

Prime Minister

3 December 1981

2

MUS 4/12

ALAN WALTERS

PRIME MINISTER

UNEMPLOYMENT, BENEFITS AND THE CHANGE FROM
THE 1950s TO THE 1970s

1. You have frequently asked what were the changes between the 50s and the 70s which gave rise to first a high level of unemployment in the 70s compared with the 50s, and secondly the fact that additional demand seems to have a much smaller effect on unemployment and a much greater effect on inflation in the 70s compared with the 50s.
2. One of the reasons, and I think it is a very important one, has been the structural adjustments that have been required in the 70s in response to the two oil price shocks. But this has always been not entirely convincing since we know that the inadequacy of demand management measures had already appeared in the mid-1960s. Unemployment started rising then and we first slipped into the familiar pattern of stagflation in the latter half of the 60s. So there must be at least some explanation apart from the two oil shocks. And any such explanation must be associated with the fact that real wages were somehow kept above their equilibrium level by some artificial pressure.
3. Many people believe that this pressure is exerted primarily by trade unions. But since they exerted the pressure also in the 50s, in order to adduce unions as the culprit one must argue there has been increasing unionism and increasing union power in order to explain the increasing effect on real wages. There is some evidence of this, but it is not substantial enough to explain the very considerable changes involved. *An increasing exercise in their power.*
4. Another explanation arises from the increase in the income of those who are unemployed, relative to the income they would have got in a job. Figures from the DHSS show that the incomes of unemployed people in real terms increased between three and four times over the period 1951-1971. And the ratio of unemployed income to employed income increased between two and three-fold.
5. The effect of this increase in the incentive to be unemployed is two-fold. First there is the supply side effect or as Ralph Howell calls it the "Why Work?" effect. We know that there are between

5 and 10% (ie 1.2 to 2.4 million) of people who are better off on the dole than working. (From the 1980 survey, a preliminary figure.) This would compare with a very much lower percentage in 1951 which I conjecture would be less than 1%.

6. The second effect, and by far the most important, is that the higher benefits will result in a much higher real wage for the kinds of workers who are affected. Employers will find that they can get virtually no labour if they offer jobs at wages below, say, some £90 a week. Employers would be out-bid by the benefits offered. Vacancies would decline because employers would know that there would be no takers at wages less than benefits. Consequently the high benefit level, reinforced by trade unions and wages councils, drives up the real wage of the low productivity job and so eliminates many of them.
7. Then one would expect that increments of demand in the 1970s would have a much smaller effect in increasing employment and mopping up the unemployed, than they did in the 1950s. Demand pressure in the 1970s would be manifest more in price than in output. And this would be the case in spite of the low unemployment in the 1950s compared with the 1970s. This explanation certainly seems to be consistent with the phenomena we have observed in the last two or three decades.

REAL BENEFITS (NOV. 1980 PRICES)				
Married Man with two children			Single Man	
	U.B £	S.B £	U.B £	S.B £
1951	21.9	21.9	9.6	9.6
1961	33.8	40.2	15.2	20.1
1971	67.3	53.6	42.5	27.9
1980	58.1	62.3	33.3	30.4

Columns 1 and 3 - real value of Unemployment Benefit plus ERS entitlement on average male manual earnings plus family allowances/child benefit.

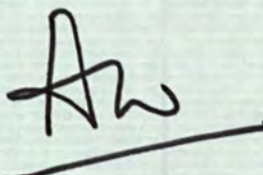
Columns 2 and 4 - real value of Supplementary Benefit entitlement including housing additions.

REPLACEMENT RATIOS (NOV. 1980 PRICES)				
Married Man with two children			Single Man	
	U.B £	S.B £	U.B £	S.B £
1951	0.36	0.36	0.19	0.19
1961	0.44	0.53	0.24	0.31
1971	0.78	0.62	0.57	0.38
1980	0.59	0.57	0.39	0.35

Columns 1 and 2: Standard rate of unemployment benefit plus Earnings Related Supplement (ERS) plus family allowances/child benefit / Net weekly income of male manual workers after deducting tax and National Insurance contributions, but including family allowances/child benefit.

8. Since 1971 the ratio of unemployment benefits to income has decreased (this is largely due to the decline in ERS entitlements). But the ratio of supplementary benefits to income has increased. It is not entirely clear what will happen in 1982, but it is likely that there will be some increase in the ratio, as the indexing impinges on supplementary benefit, and as taxes are introduced on these emoluments. It seems likely that the "Why Work?" pressure has become greater rather than less.
9. There are several policy options for dealing with this phenomenon. Probably the simplest and most acceptable one is to put a ceiling or cap on the benefit package. Thus one might limit the benefits to 90% of the applicant's previously earned net income. One could allow this limit to be exceeded but only by imposing some stringent tests of need, etc. Apparently this ceiling method has been used successfully in other countries, but has not found favour in the UK. However, the pressure of benefits on real wages are so high now that it is worth reconsidering.

cc Mr. Hoskyns
Mr. Wolfson
Mr. Scholar
Mr. Duguid
Mr. Vereker


ALAN WALTERS



10 DOWNING STREET

PRIME MINISTER

Alan Walters' note on unemployment, benefits etc.

You looked at this last in July, 1980 (I attach the Chancellor's minute to you).

A CPRS study on Professor Minford's thesis that a 10% cut in benefits would lead to 1/2m. new jobs is on its way to the Chancellor's Committee, MISC 14. Shall I say that you want the issue discussed - possibly on the basis of the CPRS note if it proves to be any good - at an E meeting?

MCS

4 December, 1981.

Should like
to be opened up in the
Committee. Which
Committee would be
best? Not

Prime Minister

You asked me to suggest an economist ^{who} ~~you~~ could open up

1

MR SCHOLAR

The issue raised in Alan's note, in the Times or Guardian. Alan

suggests John Wood of the Institute

of Economic Affairs; or John Burton. Terry

Burns thought that Patrick Minford would

be better, because more uncontroversial.

cc Professor Walters
Mr Hoskyns
Mr Wolfson
Mr Duguid
Mr Vereker

UNEMPLOYMENT, BENEFITS AND THE CHANGE FROM '50s TO '70s

You asked for advice on how this issue might be opened up in the Times or Guardian.

I think I would marginally prefer The Times to the Guardian and I think it would be better for John Burton to offer an article to that paper. The advantage of The Times is that it carries greater weight. On the other hand such an article in The Guardian (assuming they would carry it) might create greater sound and fury.

But it is very important that the Prime Minister is not associated with the ideas at a time when we are trying to project her in a more sympathetic light.

B. INGHAM
10 December 1981

shall I have a very private word

with Patrick (who I know from old Treasury days) and ask him if he'd do it? (Obviously, there to be absolutely no hint that the idea came from here.)

I don't think we can do anything from here.

MUS 19/12

mt.

Ash T Burns.

cc Mr. Ingham
Mr. Hoskyns
Mr. Wolfson
Mr. Duguid
Mr. Vereker

MR. SCHOLAR

UNEMPLOYMENT, BENEFITS AND THE CHANGE FROM THE 1950s
TO THE 1970s

The only two people I can think of who would be appropriate for opening up such a discussion in the "Times" or the "Guardian" are John Wood of the Institute of Economic Affairs, and John Burton, the author of 'The Job Support Machine' published by the Centre for Policy Studies in 1979.* Both of them have done considerable work on unemployment and subsidy.

I have also written to Sam Brittan - copy attached.

AW

9 December 1981

ALAN WALTERS

* now at University of Birmingham

3 December 1981

MR SCHOLAR

✓ P. 1.

ALAN WALTERS' MINUTE ON BENEFIT LEVELS

1. Alan's minute concludes that we should look again at imposing a ceiling on benefit levels.
2. I think this is a good idea. In putting it to the Prime Minister, you should perhaps relate it to a minute that the Chancellor sent to her on this subject on 15 July 1980. As you will see, he came down against any of the three options then identified for imposing a cut-off. But he also suggested that we return to this question later, in a wider context.
3. If the Prime Minister wants it looked at again, you could pick up this reference. You probably recall that on the Chancellor's initiative, MISC 14 will shortly be considering the scope for measures to reform the labour market. This would be one quite suitable forum in which the Chancellor could raise this subject shortly.
4. There is a slight difficulty about the timing of any note from here on this subject. The CPRS have been asked to give a view on the Minford thesis that a 10% cut in benefits could lead to an increase in employment of 500,000 over two years. John Rickard in the CPRS is co-ordinating a note, in which we have been involved. I expect this will arrive within the next week or so, but am unable to check tonight. Ideally, a request to look again at a benefit ceiling should follow the CPRS note that has already been commissioned.

X

Mr Scholar ✓

ANDREW DUGUID

The CPRS work of X will also be taken at the MISC 14 meeting, so paragraph 3 does still stand.

✓
4/12.

MR. INGHAM

cc: Mr. Walters
Mr. Duguid
Mr. Vereker

UNEMPLOYMENT, BENEFITS AND THE
CHANGE FROM THE 50s to the 70s

You kindly gave me advice (as did Alan Walters) on how this issue, raised in a note from Alan Walters to the Prime Minister of 3 December, might be opened up in the Times or the Guardian.

The Prime Minister has decided, on reflection, that we cannot stimulate an article from here. It seems to me, therefore, that we should now allow the matter to rest.

M/S

21 December 1981

Social Services File

B/F for MCS

9/11/81

PROFESSOR WALTERS

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cc: Mr. Ingham
Mr. Hoskyns
Mr. Wolfson
Mr. Duguid
Mr. Vereker

UNEMPLOYMENT, BENEFITS AND THE CHANGE FROM THE 1950s
TO THE 1970s

The Prime Minister commented against paragraph 3 of your
minute "An interesting exercise of their powers".

*B/F
in hand
with HES*
She has also commented that she would like the whole issue
to be opened up in the "Times" or "Guardian". She asks which
economist would be the best to do this.

I would be grateful for any ideas you or Bernard Ingham
might have on this.

Mus

7 December 1981

FINANCIAL TIMES

BRACKEN HOUSE 10 CANNON STREET LONDON EC4P 4BY
TEL: 01-248 8000



7 December, 1981

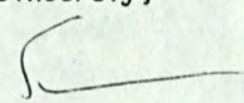
Dear Alan,

I was considerably cheered by your letter.

Since then, we have had three more establishment economists treating inflation and unemployment entirely in the way you castigated, and gaining appropriate publicity.

W h best with

Yours sincerely,


Samuel Brittan

Professor Alan Walters,
10, Downing Street,
London, S.W.1.

JH
AD



10 DOWNING STREET

1 December 1981

Dear Sam

I found your Lombard column most agreeable. I had imagined, in my hopelessly optimistic manner, that some progress had been made with the National Institute. Alas, they still believe that economics should be priceless.

I wonder whether you thought of a further reflection. I am sure that the National Institute explanation of "insufficient demand" is the standard one accepted in virtually all conventional schools of economics in the UK. Layard and his Centre, Minford at Liverpool, and Buddat the LBS are the exceptions rather than the rule. The vast majority of academic economists continues to believe that the rate of inflation is determined by institutional forces and can be taken as a datum, extraneous to the analysis.

Yours ever
Alan

Sam Brittan, Esq.,
The Financial Times,
Bracken House,
Cannon Street,
London, EC4.