cc Back up J/R II

(D)

SECRET AND PERSONAL

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

A Turnbull Esq
Private Secretary
10 Downing Street
London SW1

11 September 1984

Dear Andrew

INDUSTRY AND EMPLOYMENT SEMINAR

As foreshadowed in your letter to me of 6 September, I am circulating herewith a further paper - on the link between pay and jobs - relevant to item 3 on the agenda for 13 September.

attached to letter below.

I am sending copies also to Callum McCarthy (Department of Trade and Industry), Elizabeth Hodkinson (Department of Education and Science), David Normington (Department of Employment), John Ballard (Department of the Environment), Michael Reidy (Department of Energy), Steve Godber (Department of Health and Social Security), David Young (Manpower Services Commission) and Richard Hatfield and Peter Gregson (Cabinet Office).

Yours ever

David

D. L C PERETZ

SECRET AND PERSONAL

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

The Right Hon Sir Keith Joseph MP
Secretary of State for Education and Science
Department of Education and Science
Elizabeth House
York Street
London SE1 7PH

11 September 1984

Dear Secretary of State

I enclose a copy of a Treasury paper on "The Link between Pay and Jobs". This follows up the suggestion in your minute of 8 August to the Prime Minister that an analysis should be carried out of the arguments involved and the counter-arguments that have been made by those who have attempted to play down this link. I agree that we need to embark upon a systematic and sustained explanation of our position, and believe that the paper provides useful materal for the purpose.

You will see that on one point the paper takes a different position to the point (a) in your letter. You suggest that increased productivity is an acceptable alternative way of lowering wage costs. The paper explains that if we are to have more jobs we need lower real pay levels as well as higher productivity. At the margin employers have a choice between men and machines. If the level of real pay is too high it is possible to increase productivity by substituting machines for men. This has the effect of controlling wage costs - but at the expense of jobs.

It is also worth noting that some of the employers in the US that have been increasing their use of labour most rapidly have been in labour intensive service operations. If that sector of the economy is to prosper here it is important that there is an adequate supply of low-paid labour available. Otherwise they will not be able to compete with more capital intensive products.

More generally of course, there is a need to get labour costs per unit of output as low as possible. So it is important for industry to operate on both fronts: pay and productivity.

I am copying this letter to the Prime Minister.

Yours sincerely

David Peretz

pp NIGEL LAWSON
(Approved by the Chancellor and signed in his absence)

THE LINK BETWEEN PAY AND JOBS

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11 September 1984

HM TREASURY

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THE LINK BETWEEN PAY AND JOBS

Summary

This paper discusses the proposition that the slower growth of pay will reduce unemployment.

2. It begins by setting out the arguments in support of the proposition. It attempts to distinguish between two aspects of the argument that are often confused. The first is the increased growth of demand that occurs with a lower growth of nominal wages (and prices) for a given financial framework. Lower inflation is likely to boost demand through a combination of a lower savings ratio, lower interest rates, a higher volume of public expenditure for given cash limits and a better trade performance.

3. The second aspect is the improved supply performance of an economy with lower real wages relative to productivity. This should produce more jobs by encouraging a higher level of profitable output; a lower incentive to substitute machines for men; and increased demand for more labour intensive activities.

4. This sets the scene for a discussion of the counter-arguments that have been raised against the proposition that a slower growth of pay will reduce unemployment.

(i) "lower wages imply lower spending and a lack of demand." BUT there are other sources of demand, particularly from companies whose income will improve, and the higher level of employment.

(ii) "the extent to which labour costs can be substituted for other costs is very small." BUT there is evidence that at the margin there will be substitution. In addition higher profitability means a greater incentive to expand output.

(iii) "there is no evidence that pay and jobs are related; recently the real product wage has been unchanged and yet employment has fallen." **BUT** this definition of the so called real product wage is only unchanged because of the very sharp fall in employment and hence the increased productivity. Excessive wage costs have meant lower employment.

(iv) "the evidence of the US is not relevant because success on jobs there has been the result of expansionary fiscal policies." **BUT** the rise in employment has taken place over many years and does not coincide with the higher budget deficit. The key has been in labour market performance and is reflected in the way that higher demand has shown up as real demand not simply higher inflation.

(v) "a low wage/low productivity economy is undesirable as it means low status, insecurity and inefficiency." **BUT** although a high wage/ high productivity economy is better the higher productivity must come first. To attempt to force higher productivity by first achieving higher wages is a simple recipe for increasing unemployment.

(vi) "we do not know how to achieve lower real wages." **BUT** experience suggest that slower growth of money wages would mean a slower growth of real wages.

(vii) "competitiveness can be improved more efficiently by a lower exchange rate than lower wages." **BUT** at best devaluation is a way of reducing real wages by increasing inflation. If the lower real wages are not accepted it means repeated devaluation and accelerating inflation.

(viii) "The Treasury model shows lower wages leading to more jobs because it has been adapted to reflect the views of its proprietors." **BUT** the reason for adapting the model has been to explain better the experience of 1980 and 1981 where excessive wage costs led to major labour shedding. If anything Treasury model simulations understate the advantage of lower real pay.

(ix) "Trade Unions are not to blame for unemployment." **BUT** restrictive working practices, strikes and a union mark-up on pay raises wage costs above the competitive level. The result is more pay for employed members and reduced employment in that trade.

5. This is an issue that arouses strong feelings as well as disagreements about the economic analysis. (A list of recent articles on this subject is given in Annex 1). And where there is agreement about the analysis there can be disagreement about the magnitude of effects. Part of the confusion is due to a failure to distinguish between the benefit of pay moderation in helping to accelerate the adjustment of the economy to the rate of unemployment consistent with stable inflation; and the extent to which it can lower that rate by producing significant structural changes to the economy.

6. Part of the confusion is also due to the ambiguity about the term "lower pay". As long as there is some underlying growth of productivity this does not mean that real wages have to fall in absolute terms. They just have to grow less rapidly than trend productivity. For example if the level of real wages was held unchanged over the next five years (more in line with recent US experience) the argument of this paper is that the gains to employment would be considerable - yet the living standards of those in work would not have declined. When the paper discusses "lower pay" it has to be seen in this context and normally means relative to what might otherwise have occurred.

7. There is also confusion about the role of higher productivity in generating new jobs. The Government shares the objective of a high wage/high productivity economy. But this cannot be achieved overnight and it is important that the productivity increase comes before increased pay. It is also important that the reason for higher productivity is better working practices and improved technology. If it merely reflects a displacement of people by machines in response to excessive labour costs the higher productivity and higher incomes will simply be at the expense of the unemployed. Productivity increases are the key to higher incomes in the future.

But they are not a substitute for wage moderation if an immediate improved prospect for unemployment is to be achieved.

Wage Moderation and the Level of Demand

8. It is the behaviour of money wages that is most important for the level of demand within the framework of policy that the Government is operating. To the extent that firms pass on lower labour costs into lower prices, inflation will be lower and, with an unchanged financial framework (ie. monetary targets, PSBR/GDP ratio, and cash limits), this will boost output and employment. If firms do not fully pass on lower labour costs real wages will fall; the effects of this are discussed in the next section from paragraph 15 onwards.

9. Lower inflation and wage costs are likely to boost demand in a number of ways. For example:

(i) lower inflation means less of an erosion of the real value of consumer's financial wealth and reduces the need to save. With a lower savings ratio consumer demand is higher for a given level of disposable income.

(ii) lower inflation increases business confidence and encourages business investment and stockbuilding.

(iii) if cash limits are unchanged, public expenditure will be higher in real terms.

(iv) if monetary targets are unchanged, nominal interest rates will tend to fall and this will boost private expenditure.

(v) if the exchange rate does not rise to fully offset the lower inflation, for example because interest rates are lower, there will be a net improvement in international price competitiveness that will contribute to higher output and employment.

10. In the main these effects stem from a lower price level and involve a faster speed of adjustment of the economy to the financial framework. The main benefit is to reduce unemployment faster than would otherwise have occurred rather than to lower the rate of unemployment consistent with stable inflation.

11. But this should not lead us to underestimate the importance of a more rapid adjustment of inflation. At a time when policy is designed to bring about a reduction of inflation there are likely to be temporary effects on unemployment if wages and prices adjust slowly. Therefore to the extent that wages adjust more rapidly these effects can be reduced.

12. The scale of the further benefits to employment from lower inflation is inevitably uncertain. We have already seen considerable increases to demand over the past two years as a result of lower inflation and wage costs. We do not know the growth of output that is consistent with stable inflation but many economists now argue that, if anything, it is likely to be be below recent rates given the present structure of the labour and goods markets. In evidence they point to the apparent absence of significant downward pressure on real wages at current levels of unemployment and reduced downward pressure on inflation at present levels of capacity utilisation. This emphasises the need for a lower growth of real wages as we discuss later.

13. Lower inflation and unit wage costs brought about by productivity increases rather than pay moderation would also bring about increases in the level of demand and output. But by definition these effects on demand would not at the same time reduce the level of unemployment. We have seen some of this effect over the past three years. Higher levels of productivity have helped in controlling wage costs and bringing down inflation which in turn has boosted demand. Output has grown faster than the historical trend but at a slower rate than productivity; hence unemployment has continued rising.

14. So from the point of view of the immediate prospects for unemployment it is important that the demand side benefits of lower inflation

and wage costs should be brought about by wage moderation rather than higher levels of productivity.

Wage Moderation and Supply Behaviour

15. When we come to the effect of wage moderation on supply behaviour and longer term labour market adjustment it is the level of real wages that is important. There are two kinds of effect. With a slower growth of real wages and hence a higher overall rate of profitability employers will be encouraged to increase the level of output; involving both higher levels of investment and employment. And with a given level of output a lower level of real wages relative to other costs will increase the attractiveness of employing labour relative to other inputs.

16. The first of these, the impact of profitability on the level of output, will be gradual but there are also some clear short term benefits. In an open economy such as the UK much of the effect will be seen in the behaviour of exports and imports. Higher profitability will encourage higher output to supply export markets and substitutes for imports. But there will also be effects in non-traded goods markets where the provision of the supply of many services is dependent upon the profitability of supplying them.

17. It will also take time for the impact of a slower growth of real wages to be seen on the mix of labour and capital used. In some processes there is no short term scope for employing more labour. In others substitution is possible but will not follow immediately. In most industries decisions about the extent of labour saving investment will be taken from time to time. And more generally, the relative importance of labour intensive industries within the economy will depend on the pattern of demand. With lower real wages, the price of the products of labour intensive sectors of the economy will fall relative to prices elsewhere and demand and hence employment in those sectors will tend to expand.

18. Taken together these arguments suggest that a willingness to accept lower real wages can reduce the rate of unemployment that is

consistent with stable inflation and lead to a better division of the level of money GDP between real GDP and prices. This is important if the level of unemployment that is consistent with stable inflation has increased in recent years. There is some evidence that this may be the position; for example the continued rapid growth of real wages and signs that unemployment may remain historically high even when the number of job vacancies is back to a more normal level.

19. Strictly speaking, when we talk of the need for lower real wages in the long term we mean lower real wages relative to productivity (output per head). As long as there is some underlying growth of productivity, real wages do not have to fall in absolute terms for unemployment to improve. They just have to grow less rapidly than productivity. There are clear presentational advantages in putting it like this. Unemployment would have been lower, yet the living standards of those in work would be unchanged. If the level of real wages was held unchanged over the next five years (more in line with recent US experience) the gains to employment could be considerable.

20. In judging the impact of a higher level of labour productivity on unemployment it is important to distinguish between alternative ways that higher productivity may come about - increases that reflect overall efficiency gains due to improved technology and working practices; and measured labour productivity increases that merely reflect a displacement of people by machines because of excessive labour costs. The first is likely to have beneficial long term employment effects; the second simply means higher unemployment. But even in the first case, where the productivity increase reflects overall efficiency gains rather than labour substitution, the timescale of the employment benefits will be much longer than if the cost of labour is reduced by lower real wages. Higher profitability brought about by lower real wages will increase the level of output and the impact on the level of employment is likely to be rapid. Higher profitability brought about by increased productivity will encourage a higher level of output but initially without corresponding benefits to employment.

21. Again recent experience shows the short term unemployment costs of improved profitability brought about by higher productivity. As

companies came under pressure to reduce their labour costs they did the easier thing first; they improved productivity rather than reducing or holding down real wages. Profitability has improved but despite the historically respectable output performance unemployment has continued to rise.

22. Great care is therefore required in presenting the case for higher productivity. The emphasis should be placed on its long term benefits, in terms of higher real incomes and potential output. A high wage and high productivity economy is obviously better than a low wage and productivity one. But how do we get from here to there and what is the impact on unemployment? Clearly the high productivity must precede the high wages. To go the other way around would increase unemployment, inflation or both. But even if high productivity comes first and output grows faster it will not reduce unemployment quickly without a slower growth of real wages. Otherwise the productivity increase will show up as higher real incomes of those in work but unemployment will remain high for longer . To achieve both higher incomes and more employment without an inordinate delay requires both a faster growth of productivity and a slower growth of real incomes.

Counter-arguments

23. In the rest of the paper we set out and comment on a number of counter-arguments that have been raised against the proposition that slower growth of pay reduces unemployment. In most cases the counter-arguments have not been attributed to particular sources, mainly because they have appeared in a number of different places at different times. Here we have drawn mainly on the publications of the Low Pay Unit (especially Unemployment: Are Wages to Blame? March 1984 and From the Dole Queue to the Sweatshop July 1984, both by Henry Neuburger) and their director Chris Pond, and on a recent article by David Basnett (FT, 8/8/84). Sir Douglas Wass (Observer, 19/8/84) and A M G Christopher(FT, 26/7/84) have also contributed to the debate. Article presenting the opposite case have appeared from Samual Brittan (FT, various dates); Forest and Dennison in their Hobart Paper Low Pay or No Pay? and various letters to newspapers; and Professor Hayek in the Times (7/8/84).

24. **Lower wages imply lower real incomes and consumers's expenditure and hence lower output and employment**. (This case has been made frequently by both Neuburger and Pond on behalf of the Low Pay Unit and it often appears in TUC statements). It is argued that workers will not be able to afford to purchase the products they produce. To the extent that lower wages are not compensated by lower prices there may be some impact on consumer's expenditure. However we have argued that in these circumstances there will be some offset for a time because of a move to a lower savings ratio which has the effect of increasing consumption for a given level of disposable income.

25. But what is ignored in this argument is that there are other sources of demand. Lower real wages imply higher real profits which will stimulate business expenditure and distributions to shareholders. Secondly, lower real wages will probably mean improved cost competitiveness which will stimulate the demand for exports and mean that more expenditure is on home produced products rather than imports. Thirdly there will be scope for more employment for a given level of output which will increase the incomes of those who otherwise would have been unemployed; this will increase the level of consumption and compensate for the lower incomes of those who were originally in work. In other words income and consumption of those who were out of work rises at the expense of those who were in work.

26. More generally this argument harks back to the early thirties when the overall level of nominal demand was growing less rapidly than policy makers intended. That is not the position today. The government's fiscal and monetary policy will ensure that the level of money demand will be maintained. A slower growth of real wages will not in these circumstances create a problem of insufficient demand. By contrast it will improve supply conditions and mean a better distribution of income between those currently in work and those out of work.

27. The relative importance of these factors is an empirical matter, and can only be fully assessed using a model of the whole economy. Simulations on the Treasury and LBS models show that a reduction in

nominal wages leads to increased employment, through a combination of the lower real wage and lower inflation routes. Thus the reduction in employment resulting from lower consumer's expenditure by those initially in work is more than offset by the increases from the other mechanisms. Models are, of course, imperfect and it might be possible to construct a plausible model that did not have this property. But as far as we know a respectable model of the UK like this does not exist.

28. **Lower real wages would not help because the extent to which labour can be substituted for other inputs in response to a fall in the relative cost of employing labour is very small.** This counter-argument appears in the article by Sir Douglas Wass. It accepts the basic premise that there can be pricing back into work, but downplays its quantitative importance. Examples of the limited scope for substituting men for machines in particular processes are cited in support. Or it is suggested that the fall in the relative cost of labour would have to be large and perceived to be permanent before decisions about the mix of labour and other inputs were altered.

29. This note has made the point that there are a number of ways in which lower real wages can lead to a substitution of labour for other inputs. For example, at the margin decisions are taken about the scale of labour saving investment; and with lower real wages the labour intensive sectors of the economy will expand. The United States has experienced the benefits to employment of a low growth of real wages. Moreover, there is empirical support for the significance of the substituion effects, as we shall see later.

30. In addition we have already argued that it is not only the substitution effect - the replacement of men by machines - that matters from the point of view of supply behaviour. Better profitability will encourage higher levels of output that will also help the level of employment.

31. **There is no evidence that pay and jobs are inversely related.**

The chart at Annex B from the **Midland Bank Review** (Spring 1984) has been cited a number of times as evidence of the absence of a relationship. Examples are the article by Basnett in the FT and a letter from Tony Christopher on July 26 in the FT. The point made is that from 1978 onwards real wages adjusted for productivity in manufacturing hardly changed but employment fell by over 10%. But this definition of the so-called real product wage cannot be expected to bear a simple relationship with employment. It takes the real wage and adjusts for productivity changes. It ignores the fact that this definition of the real product wage did not rise over this period precisely because employment fell and productivity rose. But we have already pointed out that if the adjustment is in the form of higher productivity output may benefit but employment will not. The key to the prospects for employment is the real product wage without allowing for productivity shifts - particularly those that occur partly in response to excessive real wages.

32. In any case conclusions from a simple relationship like this can be misleading if other factors are not taken into account. There has been a certain amount of careful work in recent years which has tended to provide empirical support for the inverse relationship. It also controls for other factors that were affecting employment at the same time. Much of it was done by economists at the Centre for Labour Economics at LSE, although internal Treasury work and studies by Patrick Minford and Michael Beenstock come to similar conclusions. All these studies show an inverse relationship between pay and jobs, part of which reflects the scope for substituting labour for other inputs when the relative cost of labour falls. Most economists would probably support this view.

33. **<u>The evidence of the United States is not relevant</u>.** Those who argue in favour of the pay and jobs relationship, including the Chancellor, have often cited the example of the US. Over the last ten years there have been 15 million new jobs created in the US, while employment has fallen in Europe. Real earnings rose by around an eighth in Europe over the same period, while they actually fell in the US. The counter-argument is that this evidence is not relevant because the rise in employment in the US was due to expansionary fiscal policies

rather than to the slow growth of real wages - it appears in the articles by Basnett and Wass .

34. The counter-argument does not appear to be based on a close examination of the data. The timing of the rise in employment does not fit with the timing of the rise in the budget deficit. Employment rose by 13 million between 1975 and 1979, a period over which US fiscal policy became more restrictive, but by only 2 million between 1979 and 1983 when it became much more expansionary.

35. Although money GDP has accelerated because of easier monetary and fiscal plicy, the striking feature of recent US performance has been the extremely favourable division of nominal GDP growth between output and inflation. The latter is not a reflection of fiscal policy other than to the extent that it has led to a high dollar. The key has been the good supply peformance of the economy and the extent to which fast growth of money demand has shown up in real demand. Whereas there has been little downward pressure on real wages in the UK despite high unemployment there has been a considerable degree of wage restraint in the US at considerably lower rates of unemployment. The rate of unemployment in the US that appears to be consistent with stable inflation appears to be considerably below the equivalent rate in the UK. The key to this is the behaviour of the labour market and the moderate rate of pay settlements.

36. **A low wage/low productivity economy is undesirable.** Basnett says that low wages "go together with low status, insecurity and inefficiency. Low-paid workers are inadequately trained and are given little or no responsibility or prospect for advancement. Their talents are therefore ignored and potential contribution to the economy's performance is wasted" (FT 8/8/84).

37. As already noted, a high wage/high productivity economy **is** better than a low wage and productivity economy, although Basnett no doubt exaggerates the extent to which there is untapped potential within individual workers as opposed to scope for raising their productivity through organisational and technical changes, including investment

in new equipment. But we cannot overnight become a high wage and productivity economy. In particular, the following two routes sometimes proposed are not sensible:

a. major increases in investment (Who would do it? If the public sector invested much more, or subsidised the private sector to do so, the quality of investment would be low. Productivity in such cases may not always be great. The private sector will invest more when it is profitable to do so. Compared to other countries there is evidence that investment has been higher in the UK relative to the change in output. Hence the Budget changes to corporation tax);

b. the "shock" effect of higher wages on management, forcing them to increase effficiency and productivity (It is extremely dubious whether this would work. If it did it would more often be because firms reduced employment than because they raised the output and productivity of all the initial workforce. Thus unemployment would rise).

39. The image that many people have of the low wage/low productivity economy that might result from more pricing back into jobs tends to be inaccurate and misleading. It would not involve an actual decline in the level of technology in any existing occupation or process. The changes would take place at the margin: firms would choose new equipment that was slightly less labour-saving than they would have chosen at higher wages; they would delay new investment of a labour-saving nature a little longer; and, perhaps most important, there would be a shift in the structure of the economy towards activities that used a higher proportion of employees together will a general incentive for companies to increase the level of output. In none of these cases would Basnett's description of low status, insecure and inefficient workers be appropriate. Of course, such shifts at the margin would only be gradual, which is why real wages should grow more slowly for many years so that the impact cumulates to something substantial over time.

40. **Even if everyone agreed that they wanted real wages to grow more slowly, they are powerless to achieve such an outcome.** This is a point made in the Wass article. It is argued that when money wages grow more slowly (which can be achieved), firms react by passing the lower costs on in lower prices, and real wages are unchanged.

41. In principle this could be true but in practice is unlikely and experience does not support it. Upward pressure on nominal wages has increased real wages faster than productivity and reduced profits. Slower growth of wages would likely lead to lower real wages , although not to the full extent of the wages slowdown. Lower wages would not feed one for one through to prices because imported costs would probably not fall as much as wage costs, if at all, and there would be increased scope for firms to improve their margins without adversely affecting their competitiveness. In any case as explained earlier, a short-term reduction in inflation within a given financial framework would boost output and employment. So wage moderation would lead to a reduction in unemployment even if real wages were unchanged.

42. There is one situation in which this mechanism would be delayed and the growth of real wages would not slow down, at least not for a number of years. This would be if the Government tightened fiscal and monetary policy following the reduction in the growth of money wages. In this case all of the reduction in money wage growth could feed through into lower inflation: there would be no real wage deceleration. The reduction in inflation here would not have as much impact on output and employment in the short term as with the unchanged financial framework, mainly because interest rates may not fall, the exchange rate could rise and cash limits would be reduced.

43. But the Government has no intention of responding to lower wage growth in this way. Against this background a slower growth of wages would both help demand and by leading to lower real wages would improve employment opportunities.

44. **Lower Real Wages are of no use without increased Demand.** Some accept the argument that lower real wages would help to improve supply

conditions but fear that it will be of little use if the demand is not present. This point is made in the Christopher letter.

45. But we have argued that given the Government's financial policy lower real wages will benefit demand as well as supply conditions. A demand stimulus through a higher PSBR and lower interest rates can equally be obtained by lower wages and prices within a given financial policy. The extra benefit from wage moderation is lower inflation and business confidence. There is no shortage of demand. Money GDP is currently growing at around 8 per cent a year. The Government's financial policy is consistent with continued growth at about this rate this year followed by a slow decline. A lower growth of earnings and prices within the framework leaves room for a rapid growth of demand. It is sometimes asked what the Government's response would be to lower earnings growth. The answer is that the appropriate response is to ensure that nominal magnitudes continue to grow at the rate implied by the financial strategy. That may require interest rate reductions but it would be within the framework of existing policy.

46. **Any benefits of improved competitiveness can more efficiently be achieved by a lower exchange rate.** This argument is made by Neuburger. But it is often forgotton that a lower exchange rate will only improve competitiveness **providing** that it reduces real wages. Without an acceptance of lower real wages exchange rate depreciation will increase prices without any competitive gain. Why should employees be prepared to accept lower real wages by this route which increases inflation and not by wage moderation which helps inflation? By contrast wage moderation produces the same lower real wage but at a lower inflation rate. That must be a better outcome. It is sometimes argued that it is easier to accept lower real wages by exchange rate depreciation because everyone is affected equally at the same time. But in that case it is not the principle that is being disputed but the best mechanism for bringing it about. It is also argued by Neuburger that for a given improvement in competitiveness a lower exchange rate does less damage to the real incomes of workers than lower pay levels. It is difficult to see how this can be sustained if full allowance is made for both the impact of the exchange rate and wages on prices.

[illegible]. What is clear is that a refusal to accept a lower real wage combined with currency depreciation is a (well-known) recipe for an acceleration of inflation.

48. **Simulations of the Treasury model show benefits to unemployment from lower pay settlements because the model has been adapted to reflect the views of its proprietors**. Henry Neuburger has argued, in a recent Low Pay Unit pamphlet and elsewhere, that the Treasury model considerably overstates the effect of changes in pay on unemployment. The implication is that the Treasury has fixed the model to produce the results it wants by incorporating an arbitrary feedback from improved company liquidity to increased employment. However the motivation for this change to the model, implemented in early 1982, was quite different. Previous versions of the model had completely failed to track the experience of 1980 and 1981, when financial pressures on companies caused them to shed labour to a marked degree; and the introduction of a feedback from liquidity to employment in the model was designed to remedy this failure. Far from overstating the effects of pay on employment, our view is if anything that the effects will be understated due to the absence of any specific allowance for the impact of real pay on the labour intensity of output or the composition of demand.

49. **Trade Unions are not to blame for unemployment; Government needs to work with a strong democratic trade union movement**. This is an argument put forward by David Basnett in his FT article. Trade Unions can have both positive and negative effects upon national output and employment. The positive effects can occur through reductions in labour turnover, co-operation among workers and improved communications with management. The negative effects of unions occur through three well-known avenues. First, there are restrictive working practices which lower productivity, such as minimum manning requirements, demarcation rules etc. Second, there are the destructive effects of strikes. Third, there is the trade union mark-up on pay, where unions raise the level of pay of their members relative to other workers. If the union successfully raises the level of pay above the competitive level, more pay for employed members will be at the expense of reduced employment in that trade.

50. There is no empirical evidence in the UK on the positive effects of unions. On the negative side there are several estimates on the size of the wage mark-up due to trade union power from a 10 per cent mark up for manual workers in 1980 by Blanchflower(1983), 32 per cent in a study by Nickell and Andrews (1983) and an extremely high estimate by Minford (1983) of 74 per cent. Estimates of the effect on employment range from a reduction in employment by over 400,000 between the mid '50s and the mid'70s (Nickell and Andrews) to a reduction of over a million (Minford).

ANNEX A

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21. 20 August — Sam Brittan, Article in Financial Times "Bad Reasons for Pay Worries".

22. 22 August — Henry Neuburger, Letter in Financial Times, comment on Dennison of 16 August.

to the supply side?

If that is how the Budget comes out, it could indicate that the Government is setting its course towards the ultimate objective of stable prices which the Chancellor has proclaimed. It could also be defended on the argument that maintainable growth in the economy comes not from fiscal or monetary stimuli to demand but from the supply side, and in particular through a lower relativity between wages and output per head. The importance of these things cannot be underestimated; we have stressed them at various points above. The question is whether they can work by themselves, and the demand side be left to follow along. The CBI in its Budget submission to the Chancellor appears to have been partially converted to the supply side view; it also calls for a somewhat higher PSBR, but in order to finance 'supply side' measures. The view can be traced way back into the history of economic thought, and is not necessarily the worse for that. And yet . . .!

The idea that employment and output are related to the real cost of employing labour has been ventilated in these pages on a number of occasions. Chart 5 updates the relationship for UK manufacturing industry. The 'real product wage' is calculated from an index of wages and salaries per employee, plus the employers' contributions for National Insurance and superannuation, which is then divided by an index of output per employee and an index of (value-added) prices of manufactured products. The result is an approximation to the movement in the real effective cost of employing labour. It is akin to the share of labour costs in value-added, but it should be borne in mind that these are the costs of labour as seen by the employer rather than the rewards enjoyed by the employee. The latter would have to take account of income taxes and of retail prices in general rather than the prices of a particular product such as manufactures. It now appears that the post-war history of the relation between the 'real product wage' and employment has had three phases. Up to the late 1960s they rose together. From then to the late 1970s employment fell as the 'real product wage' rose. It was this second phase which reawakened interest in the notion that unemployment was rising because real wages were too high. But the relationship now seems to have moved into a third phase, in which since the end of the 1970s employment has been dropping like a stone while the 'real product wage' has been stable or even slightly falling. (The figures plotted are five-year averages. The annual data show a steep decline from 1975 to 1978, a rise in the two years to 1980 when wages rose sharply relative to prices and output per head fell in the recession, and since 1980 a decline resumed at a moderate pace. The annual data for employment show a continuous drop since 1978.)

What are we to make of this? The new experience from the end of the 1970s indicates that the 'real product wage', our proxy for the real effective cost of employing labour, may have lost its earlier influence on the level of employment—perhaps either way. Something else must have been at work. Is it perhaps declining demand? The figures plotted in Chart 5 relate only to manufacturing, and it is necessary to be cautious about drawing from them conclusions concerning the economy as a whole. Nevertheless, what has been happening in manufacturing since the late 1970s appears not to support the view that the key to higher levels of employment and output can be found in lower real labour costs alone. Lower labour costs may be necessary to ensure that any given level of demand can be profitably supplied, but if demand sags output may fall nevertheless. In other words, supply without demand may be as futile as demand without supply is dangerous. If we are right in thinking that this year will see the growth of demand diminishing in the UK economy, there is a case for some fiscal action to sustain it provided that it is balanced by at least some of the 'supply side' measures which the CBI and others have advocated, including the abolition of the National Insurance Surcharge. Equally, there is a case for the latter measures provided that they are balanced by some stimulus to demand. To produce a balanced package some increase in the PSBR would probably be required. Perhaps the day for this has dawned; but will it be visible through the Treasury's blinds?

Chart: 5 **Real product wage* and employment in UK manufacturing (1980 = 100)**