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*File L16
Manspawes*

10 DOWNING STREET

From the Private Secretary

10 July 1981

Dear John,

I enclose a paper by Alan Walters, which the Prime Minister has asked to be brought to the attention of Ministers attending the E meeting on Measures Against Unemployment arranged for next Tuesday (14 July) at 1045.

I am sending a copy of this letter and its enclosure to the Private Secretaries to the members of E Committee, the Chancellor of the Duchy of Lancaster, the Secretaries of State for Scotland, Wales, Northern Ireland, Social Services, Education and Science, the Chief Whip and to David Wright (Cabinet Office).

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A. J. Wiggins, Esq.,
H.M. Treasury.

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UNEMPLOYMENT MEASURES PROPOSED IN E(81)74

Introduction

1. There are really two distinct ways of looking at the problem of high levels of youth unemployment - an essentially cosmetic way, and an economic way:
 - The cosmetic way is to ask "How much can we afford to spend in order to move as many people as possible, especially young people, from the group embarrassingly labelled 'unemployed' to some other group - eg still at school, in training, in some work experience scheme?"
 - The economic way is to ask "How can we reduce the cost of employing young people so that they immediately have a better chance of finding a job; which then exerts a downward pressure - through simple labour price competition - on all pay levels?"

2. Of course some extra training and even work experience schemes can be worthwhile and are in any case politically necessary. But to extend these devices further and further beyond their capacity to provide useful experience, is to adopt the cosmetic approach. This is expensive, distorting, and in the end, dishonest, because it only temporarily suppresses the symptoms. The economic approach is cheaper, designed to reduce distortions by exerting downward pressure on wages elsewhere, and honest because it helps the labour market to adapt permanently to the monetary constraints.

The Analysis

3. The analysis of unemployment in Section 1.3-1.5 of E(81)74 does not mention wage rates. It says that the three main factors affecting unemployment in the next 2-3 years are:

a. the rate at which output expands;

/b. the trend of

- b. the trend of productivity; and
 - c. over-supply as well as the change in skill mix and technological change.
4. It is hard to understand how, either in the short run or the long run one can sensibly talk about unemployment without analysing and commenting on the predominant importance of the real wage rate. This is like the analysis of demand and supply without mentioning price! As an illustration, does not everyone believe that were the real wage rates in Britain to fall 10 or 15%, there would be a most dramatic reduction in unemployment?
5. The tone of the report by officials is of a given number of jobs which have to be shared out among a larger number of applicants. This is the concept of a job for one man means no job for another; a fixed cake. But the whole point is that the cake would expand significantly with the reduction of wage costs per unit of output.

Measures for dealing with youth unemployment

6. The main recommendation is a comprehensive scheme for the young (COSY), to be phased in to replace the current YOP. It is a general subsidised State training scheme for school leavers who are unemployed after a year. It would need to be closely supervised by the State. If young people are unable to find a job and don't join the scheme they lose their SB.

The Main Deficiencies of the Scheme

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The main deficiencies are:

- 7.1 There is little or no effect on reducing wage rates both for juveniles and for others. The main reason for unemployment is the high level of wages. Unemployment is concentrated among youth because the trade unions, which are dominated by adults, keep the youth wage rate high to discourage their employment. In Germany relative youth wage rates are much lower, and so is youth unemployment.

COSY will not moderate youth wages. It will tend to exacerbate the problem. There will be, as will be shown below, an incentive to switch youth out of the normal working labour force into COSY. This will reduce the supply of youth labour on the market - an effect which the adult-dominated trade unions will applaud. Under the scheme the youths will do some work which would have been done by adult workers, but it is likely that in each company unions will ensure that this is a fairly small overlap.

In the labour market it is true that the supply of juvenile labour will be increased by reducing the allowances, making idleness on the dole less attractive. But the important point is that there is no positive inducement, in the way of low wages affecting the demand side, to enable entrepreneurs to expand their absorption of youth labour. Nor is there any knock-on effect on adult wages at the lower end of the scale, where adults and juveniles are fairly close substitutes.

- 7.2 COSY will create a considerable incentive to off-load existing "apprenticeships with proper training" on to the finance of the public sector. This is contrary to the Government's aim of getting employers to shoulder more of the burden of training.

The report, para 3.4, suggests that youths would be encouraged, on leaving school, to get into jobs including apprenticeships with proper training. But it must follow that there would be very considerable incentive on the part of the employer - and by suitable arrangements to the employee - to make young workers nominally unemployed at the end of 12 months and then join the

/State scheme

State scheme for the next 12 months. Then effectively the State would pick up the bill for one year of any apprenticeship scheme. Yet of course both employer and apprentice may have been perfectly happy with the present arrangements.

- 7.3 The scheme would require considerable administration and it is not clear that it would provide an appropriate training.

The claim is that the bureaucracy will be minimised by stimulating the creation of "consortia" or "networks of sponsors in a locality" and that this will reduce costs. But, as the report says, the scheme would require an expansion of the Manpower Services Commission. Furthermore it is clear that administrative costs will be minimised by restricting the YOP generally to large firms where the training element can be easily supervised. This seems undesirable at various levels. First, it will be subsidising the large firms more than the small ones. Secondly, many of the youths who join the scheme will be incapable of profiting from the additional training. What they require is the opportunity to acquire the disciplines and habits of work-punctuality, reliability, etc. But although many would be much better off working at a normal job, the incentive will be for them to go through the motions of "training".

- 7.4 Delay in implementing the scheme. The problem of youth unemployment is an urgent one, which probably deserves tackling on something like an emergency basis. Yet the paper recommends that the scheme cannot really be put into operation for another two years.

- 7.5 The budgetary cost of the scheme does not take account of the fact that such public expenditure, if raised either by taxes, borrowing or money creation, will also generate substantial unemployment. The gross and net costs are calculated only for the elimination of youths from the register and their transfer to COSY. Department of Employment apparently believes that the additional net expenditure will not cause the diminution of output and unemployment in the rest of the economy through, let us say, raising interest rates by 1 or 1½ percentage points. And since the measures are unlikely to reduce wages, and may increase the monopoly power of unions, they are likely to reinforce rigidities which increase unemployment.

The requirements of an alternative scheme

8. A better scheme would meet the following requirements:
 - 8.1 It should directly stimulate the reduction of wages to juveniles, in particular reducing the wage cost per juvenile to the employer.
 - 8.2 It should avoid the administrative costs of a large State administered and approved scheme.
 - 8.3 It should avoid the invidious distinctions between those who are formally on training and those who are not. It should thereby avoid providing an incentive to young people (and employers) at the end of 11 months employment to become unemployed for the twelfth month in order to qualify for the scheme.
 - 8.4 It should encourage school leavers to go straight into employment and stay there, if they are likely to be quickly both valuable and competent members of the labour force. Implicit in my approach is a belief that real work experience is much more valuable than artificial "training" packages.
 - 8.5 It should be cheaper, ie not put at risk our whole strategy of reducing public spending.

An Alternative Approach

9. An alternative scheme would be to concentrate on the central problem of wages at too high a level to sustain a higher level of employment, and to do so quickly.
10. The best way to generate employment is to devise a subsidy, or tax remission scheme, which subsidises low wages and, by implication, penalises high wages. One way of doing this would be:

To remit the employer's National Insurance contribution for any school leaver during his first year in the labour market (or, for simplicity, any 16 year old). This remission would last for one year and would be justified on the grounds that for his

the first year he is effectively in training. But this tax remission would only apply to those earning, say, less than £40 a week.

11. This scheme would then give school leavers, without any interim period of unemployment, the opportunity to get on the first rung of the ladder. It would enable him to show that he was a reliable and competent worker. Under present legislation the employer would be able to dismiss him before twelve months expired without recourse to the employment tribunal.
12. The main advantage of this scheme would be to encourage the employer and employees to agree to lower wages for youths. It would also have some effect on the wage negotiations for adults since they would be affected by the substitutability of these low paid youths for nominally adult jobs.
13. The scheme would be politically attractive. It could be introduced alongside YOP on the present scale. It might be feasible to extend the approach to a modest outright grant, thus reducing the scale of YOP. By exempting the employer from National Insurance contributions (equivalent to 13.7% of earnings) we are recognising the training element in every first job. We can forcefully argue that we are reducing taxes on only the lower paid youths. Those who are potentially high income earners will not receive the subsidy. We can say that this is a way of subsidising a first job and giving youth a chance. There will be much less opportunity to plead that particular youths "never had a chance to show what they could do".
14. The main disadvantage of the scheme is that there would be a temptation on the part of the employer to fire the youth at the end of his first year of employment. But any youth who had proved himself, would be likely to be retained by the employer. Those who would be again on the dole at the end of the first year may find it more difficult to get employment than in the absence of the scheme. But this will be mitigated by:
 - a. the effect of bringing down real wages, which will ensure that there are more jobs available; and
 - b. the value to potential employers of genuine work experience acquired.

/ It might

(It might make sense to ease the transition to the normal regime by having a half-rate employer's contribution for 17 and 18 year olds.)

15. The other aspect of the scheme that would make it unwelcome in some quarters would be the encouragement it gives to employers to substitute young employees for adults. We see this as a benefit, tending to depress wages elsewhere and thus expanding employment. But the trade unions will, of course, see it quite differently.
16. This scheme could probably be introduced rather quickly and would require fairly minimal supervision. It would not require, for instance, employers to register and form the "consortia" that is required by COSY. All employers would automatically qualify, provided they paid the £40 a week or less wage. Similarly, there would be no need for any detailed inspection of training. The presumption would be that all first-year employees were receiving some relevant training. In any case, this approach would put much more emphasis on the value of real work experience as the most important training requirement.
17. This alternative scheme is presented here in only general terms. It is not at all clear that either the subsidy element, in terms of eliminating the National Insurance contribution or the £40 maximum, are the best values. A little study may show that they are quite wrong and different numbers may be appropriate - even including a modest outright subsidy. It is only suggested that the general principle of subsidy with a maximum wage restriction is the appropriate way to proceed.

Costs

18. We have attempted below a very rough indication of the orders or magnitude involved in such an approach. Obviously this would need close examination by relevant Departments.
19. Assuming a maximum of 400,000 eligibility, the gross cost might be:

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	<u>£m</u>
(1) with NIC remission only	56
(2) with NIC remission <u>plus</u> £5 a week subsidy	156
(3) with NIC remission <u>plus</u> £ 10 a week subsidy	256

(Note that the greater the subsidy, the larger the take-up; so that the £10 subsidy is likely to give a gross cost of about £200m, whereas only the NIC remission will cost, perhaps, some £25m)

20. The budgetary benefits depend on the reduction in registered unemployment and will increase over time - and about half the ultimate benefits would accrue by a period of about 20 months. With no knock-on effects, a very conservative estimate is that, with the £10 subsidy, the 40% decrease in wage costs would increase youth employment by 80,000 in 20 months, and eventually by 160,000. With knock-on effects, which is what the scheme is designed to achieve, the increase in employment should be much larger, but there is no basis for giving even a rough figure.
21. With no knock-on effects, the net budgetary annual cost per job created in the 20-month period is about £1,000, while the cost per job ultimately is about £500. These estimates should be taken as very rough figures only. But it is important to note that they are not merely the costs of eliminating youths from the register: the newly-employed would be producing real goods and services under the aegis of private sector disciplines.

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