28 Between the second quarters of 1979 and 1981 - the peak and trough of economic activity in the present cycle - GDP in the United Kingdom fell by 7 per cent and manufacturing output fell by 18 per cent. Of the 1.7 mn decline in employment, two-thirds was accounted for by falling jobs in manufacturing. Since early 1981, output has stabilized but employment has continued to fall.

2.29 Some of the output and employment difficulties reflect those experienced in the rest of the world in the wake of the second oil price increase, though a rise in the oil price itself should have affected the United Kingdom much less harshly than others who are not oil self-sufficient. The United Kingdom's real income would not have been reduced directly by the rise in oil prices, although the "oil effect" may have, nevertheless, caused some problems of adjustment and consequential loss of jobs in the trading sector. On balance, however the possession of oil was a substantial advantage for the United Kingdom.

2.30 Nevertheless, the gap in growth performance between the United Kingdom and the OECD economies widened. Annual average United Kingdom GDP growth had been 1½ percentage points below the OECD average between 1973 and 1979. In the subsequent two years, this "gap" doubled: OECD economies grew at about 1 per cent per annum while United Kingdom output

fell by over 2 per cent per annum. As already noted, United Kingdom unemployment also rose relative to that in other main economies. Between 1973 and 1979, United Kingdom unemployment represented typically just over 30 per cent of total unemployment in the rest of the EC (according to national definitions). By 1982, this ratio had jumped to over 40 per cent. Had unemployment in the United Kingdom moved in line with the rest of the EC (maintaining the 1973-79 average relationship) unemployment would now have been around 800,000 less. The increase in unemployment in the United Kingdom relative to abroad would have been considerably greater but for the fall in numbers in the working population.

2.31 Part of the sharp rise in unemployment can be ascribed to the temporary costs of bringing down inflation which was on a rising trend in 1979 due to the previous strong growth in the money supply and in earnings. It was always recognised by the Government that the side effect of squeezing inflation out of the system by containing the growth of the money supply would be a transitory fall in output and loss of jobs. The size and duration of these temporary costs depend on the speed with which inflation adapts to lower monetary growth. This in turn depends in part on how quickly expectations of inflation adapt. Had the mere announcement of a declining path for the money supply caused employers and employees immediately to mark down their price increases and wage demands, the output costs of counter-inflation policy would have been small. If inflation expectations remain sticky, the output/job cost of counter-inflation policies will be high.

2.32 Overseas perceptions of the counter-inflation policies embraced in the Medium Term Financial Strategy caused a strengthening of the exchange rate. Despite the fact that the broad measure of the money supply overshot its target, confidence in sterling was boosted by the commitment to bring inflation down and by the relatively high interest rates of the period. These monetary influences on sterling were reinforced by its petro-currency status and the sudden rise in real oil prices.

2.33 The shift in the behaviour of sterling was quite outside past experience: previously, and over broad periods, the exchange rate had moved downwards maintaining the United Kingdom's price and cost competitiveness. This failed to happen after 1979. Inflation of earnings rose between 1978/79 and 1979/80. Combined with the appreciation of the exchange rate, the surge in domestic wages and prices led to an unprecedented loss of labour cost competitiveness of 50 per cent between end 1978 and end 1980.

2.34 The initial major impact of the deterioration in competitiveness operated directly on domestic demand and output rather than through a worsening trade balance. In order to retain hard-won export markets, manufacturers cut back on their export prices and attempted to compete at home by containing the rise in prices of import-competing products. In both 1979 and especially 1980, export prices of manufactured products rose much less fast than domestic prices. Generally manufactured product prices rose less fast than retail prices or earnings. Added to the rise in real oil prices, the effect was to produce a severe squeeze on manufacturers' profitability and cash flow. Firms reacted by cutting back on stocks, investment and employment. This reaction initially had the tendency of reinforcing the cash squeeze as suppliers' stocks of finished goods rose and productivity fell (because output fell more quickly than employment), adding to the rise in real unit labour costs.

2.35 The severity of the recession in the United Kingdom and consequential sharp loss of jobs therefore occurred in part because pay expectations in all parts of the economy did not adjust quickly enough to the new environment, including an unexpectedly strong exchange rate. Employment may not, however, respond sufficiently when output recovers from the cycle to secure a fall in unemployment in the short run. The reversal of previously accommodating monetary policies and the sharp squeeze on industry forced management to take hard decisions to rationalise and cut jobs, decisions which had been deferred over the years partly because of the fear of opposition to closure and redundancy. Moreover people will not as a rule return to the actual jobs they have left. Prospects for unemployment to the end of the decade are considered in the next chapter.

CHAPTER 3: THE OUTLOOK FOR UNEMPLOYMENT

3.1. It is widely accepted that unemployment is a major problem and there are two reasons why it must attract Government attention in formulating policy at this time. First, the chances of unemployment returning to 'normal' post-war levels in the foreseeable future are low so long as the rigidities in the economy remain. Secondly, if unemployment continues at a high level, or indeed rises further, there will be harmful social and economic consequences both for the individuals concerned and for society at local and national levels. This chapter assesses the extent of these problems by describing the prospects for employment and unemployment and some of the major consequences of unemployment for individuals and for society.

Prospects for unemployment

3.2. An economy with zero unemployment is neither feasible nor desirable. For example, some degree of "frictional" unemployment is a necessary component of a dynamic economy: that is people are always changing jobs and moving in and out of the labour force temporarily. Changes in technology and market structures can make some workers "structurally" unemployed. There are some workers who for personal reasons are only marginally employable even when labour demand is high. Finally there are cyclical fluctuations in unemployment caused by variations in world trade. Allowing for these factors Beveridge recommended an average of 3 per cent unemployment as a desirable target for post war Britain. In practice in the 1950s and 1960s, unemployment stayed well below this figure and overheating often resulted. Also higher incomes have led to people being more selective about the jobs they take and this combined with more rapid economic change today requires a higher level of frictional unemployment so that a figure of 3 per cent is probably too low. Getting down to levels of 4 per cent - 5 per cent that is 1 million to 1.25 million could be regarded as a satisfactory outcome. But to attempt to achieve such a level quickly would involve serious inflation problems. At best the transition must be gradual and the figure considered as a long term goal.

3.3. As explained in Annex A (where the composition of unemployment figures is discussed in greater detail), a significant minority of the existing register of 3 million are not genuinely unemployed and would withdraw from the register if obliged to accept jobs. The numbers cannot be quantified with any certainty but our guess is that the number is around 500,000 (perhaps 300,000 of whom work in the black economy). On the other hand there are probably a greater number of people who do not at present register but who would do so if jobs were available or who participate in Special Employment Measures. Thus to reduce unemployment from 3 million to 1 million requires more than an extra 2 million jobs.

3.4. Looking ahead, the working population will change too and the chances of achieving this outcome over the rest of the decade depend upon -

- the rate of growth of the economy;
- changes in the size of the population of working age;
- the participation rate, (that is the proportion of the population of working age who will be actively seeking full time work);
- changes in the level of productivity including the effect of technological change.

3.5. Unless there is a further intensification of the world recession during 1982 the United Kingdom economy should begin to expand and attain growth of GDP of around 2 per cent from 1983 onwards. By the end of 1984 or early 1985 GDP should have returned to the level of 1979. Given a continuing recovery in competitiveness, there is then the prospect of steady growth for the rest of the decade of about 2-3 per cent per annum. However because of the changes in the other factors the return to 1979 levels of GDP is unlikely to bring about a return to the 1979 unemployment level of 1.3 million. Nor will growth of 2-3 per cent necessarily bring about a significant decrease in unemployment thereafter.

3.6. First between 1981 and 1991 the total population of the United Kingdom is projected to grow by around 2 per cent. The population of working age between 16 and 65 will rise more rapidly by 4 per cent, or 1.1m, and the largest increase will be in the 20-44 age groups. The numbers in the younger group (16-19) and the group (60-64) nearing retirement will actually be falling during this time.

3.7. Secondly participation rates may change. By 1980 they were higher in the United Kingdom than in most developed countries except Scandinavia but continued high unemployment has since discouraged some people from seeking jobs. For example, more men have chosen earlier retirement and fewer married women try to get jobs: these trends may now continue.

3.8. Because of the uncertainties it is difficult to derive precise figures for the overall increase in the numbers of people who will be actively seeking work by 1990. But taking the increase in the population of working age and allowing for the 'discouraged worker' effect it is likely that by 1990 the number of people actively seeking work will be 500,000 greater than now. If the economic situation improves, this in itself could encourage more people actively to seek work and so increases this number.

3.9. Thirdly, there is the problem of predicting productivity trends. Labour productivity in the 1960s and early 1970s increased at around  $2\frac{1}{2}$  per cent per annum for the economy as a whole, higher for manufacturing. There was a marked slowdown in the mid 1970s associated with lower levels of output growth and changes in relative prices. Then in 1979 productivity fell back as output was reduced and, despite the significant shake-out of labour, employers failed to adjust their labour force immediately to the same extent. The re-adjustment between labour and output followed from 1980 onwards and by 1981 labour productivity began to rise again quite sharply, especially in manufacturing. The question now is whether this rising trend of productivity is a temporary phenomenon or can be considered a more permanent change.

3.10. An improvement in United Kingdom competitiveness is an essential condition for economic growth and a rise in labour productivity an important element of that. The recent shake-out of labour and improvement in working practices mean that the same output is being achieved with a reduced labour force. This trend may continue: anecdotal evidence from some businessmen is that some further labour shedding may take place, particularly in sectors hitherto protected. Also, having gone through the 'trauma' of laying-off workers on a large scale (which was more acceptable to trade unions when output was falling fast and bankruptcy threatened) firms may be reluctant to increase their labour force to former levels: instead it is both cheaper and easier to reduce short time working, increase overtime and also install labour saving investment.

3.11. The other determinant of improved productivity and a further unknown is the pace and dissemination of technological development, (especially the wider use of micro-electronics). Historically technical progress has been associated with improved economic growth and higher living standards. Initial job losses have been offset by the effects of greater efficiency as the lower costs and prices have led to an increase for the demand of products generally and improved market opportunities overseas. It is not clear that current technical changes are of an entirely different order of magnitude from those historically. However a number of commentators have raised this as a possibility, in particular questioning how far increased jobs in the service sector can offset the loss of jobs elsewhere.

3.12. Micro-technology will probably result in job displacement in some sectors. For example, further computerisation and the more extensive use of word processors may cause job losses in routine clerical and typing work. Further use in financial services such as insurance and banking could result in lower need for labour there. And the greater use of computer controlled manufacturing processes and robotics will have a continuing effect on some manufacturing activities. However there is certainly no case for slowing up the introduction of these techniques because of the employment consequences: this could only lead in the longer term to a less efficient and less competitive economy.

3.13. Our general expectation is that new technologies will be introduced fairly slowly because of the high initial costs involved, the need to train staff and supervisors and probably because of some continued resistance. In the immediate outlook, the job displacement effects are not likely to be significant in relation to the current level of unemployment. The importance of these developments lies in the consequences for the pattern of employment, and in particular the further decline of routine, unskilled work; the implications for education and training are considerable. The major growth of employment in the service sector is likely to arise where human care and attention cannot be replaced by mechanisation for example in health and welfare services (in both the private and public sectors) and in other areas such as tourism, leisure and personal services where demand can be expected to grow with increasing prosperity.

3.14. If, as seems likely, productivity growth continues at 2 per cent or more, as it did in the 1960s, an average growth of GDP from now to 1990 of 2 per cent will succeed only in keeping employment at around current levels. Combined with the expected growth in the labour force, and - an important reservation - other things being equal, this could lead to unemployment rising rather than falling for the rest of the decade. A lower growth rate would also lead to further increases in unemployment.

3.15. Other things must therefore not remain equal. The prospect referred to above is based on a continuation of former economic relationships and it is possible to conceive and necessary to achieve a more optimistic scenario. A restoration of business confidence could significantly change the outlook. There are already some signs of this in terms of greater realism on pay, and a reassertion of the will of management to manage (and sweep away inefficient practices). There is also the possibility of a further upturn of world trade as inflation falls and interest rates follows suit. Throughout the industrial world, the adjustment of the capital stock to a regime of higher



energy prices may be complete and this could now be followed by a new wave of investment to take advantage of technological improvements. Rigidities in the operation of market forces should weaken. A further stimulus should follow in the United Kingdom from a reduction in tax burdens in general when we reach the stage of fiscal headroom anticipated in the MTFS. All these factors could gel to provide a period of sustained recovery and rates of economic growth much higher than those of the 1970s.

3.16. The rate of growth would still be constrained by two key factors - the level of productive capacity available, including a labour force with the right skills, and the inflation proneness in the economy. It is not known how much capacity has been lost over recent years and how much has become technically obsolete (particularly at current wage levels). The longer the recession lasts the further the capacity base will be whittled away. Various estimates of excess capacity in the United Kingdom economy have been derived but these vary widely from 6 per cent to around 27 per cent (depending on different definitions and methods of estimating). If it is at the lower end of the range, a rapid expansion of demand would cause shortages and lead to a significant increase in imports.

3.17. To be sure that higher growth leads to more jobs and is not accompanied by higher inflation it is important that wage increases are contained. Lower wage increases from now on would further improve international competitiveness so increasing export opportunities and displacing some imports. Lower rates of inflation would permit a higher level of real growth within a given money supply, though the lags in the process are such that this improvement may take some time to come through unless Government responds promptly to the need to ensure that any headroom available is used to boost economic activity: this aspect is discussed in Chapter 10. Further, in the longer term, a substantial reduction in the cost of labour in relation to capital would result in the substitution of labour for capital and an increased demand for labour intensive activities, opening up the prospect for a new range of jobs.

3.18. The question is how great is the overall effect on unemployment of a lower rate of wage inflation? It is difficult to give precise estimates but on the basis of some simulation work by the Treasury a rough guide is that if, over the next two or three years wage settlements could be held at zero and earnings overall allowed to rise by no more than 2-3 per cent, the level of unemployment should fall by about 500,000, possibly more. Part of this comes from improved competitiveness but the greater part comes from the favourable effects on activity of lower inflation. Such restraint would entail an initial fall in real wage rates which could be offset by fiscal relaxation. As employment then rose, so total employment income would rise too.

#### Consequences

3.19. The prospect of unemployment continuing at or around its present level has profound consequences. In economic terms the cost of paying benefits to the unemployed (£140 million for each extra hundred thousand unemployed) has been one of the main causes of the continuing growth in public spending. In addition there is a substantial but unquantifiable loss of output from leaving human resources idle, together with a longer term loss of productive potential. There is evidence that long spells of unemployment, regardless of age, set workers on a downward trail: they drop down the occupational ladder and are more likely to become unemployed again in future. And it is plausible though unproven that widespread experience of unemployment will weaken the 'work ethic' among young people.

3.20. The depressed state of the labour market and the economy entails other efficiency costs. Employers' cutbacks in skill training and in recruitment foreshadow (despite the general training being given to the young unemployed) a new generation whose employment potential has not adequately been developed. Labour mobility is depressed because workers with jobs lack the confidence to move. Similarly as previously discussed, businessmen may become more risk averse and useable capacity may decline.

3.21. The social consequences arise not only from the level of unemployment but also from its concentrated incidence. Although 300,000 people join and leave the unemployment register every month, well over 1 million have been without work for at least a year\* and many others face recurrent unemployment. One in every 5 young workers under the age of 25 is unemployed at any time, and 265,000 of them have been continuously on the register for a year. One in every 3 unskilled or semi-skilled male workers is unemployed. The picture for these groups is worse outside Southern England.

3.22. The financial consequences of being unemployed are particularly severe for heads of families with children, who however make up under 20 per cent\*\* (ie under 600,000) of the unemployed. Cash benefits and free services ensure that unemployment need no longer cause abject poverty. But families with an unemployed father are much poorer than families with a father in work (partly because unemployed men are much less likely to have working wives) and families with a long term unemployed father are poorer than any other group in society. Households containing single unemployed people are less well off, (relative to their needs) than the average working household, but significantly better off than households where the main breadwinner is unemployed. Under a fifth of single unemployed people live in households whose aggregate income is at or below the supplementary benefit level (see table 1).

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\* Over 1 million have been continuously registered for a year (including 375,000 for 2 years). Others have had their spell of unemployment broken only by sickness, or a training course. The reasons for the concentrated incidence is not clear: it is noteworthy that in the United States less than a million <sup>people</sup> are currently reported to have been continuously <sup>un</sup>employed for over a year, even though the total number of unemployed is three times <sup>the UK</sup> that figure.

\*\* This estimate relates to February 1982.

TABLE 1. INCOMES OF HOUSEHOLDS AFFECTED BY UNEMPLOYMENT\* - 1980

Family Type of Unemployed Person	Distribution of Incomes Relative to Supplementary Benefit Levels** (%)			
	(% of total unemployed)***	Incomes at or below SB levels	Incomes up to 40 per cent above SB levels	Incomes more than 40 per cent above SB levels
Single Person	(55)	16	20	64
Married Woman	(10)	4	4	92
Married Man with children	(19)	40	37	23
Married Man without children	(16)	26	26	48
All Households with Unemployed member	(100)	23	20	57

Source: 1980 Family Expenditure Survey

Notes:

(\*) One or more member seeking employment, not necessarily registered unemployed.

(\*\*) The table shows the distribution of actual incomes of households, where at least one member ("single person", "married woman", etc) is unemployed, relative to the sum of notional supplementary benefit entitlements of household members. The current SB levels for a married man with non-working wife and two children aged 4 and 6 are £55 plus an average of £20 for housing costs. For married couples without children they are £38 plus an average of £17 for housing. For single non-householders over 18 they are £21 (figures rounded to nearest £)

(\*\*\*) Estimated composition of registered unemployed at February 1982.

3.23. Although they are the poorest of the unemployed those family men who become unemployed tend to have been poor even when in work. The proportional drop in income on becoming unemployed is greatest for those without dependents. The young unemployed tend to feel financially deprived compared with others who have decent jobs and compared with the high material standards of previous post-war generations of young people.

3.24. Probably the most worrying effect of modern unemployment on living standards is the long term impoverishing effect of prolonged dependency on benefit. Supplementary benefit rules encourage people to reduce what savings they have. On benefit people have no prospect of bettering their financial position or saving in preparation for setting up a home of their own, or for their retirement. Because prolonged unemployed sets people on a downward path it risks locking them into life time poverty with increased dependence on the state at every stage in the life cycle.

3.25. Financial considerations aside, there is evidence that most unemployed people understandably feel deprived by the loss of interest and activity which employment provides and become depressed and frustrated by their inability to find work. Though individuals differ people who have been accustomed to regular employment, together with young people expecting to make their way in life, appear in general to be more seriously affected than people with an irregular employment history. Other things being equal, men seem to suffer these feelings more than women, presumably because it is easier for women to fall back on a housekeeping role. There is some limited evidence that prolonged unemployment also adversely affects the physical health of unemployed people, particularly men from stable employment backgrounds, but for the majority of the unemployed a link between unemployment and ill-health has not been firmly established.

3.26. The consequences of high <sup>national</sup> unemployment for local communities are highly variable. Because of the pattern of industrial decline, the incidence of unemployment is nearly twice as high in the old industrial regions as in the South. Moreover, in large urban areas, the unemployed tend to be heavily concentrated in inner city areas and council housing estates where rates of unemployment among the resident working population can exceed 50 per cent. Concern about the social effect of such concentrations of unemployment currently tends to centre on the potential effects on crime and socially disruptive behaviour. While the link between youth unemployment and socially disruptive behaviour is complex and little understood, common sense suggests that it is dangerous for society to have a young generation which feels it has little stake in the future.

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3.27. The social effects of unemployment can only properly be understood within the context of particular communities, taking into account their social cohesiveness, notably the strength of family ties, relations between majority and minority groups, the quality of leadership in the community and police community relations. Our 1981 report on Merseyside identified the spiral of decline which characterizes communities whose economic main spring has gone. The most able people leave; people in authority despair of restoring prosperity; local people, including school children, resign themselves to a future of chronic unemployment. The welfare safety net ensures that the communities remain in existence but cannot make them thrive. Such problems have increased in severity and extent because of high unemployment but existed in some areas when unemployment nationally was at a tolerable level. Though it is beyond the scope of this report, working out how to cope with such areas should be a major part of a strategy of living with high unemployment.

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CHAPTER 4: REMEDIES FOR UNEMPLOYMENT - GENERAL APPROACH

4.1 A strategy for tackling unemployment needs to meet two basic requirements. First, it must recognise the complexity of the overall objectives: what society wants is not just high employment but worthwhile paid employment which leads to high living standards in a stable society with low and stable inflation. The first part of this chapter discusses the kind of economic structure which could reconcile this mixture of objectives in the long run. Secondly, it is necessary to recognise the length of time which it will take to cure the fundamental causes of unemployment; the strategy must therefore continue to balance longer term cures with measures of relief which do not subvert the longer term objectives. The general approach to coping with unemployment is discussed in the second part of this chapter.

**The Future Shape of the Economy**

4.2 The earlier analysis showed that the achievement of high employment, high growth and low and stable inflation depends fundamentally on improving the general competitive performance of Britain's internationally traded sector and on introducing a much greater degree of flexibility into the operation of labour and product markets, so that the economy can become more resilient in the face of recession and other shocks.

4.3 Trading competitiveness depends on the wide range of factors which make up supply side performance. There is for example a need to improve profitability and to use these profits to achieve the investment in both human and physical capital which will secure new markets and products; to develop and apply innovative ideas effectively; and to improve the quality of management and the level of risk taking. A detailed appraisal of all these issues would be out of place in this report though some are covered in Chapter 5.

4.4 Our analysis of the need for greater flexibility is primarily in terms of the labour market, though there is also a need in product markets for greater flexibility of response to market opportunities (see paragraph 4.12 below). In present circumstances the particular need is for real wages to fall relative to productivity in order to restore profits. Also wage differentials need to reflect and thereby correct imbalances in demand and supply for different categories of labour.

4.5 The aim of increasing real wage flexibility (at a time when the initial flexibility must be downwards) is likely to run into conflict with trade unions and often with the public's sense of fairness. In addition, in important parts of the labour market the idea of lowering wages meets opposition from some employers. Although there are signs of favourable changes in some of these attitudes, they remain strong enough to hinder progress to higher levels of employment, by delaying the process of change. It needs to be made clear that the goal is not a low wage economy but an abatement in living standards today so that the seeds can be sown for future prosperity.

4.6 In considering how change can best be brought about it is useful to distinguish between what for the purpose of this report we call the primary and secondary sectors of the economy. The primary sector comprises the large, well established, more stable employers both private and public. The secondary sector includes medium and smaller enterprises and new ventures (including those established here recently by foreign companies) where risks and opportunities are often higher and where changes in market conditions have a more immediate impact. The boundary between these two is not precise and an individual company would fall somewhere along the spectrum between them. Moreover the de-merging and decentralisation of large companies can result in a number of their activities having the characteristics of the secondary sector. The significance of the distinction is that, whilst it is essential that both the primary and secondary sectors become more competitive, we would not expect this necessarily to lead to higher employment in the primary sector: employment gains will come mainly in the secondary sector.

4.7 In general, firms in the primary sector find it efficient to have highly-trained, well-motivated staff in secure career jobs. To achieve this they would rather have few relatively well-paid people than more people on lower pay. In particular, firms in the trading sector consider that survival in world markets will depend at least as much on having the right products of the right quality as on cost. These quality factors in turn depend on having highly trained staff with low turnover and co-operative working relationships between workforce and management. Managements take the view that their task is to improve efficiency, not to maximise employment. There is considerable justification for these views.



4.8 Some trading organisations are consequently reluctant to support radical labour market reforms, designed to free up employment. They fear that these would disrupt working relations and hence undermine other management initiatives to improve efficiency and competitiveness. Moreover, even if statutory employment protection and union power could be wished away and the "wage floor" reduced, providing wage flexibility, many organisations would, for reasons of long run efficiency as well as fairness, be reluctant to employ people at lower wages.

4.9 Lessons from abroad, notably Japan, show that a high wage career job sector operates far more successfully if it has internal and external mechanisms of wage flexibility and adaptability to give it the necessary resilience. Big Japanese firms have a large bonus element in wages and obtain flexible use of labour (eg no demarcation disputes) and consensus about company aims in return for job security. They are also underpinned by a flexible sector of small businesses and sub-contractors and the self-employed. Comparatively few British firms have managed to secure comparable adaptability and wage flexibility from career employees, or developed similar consensus between workforce and management about company aims. There is an external margin of flexibility in the use of sub-contractors and short contract labour but our secondary sector of small businesses and self employed is very small by international standards.

4.10 We must increase the degree of flexibility and competition in our economy if we are to generate growth and employment in a non-inflationary way. It is essential in particular to persist with efforts to import more flexibility into wage setting arrangements of large organisations in a way which recognises the requirements for efficiency of the trading sector. Moreover, in order for the income earned by the trading sector to be effective in generating service jobs there needs to be sufficient flexibility and enterprise elsewhere notably in services and construction, to identify and exploit opportunities offered by current market needs and available labour. Several service sectors (e.g. construction, distribution, catering) do have a greater margin of flexibility in that they have a comparatively high proportion of small businesses, or else part-time or casual employment. But many service industry markets are dominated by public monopolies or by private organisations (e.g. banking) in the primary sector.

4.11 The most promising way of achieving a more flexible labour market and a competitive economy may be to allow the secondary sector to operate and expand in a less regulated environment. Even within the present framework of regulation an expansion of small businesses and self-employed would increase the overall amount of flexibility in the economy because there would be more entrepreneurs, more competition in product and service markets and more people whose wages and working conditions are set by individual rather than collective bargaining. If, in addition, measures are taken to make people cheaper and easier to employ, they are likely to have their principal effect in this sector. The expansion of the secondary sector should be assisted by encouraging de-mergers and greater decentralisation of control in the private sector and by contracting out and privatisation in the public sector.

4.12 This strategy for encouraging the secondary sector offers scope for efficiency gains. The increasing concentration in United Kingdom product markets, facilitated by too many mergers, (as well as too much public ownership) has not brought about the hoped for gains in efficiency. Instead there have been diseconomies of scale, with poor industrial relations and the general inertia which comes with large managerial bureaucracies. In product markets, large scale will still remain important for certain activities eg those requiring heavy pre-production expenditure <sup>or</sup> research and development. But to meet the rapidly changing patterns of demand in the 1980s there is a need for some shift from large to small scale units of production.

4.13 Moreover expanding the secondary sector offers the best scope for introducing labour market flexibility into the operations of the primary sector while minimising the risks of efficiency losses brought about by disruption and confrontation. Through the supply of sub-contracted services the secondary sector would provide increased flexibility. Also increased competition would pose a challenging effect so that existing constraints are broken down and the efficiency of the primary sector increased. We discuss in Chapter 5 how individual areas of policy (such as policy towards trade unions) can contribute to these ends.

4.14 In one sense the approach suggested here is a restatement of existing Government policy ie to encourage entrepreneurship and small scale business. In another it is a radical reversal of past trends towards the extension throughout the labour market of job security, stable wages (at worst) and constraints on management's freedom of action. The message to be got across is that the mixture of employees' rights which appeared attainable in a historically unprecedented period of steady economic growth is no longer apt for an age which is likely to be prone to economic shocks. In these less certain circumstances working people at all levels will need to be prepared to trade something, whether it is their employment security, the stability of their pay, or adherence to their accustomed tasks. The primary and secondary sectors offer the opportunity for these trade offs to be made in different ways.

4.15 The more the primary sector adapts, the more secure employment there will be and the less concern there need be about the prospect of secondary sector workers being poor and exploited. Low paid or irregular work will usually be a lesser evil than having no jobs at all. But there is a growing problem here which must be acknowledged and resolved if the approach is to be accepted as compatible with social stability. It can be addressed in several ways eg through income transfers to prevent family poverty, safeguards against outright exploitation, flexible patterns of working time which allow careers to be split between primary and secondary sectors, and an education system which provides effective ladders to upward mobility.

#### **Cures and Palliatives**

4.16 The approach discussed above aims to achieve both high employment and lasting growth in the longer run. But this will not cure unemployment in the shorter term. At present, economic policies are supplemented by a variety of Special Employment Measures (SEMs). These already absorb large amounts of public expenditure even in net terms and the constraints on spending more are severe. This strengthens the need to appraise the role of SEMs and to see whether there are more cost effective ways of meeting employment objectives. At present SEMs are designed and presented as temporary measures whose common feature and overriding aim is to reduce the level of

registered unemployment in the short term. They work in a variety of ways. Some promote training and/or lower wages and hence make a positive contribution to the economic strategy. Others, involving such things as labour intensive work outside the normal market, early retirement and job-sharing, tend rather to be seen and presented as temporary deviations from the main thrust of economic policy. Labour intensive activities, reduction in the labour force and work-sharing are not at present regarded as desirable objectives in themselves, because of fears that they may be inconsistent with efficiency and hence with long term growth. They need not have these undesirable effects, particularly if they are introduced on a voluntary basis.

4.17 The need is for a broader view of economic strategy which incorporates measures to reduce and alleviate unemployment for as long as they are needed. Because they will be more than temporary, it will be even more important to minimise any efficiency costs. Measures designed to relieve the pain of unemployment do not necessarily entail an efficiency cost and wherever possible, measures which have no such cost should be preferred. It is also desirable to design measures so that if possible they further the aims of market flexibility discussed earlier.

4.18 There is considerable scope for measures which would alleviate unemployment by removing market rigidities. For example, the level of employment is affected by the higher taxation of labour, relative to capital and by the institutional factors which hold up the wage floor. Labour force participation is affected by tax incentives for working wives, and by the rigid pattern which pension schemes impose on the pattern of working life. The incidence of unemployment on given groups is influenced by the job security afforded to existing employees which leads the "market" to discriminate against new entrants, and by the rigidity of collectively bargained wage structures which prevents disadvantaged job seekers from pricing themselves below other candidates.

4.19 The danger of subsidies to employers is that they can reduce the downward pressure on wages and hence delay the market's adjustment. But wage subsidies can be designed which work with the grain of the market,

notably by incorporating a wage ceiling. In this form they need not entail an efficiency cost. Wage supplements for heads of families in low wage jobs will be an important part of the strategy approach. Only by breaking the linkage in the public mind between low pay and family poverty will the public be brought to accept a substantially larger low wage sector.

4.20 Measures which enable people to cope with being unemployed (by providing income, useful occupation and status), currently barely figures at all among the explicit aims of employment measures. Yet they could be both important and cost effective in enabling society to live through a period of high unemployment and thus retaining public confidence in tackling the long term problems.

4.21 The policy proposals which follow reflect the range of objectives and the longer term economic framework discussed in this chapter. Chapter 5 discusses measures to help improve economic performance. Chapter 6 discusses efficient ways of generating more employment. Chapter 7 considers possible changes to the tax and benefit systems which would provide a greater inducement to create and take employment, while preserving a welfare safety net. Chapter 8 deals with the development of more flexible patterns of working time. Chapter 9 considers other possible measures to reduce, and alleviate the incidence of unemployment, particularly long term unemployment.

**CHAPTER 5: IMPROVING THE ECONOMY'S SUPPLY SIDE PERFORMANCE**

5.1 The analysis in Chapter 2 confirmed the view that supply side deficiencies have been a major limitation to growth of output and employment in the United Kingdom, most evident in the lower level of productivity compared to that of other advanced industrialised countries and in our greater susceptibility to inflation. The Government has already undertaken a number of policy initiatives to reduce the constraints imposed by, for example, the monopoly power of trade unions, excessive taxation and bureaucratic regulations. The purpose of this chapter is to review what scope there is for further action in a number of key areas. In doing so, the chapter adopts the approach of Chapter 4 in reflecting the distinctive roles of the primary and secondary sectors and the different scope which they offer in practice for achieving and exploiting labour market reform to generate employment. Thus, for the policy areas considered, we look for further ways to improve the competitiveness of the primary part of the trading sector and to improve wage flexibility while also recognising the constraints imposed by the bureaucratic tendencies of such organisations. We also look for ways of expanding the flexible secondary sector and encouraging greater employment there.

5.2 The policy areas considered are -

- a. education and training;
- b. trades unions
- c. labour mobility
- d. competition policy
- e. small firms
- f. innovation

A. EDUCATION AND TRAINING

5.3 It is something of a paradox that while Britain's record of scientific and creative achievement is internationally renowned, weaknesses in education and training are an important cause of our poor industrial performance. Basically this is because we give too little attention and status to technical education and to the education of the least academically able. (Also, some problems blamed on education and training arise more fundamentally from social attitudes, including an anti industry culture.)

5.4 In the unemployment context, the role of schools has particular relevance. The 11 years of compulsory schooling should give all young people the basic equipment to cope with adult and working life. At present it does not. The deficiencies are reflected in the fact that the Youth Training Scheme (YTS) for school leavers will include instruction in basic literary, numeracy and spoken English, work discipline and skills in dealing with people, - all things which should be learnt in school. In 1980 nearly 25 per cent of workers aged under 25 with no educational qualifications were unemployed and the present rate will be considerably higher. The younger the age group, the more the employment prospects of the qualified and the unqualified diverge. The problems of the unqualified partly reflect the use of qualifications as a screening device in recruitment and partly the relative decline in demand for unskilled <sup>manned</sup> ~~manned~~ labour.

5.5 It is vitally important both for economic performance and for social mobility that ladders should exist for young people, including those from less privileged backgrounds, to progress upward through the educational system. It is a deficiency of the British system that there is no effective ladder through vocational education, partly because of craft and professional barriers and because of weak links between further education on the one hand and school and higher education in the other. At present the proportion of young people continuing their education beyond 18 is lower in Britain than in several newly industrialised countries, for example Hong Kong and Korea.

5.6 Within industry the low output of technicians and craftsmen (half the German level), the low percentage of managers with formal qualifications, and the small percentage of the workforce with any vocational qualifications (one third, counting all degrees and A levels, compared with two thirds in Germany), together with the restrictive practices which surround our apprenticeship system, have all contributed to the overmanning, inflexibility, and inefficiency of British industry. For years there has been a conflict of objectives in Britain between keeping up the number of apprentices trained and reforming the system or replacing it by something more flexible. Apprentice numbers are on a downward trend and the new Youth Training Scheme (YTS) may hasten the demise or reform of the present system. This will ultimately be a good thing so long as YTS achieves its objectives on quality as well as quantity. The Government have said that companies should eventually take over responsibility for financing YTS, but the unlikelihood of recovering an adequate return on training which equips people with very general skills is such that, as with apprenticeships, companies are unlikely to accept the responsibility without a clear financial inducement (such as the apprenticeship tax in France).

5.7 The highly specialised nature of many jobs, together with geographical immobility and rigidities affecting access to training and skilled employment, create the risk that skill bottlenecks will emerge as economic recovery gets under way, despite the high level of unemployment and the very slack market for skilled workers at present. Difficulties are more likely at technician and higher levels than in manual grades.

5.8 Some of the training problems outlined here have been addressed by the Government's new training initiative. Others were covered in the CPRS report on Education, Training and Industrial Performance and we are to do further work in this area at Ministers' request. This is not the place for a comprehensive set of policy recommendations. From the particular viewpoint of unemployment, however, the following specific <sup>options</sup> points are worth consideration -



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- a. a determined effort to improve the standard of education overall to reduce the numbers of academically unqualified, and to fit young people better for a world in which jobs in service occupations will predominate;
- b. the introduction of a balanced school leaver certificate (preferably comprising a profile of achievements relevant to employers) to reduce the problems of those currently unqualified but employable and to exert leverage on the school curriculum to secure the improvements mentioned at a.;
- c. the experience obtained in the Youth Training Scheme is of considerable relevance to schools and DES could take on responsibility for disseminating this;
- d. if resources permit, the introduction of a means-tested scheme of financial assistance to encourage able pupils from low-income families to stay on at school, perhaps introduced initially on a pilot basis in areas of high unemployment;
- e. a low cost programme (described in Chapter 9 paragraph 24b), to address the education<sup>al</sup> deficiencies of the existing unemployed and improve their ability and willingness to take jobs in service occupations.

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B. POLICIES TOWARDS TRADES UNIONS

5.9 Chapter 2 showed that the action and attitudes of trades unions, and the growth and wide extent of unionisation in the British economy are important contributory factors to our historically poor industrial performance and, in particular, to the lack of flexible wage adjustment. Equally important in the analysis are the factors which have permitted the growth of union power - the legislative framework, weak management, lack of competition in product markets, public notions of "fairness" in pay matters, together with the now diminishing role accorded to the TUC in the conduct of public affairs.

5.10 In the primary sector the existence of unions has to be accepted as a fact of life ~~in the primary sector~~ and they can, indeed play a constructive role. Here policies should aim to get management and the labour force working together more effectively. This can be done not only through measures to restore the balance in bargaining power but also by making the unions more aware of their responsibility for the true long term interests of their members, and by increasing employees' commitment to the future of their employer's business. In the secondary sector the direct influence of trades unions should be much less and policies should aim to minimise their indirect influence by preventing the attitudes of organised labour from spilling over into the non-unionised sector and by reducing unions' power to inhibit the sector's expansion.

The primary sector

5.11 Policies to reduce trades union power in the primary sector, and to swing the bargaining balance back in favour of management, can follow two complementary approaches. Some measures can be taken to restrict the activities of trades unions and to limit the damage they inflict through industrial action: other measures can be used to change the internal structures of unions to make them more responsive to the realities of the competitive markets in which their members operate.

5.12 The 1980 Employment Act incorporated measures to reduce trade union power through reducing the immunity of individuals. Subsequently, the 1981 Green Paper extensively discussed the question of union immunities and as a

result the 1982 Employment Bill incorporates further measures to reduce union power. Should this legislation prove inadequate, it may be useful to introduce legislation, eg requiring secret balloting before strike action or imposing cooling off periods, further to reduce unions' abilities to disrupt employers' business through industrial action.

5.13 In parallel with moves to reduce trades unions' immunities, the Department of Employment has been considering measures to make unions more democratic and as a result reflect their membership's views more accurately. Such measures as the election of union officials by secret ballot will be comprehensively discussed in a forthcoming Green Paper, and subsequent legislation considered.

#### The secondary sector

5.14 The power of unions to inhibit the growth of the secondary sector arises first from the power to take industrial action to prevent the use of non-union contract labour and to delay the contracting out and privatisation of public sector functions to the private sector. The 1982 Employment Bill takes some first steps to reduce the problems by outlawing trade union labour only contracts and by removing immunities from unions and individuals taking industrial action against the use of non-union labour.

5.15 Unions can also use their influence to extend the concepts of job security and collectively bargained wage rates throughout the labour market. This has been much reduced recently, although the vein of thinking still influences some European initiatives, the most recent examples being the proposals to regulate part-time and temporary work. The TUC's presence on the MSC also imposes a constraint on the development and implementation of <sup>politics to secure</sup> ~~coherent~~ employment opportunities through labour market reform.

#### Employee awareness

5.16 In parallel with moves to reduce trade union power, measures to increase individual employees' awareness of and commitment to their employers' business should be encouraged. There is a need for greater understanding of the effects on the business of excessive wage claims, and restrictive practices. Also individual employees should have information about developments which will affect substantially their jobs and area of work.

This can be brought about by better, effective, and more regular communication between management and workforce, and not only through established trades unions channels. Encouraging moves to link pay more closely to the overall performance of companies will also help.

5.17 Action the Government could take includes -

- a. if they prove necessary, further legislative measures to reduce trade union immunities;
- b. measures, including legislative changes, to make unions more responsive to their membership's views;
- c. encouraging firms to increase their employees' sense of commitment to the business through moves to increase employee understanding of financial results and factors affecting the business as well as linking pay more closely to performance.

C. LABOUR MOBILITY

5.18 The amount of job changing in the British labour market has declined considerably over the past decade. This appears to reflect the growth in company labour markets and job security, the increasing effect of pension schemes, and the reduced growth and dynamism in the economy. Uncertainty about job opportunities has made voluntarily job changing particularly sluggish at present.

5.19 Geographical mobility in Britain is generally regarded as low, especially by North American standards, but there is no firm international evidence to support this. The obstacles are well known. These relate to the cost and ease of finding housing, the standard and continuity of children's education, the availability of a job for the other partner in two-job households and also the general reluctance of people to leave familiar surroundings - the rest of their family and friends - to live elsewhere.

5.20 The CPRS studied ways of overcoming the obstacles to geographical mobility in a report for MISC 14 in 1980. The main area which is amenable to Government action is housing and the Government have taken a number of steps to encourage mobility in all housing sectors. The remaining options mostly entail major financial or political costs and these seem hard to justify at present when the demand for housing to attract mobile workers is comparatively low. Some unsatisfied demand exists, however, in a few local labour markets in southern England and more local problems could quickly emerge in an upturn. Given the large supply of unemployed unskilled workers in most areas, it appears improbable that the expansion of the secondary sector advocated in Chapter 4 would be unduly constrained by geographical immobility, though ultimately the limited supply of, and problems of access to, low-cost housing in more affluent parts of the country could become a problem.

5.21 The following are some of the main measures (most of them already considered and rejected) which could be taken to free up the housing market for mobile workers:

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- a. Remove the power of local authorities to deny non-residents access to council houses.
- b. When it becomes possible to spend <sup>more</sup> ~~none~~ on housing, allocate more investment funds to housing associations to build houses and hostels for mobile workers in areas of buoyant labour demand, and induce associations to give a higher priority to mobile workers when reletting existing dwellings.
- c. Outside London, remove Rent Act controls from new private lettings of existing dwellings, substituting an arbitration arrangement in cases of dispute about rent increases but allowing the initial rent to be arrived at by agreement between landlord and tenant.
- d. Simplify the legal arrangements for house purchase and remove the solicitors' conveyancing monopoly, so as to reduce transaction costs and delays.

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D. COMPETITION POLICY

5.22 In the United Kingdom concentration of production in the hands of a few large firms has increased significantly in the post-war period and is generally reckoned to be greater than in other countries, for example compared to the United States and West Germany. Greater concentration does not necessarily mean less competition, especially where there is freedom to import. However many mergers have reduced competition without bringing any return in the shape of greater efficiency or higher employment. In addition trade policy has in general become more restrictive in recent years (for example, the proportion of trade of manufactured goods subject to one of a number of non-tariff barriers or "voluntary" agreements has increased). The effect of these developments on employment is not clear but they have probably contributed to a generally lower level of efficiency, greater proneness to inflation (because costs can be passed on in higher prices) and a bad distribution and utilisation of resources, especially of investment. The most pernicious effect on productivity growth is in situations where lack of competition in product markets is associated with a lack of management incentives, with strong trade union power and restrictive labour practices. These have been most evident in the sheltered part of the public trading sector (eg energy industries, railways and water) though they also exist in some parts of the private sector.

5.23 Actions the Government could take include -

a. a more rigorous mergers policy by requiring the OFT to impose tighter criteria and, perhaps by re-considering the earlier proposal to require a "neutral" presumption;

b. further encouragement to large firms to de-merge to form more flexible units: the formation of new firms and the ability to spot profitable activities would also be encouraged by requiring ~~con-~~glomerates to publish details of the profitability of their separate trading activities;

*companies*

*disaggregated*

*diversified*

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c. more references of abuse of monopoly power to the MMC (under the Fair Trading Act): each year since 1979 there have been two such references and there is scope for increasing the number of these;

d. further steps to weaken the monopoly position of parts of the public trading sector by decentralisation, privatisation of subsidiaries and liberalisation of private sector competition.

e. whenever specific proposals for subsidy or for trade protection are revised, greater attention should be given to the consequences for the level of competition and in <sup>from</sup>~~time~~ the long term efficiency of the economy as a whole.

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E. SMALL FIRMS

5.24 One of the main themes of this report is the importance of the secondary sector: this will benefit from expanding the role small firms play in the economy. The significance of the Black Economy is covered in a separate CPRS report. In this section we consider the legitimate small firms sector and the scope for further action, covering -

- enterprise zones
- enterprise allowances
- public purchasing, contracting out and privatisation
- enterprise agencies.

The objectives are to encourage the growth of existing enterprises and to encourage the creation of new ventures.

Enterprise zones

5.25 The Government has decided that enterprise zones have been sufficiently successful to justify creating eleven more. Much of the success of the existing zones stems from the preferential tax reliefs which have been marketed by public development bodies as an additional locational inducement to mobile enterprise. However, in general enterprise zones have not been used specifically to promote the secondary sector as originally envisaged in the Chancellor's "Isle of Dogs" Speech. Incentives should be concentrated to provide help for smaller, enterprises especially where the zones are located in run down urban areas. Guidance from a local enterprise trust and financial support by the enterprise allowance scheme would enable the local, unemployed people to develop new activities.

Enterprise allowance

5.26 The pilot enterprise allowance scheme, currently being run by MSC in 4 areas, provides £40 a week (taxable) for a year to people wanting to start their own small business, provided that they have been unemployed for at least 13 weeks and can show that they can lay their hands on £1,000 business capital. The scheme is a special employment measure, designed to reduce registered unemployment as well as expand the supply of successful

entrepreneurs. Provisional assessments of the register effect of the pilot schemes have been disappointing because most participants say they already intended to go into business. But no account has yet been taken of the scheme's effect in transferring people from the black to the white economy, nor of the effect on the success of the enterprises. There must be some positive effect of both kinds and these should be taken into account when the future of the scheme is decided.

5.27 No doubt the pilot studies will reveal a number of deficiencies and opportunities for abuse. If these can be ironed out in this autumn's review, and a workable and effective national scheme devised, we believe this should have high priority when the balance of employment measures comes to be renewed. In particular consideration could be given to extending the scheme to people already in employment, perhaps as a variant of the existing Job Release Scheme. Thus, people would be eligible for a year's enterprise allowance if they gave up their full time job and were replaced by someone from the unemployment register.

#### Public purchasing, contracting out and privatisation

5.28 It remains extremely difficult for a small business to become eligible to tender for work for large public and private bodies. Often centralised purchasing results in substantial discounts and so saves public money. But where this is not so the purchasing authority should be decentralised.

5.29 The Government are committed to extend the area of public purchasing by contracting out the provision of goods and services currently provided in-house by Government bodies. Until now, contracting out has been seen primarily as a way of exposing the public sector to competitive pressures and thus eliminating waste. When it fulfils these conditions, it can also be seen as a tool for encouraging the secondary sector. The work contracted out would provide a regular income for small businesses, which would then have a sounder basis on which to identify and meet further market opportunities in the private sector. In some cases, management and the employment of labour could be contracted out ahead of the transfer of premises and plant, which could be sold to the contractor when established. Where private sector

capacity is unavailable, because there is currently no demand for it, the problem would be reduced if encouragement were given to the equivalent of "management buy-outs" whereby the public employees currently providing a service were given an incentive to move into the private sector and contract for their previous work.

5.30 The breakdown of public monopolies and/or exposing them to private competition is viewed primarily as a way of improving efficiency, extending choice and reducing public expenditure. Ministers are interested in extending privatisation into the public services eg health and education. Privatisation could also increase the scope for expansion of the secondary sector, where the activities transferred to the market sector were capable of being picked up by entrepreneurs operating in a competitive environment. In time, this would generate extra job opportunities by enabling demands to be met which are currently suppressed by public spending constraints and the high cost of public provision, and (like contracting out) by providing a launching pad from which the entrepreneurs concerned would develop new market opportunities, including wider opportunities for international trade.

#### Enterprise agencies

5.31 A distinguishing feature of small firms is the desire for independence - the black economy is the extreme example of this. However, lack of expertise in every aspect of business means that small business owners can often benefit from the large number of agencies which are available to offer advice, both at national and local levels. Government help from a number of agencies is further supplemented by local authorities and also a number of private sector organisations. This multiplicity of agencies can become counter-productive and it is not necessarily in the national interest to have a large number of organisations "competing" to give finance and other facilities on subsidised terms. Thought should be given to rationalise the support for small businesses, without dampening initiative.

5.32 Local organisations, particularly enterprise trusts drawn from the local business community, are probably better suited than national bodies to provide help to small businesses. In particular these have the flexibility to provide informal help covering such matters as form filling, planning and fire regulations, tax and national insurance. Such informal help is often more useful than formalised training and other forms of assistance.

5.33 The Government is already doing a great deal to help the growth and viability of small firms. When considering further action, the following should be taken into account -

- a. enterprise zones should be organised to give special encouragement to the secondary sector, especially by the development of new small firms in urban derelict areas;
- b. the aim of this autumn's review of the pilot enterprise allowance scheme should be to develop a cost-effective national scheme for implementation when it becomes possible to allocate resources for this purpose;
- c. public purchasing, contracting out and privatisation proposals should include an objective of increasing the opportunities of small firms to increase their share of the business where it is cost-effective;
- d. the system of providing help for small firms needs to be rationalised: preference should be given to local enterprise trusts which are the most effective help at the local level.

F. INNOVATION

5.34 Innovation to provide new products and increased productivity in the manufacture of existing products is vital if industry in the United Kingdom is to improve its competitive performance, halt the decline in our share of world trade and resist imports in our home market. A poor record of innovation has cost us dearly in a number of sectors, for example electronic equipment and consumer durables. We have also failed to develop a significant sector of new technology-based companies which has been one of the most dynamic areas of new employment opportunities in other countries, especially the USA.

5.35 Our scientific excellence and inventive capacity is recognised world wide (many highly innovative companies, especially in the USA and Canada, have British scientists and engineers in key positions). Our failure has been to translate these qualities into successful innovation in the market place. It is unlikely that this failure is due to insufficient total spending on R & D which, at least as a proportion of GDP, is at roughly the same level as in other countries. However, much of our R & D is in non-traded areas such as defence and contributes little to industrial performance. There is often a 'development gap' between R & D and commercialisation where typical R & D funding levels are inadequate but project financing is too risky. Financial assistance has too often been given to prop up older declining industries rather than speed the growth of newer industries.

5.36 Government action is best taken to lubricate the role of market forces in stimulating natural innovation rather than attempting to force innovation where the will or incentive does not exist. Action the Government could take includes:

- a. Enhancement of the industrial effectiveness of the large Government expenditure on R & D, particularly in defence, by promoting commercial awareness and incentives in Government R & D establishments.

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- b. Greater financial assistance to industry and independent R & D organisations for technology transfer (including 'demonstrator' projects) especially for technology originating from abroad and for new high growth/high risk technologies such as robotics, microelectronics, fibre optics and opto-electronics, and biotechnology.
- c. Reassessment of the role of the British Technology Group as an agent for technology transfer, especially its performance as a monopoly holder of the right of first refusal to inventions made through public expenditure on R & D.
- d. Improved protection for intellectual property through a reformed system for patents, design copyright and trademarks.
- e. A request to the University Grants Committee and the National Advisory Body for local Authority Higher Education to identify future shortages of skills for innovation in areas of new technology and to divert resources to increase selectively the output of our education and training system to meet these shortages.

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CHAPTER 6: ENCOURAGING EFFICIENT WAYS OF GENERATING MORE EMPLOYMENT

6.1 The level of employment in the economy depends not only on the economy's efficiency and trading performance. It also depends among other things on the responsiveness of wage levels to labour supply and demand; the indirect costs of employing people, relative to other factors of production; and the presence of adequate market mechanisms for matching available labour and unmet market needs.

6.2 In this Chapter we consider ways of increasing the economy's potential to offer employment, without sacrificing efficiency. We cover ways of:

- a. lowering the wage floor;
- b. reducing or compensating for the administrative burdens of employing labour, especially for small employers;
- c. reducing the taxation of labour relative to capital;
- d. providing incentives to domestic households to provide employment;
- e. providing public goods and services in a more labour intensive, but efficient, way.

a. Lowering the Wage Floor

6.3 It is easier for small firms than for larger organisations to vary their wage rates according to the state of the labour market. However, this freedom is curtailed, in the industrial sectors in which small businesses chiefly predominate, by the existence of statutory minimum wages set by wages councils. At present, there is widespread public suspicion that the abolition of wages councils would lead to the impoverishment of low-paid workers without any appreciable compensatory increase in employment. Public unwillingness to believe that "a good thing like high wages can cause a bad thing like unemployment" (Beveridge, 1931) or the corollary, is a long standing phenomenon. We believe it will be desirable to abolish wages

councils when international obligations permit but this will not be politically acceptable unless it is accompanied by complementary measures. These should aim to expand the market opportunities available to the secondary sector and to remove other obstacles to the provision of employment (see below) together with changes to the tax and benefit systems so as to provide an effective and acceptable safety net for people with families in low-paid employment.

6.4 It would be best to precede the introduction of such measures by a campaign of public education, directed not least at employers, which would address people's genuine fears about the consequences of low wages. An immediate purpose of this campaign would be to seek to persuade members of wages councils (while they still exist) to set more realistic minima. The campaign would emphasise the fact the most people in low paid jobs do not come from poor households; that the great majority (80 per cent) of the unemployed do not have children to support, and a considerable proportion are single with other earners in the household; and that only a minority (16 per cent) of all jobs are filled by people with children to support on a single wage. It would point out that family income supplement (FIS) is available to support the wages of breadwinners whose responsibilities are large relative to the wage their skills command. It would argue that, if society insists that all jobs must carry a family wage then the effect is to prevent jobs from arising which would meet the needs for income and occupation of very many of the unemployed.

6.5 The State system of unemployment benefits can exercise an upward influence on wages in the secondary sector, while benefit rules affect people's preparedness to take secondary jobs. Chapter 7 discusses the extent of these problems and how they might be dealt with.

b. Reducing or Compensating for Administrative Burdens

6.6 On top of the intrinsic difficulties of employing people the state imposes a series of administrative burdens on employers. These responsibilities are particularly burdensome for small firms. There are in principle two complementary ways of reducing these:



- a. make the obligations on employers lighter for small businesses than for larger ones;
- b. give small businesses special help in meeting their obligations.

The Government has made progress on both these fronts. For example, employees of small firms (with up to 20 employees) now have to be employed longer (2 years) before unfair dismissal legislation bites and there are various schemes of training and advice to help small employers to cope with their administrative burdens.

6.7 So far there has been a reluctance to go much further down the first road, for fear of creating a second class of employee with inferior conditions of employment. However, a secondary market of irregular less attractive jobs already exists and indeed it forms the employment background of many of the unemployed. If the minimum standards for employment set in the primary market are applied across the full economy, then the effect is to squeeze secondary employment out of the system altogether or into the black economy. It may be a lesser evil to provide (at least for small firms) lower minimum standards for conditions of employment than emerge from the shared values and interests of managers and organised labour in the primary sector. If Ministers agree with this conclusion they might want to reconsider options which have previously been rejected eg to relieve small firms of statutory obligations to provide redundancy payments, to permit employees to opt for non-protected employment contracts and to relax small firms' obligations under equal opportunity legislation. In addition, it will be essential to continue resisting EC initiatives to regulate part-time and casual employment in the same way as full-time jobs.

c. Capital subsidies and labour taxes

6.8 The present system of taxation in the United Kingdom provides substantial inducements to capital investment combined with various taxes on the employment of labour. Examples of investment incentives include the 100 per cent first year tax allowances for expenditure on plant and machinery, the deductibility for tax purposes of interest payments and, in regions of high

unemployment, the payment of grants for capital expenditure. Employers' contributions to national insurance and the national insurance surcharge are measures which have the effect of labour taxes by adding directly to labour costs though, in principle, a case can be made for so regarding all taxes (direct and indirect) which have the effect of raising the wage at which people are willing to work.

6.9 A characterisation of the tax system as one which simply subsidises capital and taxes labour is of course an over-simplification. A variety of reliefs on personal incomes mitigate the full effect of direct taxation on the supply of effort. And, to a certain extent, capital allowances (and stock relief) can be seen as a way of confining taxation of the corporate sector to "real profits" as distinct from the "paper profits" which result from inflation. Nevertheless, despite these and other complications, there is little doubt that present tax arrangements are biased in favour of capital: making it more worthwhile, at the margin, for a company to invest in machines rather than men.

6.10 The rationale for this bias in tax arrangements was, in our view, poorly founded and it is even less compelling in today's conditions of high unemployment. Various grants and incentives were introduced over the years in the belief that this would stimulate investment, particularly in manufacturing industry. The underlying reasoning was that Britain's problems stemmed from inadequate investment. Even at its best, this argument was weak. More investment, embodying the latest technology, to develop new products and processes is certainly desirable but unlikely to be achieved in a cost-effective manner by indiscriminate capital subsidy. Moreover, the same incentives made it easier to live with, and may have encouraged, low rates of return and an inefficient use of capital, which, as noted in Chapter 2 is a feature of the United Kingdom's productivity record. Jobs, especially unskilled jobs, may well have been prejudiced as a result of excessive labour-saving investment and by the encouragement of capital-intensive rather than labour-intensive activities.

6.11 For these reasons, the CPRS believes there is a good case for reconsidering the balance of present taxes and incentives. The general approach would be to reduce capital subsidies and labour taxes together in a way that leaves industry no worse off overall but nevertheless helps to arrest and reverse any tendencies towards an excessive substitution of machines for labour. The juxtaposition of higher-than-average levels of unemployment and of rates of subsidisation for capital investment in depressed regions makes this change particularly desirable in the context of regional policy.

d. Encouraging Private Households to Offer Employment

6.12 Notwithstanding the mechanisation of many household tasks there ought in principle to be a considerable unmet demand by domestic households (notably among two income couples and single working householders) for labour to carry out work (including child minding) in and around the house. There are many constraints which prevent this demand from being fully translated into jobs for the unemployed. These include the level of wage rates in the regular economy, competition from the black economy, the present benefit rates, and the difficulty of arranging the supervision of work during normal working hours, of finding suitable workers and checking their reliability.

6.13 It is worth considering seriously how to overcome these obstacles and encourage private households to offer work opportunities to the unemployed. Options to be considered include a tax allowance for accredited expenditure on household services (a system of spot checks would be required) together with exemption from employer national insurance contributions. Since many of the jobs would be for odd hours, this might lead to the development of a network of agencies (perhaps provided by the private sector on a franchising basis) to package odd jobs into worthwhile part or full-time job opportunities, to arrange back-up facilities such as transport and to act as a trouble shooter. Already firms like Dynorod franchise individual entrepreneurs and centrally provide a well-known name, advertising promotion, a telephone number to ring, and assurance of quality. We believe that a study should be made of ways in which the private sector could be encouraged to do more in this area.

6.14 Support for employment by the domestic household sector might be a cost-effective alternative to some existing special employment measures. Bearing in mind the substantial resources that are to be consumed in running the new Youth Training Scheme and the Community Work Scheme, it might be cost-effective to shift some of these resources of manpower and publicity into marketing the services of the unemployed, particularly those who do not need a family wage, among small firms and the domestic household sector. We understand that the Secretary of State for Employment is considering whether to extend the scope of the Young Workers' Scheme, by making it available for jobs in domestic households. We support this. We would see merit in repackaging the Young Workers' Scheme to cover young people up to the age of 25 with a wage limit of perhaps £60 for the over 18s. In any event we recommend that the scheme should be marketed more vigorously.

e. Labour Intensive Patterns of Public Spending

6.15 A large part of the nation's income is recycled through the tax system in the form of central and local government spending. Public spending priorities and the mix of inputs to individual spending programmes thus have a considerable influence on the level of employment in the economy at any given level of national income. Given the necessary information about the employment effects of different spending options, government can therefore in principle adjust the pattern of public spending so as to increase employment. This is already done to some extent on an ad hoc basis and we cover the scope for doing so more systematically in the discussion of palliative measures in Chapter 9.

6.16 The difficult question is to decide what scope, if any, there is for increasing the employment generating capacity of the public sector without loss of efficiency, within planned spending totals. We see the following opportunities:

- a. The ranking of public spending priorities is always arbitrary to some degree: where options appear equally worthwhile in other respects, preference could be given to the option generating most employment: this could apply particularly to capital projects. We suggest examples in Annex C.

b. Sometimes there is a choice of ways of meeting the same public need and one is more labour intensive but no more expensive than the other. The House of Lords Select Committee quoted examples relating to the choice between conservation of energy and water on the one hand and the construction of new supply capacity on the other.

c. Departmental manpower targets and local government head-counts are the most effective way of cutting back overmanning. They may also be a convenient way of keeping up the pressure to eliminate unnecessary Government functions and to reduce bureaucracy and waste. However, they may also have an effect (similar to labour taxation) of unduly depressing the balance between labour and capital inputs. They also prevent staff from being offered a direct trade off between pay moderation and jobs. Once overmanning has been eliminated targets expressed in terms of annual running costs ought to be equally effective in securing efficiency and would avoid the risk of harmful effects on employment.

#### Conclusions

6.17 This chapter discusses a number of ways of increasing the supply of jobs in the economy by encouraging, without loss of efficiency, the development of more labour intensive activities. The main points are:

a. The Government should decide in principle to abolish wage councils and should prepare for this by introducing other measures to increase the supply of jobs in the secondary sector and by mounting a campaign of public education to address public fears about low pay.

b. Allowing small firms to provide lower minimum standards of employment conditions and job security is a lesser evil than mass unemployment; previous decisions eg to retain statutory redundancy payment obligations for small firms should be reconsidered.

c. Present tax arrangements, which subsidise capital extensively and tax labour, are a hangover from a time of labour shortage. They have accommodated the inefficient use of capital and probably led to excessive labour saving investment. It is desirable to correct the imbalances without making industry worse off overall, by reducing capital subsidies and labour taxes together. There is a particular need to achieve this in the regional context.

d. It seems probable that there is a considerable unmet demand for labour to carry out household tasks. Ways should be found of translating these unmet demands into jobs for the unemployed. We make a number of suggestions, including when they can be afforded a tax allowance for expenditure on household services, and development and promotion of the Young Workers' Scheme.

e. The share of labour intensive activities in national output is considerably influenced by the pattern of public expenditure. Systematic account should be taken of employment effects when priorities are decided. Where other factors are equal there should be a preference for options which generate more jobs. We favour the use of limits on annual running costs, rather than manpower targets, as a means of eliminating bureaucracy.

CHAPTER 7: THE TAX AND BENEFIT SYSTEMS

7.1 In Chapter 2 of this report we identified ways by which the personal tax and benefit systems affect the efficiency of the economy in general and unemployment in particular. As a broad generalisation, the higher the rate of taxation of work income at the margin, and the higher the level of benefits paid to those out-of-work, the less the incentive to seek work and the higher the wages that have to be paid to attract workers. One way of reducing these effects is to change the levels of direct personal taxation and benefit payments: the other possibility is to change the structure of the tax and benefit systems.

7.2 Annex B provides a discussion of background data, including material on the previous earnings of unemployed people, which need to be taken into account in considering any reforms. For example, of the total men out of work, 53 per cent are single, and 76 per cent are without children. Less than one in ten fits the much quoted stereotype of a married man with two children. Moreover the proportion of the unemployed with dependent children has declined steadily over the last 10 years.

7.3 In this chapter we consider three particular ways in which the present system is detrimental to employment -

- a. the effect on the "wage floor";
- b. lack of incentives to seek and take work;
- c. the disincentives, once unemployed, to take part-time work.

(The question of the taxation of labour relative to capital was discussed in Chapter 6.)

7.4 The disincentives and complexity of the present system argue strongly for radical reform. However, radical proposals run into difficulties both on grounds of cost and because their introduction is judged not to be administratively feasible before income tax is fully computerised. While both arguments are reasons for delaying the implementation of major changes, neither should be a barrier to the planning of a reform strategy. In particular we note that PAYE computerisation is well under way.

7.5 The details of a radical strategy would take us well beyond our terms of reference. But we would offer three observations. First, history and the experience of other more prosperous countries suggest that to wait for economic growth alone to reduce marginal tax levels and to end unemployment and poverty "traps" will be to wait a very long time. The time could be shortened if there was a deliberate plan to reduce tax allowances and reliefs and introduce instead lower tax rates which rose in small steps over narrower income bands. Secondly, because of the high cost, it is unrealistic to expect to be able to "buy out" the main means tested benefits for those in work through the development of universal benefit such as child benefit. Income tested benefits for the employed have grown significantly in the last few years, in terms both of cost and of their potential importance for work incentives. If there is to be greater readiness to accept low and variable wages and work sharing, in-work benefits will have to become more effective. The key question is how to use the income tax system to improve the receipt and visibility of income related in-work benefits. Finally, a smooth transition from benefit recipient to taxpayer is not dependent on the introduction of tax credits or a negative income tax system: if the Government decided upon the desired pattern of transition (for example no marginal tax rates over 90 per cent) it could then seek to adjust the various elements of the present tax and benefit systems to conform broadly to such a pattern.

7.6 For the short term, we consider various piece-meal changes.



The "Wage Floor"

7.7 One way by which the tax and benefit systems could diminish the supply of low paid jobs is by raising the "wage floor". Because some employees expect, and some employers feel obliged to pay, a wage rate which covers the 'family wage' (interpreted as the gross wage necessary to match the basic supplementary benefits a married man with two children would receive out of work) the benefit levels could put upward pressure on wage negotiations. In so far as this keeps wages higher than they would otherwise be, this in turn limits the number of low paid jobs - even for single people who might be willing to work for less than the 'family wage'.

7.8 There is no strong evidence of this effect (see Annex B), but as can be seen in figure 8, for a man with two children (and a wife who is not in work and lives in a council house) there has been a marked narrowing of the gap between the 'family wage' and earnings in a low paid job (ie earnings at the lower quartile of the earnings distribution). As noted above, such families continue to be given prominence in official statistics, and in turn in wage bargaining, but in fact they represent less than 2 per cent of all families with a head below pension age.

7.9 The simplest solutions are to adjust the levels of taxes and out-of-work benefits. For example -

a. the uprating of the supplementary benefit scale rate could be held back. Apart from a once-and-for-all increase for most families with children in 1980 (following the Supplementary Benefit Review) there has been no significant increase in the scale rate in recent years. One way of achieving a real reduction if wages are expected to fall in real terms, would be to link benefit changes to prices or earnings whichever rose the slower (or fell more) or, more equitably to earnings alone: alternatively indexation could be abandoned completely;

b. the unemployed on supplementary benefit could be given less generous help with housing costs. The main element in the rising level of supplementary benefit has been the automatic increase given for

housing costs (which have risen substantially as the result of the move towards economic pricing for council rents). If rents are expected to continue to rise faster than earnings, there is a case for offering benefit recipients less than 100 per cent of housing costs;

c. the tax burden on the low paid could be lessened. Increases in the burden imposed on the low paid by income tax and national insurance contributions caused a third of the rise in the gross 'family wage' in the last three years. The British married man now faces a marginal income tax rate of 30 per cent at one-third of average earnings. His peers in France, Germany and the USA do not enter such a rate until their earnings are between 120 per cent and 260 per cent of average earnings. The re-introduction of a lower rate band would help to reverse the trend, though it is strongly opposed by Inland Revenue for administrative reasons. Increasing the tax threshold for everyone or ending national insurance contributions for earnings below the floor (or the first £29.50 earned) for everyone would be very expensive.

7.10 An alternative approach is to strengthen the contribution of in-work benefits. The above analysis of the 'family wage' ignored the effect of in-work means tested benefits (primarily Family Income Supplement and housing benefits) because take-up is low (50 per cent or less) and their influence on pay negotiations appears to be limited, or sometimes perverse. However if these problems could be overcome and in-work benefits were generally accepted as an earnings subsidy, the gross 'family wage' employers would be expected to pay would be reduced to a level below earnings in even the lowest paid jobs (see figure 8). The new Housing Benefit Scheme to be introduced from November 1982 should improve take-up of rent and rate rebates. For FIS to become more automatic and to be regarded as part of the wage, it will be necessary to bring employers more fully into its administration.

7.11 Forty years ago the forerunner of Child Benefit ("Family Allowances") was introduced because it was seen as an effective means of reducing wage pressures for family men. An increase in Child Benefits would help families with low incomes in work, but the universality of the benefit makes such an

increase expensive: a 10p increase costs about £55 million (net of savings on other social security benefits). To concentrate assistance just on low paid families in work would require an income tested second tier child benefit similar to the Canadian Refundable Child Tax Credit.

#### Incentive to work

7.12 As described in Annex B evidence from the 1978 DHSS Cohort Study of the Unemployed shows that about 5 per cent of men becoming unemployed received benefits as high as their previous net earnings and so had no financial incentive to return to work, and a further 10 per cent had only a limited incentive. Since then benefits have been made subject to tax and with the other changes to taxes and benefit levels, there has probably been a reduction in the proportion of the unemployed with no or little financial incentive to re-enter employment, though with 3 million now unemployed the absolute numbers may have increased. The main explanation for the minority of unemployed with such high "replacement ratios" is that the means-tested benefits for those in work (particularly benefits for children and rent and rate rebates) are less generous and are less frequently claimed than is supplementary benefit for those who are out of work.

7.13 A general reduction in the level of supplementary benefit for the unemployed, designed to reduce the disincentive effect for the minority would also have the effect of making the majority (for whom the disincentive effect does not apply) worse off. Additionally, it would be necessary to de-couple benefit levels for the unemployed from the levels applying to other supplementary benefit recipients: the sick, disabled and single parents. Moreover the most recent research findings on the impact of benefit levels on unemployment suggest that, in a time of slack labour markets as at present, the effect of reducing benefits would be small - smaller than indicated by earlier research. The more direct way of ensuring that no one is better off out of work is to reintroduce the 'wage stop' on supplementary benefits at a level equal to say, 90 per cent of the claimants' net income when previously employed. The wage stop was abolished in 1975 mainly because it was administratively expensive and reduced the benefits of so few people (8,000 in 1974). These arguments still apply but the re-introduction of a wage stop would ensure that those in work did not believe that they would be better off unemployed.

7.14 An alternative approach is to improve the take-up and the value of in-work benefits. For example the value of FIS could be increased by raising the limit on eligibility or by relating the benefit to children's age (at present there is a fixed sum regardless of age), and housing benefits could be improved by increasing the "needs allowance" or changing the "income tapers."

7.15 People's incentive to work can be influenced by the terms on which unemployment benefits are available as well as the level of those benefits. So long as benefit is available to meet basic needs, many may prefer to remain unemployed and search the market for a decent "primary" job rather than accept a less attractive vacancy. Under the present benefit rules nobody can be penalised for declining an "unsuitable" job, ie one which offers pay and conditions which are inferior to those provided by collective agreement or which are typically provided by "good employers" (sic) in the area concerned. These rules have their origin in the contributory national insurance scheme which was initially designed to cope with transitional unemployment among workers with an established trade. It seems wrong that the same principle should apply to the non-contributory means-tested supplementary benefit scheme. A better approach would be to expect people after a specified reasonable period of job search to accept any job offered to them which was not unsafe or unhealthy and which avoided exploitation by providing a net income (allowing for in-work benefits) no worse than their income from benefits when unemployed.

7.16 In present labour market circumstances, the introduction of this new rule would not lead to the offer of jobs to patently unenthusiastic applicants. However, it could have a useful psychological effect, and could guard against the danger that young people who now have extensive experience of claiming benefit since leaving school, may be less likely than previous generations to take unattractive jobs. Such a change would, however, require primary legislation.

Part-time work

7.17 At present an unemployed man on supplementary benefit (and/or his spouse) may earn up to £4 a week without loss of benefit, ie work 2 or 3 hours. But if he commands a low wage rate (eg £2 an hour) he enjoys no further net gain unless he can work for more than 20 hours (if he is a single householder) or 30 hours (if married with two children). Thus there is no incentive to take part-time work (except in the black economy). The impact of this disincentive on the behaviour of unemployed people is difficult to assess but any disincentive is hardly consistent with attempts to encourage part-time work. Furthermore there is now good evidence that present benefit rules discourage the wives of the unemployed from working.

7.18 The danger, however, is that if changes are made to significantly improve incentives to work part-time, this may create dis-incentives to move from part-time to full-time work. If this risk is accepted (as seems reasonable at present levels of unemployment), there are various possibilities for increasing the incentive to take part-time work -

- a. supplementary benefit recipients (and their spouses) could be allowed to retain more of their earnings as their hours of work increase: such a concession might be confined initially to the long term unemployed;
- b. supplementary benefit levels for unemployed could also be reduced overall (though unless a way could be found of ensuring that all benefit recipients had access to part-time jobs, very large numbers of claimants would suffer a loss of income);
- c. eligibility for FIS could be extended to those in part-time work (for example by a limit of 16 hours instead of the present 30). To avoid eliminating the incentive to move from part-time to full-time work this would have to be accompanied by a reduction in the 50 per cent tax rate which applies to FIS as income from work rises. The major advantage of such a combined measure is that it would not only provides an incentive to take part-time work but would also remove the most severe aspect of the "poverty trap" where, at present people are not able to raise their own living standards by working harder. The cost could be less than £100 million per annum.

Conclusions

7.19 Through their impact on incentives and wage levels the tax and benefit systems affect the scope for reducing unemployment. There are broadly three ways out of this problem -

- a. reduce benefits for the unemployed;
- b. raise net incomes of people in work through reducing income tax or increasing child benefits;
- c. improve selective benefits aimed at lower income families in work.

7.20 A general reduction of benefits would reduce living standards of many for whom benefits do not act as a disincentive. We recommend consideration of more narrowly targeted measures -

- a. on the assumption that wages are expected to fall in real terms, the linking of increases <sup>in</sup> ~~is~~ supplementary benefits for the unemployed to prices or earnings, whichever rose the slower, or (and more equitably) to earnings alone;
- b. a change in the "job availability rule" to require people on supplementary benefit to accept any job offered which pays (with in-work benefits) no less than income from benefits when unemployed.
- c. re-introduction of a wage stop (or benefit limit) so as to ensure that benefits out of work could not exceed, say 90 per cent of the claimants net income in work;

7.21 General measures to raise net incomes in work by increasing tax allowances or increasing Child Benefit are very expensive and extremely slow to make much impact. Instead, selective benefits for lower-income families in work are a more cost-effective way forward. An effective mechanism for subsidising the earnings of low income families could encourage the acceptance of low paid jobs, reduce upward wage pressures for family men,

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increase incentives to seek work and facilitate the growth of part-time employment. The present income tested in-work benefits (particularly Family Income Supplement and housing benefits) fill this role inadequately, if at all. The new Housing Benefit Scheme may bring some improvement but we recommend that a new way be sought of subsidising the earnings of low-income families that is more effective than FIS in its present form and less expensive than increasing universal child benefit or raising tax floors. In the meantime the take up of part-time work can be encouraged by allowing people on supplementary benefit to retain more of their earnings as their hours of work increase.

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**FIGURE 8** Comparison of lowest quartile of gross earnings with 'family wage'\*  
 (For married man with non-earning wife and two children,  
 living in local authority accommodation)





CHAPTER 8: NEW PATTERNS OF WORKING TIME

8.1 It is a paradox that, while the United Kingdom has one of the highest rates of unemployment among OECD countries, British workers also work one of the longest working weeks. In addition, the number of hours of overtime worked in British manufacturing industry has increased by a fifth in the last year, while employers' ability to increase pay remains tightly constrained and unemployment continues to rise. Less paradoxically, part-time employment in the United Kingdom has fallen considerably less steeply than full-time employment in the present recession. This represents a somewhat faltering move in the direction of job-sharing, away from the often excessive costs and rigidities of the standard week plus overtime. This chapter examines ways of widening and accelerating this trend, while maintaining the efficiency of British industry. We do not here consider a shorter working life, which is dealt with in Chapter 9.

Cutting Working Time

8.2 This approach would be unfruitful if the length of the working week, or the number of hours worked in a year, were already set by considerations of efficiency. But there is a good deal of evidence that this is not so. The fundamental objection to a shorter standard working week, is that workers often expect to be paid as much, say, for a 39 hour week as for a 40 hour week. In more favourable circumstances in the past the potential loss in competitiveness that this entails has been offset by a gain in productivity. But the consequence of this approach, as studies show, has been that there has been very little extra employment, or even reduction in job cuts. In principle, this could be circumvented by gaining management and union acceptance of the principle that, in present circumstances, there must be a fall in weekly earnings commensurate with the shortening of the working week. Even if this could be achieved for basic wage rates, the likely result, especially for companies dependent on intensive machinery use or customer demand, would be an increase in overtime at premium rates. This would not help unemployment or international competitiveness.

### Cutting Overtime

8.3 Some overtime is economically justified, for example to meet peaks of demand or emergencies. Also one of the effects of the Employment Protection Act and of redundancy payments is to act as an incentive for even efficient employers to increase output by maximising overtime rather than by taking on additional staff. But, on the other hand, since 1945, high levels of regularly worked overtime have developed and persisted in the United Kingdom to a greater extent than in most other countries. Overtime is especially prevalent among low-paid manual workers, and among those with family responsibilities. The evidence of the twenty years after 1945, summarised in a research paper for the Donovan Commission, was that "much of British overtime now seems to arise out of a desire to waste time at work in order to obtain a living wage". Nothing that has happened since 1967, when this judgement was made, leads us to suppose that the situation has changed for the better.

8.4 We believe, therefore, that the exceptional length of the British working week reflects, not the most efficient pattern of work, but rather a deep-rooted tradition of inefficiency. In the 1950s and 1960s a partial justification was the need to hold on to staff against labour shortages. With high and continuing unemployment, it is now the unemployed who suffer when employers increase overtime instead of taking on more workers. Yet the unemployed are in no position to undermine the long-established behaviour of management and unions. Both of them react badly to proposals for change, such as the efforts by the European Commission to obtain agreement on a limitation of overtime. (Such limitation is already legally enforced in the Federal Republic of Germany, France, Italy, Belgium, the Netherlands, and Luxembourg, as well as in other countries outside the Community.)

8.5 We do not believe that a statutory solution is appropriate. However the effect of the Employment Protection Act and redundancy payments is often exaggerated in employers' minds. Efforts should be made, in conjunction with the CBI (and perhaps NEDC) to bring out the efficiency and employment gains from cutting overtime and to correct misapprehensions.

More shifts

8.6 Another possible advance would be a greater use of shifts, and a shorter length of shift at an appropriately reduced earnings level. For continuous processes needing 168 hour operation a week, there could be five groups of workers doing 34 hours a shift, rather than four groups doing 42 hours. This would raise shift-worker employment by 25 per cent and probably increase productivity, though there would also be extra costs on administration, etc. The possibility of an initial subsidy to meet the employers' extra costs, perhaps as part of the development of the job splitting scheme discussed later, should be examined. For less than continuous operation, similar principles should be applied.

Encouraging part-time work

8.7 The Government have recently announced a job splitting scheme (JSS) to encourage employers to split existing full time jobs into half time jobs. A subsidy will be paid to employers for each additional half time job to which an unemployed person, receiving benefit, is recruited. The scheme will include cases where existing full time workers switch to half time and release the other half to a registered unemployed person. The immediate purpose of the scheme is to get unemployed people into jobs for no net increase in public expenditure. In addition, the Community Enterprise Programme is being replaced by a Community Work Programme with part time as well as full time options.

8.8 We welcome these developments, not only because they are cost effective ways of getting unemployed people back to work but because they may have wider economic benefits in breaking down the rigidities of the standard working week. Compared with full time work, part time work often has the following advantages for the employer -

- a. Lower wage rates per hour, lower contributions to pensions, if any, and less employment protection.

b. More flexibility: two part-timers can work simultaneously during peak demand, and neither need be paid when there is no work to be done. Hours can be increased as needed without paying premium overtime rates;

c. Less absenteeism and sickness, and lower labour turnover.

8.9 But part-time work also has the disadvantage for the employer of higher recruitment, training and administration costs. (The first two occur once, and a subsidy to cover them, if needed, could be paid as a lump sum rather than over a period.)

8.10 The advantages of part-time work may well outweigh the disadvantages more often than employers realise; sometimes they do not consider the possibility, because it is not how work has been organised in the past. In this case, drawing attention to it may lead to not only the splitting of existing jobs but the creation of quite new part-time jobs. The crucial step is to remove the rigidity of thinking only in terms of the standard working week.

8.11 At present there is a tendency for people to believe that part time work must be a poor second best to full time work, except for women with young children and people nearing retirement age who do not want to stop all work but would like gradually to work less. These are certainly the groups most likely to want part time work, but there are others who might see positive attractions in it, eg people with second jobs, (including budding entrepreneurs), shift workers, and two career couples who would be prepared to trade some income for leisure.

8.12 It is likely that more people would be prepared to switch from full time to part time work if they could choose their own pattern of reduced working hours. There seems no reason in principle why the job splitting scheme should not subsidise extra jobs created by converting 2 jobs into 3, or 3 jobs into 4 and this might be considered as a refinement of the scheme if it proves a success in its initial form. Another development might be the changes in shift working suggested above. Some employers and employees might find it <sup>mutually</sup> eventually more convenient to arrange other types of job split eg 'week about' or split years. The Government might attempt to pioneer such arrangements in the public sector.

8.13 In the shorter run, the scope for helping the unemployed through part time work lies in the fact that part time work at prevailing wages is likely to offer a better income than benefit for the single workers and people without dependents who make up the majority of the unemployed. Moreover the income is being earned and there is access to the other benefits of work: a sense of personal worth, the discipline of regular timekeeping, and companionship. Under present benefit arrangements, however, there is no incentive for unemployed family men or their wives to take part time work. The proposals in Chapter 7 to improve benefit disregards and to extend in-work benefits to part timers would enable JSS and similar schemes to provide jobs for the unemployed with families.

8.14 It has yet to be decided whether JSS will apply to jobs of at least 15, or 16 hours per week. The choice has great significance since jobs of 15 hours do not qualify for redundancy payments and employment protection measures, but jobs of 16 hours do. A lower limit of 15 hours should therefore encourage a much bigger take up by employers, because the burden of employing part timers will be significantly reduced. There could be safeguards for full time workers whose jobs are split; they should participate voluntarily and they should be warned of the loss of job security which dropping to 15 hours might involve.

8.15 It is equally important to continue resisting the EC proposals for Directives on part-time work and temporary work. There can be no doubt that these proposals, particularly those requiring proportional rights, will inhibit employers from recruiting or retaining part-timers as well as making them more reluctant to use temporary labour, instead of, say, overtime working.

#### CONCLUSIONS

8.16 This chapter examined the possibility of increasing the number of people in employment by changing the conventional patterns of working time. We conclude that there is unlikely to be much benefit in employment terms or reducing the standard working week. However we note that excessive overtime working is far more prevalent in the United Kingdom than in many

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other developed economies. A reduction in overtime working is likely to create more jobs and we recommend consultations with industry about the implications. Changes in the pattern of working and the introduction of more part time working also offer the prospect of more jobs. We welcome the introduction of the scheme proposed by Department of Employment to create more part time jobs through job splitting and feel that it should be developed to encourage other, different, patterns of working, eg shorter shift working, which will create more jobs. If applied to part time jobs involving less than 16 hours per week, for which employment protection measures need not apply, such schemes may prove more popular because the burdens of employing part timers will be reduced.

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CHAPTER 9: OTHER MEASURES TO COPE WITH UNEMPLOYMENT

9.1 This Chapter considers the role of measures which ease the distress of unemployment, for people and for society. Such measures rightly form part of the strategy for tackling unemployment, for if society cannot accept the pain it may reject the treatment. At the same time, they must not subvert the long run aims of the present strategy and must be capable of being unwound as employment prospects improve.

9.2 The level of expenditure which should be devoted to such measures, within the broad policy objective of reducing public expenditure, is not something which can be determined objectively, because it depends on a political judgement of the seriousness of the consequences of unemployment and of the proper balance to be struck between the relief of unemployment and other objectives. A great deal is already being spent on special employment measures and large resources are committed to existing or planned measures for some years ahead.

9.3 Against this background the aim of this chapter is to suggest how the arrangements for deciding priorities in this field could be improved, and to offer some views, arising from the earlier analysis, on future priorities and on options which might be effective alternatives to, or adaptations of, existing measures. The Chapter starts with a general discussion of the approach to employment measures (paragraphs 4-9) and then considers in more detail the role of three types of measure -

- to reduce the size of the labour force (paragraph 10-17);
- to reduce the concentrated incidence of unemployment (paragraphs 18-21)
- to help the unemployed use their time productively (paragraphs 22-24).

Employment measures

9.4 Special Employment Measures (SEMs) are a collection of measures undertaken with the primary aim of reducing the number of registered unemployed in the short run. We have not conducted a detailed study of the existing Special Employment Measures for the purpose of this report. We looked in detail at the principal measures - the Youth Opportunities Programme and the Community Enterprise Programme - in our 1981 report on "Unemployment and Young People" and several initiatives since taken, notably the introduction of the Youth Training Scheme and the new Community Work Scheme, are broadly in keeping with the recommendations of that report.

9.5 On this occasion we have looked more generally at the part which employment measures play in the Government's approach to unemployment. Table 1 <sup>(at the end of this chapter)</sup> provides a list of existing SEMs, classified according to the labour market mechanisms by which they reduce registered unemployment. These mechanisms include safeguarding and inducing jobs in the private sector, training, temporary work of value to the community and early retirement. As Table 1 shows, nearly all SEMs have counterparts in other Government spending programmes and instruments, which also have an effect on employment or unemployment. The overlap arises particularly with measures which create, induce or preserve employment and output. SEMs which have this effect (for example the Community Enterprise Programme, parts of the Youth Opportunity Programme, the Temporary Short Time Working Compensation Scheme) are paralleled by a large number of conventional instruments of Government policy which influence employment.

9.6 What chiefly distinguishes SEMs is that they are directly targeted on the registered unemployed - often on particular priority groups. It is the reduction of the number of unemployed that has priority rather than the amount and quality of work (or other output) which accompanies it. SEMs are more cost effective in reducing registered unemployment, than conventional instruments. "Cost per job" considerations also feature in the design or appraisal of several other instruments, notably selective aids for industrial projects, but in these cases the primary criterion is usually the expected long run viability of the project. In other activities such as public investment



programmes the employment effect is recognised only in a general way and it is rare for projects to be designed so as to maximise employment impact, far less their impact on the registered unemployed. The aim, naturally enough, is to choose the projects which offer the highest return in terms of the objectives of the particular programme, and to design them in the most economical way. Similar observations apply to the other classes of instruments in Table 1 eg training and education measures.

9.7 This "ring fencing" of SEMs has some practical benefits. It is a simple way of putting a limit on the extent to which the Government is prepared to skew its public spending priorities and abate its drive for efficiency, in the interests of increasing employment and reducing unemployment. But it also has disadvantages. It would be an oversimplification to say that within the ring fence only cutting unemployment matters and outside the ring fence only efficiency matters. But the present arrangements will tend to rule out intermediate options which would perhaps offer a better trade off between employment and other output objectives, especially if attempts were made to increase the benefit to the register of conventional measures.

9.8 For example, the idea has been floated in the past of offering some construction contracts on condition that a high percentage of unemployed labour is engaged and labour intensive methods used. At present such ideas tend to be viewed as a source of inefficiency. They are not judged by the same yardsticks as, for example, community work. What is needed is a consistent basis of comparison, taking account of the relative value of output, the contribution which could be made to unemployment, and other factors such as effects on wage levels and opportunities offered to the secondary sector. A comparison of output value might not necessarily be disadvantageous to community work which, despite allegations of "make work", produces (according to some assessments) highly valued output. The facts about this need to be explored more thoroughly as a basis for future decisions on priorities when the scheme comes up for review in 1984. In addition the scope for matching unmet needs and unemployed labour through the mechanism of the private sector, particularly small entrepreneurs, ought to be thoroughly explored as an alternative to community work. We suggested examples in <sup>Chapter 5.27</sup> Ch5 paragraph 27 (a national enterprise allowance scheme) and <sup>Chapter 6.14</sup> Ch6 paragraph 14 (an expanded young workers scheme).

9.9 In view of the large number of programmes which could affect employment and because high unemployment is unlikely to be a short term problem, there is a case for reviewing public expenditure procedures to see how effects on employment and unemployment could more systematically be taken into account. A simple way would be to document the job (and labour supply) consequences of spending bids and options for cuts. A ceiling could still be kept on the amount of public spending which would be used positively to reduce unemployment, if it were undesirable or impracticable to do this across the board.

9.10 In addition, existing public spending programmes and policy objectives could be implemented in ways which would be more helpful for employment and unemployment. One example is labour intensive ways of carrying out given public needs (as mentioned above and in Chapter 6). Another would be a review of the scope for relaxing the rules governing recruitment to the civil service to allow some preference to unemployed recruits. There are always problems in mobilising the spending power and influence of many Government departments, with their disparate aims and priorities, towards a cross-departmental Government objective. It does not happen without determined effort. The "bending" of main programmes towards a particular objective has been tried, not with outstanding success, in the case of the urban policy. Nevertheless our diagnosis can be seen as pointing to the need for machinery for reviewing systematically the scope for each Department's activities to do more to increase employment and reduce unemployment. If such an exercise were not to run into the sand it would need firm Ministerial leadership.

#### Reducing the labour force

9.11 Measures, such as the Job Release Scheme, to reduce the labour force do not currently have a high priority among employment measures because they could offset the downward pressure on real wages. However at current levels of unemployment this effect is likely to be small. And in the light of the prospects for unemployment there is a case for reviewing the balance of financial incentives and opportunities affecting labour market participation, as it affects young people, two income couples and older people's retirement.

(i) Further and higher education

9.12 The financial disincentive of continuing in education compared with getting a job or being unemployed with supplementary benefit still acts as an obstacle for young people from less well off families. If financial assistance were available on a family means tested basis to children of proven ability, those staying on would improve their potential and the less able would face less competition for the available jobs. If an effective scheme can be devised at reasonable and affordable cost it could be launched initially in selected areas of high unemployment, and could act as a trial for a possible national scheme.

(ii) Two job couples

9.13 A married man with a non-working wife receives the married man's tax allowance, whereas his counterpart with a working wife receives both this and the single person's tax allowance. We continue to take the view, expressed in our report on "Unemployment and Young People" and subsequently endorsed by the Manpower Group, that this fiscal bias in favour of two income couples promotes a higher level of participation in the labour market than would be found under a more neutral system. We repeat our recommendation that full weight should be given to the implications for unemployment when decisions on the taxation of married couples are taken. A minor additional suggestion is that the MSC might (without discriminating against women) adopt more limited objectives for positively attracting women into training and hence employment. At present women (of all kinds) are regarded as a disadvantaged group on a par with the disabled and ethnic minorities. In future assistance might be limited to women with the potential to acquire scarce skills and women from low income families.

(iii) Retirement

9.14 The Government are committed to the abolition of the earnings rule for State pensioners, when this can be afforded. While recognising the considerations of equity which underlie this, at present unemployment levels it would undesirably increase competition for jobs and there are thus better uses for the resources which implementation of the commitment would entail.

9.15 The main questions in this area are whether early retirement should play a bigger part in Government policy, and if so in what form. Quite apart from the major costs involved there is a view that early retirement is undesirable, because it creates no extra output, may create income problems for the elderly, and may reduce productive potential by substituting green labour for skill and experience. The last of these fears is often exaggerated: while circumstances vary, it is very often the case that older workers hold on to their jobs at the expense of new entrants because of rigidities in the labour market rather than because of higher productivity. Moreover early retirement could be a lesser evil than the present level of unemployment among young people, which is likely to damage productive potential in the long run, and which may entail bigger individual and social costs than bringing forward retirement by a few years. For all those reasons early retirement is worth considering as part of the strategy for tackling unemployment.

9.16 One solution would be to introduce a common pension age of 60 (which would incidentally respond to EC pressure for removal of the discrimination inherent in allowing women to retire 5 years earlier than men). However, this would be extremely costly and would permanently transfer over 1,300,000 men from the working to the dependent population. A change of this magnitude could be contemplated only if it was certain that unemployment would remain at present levels, or if the nation felt rich enough to offer retirement at 60 so as to increase the leisure of the elderly. In our view neither of these applies.

9.17 A more flexible approach, which we recommended for consideration in "Unemployment and Young People", would be to reduce the male pension age to 63 combined with flexible retirement provisions from 60 to 65, with reduced pension for those retiring early and enhanced pension for those retiring later up to 65. This would combine some of the benefits of earlier retirement for men with the flexibility to cope with uncertain labour market conditions. However, because a great deal of early retirement is occurring voluntarily only about half the workers receiving an earlier pension would release jobs. The scheme would thus be cost ineffective, costing at least £800 million a year net to take a quarter of a million people out of the labour force.

9.18 In present circumstances the more cost-effective approach, if Ministers accept the general argument in favour of flexible early retirement, is to develop the Job Release Scheme, which targets on people who release their jobs to the unemployed. Options which might be considered, when priorities in the employment field are next reviewed, include lowering the minimum age for Job Release from 62 to 60 and the introduction of a part-time option. Another option would be to enforce retirement at 60 more widely in the public sector.

#### Reducing the concentrated incidence of unemployment

9.19 Chapter 3 mentioned the particular social and economic problems which result from long duration unemployment, from heavy geographical concentrations and the high incidence among the young and unskilled. Regional disparities are being addressed in the current inter-departmental review of regional policy, and we have not therefore covered them here, though they are among the most worrying and intractable aspects of the unemployment problem.

9.20 In the past, unemployed job seekers as a group were often discriminated against; many employers preferred to recruit people who already had jobs or new entrants to the labour market. Such attitudes are less prevalent in present circumstances. Instead employers are now said to discriminate against the long term unemployed, assuming that they must be poor candidates. In view of the large number of unemployed relative to the resources available to help them, we believe that these special measures which find work for the unemployed should concentrate in future on the long term unemployed in the "12 months plus" group. This should become a formal criterion of effectiveness.

9.21 There are a number of options for giving help to the long term unemployed which should be considered. We have concentrated on options which are cost free (a.), could be incorporated into existing schemes (d.), or which might prove effective alternatives to existing programmes.

a. Employers and unions could be encouraged to negotiate "starters' rates" whereby adult recruits would start below the rate for the job and progress to the full rate over a period of perhaps 18 months. (There are recent precedents for this in the USA.).

b. Long term unemployed workers could be given vouchers, cashable as a wage subsidy by employers engaging them for a minimum period. To ensure that the subsidy encouraged rather than impeded wage flexibility, there could be a wage ceiling or a requirement to pay starters' rates. This would be a convenient way to overcome employers' resistance to the idea of taking on the long term unemployed.

*There could be an increased emphasis on improving educational attainment, both through*

c. ~~A~~ work preparation programme on the lines described below ~~could improve employability and job getting skills.~~ *and as part of existing schemes for the long term unemployed.*

d. Spells of work experience "on employers' premises", if incorporated towards the end of training and community work attachments on existing programmes could help adults establish a track record with a real employer, as young people do on YOP.

e. The new job splitting scheme might incorporate a two tier subsidy with a supplement (perhaps in voucher form) for recruiting the long term unemployed.

f. Private employment agencies could be paid a fee for finding jobs for the long term unemployed.

9.22 In addition there are a couple of options which would help the unemployed as a group. (The first involves extra costs but the second offers savings.)

a. The public employment service could increase its knowledge of vacancies in the secondary market, including part-time and casual work, and bring them to the attention of the unemployed. Or, perhaps better, private agencies could be contracted to do this.

- b. Employers using the employment service to select job candidates could be charged for the service, except where the successful candidate is unemployed.

Helping the unemployed to use their time productively

9.23 It is useful to try and distinguish how far particular groups of the unemployed need employment as such, as distinct from the benefits obtained from work which might be provided in other ways. For most of the unemployed, a regular job will be the best solution and this is particularly likely to be true for young adults, both from the viewpoint of society and that of the individual. But others might be readier to accept substitutes. Workers with family responsibilities seem primarily in need of extra income and the choice whether to provide this through extra benefits, through created work projects or through more generous rules for supplementing benefit by part-time earnings rests primarily on what society finds most acceptable. Among older people, whose chances of getting jobs are particularly poor, the most useful approach may be to provide alternative forms of useful activity, status and companionship.

9.24 These questions are rarely addressed in the context of special employment measures, because the emphasis there is on reducing the numbers actually unemployed and on the needs of the unemployed as workers, not as individuals within families. We understand the importance of reducing the numbers of unemployed. But the prospect that these numbers will remain high for some years makes it all the more important to ensure that effective ways of meeting the needs of unemployed people are not overlooked.

9.25 There are several ways in which it might be possible to help more people from existing resources if a broader approach were adopted. We suggest that when existing programmes come up for review the following ideas should be considered:

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a. The need of family men for work to raise their household income could be met by applying to them and their wives the more generous rules about earnings disregarded for benefit purposes which currently apply to single parents. The employment service could give special help to long term unemployed family men to find them (or their wives) part time jobs.

b. The educational standards of the unemployed and their general employability could be improved in a variety of informal ways, using voluntary tutors and counsellors wherever possible, and including mutual help arrangements among the unemployed themselves. Participants without formal qualifications could be helped to compile a profile of their achievements gained through voluntary work and other activities, for use in job applications. Use could be made of educational, voluntary and recreational activities to develop and sustain many of the qualities needed in work (eg concentration, stamina, fitness, discipline, working in a team). A particular aim would be to widen the horizons of men from a background of manual work, by helping them overcome their resistance to "womens work". Existing full time courses in education and training institutions are not suited to provide this range of needs. The main benefit of meeting the need for work preparation via full time courses is that it enables people to come off the register. The price for achieving this gain can be too high. Hence, instead of the adult work preparation courses currently run by the MSC, we would prefer consideration to be given to ways of stimulating informal and voluntary provision. On the face of it, this is more a task for the informal education departments of local education authorities (LEAs) than for the MSC, though the Job Centres could play their part in publicising the kind of help locally available.

c. Within the new Community Work programme, comprising full time and part time options, the balance could progressively be shifted so as to organise a few hours of work, most weeks, for those who cannot find any for themselves. This may be a more cost-effective way of reducing human misery than the present aim of providing a part time

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or full time job for a full year, since more could be helped. This would be particularly appropriate for the many workers among the long term unemployed who have rarely had (and therefore may not miss) a steady job but who are depressed by the enforced inactivity of continuous unemployment.

d. The role of voluntarism both in meeting the needs of the unemployed and in engaging their energies is the subject of a research project currently being sponsored by the MSC. Voluntary work could be particularly important for middle aged and older people, particularly those made redundant from steady jobs who feel the loss of a settled role in life, satisfaction and status. The Health Departments run schemes to promote the use of unemployed volunteers. The MSC's new Community Programme will seek to organise paid and voluntary opportunities within a single programme. Though we have not studied the subject closely we have some doubts whether this is the approach best calculated to engender the growth of genuine volunteering given the different values which surround market work and voluntary work.

e. Finally, there are the people whose age and/or unfitness put them well below the margin of employability in their local labour market for the foreseeable future. Such people are unlikely to be in demand even for casual work. Requiring them to keep up the fiction of looking for work, and denying them the somewhat higher level of supplementary benefit available to invalids or retired people serves no economic purpose and appears inequitable. Unemployed men over the age of 60 are already permitted to claim the long-term rate of benefit and stop registering as unemployed. But the problem extends further down the age range. An option for consideration when resources permit would be to extend the arrangement to workers in their fifties who have been unemployed for two years.

Conclusions

9.26 The extent to which public expenditure should be used to reduce and relieve unemployment is a matter for Ministerial judgement. A great deal is already being spent. Within the total resources available, ways should be sought of bringing into consideration a wider range of government spending programmes and instruments which could contribute to increasing employment and reducing unemployment. We suggest two changes in Government decision-making machinery to help achieve this. The first is to ensure that the effects of unemployment and labour supply of all significant spending options are systematically documented, together with the real outputs <sup>of</sup> special employment measures. The second proposal is to create inter-departmental machinery to identify ways of improving each Department's contribution to employment objectives.

9.27 The primary requirement will continue to be for measures with a low net cost to the PSBR. Within this constraint was recommend the following priorities -

a. It is right to give top priority to options which increase both employment and output. To assist longer term objectives the emphasis should be on the private sector and in particular the secondary sector. Specific options include labour intensive construction contracts, a national scheme of enterprise allowances, and an extended young workers scheme.

b. Measures which reduce labour supply (voluntarily) are - along with job/ sharing - a good second-best because they increase the unemployed's chances of getting regular jobs. Options include: extension of the job release scheme; removing the tax bias favouring two job couples; and selectively encouraging staying <sup>on</sup> in education.

c. Measures to help the unemployed into work should concentrate on those who have been unemployed for at least a year. Options include: encouraging "starters' rates" for new entrants at less than the rate for the job; <sup>and educational help</sup> Work experience attachments in existing training schemes; a higher rate of subsidy within the new job splitting scheme, for <sup>security</sup> reducing the long term unemployed. <sup>Reduction of the numbers on the register for 12 months should become a formal criterion of the effectiveness of special employment measures.</sup>

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d. Measures to help people for which no regular work can be found should concentrate <sup>more</sup> ~~some~~ on cheap and effective ways of helping people use their time effectively, while unemployed. Options include: encouraging people to find legitimate casual work eg by better benefit "disregards"; improving their employability through informal education, training and self-improvement programmes, using voluntary tutors; shifting the emphasis of community work towards less regular employment for more people; and allowing ~~unemployable~~ workers in their fifties <sup>who have been unemployed for two years</sup> to leave the labour market.

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TABLE 1

Special Employment Measures: a classification according to the mechanism used to reduce registered unemployment, listing the secondary outputs of the programmes and other public programmes or instruments with similar (or potentially similar) effects\*

Special Employment Measures	Secondary outputs	Similar programmes
1. Publicly organised temporary work of community value		
Community Enterprise Programme (CEP)** Community Industry; Youth Opportunities Programme (YOP)** Community projects [Voluntary service scheme]***	Value of work done; occupation for young; improve individual employability.	Labour intensive construction and maintenance (housing, energy conservation etc). Health and social services. Support for voluntary social services and amenity groups. DHSS and MSC schemes for unemployed volunteers***
2. Extra employment in the private sector		
a. Extra trainees		
YOP employer attachments	Better stock of skills <u>plus</u> 'real job' experience and (unintentionally) output.	a. Public sector recruitment and training policy (including HM Forces). Skill training grants
b. Other jobs		
Young workers scheme; Enterprise allowance (pilot);	More output. Lower wages; more entrepreneurship. More people in "real" jobs.	Construction contracts; selective financial assistance; regional and urban aids; public purchasing; tax options; Enterprise packages; employment transfer scheme [benefit disregards for casual work]
3. Avoid or defer job losses		
Temporary short-time working scheme	Prevents skill wastage. Perhaps more output	Public and private sector 'rescues'; tariffs; subsidised export contracts

\*4. Work-sharing

Job splitting scheme	Higher productivity. More in real jobs. Labour reserve for firms against future expansion of demand: may produce net expenditure saving.	Public sector recruitment policy
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Special Employment Measures

Secondary outputs                      Similar programmes

5. Early retirement (see also 7)

Job release scheme;	More young workers into real jobs; perhaps productivity gains	Public sector retirement and recruitment policies
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6. Increase training, outside employment

YOP (education and training modules)	Better stock of skills; improved individual employability, worthwhile occupation	Training opportunities scheme; Post-compulsory school, further, higher and continuing education. [Benefit rules re availability for work effect scope for self help]
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7. Remove inactive or marginal job seekers from register

Option for "60+" age group to withdraw and claim higher benefit	More income; less stigma	DHSS policing of benefit fraud; rules re dividing line between invalids and unemployed
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Notes

- \* The list of other similar programmes is not comprehensive
- \*\* CEP will shortly become the Community Work Programme and YOP will be replaced by the Youth Training Scheme (YTS) which will continue to provide community work and training modules as well as employee attachments.
- \*\*\* Entries in square brackets can produce the secondary outputs but do not reduce the register.

CHAPTER 10: SUMMARY AND CONCLUSIONS

10.1 Unemployment is not a new problem: the United Kingdom has been through periods of heavy unemployment before. Nevertheless we have to learn the lessons again. Because current attitudes and expectations were formed over 25 years of unprecedented growth and prosperity the re-learning process is all the more painful. For unemployed individuals, living standards are reduced and aspirations thwarted. For the community as a whole, there is a significant waste of valuable resources and a potential threat to its stability.

10.2 The causes of high unemployment are not clearly understood. Indeed no simple uncontroversial explanation is possible because unemployment is the result of many disparate yet inter-locking factors, some of which can be traced back a decade or more. We have described in Chapter 2 how the post-war boom ended in the 1970s, with a slower growth of real incomes. Rising oil prices and increasing competition from newly industrialised countries called for structural changes in the economy as well as adjustments to the growth of incomes. Pressures for higher pay, the growth of public expenditure (and the rising tax burden) and reluctance to adjust to changed circumstances resulted in high and unstable inflation combined with poor growth. Unemployment was already rising before 1979: since then it has more than doubled, both because of the recession and as a result of policies designed to reduce inflation and correct fundamental deficiencies built up over the years.

10.3 Unemployment is a phenomenon common to most of the developed world and we in the United Kingdom cannot expect to solve our problems in isolation. Much depends upon the growth of world trade. But unemployment is higher in the United Kingdom than most other comparable countries because in many respects our economy is more rigid and unresponsive than elsewhere. Whilst it must be the object of policy to reduce the rigidities, the process could be long and slow. It follows that high unemployment is likely to persist for some time ahead.

10.4 In the long term, an economy which is growing healthily with low and stable inflation will generate full employment, in the sense that there will be only a limited number of people (we postulate 1m to 1½m) unemployed at any given time, for personal reasons or because they are changing jobs. The main objectives must therefore be to remove the obstacles to sound economic development. But since a return to full employment cannot be achieved quickly, there is a case for shorter term measures to ease the transitional problems. It would be desirable for these shorter term measures to work in the same direction as long term policy: it is essential that they should not work against it.

10.5 The first requirement is public acceptance of a medium term macro-economic framework aimed at reducing inflation. Mere announcement of good intentions is insufficient. Attitudes will not alter for the better unless people are convinced that there will be resolute execution of the policy in the medium term and see more evidence that it is working.

10.6 The second requirement is for a faster rate of deceleration of pay so that there is headroom for real growth within a tighter monetary environment. This entails continuing to press for lower wage settlements in the public sector and in private sector firms where the Government has influence (eg lame ducks), reducing public expenditure and thus the overall tax burden and using fiscal headroom to cut taxes to reduce costs.

10.7 The third requirement is to improve the flexibility of the economy, removing rigidities to the workings of product and factor markets. Externally, this means avoiding protectionism. Internally, it involves the removal of distortions created by Government and an increase in competition in product and labour markets. One key area of Government responsibility is the tax and benefit systems which create numerous distortions: in financial markets, in industry and in personal decisions.

10.8 We noted in Chapter 4 that many of the rigidities in the economy arise in the "primary sector" comprising large, well-established firms. Here the requirements of technology and the associated need for a highly-trained, well motivated labour force have led to the development of large, sometimes unwieldy corporations, often highly unionised which may have been well suited to the stable, full employment, high growth world of the 1950s and 1960s but are less able to adapt to today's highly competitive, more uncertain world. There is a need now for quick response to market opportunities and a more sensitive adjustment of pay to labour market conditions. Although the requirements of "scale" will remain for many capital intensive processes, the general drift will be towards smaller scale via decentralisation, de-mergers and the selling-off of subsidiaries.

10.9 The Government can contribute to this by breaking up the public sector via de-centralisation, privatisation of subsidiaries, and contracting-out and by a more vigorous competition policy. At the same time, a more flexible labour market and more efficient competitive economy will come about mainly by growth in the secondary sector (comprising not only small firms but also decentralised parts of larger organisations and in-coming firms). Improved management incentives, better labour relations and greater flexibility in this sector contribute directly to the efficiency of the economy (and so help the primary sector). But also the greater competition with parts of the primary sector should, in time, break down rigidities there too. The economy as a whole will then become more thrusting, aggressive and responsive to change.

#### **Policy Options**

10.10 Policies to restore economic growth and trading performance must first improve industrial profitability. Part of the cost burdens on industry arise from high taxation, both national and local, and to reduce these (without significant increases in personal taxation) requires continuing constraint on public expenditure. Resources for new initiatives to tackle unemployment are therefore limited and can be found only by re-ordering spending priorities.



10.11 Within these constraints, the Government should give greater attention to developing the nation's "human capital". It has a direct role in education and training and in its influence over innovation eg through funding of universities, research councils and as an employer of technological manpower. We make a number of initial suggestions for policy in Chapter 5 but these require more study. They could be developed either as part of the current CPRS study for MISC 14 on education and training or by the relevant departments. Further exploration of the suggestions on innovation policy in Chapter 5.36 could usefully complement work on university - industry links which the Prime Minister has recently commissioned from the Advisory Committee for Applied Research and Development.

10.12 In other areas of supply-side performance a number of policy initiatives have already been taken to reduce constraints imposed by trades union power, excessive taxation and bureaucratic regulations. Further developments are possible though the effect of any one on economic efficiency is modest, and the immediate gain to employment small (or even negative in the short run). But in total they have an important contribution to make.

On trades union power we offer our views on possible courses of action in Chapter 5.17.

For greater geographical mobility we identify some proposals in Chapter 5.21.

Ways to strengthen competition policy are discussed in Chapter 5.23.

10.13 There are also ways to create greater flexibility of product and labour markets and to increase the scope for labour intensive activities within an efficient economy. These include -

- a. developing existing policies for small firms (Chapter 5.33) to stimulate the vitality of the secondary sector;
- b. reducing capital subsidies and labour taxes together to leave the company sector no worse off overall but more inclined to employ labour (Chapter 6.17);

- c. lowering minimum wages in the economy by the abolition of wages councils when obligations permit: this should be accompanied by a campaign to explain the beneficial job creation consequences which follow from lower wages (Chapter 6.3);
- d. providing incentives for households to employ regular labour on domestic services and extending the Young Workers Scheme up to the age of 25; (Chapter 6.12)
- e. altering the system of personal taxation and benefits so that, while retaining a safety net against family poverty, employers are more ready to offer and workers more ready to take low paid jobs (Chapter 7). This requires a more effective and visible system of supplementing incomes of heads of families in low paid jobs;
- f. recasting supplementary benefit availability rules so that after an initial period claimants are expected to avail themselves of job opportunities in the secondary sector (Chapter 7.15);
- g. extending the notion that small firms can offer jobs with minimum standards (Chapter 6.6) and especially to expand the scope for part-time work.

10.14 A shorter working life - in terms of the working week, year or career span - will be the reward of higher economic growth: but in the short run people should be given the opportunities of more flexible patterns of working time so long as they are not at the expense of efficiency and do not increase hourly pay.

**We recommend -**

- a. the new job splitting scheme should be carefully monitored and possibly extended to cover a wider range of work-sharing options (Chapter 8.20);
- b. within resource constraints, the Job Release Scheme should be extended as the most cost-effective way of using voluntary early retirement to help the unemployed (Chapter 9.17);

- c. supplementary benefit recipients should be allowed to retain more of their earnings as they take on part-time work (Chapter 7.18);
- d. in-work benefits should be extended to part-time workers (Chapter 7.18);
- e. consultations with industry should be initiated to see whether overtime can be reduced and more workers employed instead (Chapter 8.9);

10.15 Within existing public expenditure constraints, there is a case for reviewing priorities in terms of the extent to which different programmes generate employment or reduce unemployment. Major spending options should have their employment consequences documented and Special Employment Measures should have their real outputs evaluated so that the two kinds of activities can be compared. Ministers can then choose the best trade-off between employment and other objectives (Chapter 9.25). In particular labour intensive construction contracts should be considered. Also bureaucracy and waste in the public sector might be more effectively controlled by annual running cost targets rather than manpower targets (Chapter 6.16).

10.16 There will also be a continuing case for measures to help the unemployed, in particular for the long term unemployed.

**We recommend -**

- a. work experience, introduction of starters' rates, and a higher subsidy for job splitting to recruit a long term unemployed person, development of community work to provide shorter spells of work for more people (Chapter 9.21);
- b. local initiatives to stimulate informal education, training and self help (Chapter 9.25);
- c. workers in their fifties who have been unemployed for two years to be allowed to leave the labour market on higher benefits (Chapter 9.24).

*New para.  
10.16 attached*

10.16 Within the general requirement for measures with a low net cost we favour, in descending order of priority, ~~measures~~ those which:-

- a. increase private sector employment, for example, labour intensive construction contracts, a national scheme of enterprise allowances and an extended young workers scheme (Chapter 9.8);
- b. help the long term unemployed find jobs, for example, by encouraging "starters' rates", including work experience in training programmes and paying a higher job-splitting subsidy for long term unemployed recruits. Reducing the numbers on the register for 12 months or more should be a formal criterion of effectiveness of employment measures (Chapter 9.21);
- c. help people to use their time constructively while unemployed, notably through informal education and training, and also through shorter spells of community work for more people (Chapter 9.25);
- d. allow workers in their fifties who have been unemployed for two years to leave the labour market on higher benefit (Chapter 9.25).

10.17 There are constraints to the early implementation of some of the above measures. For example, wages councils cannot be abolished until international obligations permit in 1985. Changing supplementary benefit "availability rules" requires primary legislation. Also <sup>considerable</sup> financial resources to alleviate unemployment are ~~largely~~ <sup>some years ahead, notably</sup> committed for the ~~next Parliament~~ by ~~recent decisions~~ on the Youth Training Scheme and the Community Work Programme. This means that many of our proposals can only be implemented gradually, ~~though the forthcoming review of the MSC's adult training programme will provide an early opportunity to reconsider priorities.~~

#### Scope for immediate action

10.18 A short term programme must focus on measures to speed the upturn and to get the best outcome for employment. The economy should move out of recession in 1983, though recent reports from industry suggest a downgrading of earlier views on prospects. There is a danger that the longer the recession lasts, the more companies (especially in manufacturing) will lose faith in the possibility of a return to high levels of economic activity and remain ultra-cautious about extending plant, recruiting additional labour and training for the skills required in the upturn. At the same time there will be growth of new activities, though the strength of this and its employment consequences are difficult to estimate.

10.19 Given the uncertainties of the immediate outlook, it is not clear what headroom there is for real output growth within the broad confines of measures to reduce inflation and create conditions for sound and stable long-term growth. If, as now seems possible, the rate of inflation were to fall faster than previously forecast, this should result in higher headroom. If the Government takes no positive action this would be reflected in lower interest rates. But it can also consider active steps. The possibilities include -

- lower costs of employment;
- lower direct taxes;
- additional investment in labour intensive public works.

The choice between these depends upon the strength of their effects but also on the balance of employment and other objectives being sought.

#### Interest Rates

10.20 The MTFSS targets for the growth of the money supply from now to 1984-85 look like being met and may indeed be improved on. Other things being equal, this should be associated with lower interest rates and, if we can be confident of this basic trend, should enable the monetary authorities to assist the decline. *reductions.*

10.21 Lower interest rates help reduce the costs of the corporate sector and improve cash-flow across a wide range of industry. In turn increases in investment should follow, initially in stocks. As interest rates in real terms have recently been at historically high levels, this would be a welcome development and should pave the way for longer term economic recovery.

10.22 The constraint on hastening this process at present is that a fall in United Kingdom interest rates, compared to those abroad may cause the effective sterling exchange rate to fall. Whilst this may further help output recovery, it also feeds through into higher domestic inflation. And in domestic terms, the scope for lower interest rates will be limited as demand expands and an equilibrium level is reached. The indirect short term effect of lower interest rates on employment may be relatively small since the level of interest rates does not directly influence the costs of employment. Indeed lower interest rates reduce the cost of capital. Higher investment should lead to greater employment overall via higher output, but there is no particular inducement to invest in processes which are labour intensive.

#### Lower Employment Costs

10.23 An alternative is to use fiscal headroom to increase employment directly, by reducing the costs of employment. Among these an important non-wage element is the National Insurance Surcharge. A reduction in NIS affects the whole range of employers. In the last budget NIS was cut to 2 per cent, but in the absence of any further action it will rise again to 2½ per cent. An announcement to the contrary needs to be made in the autumn at which time consideration should also be given to whether there is scope for lowering the rate further.

10.24 If the scope for reducing NIS is limited, a cheaper (though administratively more complicated) possibility would be to exempt companies from paying NIS in respect of additional workers employed compared with a given base date. Another possibility is to finance part of the reduction by cuts in capital subsidies (see Chapter 6.17).

#### Lower direct taxes

10.25 Lower direct taxes would increase demand (though part of this may go into imports and higher savings) and, given the awareness of take-home pay, should also help to bring wage settlements down. It would be important to use any scope for lower taxes ~~to raise the income tax threshold in order~~ to ease the problems of the unemployment trap. We have discussed changes to in-work benefits at greater length in Chapter 7.9c

*Raising the income tax threshold is one possibility others are discussed*

#### Public Works and Other Building Programmes

10.26 A further approach is to devote part of any fiscal headroom to public works which meet important social and economic needs and which are also labour intensive in their application. The advantages of such programmes are that they have a low import content and will promote employment to the extent that they are labour intensive. Experience suggests that there will be some delay caused by the necessary administrative arrangements before a programme can get under way. For this reason if this option is to be pursued, work should be commissioned urgently to explore the possibilities.

#### Priorities

10.27 It is for the Treasury to advise on the scope for any fiscal headroom at the present time. In considering the measures available the CPRS view is that the highest priority should be given to reducing the NIS because of its direct impact on the cost of employing labour. Lower direct taxation, by raising the threshold would make jobs more attractive at the margin and would also boost demand generally. Lower interest rates are not wholly within the direct control of Government but have their most immediate effect in the business sector. Reducing taxes and lower interest rates both have the presentational advantage of being the rewards of success in the battle against inflation and

high public expenditure. Although increasing public expenditure has corresponding presentational disadvantages, the possibility of an accelerated programme of labour intensive public works should nonetheless be explored to see if it could secure worthwhile economic and social improvements as well as create additional jobs. (Possibilities are discussed in Annex C).

10.28 Whichever steps are taken <sup>could</sup> they ~~can~~ be accompanied by the early pursuit of a number of <sup>the</sup> proposals <sup>syntact</sup> <sup>sector</sup> <sup>Options</sup> <sup>which</sup> <sup>should</sup> <sup>be</sup> ~~given above whose cost is small in relation to~~ <sup>comparatively cost-effective</sup> immediate impact. These include -

- a. active promotion of the job-splitting scheme, <sup>include</sup> to jobs of 15 hours per week which do not qualify for redundancy payments or employment protection measures (Chapter 8.14);
- b. reconsideration of a part-time Job Release Scheme (Chapter 9.18);
- c. extension of the Young Workers Scheme to the household sector (Chapter 6.14)
- d. extension of the enterprise allowance for <sup>self employment</sup> ~~small firm~~ "start-ups" (Chapter 5.26);
- e. ~~C~~ Changes to social security benefits to increase the disregards for part-time working and an effort to increase the take-up of FIS (Chapter 7.18)
- f. <sup>an informal</sup> ~~formulation of local~~ work preparation <sup>programme for the</sup> ~~for~~ long term unemployed (Chapter 9.25).

## CONCLUSION

10.29 Unemployment is a major problem and it cannot be wished away overnight. It is not a problem simply for Government, because its solution demands both action and changing attitudes from employers, trades union leaders and employees. Nonetheless, there is scope both for the Government to act and to lead and we have attempted in this report to suggest directions in which they might do so.



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10.30 There have been two major themes to this report. One has been the importance for employment prospects of a vigorously growing secondary sector of the economy and many of our recommendations have that particularly in mind, whilst recognising that it is also important that the primary sector should thrive by becoming more competitive.

10.31 The second theme has been the need for real wages temporarily to fall. In the longer term healthy economy, real wages will be high, as a reflection of the material progress that will have been made and of the growing efficiency and productivity of the economy. But in the immediate future real wages have to fall to a level at which potential employers can afford them. The process will be slow and difficult but it has to be undergone. In the longer term we must aim to adjust our economic environment so as to achieve higher standards of living. In the short term we must be more modest and adjust our standard of living to the economic environment that we have.

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CATEGORIES OF THE UNEMPLOYED

**Measuring unemployment**

1. This annex focuses on how successfully the unemployment register measures the level and trend of unused labour resources in the economy. For this purpose, unemployment figures need to count people who are capable of work, without work, available for work and looking for work.

2. These concepts pose difficult problems of measurement, whatever the method used. "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 about the work they want, how wide a range of work they are capable of performing and how hard they try to find a job. The answers to all these questions depend on subjective judgments. Hence the concept of a completely accurate and objective measure of unemployment is not obtainable in practice. The most that can be aimed for is a consistent measure which enables patterns and trends of unemployment to be identified.

3. There are two ways of measuring unemployment. The first, used by Britain and most European countries, is linked to an administrative process, either claims for unemployment benefits and/or registration with state employment services. The second, used for example in North America and Japan, relies on regular household surveys which question people about their employment status. Both methods have their advantages and disadvantages and there is much to be said for making use of both. Administratively derived figures provide a complete count, free from the sources of error associated with sample surveys, and a particularly convenient way of obtaining up to date figures for small geographical area. Their main disadvantage is that they are prone to "benefit distortions"; ie they may include people who are not available for work but register in order to obtain benefits, and exclude people who are available for work but have no benefit entitlement. (Non claimants of

benefits currently count in British unemployment figures if they register for full time work with the employment service but from October 1982 only benefit claimants will be counted as unemployed.) Also, the coverage of job seekers may change over time or differ among countries because of changes in rules or differences in coverage of benefits, thus obscuring trends and international comparisons.

4. Survey based figures have the advantage that they are free from "benefit" distortions, can be designed to facilitate international comparisons and can obtain more detailed qualitative information eg about the intensity of people's search for work, which can shed extra light on the administration-based figures, and about household income.

5. Britain has in fact collected a limited amount of survey information about unemployment since 1970, in the annual general household survey (GHS). The GHS confirms the existence of a rising trend and a high level of unemployment in 1980 but the rise is less steep than indicated by the register and the level in 1980 not so high. The difference may largely arise from the fact that the GHS only counts people who actively looked for work in the previous week, thereby excluding people who were actively seeking work but less frequently. This is thought to be a common pattern of behaviour for long term unemployed people who have already searched the local market. Many in this position rely on friends to tell them about new job openings. It would be necessary to cross check the GHS findings with other surveys and investigate in more detail the differences between them and the register before conclusions could be drawn about which source gives the better measure.

6. The following paragraphs discuss the main sources of over and under counting on the unemployment register. Where figures are given they are designed solely to suggest rough orders of magnitude. Their high degree of uncertainty must be stressed.

#### **Sources of overcounting**

7. The register may overstate unemployment because it includes the following categories.

A. "Hard to employ"

8. People who are virtually unable to produce useful work for reasons of health, or physical or mental disability should not appear in the unemployment figures because they ought to be classified as long term sick or severely disabled registrants who are excluded from the count. However, the dividing line between the unemployed with health problems who are counted and the long term sick and severely disabled who are not is bound to be arbitrary. Subjective assessments made by employment offices in the mid-1970s suggested that the number of men with poor prospects caused mainly by age, physical or mental condition or a combination, remained around the same level, about 135,000, between 1973 and 1976 (though unemployment overall rose markedly). A proportion of these subsequently did find work, a fact which illustrates the problems of defining "employability". There is no reason to believe that this group of unemployables has grown. Indeed, the number of long term sick of working age has increased by over 100,000 since the mid-1970s and it is plausible that some of these would previously have been classed as unemployables among the unemployed.

B. "Working while signing"

9. This category comprises people who are not unemployed because they are already working in the black economy. Information about the black economy among the unemployed has improved recently as a result of the work of DHSS's newly formed Specialist Claims Control (SCC) teams. These teams visit local offices and typically investigate perhaps the most suspicious 5 per cent of the unemployed who are receiving benefit in that area. Typically between 30 and 70 per cent of the people investigated withdraw their claims or have their benefit stopped or reduced. In the majority of cases the amount of revealed earnings exceeds the total amount of benefit entitlement. A minimum estimate of the registered unemployed who are secretly working is thus around 2½ per cent of the total. The full extent of "working while signing" is unknown but it is likely to be larger than this minimum, and probably much larger, due to activities among the 95 per cent of unemployed benefit recipients who are not investigated by the SCC teams. It is quite plausible that, say, 10 per cent of these receiving benefit as unemployed are not entitled to it. In this case the unemployment register would be inflated by some 300,000.

C. Not available for work

10. This group are not working but 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 ground 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 having retired. There may also be 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, but the opportunity to behave in this way is greater when vacancies are scarce.

D. Not looking for work

11. This is a category who would need to work if deprived of benefit but do not look for work. Surveys tend to show 10-20 per cent of the register (300-600 thousand) admitting to not looking for work in a given week. Taking the upper limit as more plausible, and allowing for categories B and C, this suggests that there are about 150,000 in category D. 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 of discouraged workers is bound to have risen at current levels of unemployment. The people concerned would begin looking again if the market improved. This leaves the "workshy", people who prefer living off benefits to working. It is often argued that people with high benefit/work income ratios will 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.

E. Selective job seekers

12. There are probably considerable but unquantifiable numbers of people who are genuinely 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. The rules for unemployment benefit and the aims of the employment service, with their emphasis on "suitable employment", sanction a considerable degree of selectivity.

13. Lower benefits and stricter rules on refusal of job offers would probably lead to faster job filling. In present circumstances, however, getting some people back to work more quickly would, to a considerable extent, displace others into unemployment. Econometric studies suggest that in present circumstances a 10 per cent cut in benefits would reduce the register by perhaps 100,000.

Summary of overcounting

14. Allowing for considerable overlap between the unfit and the inactive, the estimates in paragraphs 8 and 11 would prima facie suggest that somewhere over 600 thousand of the register would not meet a strict interpretation of the definition in paragraph 1, ie of being without work, available for and capable of work and seeking. The uncertainties surrounding this figure are great. Moreover overcounting is only one side of the story.

**Sources of undercounting**

A. Uncounted registrants

15. Students registering for vacation work (up to 200,000 at the seasonal peak), and people laid off temporarily (10-20,000) are excluded from the regular count. None of these is in the market for regular full time jobs and their exclusion is consistent with a view of the register being primarily a measure of people seeking permanent full time jobs. But the register does include claimants seeking only part time work (numbering a few tens of thousands).

B. Non-claimants

16. At present the count excludes about 50,000 registrants for part-time work (mostly married women) who have no claim to benefits. (Non-claimants seeking full time work - some 100,000, excluding school leavers - are currently included but will be excluded from October 1982.)

C. Unregistered job seekers

17. The Department of Employment estimates (from household surveys up to 1980) that about 300-350 thousand people are looking for work but not registered with the employment service. 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. Some increase will have occurred during the recession but unregistered unemployment tends not to rise as rapidly in a down-turn as the register does. This category probably includes only a few of the 380,000 single parents who receive supplementary benefit but are not required to register for work.

D. Special measures

18. An estimated 305,000 people (net) are currently kept off the register by special employment and training measures. They are a labour supply in the sense that the schemes reduce the register artificially.

E. Discouraged workers

19. The recession has led to increased staying-on in school, a fall in married women's participation rates and a sharp increase in early retirement. The Department of Employment is unable to estimate precisely how many have withdrawn from the labour force or have been discouraged from entering it. The figure is, however, likely to run into several hundreds of thousands. Between early 1979 and early 1982, the "working population" - the employed labour force plus the registered unemployed - fell by 600,000 despite a rise in

the population of working age. (Mid-year estimates for 1979 and 1982 show an increase in the population of working age - over 16 but under retirement age - of 500,000.) Discouraged workers represent a hidden labour reserve which is likely to re-emerge as and when job prospects improve. In past periods of recovery, every extra four jobs generated has brought one extra worker into the labour force.

#### Summary of undercounting

20. The register excludes about 150,000 unregistered people seeking full time jobs, around 300,000 people on special employment measures and, at the present time, several hundreds of thousands of "discouraged workers". The register is a very inadequate measure of the labour supply for part time work, partly because it excludes the categories at A-E above, but also because 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.

#### **Net effect of under and overcounting**

21. In terms of the strict definition of unemployment the register appears to be exaggerated by a few hundred thousands but if discouraged workers are taken into account, the register probably now understates the numbers wanting jobs. But the uncertainties on both sides of the equation are large. On balance, the register provides a reasonably unbiased measure.

#### Implications for the trend of unemployment

22. Similarly, the deficiencies in the register do not appear to obscure the general underlying trends in unemployment. The register exaggerates, perhaps by up to half a million, the rise in the numbers unemployed and actively seeking work since days of full employment: higher benefits probably induced about 50,000 extra frictional unemployed by the early 1970s (the shortage of vacancies to test availability may have had a bigger effect); at least 100,000 of the increase reflects an increase propensity of job seekers (mostly women and girls) to register as unemployed; laxer administration coupled with shortage of notified vacancies may have allowed more people to



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participate in the black economy. On the other hand, the increase would have been 300 thousand greater but for the introduction of special employment measures. The upward trend in unemployment was moreover accompanied by the withdrawal of several hundreds of thousand of workers from the labour force in the present recession.

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## THE SOCIAL SECURITY SYSTEM AND UNEMPLOYMENT

1. This annex considers whether the tax and social security system 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 the unemployed: 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 employees and employers. Even with very large declines in demand employers may be 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. At the same time employees may resist reductions in real wages on the grounds that they would be better off unemployed. Both these mechanisms may operate together. Below we review the evidence in relation to each.

2. 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 B1 and B2 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 B1 uses the best information on the actual previous earnings of the unemployed to show the position in November 1981 of the average man experiencing unemployment in each family type, on the assumption first

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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 eligible are claimed. It therefore shows the 'theoretical' replacement ratio for an illustrative example within each family type.

Table B2 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.

3. 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 and assistance with dental and optician bills but their value is likely to be highly variable and generally small. 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 B2 and national average costs for Table B1. 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

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\* 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.

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**TABLE B1 ILLUSTRATIVE INCOME REPLACEMENT RATIOS FOR THE MALE UNEMPLOYED:  
NOVEMBER 1981**

FAMILY TYPE	% of male unemployed (Nov 1981) (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) 5
	1	2	3	4	5
	%	£	£	£	%
Single man, under 20(5)	14	66	44.6	21.2	47
Single man, 20+ (5)	39	107	70.1	38.1	54
Married man, 0 children	23	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.

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TABLE B2 ACTUAL INCOME REPLACEMENT RATIOS\* FOR MEN BECOMING UNEMPLOYED IN 1978 - EARLY PART OF SPELL\*\*

	% of male unemployed stock (Nov 81)	Income Replacement Ratios				Total
		Up to - 50%	50% - 80%	80% - 100%	100%+	
Single men	53	67	28	3	2	100
Married couple no children	23	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
<b>Total</b>	<b>100</b>	<b>45</b>	<b>36</b>	<b>12</b>	<b>7</b>	<b>100</b>

\*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 unemployment.

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

appear to have claimed tax refunds before they returned to work, suggesting that the majority were not fully aware of the tax advantages of the past position. Under the new regime 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 obtains since benefits were brought into taxation.

4. 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. (Family men with children have been a steadily declining proportion of the register for the last ten years);
- 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 B1). For the great bulk of the unemployed without children the "typical" ratio is 60% or lower;
- the actual family 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 B2). 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.

5. 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

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earnings. The presence of working wives or occupational pensions serves to raise replacement ratios, particularly for married couples without children. In such 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 high replacement ratios did not stop most of the men returning to work fairly rapidly: 9 months after becoming unemployed over three quarters of those with replacement ratios of 80 per cent or more had returned to work.

6. 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, on the basis of their earnings prior to unemployment, the proportion of men becoming unemployed for whom a return to work involves an implicit marginal tax rate of 80 per cent or more is now probably less than 15 per cent. However, it can be argued that at a time of deep recession past earnings are not a good guide to current choices; the available job opportunities, predominantly in the small firm non-unionized sector, may well offer wages below the previous earnings of the unemployed who have lost jobs in the large unionized establishments. This will certainly be true for some of the unemployed. But the DHSS cohort study and the more recent (May 1980) MSC cohort study both suggest that the unemployed come largely from low wage employment in small establishments. Nearly half the DHSS sample reported fewer than 25 employees at their usual place of work and although the MSC cohort was selected at a time when redundancies were beginning to rise rapidly, only 40 per cent of the men reported union membership in their last employment. For many, and possibly most, of those currently becoming unemployed, earnings in their last employment may therefore not be a bad guide to the earnings opportunities they face once unemployed.

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7. 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 1978 survey of men who had been on the unemployment register for about one month, half reported a willingness to accept a significant drop in their real pay. About a third, mainly men with previous very low wages, appeared to require an increase in their pay. In practice, over 80 per cent returned to work within a year, at least half of them for a wage below their original "reservation wage";
- 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.

8. At the same time information on vacancies does not indicate that many low paying jobs remain unfilled for an 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 vacancies, up from 9 to 1 to 44 to 1. A small scale exercise earlier this year indicated there were only about 2,000 vacancies on the Employment Service's books that were proving difficult to fill for reasons of low pay. Studies of the residue of jobs that remain unfilled or are difficult to keep filled (for example, traffic wardens in London), 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.

9. It seems reasonable to conclude that although a small minority of the register show little active interest in finding work and a rather larger number are selective about the kinds of work sought, 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. More recent work is consistent with this estimate.

10. The second mechanism through which benefits might act as a wage "floor" - by influencing the behaviour of employees and 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. Similar questions could be put to employee representatives about the determination of wage demands. 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.

11. 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. Social security benefit levels have also featured in the wage claims of low paid workers in the public sector for many years. For example, Family Income Supplement prescribed amounts have been treated as defining "poverty wages" in recent claims by both civil servants and National Health Service auxiliary workers. There are also regular references to some workers, usually family men, being better off out of work. While benefit levels for families obviously make good, if misleading, bargaining points (very few workers in the lowest wage grades are family men) it is not clear that their role in wage negotiations has become any larger over the last ten years.

12. 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 wage settlements and to employer wage offers. For most of the unemployed, even the lowest 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). The numbers of full-time employees with incomes that provide only a small margin over their benefit entitlement will have risen since 1979, reflecting the developments discussed in Chapter 7 (see particularly, Figure 8). But the overall numbers will still be very small. Therefore if benefit levels do significantly influence wage offers and wage settlements 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'.

LABOUR INTENSIVE PUBLIC WORKS

1. In recent years there has been a significant cut-back in all public sector capital programmes, partly because it is much easier to postpone a decision to carry out investment than to reduce current expenditure. Furthermore, the effects of such cuts are not felt immediately. However this decline in public sector capital programmes, coupled with the effects of the recession on private sector capital works, has now worked its way through, and is giving rise to very high levels of unemployment among building and construction workers - not least among the unskilled labourers.

2. A boost to the construction industry could be made to provide more real jobs (at least in the short term) while at the same time it would provide useful and productive output. These are major advantages over 'make work' schemes. Furthermore -

- the sector can respond quickly to stimulus
- there is little import penetration (about half that of manufacturing industry)
- it is relatively labour intensive,
- a high proportion of the labour is unskilled (about one third) for whom there is often no alternative employment
- wage rates are not dominated by national agreements, but are more responsive to local market conditions (about 90 per cent of the firms employ less than 25 people).

3. Some types of construction work are more labour intensive than others. The table below gives estimates of the number of man-days of site labour per £1000 worth of contract (1970 prices) for various types of new construction

	Public Housing	Private Housing	Education	Hospital	Other	Industrial	Commercial	Roads	Water	Sewerage
Skilled and Semi-skilled	41.2	39.8	42.8	40.3	38.3	34.8	28.8	14.3	16.0	14.2
General Labourer	14.5	16.8	15.5	12.6	16.3	15.5	9.7	13.2	8.1	14.3
Total	55.7	56.6	58.3	52.9	54.6	50.3	38.5	27.5	24.1	28.5

Employment of site operatives: site man-days per £1000 contract value at 1970 prices  
(Source: How flexible is construction, HMSO 1978)

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work. This shows that the labour content of building work is about twice (£ for £) that of civil engineering work, although the latter requires a higher proportion of site supervisory staff. Within building, there is little to choose between the types as far as labour intensity is concerned. There is also evidence that the labour content of building (or at least of house building) has been declining by an average of about 3 per cent per annum over the last 20 years or so. This is due partly to design changes, but partly to methods of construction and in particular the greater use of prefabricated materials. Although there is little hard evidence, it is believed a similar fall has taken place in civil engineering works primarily due to the increased sophistication of plant.

4. For house improvement work the labour content is very similar to that for new house building (£ for £ but not per dwelling unit). This somewhat surprising fact is due to the high value of materials used in improvement work (eg fitted kitchens) compared with the bulk of materials used in new construction (eg bricks). However the skilled component of the labour is about 25 per cent higher for improvement work than for new building.

5. For repair and maintenance work, in both building and civil engineering the labour content is significantly higher than for new work, and the difference between building and civil engineering is narrowed.

6. For all types of construction work there is of course an indirect employment effect associated with the materials used. Only about a quarter of the total materials used are imported (mainly timber), about half the proportion for manufacturing industry. One estimate suggests that the figures may be as high as an additional 30 per cent employment for housing work and 50 per cent for civil engineering.

7. To increase employment in the construction industry, there are three possible approaches. First the Government could seek to increase demand from the private sector for the products of the construction industry; the budget measures on housing were examples of this. Secondly improvement grants for private housing have for some time been designed to increase

rehabilitation: it would be possible to extend these, by for example relaxing the conditions on which they are given, or increasing the grant percentage. A similar grant system could be developed to encourage renovation and/or conversion of industrial premises.

8. Thirdly, the public sector nature of much of the work offers a very direct way of increasing employment while improving some of the physical infrastructure. There are a number of advantages -

- there is no shortage of valuable work which needs to be done
- much of the output is infrastructure which can increase the effectiveness of industry in an economic recovery
- any boost can be targeted at geographical areas of high unemployment
- even though the expenditure would be public sector, the employment would, on the whole, not be (only around 10 per cent of public sector work is done by direct labour).

9. The simplest and most direct way of doing this would be to expand selected public sector capital programmes. We consider four examples. Public sector housing is mainly the responsibility of local authorities. Because of the block allocation of capital to local authorities, there is no guarantee that any increase would in fact be used for housing. Furthermore the local authorities have underspent their capital allowances for housing for last year.

10. Government capital funds for the Housing Corporation are better able to be steered than those for local authorities; they cannot leak through to revenue spending and the Housing Corporation could be advised to allocate funds only to those housing associations with a proven track record. Because of the heterogeneous nature of housing associations there would be policing problems requiring some extra administrative staff in the DOE and in the Corporation. The capital budget of the Corporation is around £600 million now, and it might prove possible to increase it by, say, £100 million per annum over each of the next three years. There would, of course, be presentational problems associated with extra money for housing associations and not for local authority housing.

11. As this would be new money it could, with little difficulty, be channelled to those associations that were prepared to give a degree of priority to applicants seeking to move home for employment reasons. In the CPRS study on labour mobility, we recommended that Ministers should consider using housing associations to provide the flexibility of allocation so manifestly lacking in most local authority allocation schemes.

12. For roads the very long lead time for new construction means that attention should be concentrated on ways of increasing repairs and structural maintenance. Not only is there a large backlog of such work anyway, but as noted above it is more labour intensive. Some roads come directly under Government control, but even for those that are the responsibility of local authorities, the Transport Supplement Grant system offers a more powerful lever to direct spending.

13. For sewers, again there is a very large backlog of repairs and maintenance in many areas. Here Government has powers of direction under the Water Act 1973, to make funds available to water authorities for specific purposes.

14. In health there is a massive backlog of maintenance repairs and redecoration. The financial allocation mechanism would allow funds to be earmarked for such purposes: the health authorities could be invited to draw up programmes for the work and put in bids for money through the normal channels.

15. We have not sought to estimate the scope for increases in labour intensive capital programmes in the immediate future: this will depend upon the amount of fiscal headroom available and other measures which are allowed to have priority. The merit of these schemes is that they lead to an increase in real jobs in a cost effective way and constitute replacement or refurbishment tasks which are going to have to be done anyway at some point in the near future.

