Centre for Policy Studies

THE PRICE OF FAIRNESS

THE COSTS OF THE PROPOSED LABOUR MARKET REFORMS

Patrick Minford & Andrew Haldenby

THE POINTMAKER

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SUMMARY

New Labour was elected on a promise to combine 'fairness' and 'flexibility' in its labour market policies.

The Government intends to implement its labour market proposals over the next year.

This paper estimates the projected costs of these measures **for the first time**. Its calculations, which veer on the side of caution, show that the labour market reforms will:

- impose additional costs totalling £2.7 billion per year on British business;
- increase unemployment by approximately 860,000. British levels of unemployment would then approach the European average;
- contribute to a climate of business retrenchment and caution.

Some measures – such as the Fairness at Work proposals – are still before Parliament and can be amended. It will be far easier to amend or withdraw the legislation at this stage than to repeal it at a later date. The threat, therefore, is that this legislation could pose not only grave but **lasting** damage to British competitiveness.

The **annual costs** of the major labour market reforms on employers are estimated as follows:

Measure	Cost on Employers
Working Time Directive	£2.3 billion
Rise in limit for compensation in unfair dismissal cases from £12,000 to £50,000	£213 million
'Family friendly' measures	£50.7 million
Compliance cost of WFTC et al.	£100.0 million
Compliance cost of student loans	£79.0 million
Compliance cost of stakeholder pensions	£5.3 million
TOTAL	**£2.7 billion**

It is also estimated that the Minimum Wage will have an effect equivalent to a rise of 2% in unemployment benefits and income support.

In addition to the above costs, the measures to facilitate new union recognition are expected to increase union membership by one million.

The Liverpool econometric model has been used to assess the impact of these measures on unemployment. The model has one of the longest and most accurate track records of any model in terms of its supply-side forecasts, and indicates that:

- the £2.7 billion extra business costs will increase unemployment by about 43,000 after a year and a half, before falling back to an average of around 27,000;
- the Minimum Wage will increase unemployment by 280,000 after two years, before falling back to around 215,000;
- the new union membership will increase unemployment by about half a million after two years, before falling back to around 400,000.

The cumulative long-term impact on the labour market of these proposals will be greater than the sum of the individual measures. The table below shows how the overall long-term effect will be to increase unemployment by 860,000.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Increase in business costs	38,000	44,000	40,000	31,000	26,000	24,000
Higher union membership	277,000	497,000	566,000	516,000	417,000	395,000
Minimum Wage	171,000	288,000	317,000	285,000	229,000	217,000
Additional impact	58,000	193,000	280,000	284,000	238,000	224,000
Total	544,000	1,022,000	1,203,000	1,116,000	910,000	860,000

These estimates represent the most likely future for the British labour market. They are supported by surveys of business opinion. Nearly half of the larger companies in a CBI survey consider that the Minimum Wage, statutory trade union recognition and Working Time Directive will have a 'negative' or 'very negative' impact on their competitiveness.

Employment Trends Survey

CBI/William M Mercer 1999

In addition, these calculations do not take account of the intangible effects of the labour market reforms on the expectations of both business and the labour market. The fear is that a different business environment could be emerging: one based on retrenchment rather than growth.

EUROPEAN COMPARISONS

The unemployment rate in the UK is much lower than the European average – a performance that is often ascribed to the UK's more flexible labour market. However, given the above estimates, the labour market regulations imposed by the Government would increase UK unemployment to 2.7 million (9.2% of the workforce).

Number of Unemployed People (ILO methodology)	Unemployment Rate (%) (ILO methodology)
1.8 million	6.3
2.7 million	9.2

Labour Market Trends, HMSO, May 1999

At 9.2%, UK unemployment would be approaching the European average. It would be similar to current German unemployment but still considerably lower than the level in France, Italy and Spain. It would, however, be more than twice the level of that in the United States.

Country	Unemployment Rate (%)
UK (current)	6.3
UK (extra 880,000 unemployed people)	9.2
EU average	9.7
Germany	9.2
France	10.8
Italy	12.1
Spain	18.0
United States	4.3

Labour Market Trends, HMSO, May 1999

WHAT CAN BE DONE?

There is still time to prevent the worst effects of the legislation. In particular, the measures in the Employment Relations Bill – including those on trade union recognition, unfair dismissal and 'family-friendly' policies – are under discussion in Parliament. Ministers can still amend the legislation and reduce the impact on competitiveness and unemployment.

In effect, the Government is forcing business to pursue its social goals through regulation. These regulations are effectively a tax on business, even though they do not appear as taxes in any of the Government's Budgets. If New Labour wishes to honour its manifesto promises, then it should act, as a matter of urgency, to protect British competitiveness and employment from the impact of this legislation.

CHAPTER ONE
INTRODUCTION

New Labour was elected on a promise to combine 'fairness' and 'flexibility' in its labour market policies.

In the section on business in its 1997 manifesto, New Labour promised to 'introduce minimum standards for the individual at work'. At the same time, New Labour promised to 'build a new partnership with business to improve the competitiveness of the British industry for the 21st century, leading to faster growth'. Measures such as a Minimum Wage and new means for unions to be recognised would take place 'within a flexible labour market'.

Labour Party Manifesto, 1997

New Labour has made the same promises in government. For example, the Prime Minister has stated:

I want Britain to be a country of enterprise and ambition where small businesses grow, manufacturing and engineering revive, where we learn the lessons of British industrial relations over the past 100 years. Fairness at work yes. But flexibility will remain. For business, this will be a Government on your side not in your way.

Rt Hon Tony Blair MP

Speech to the 1997 Labour Party Conference

THE NEW LEGISLATION

New Labour's labour market legislation has been introduced over the last two years and is now on the verge of implementation. Until it is fully implemented, it will not be possible to measure the exact impact on business. But it is possible to estimate the potential cost to business and the effects on the wider economy of the following labour market reforms:

- The Working Time Directive (effective from October 1998);
- The rise in maximum compensation for unfair dismissal (currently under discussion in Parliament);
- The impact of new measures for trade union recognition (in Parliament);
- 'Family-friendly' employment legislation (in Parliament);
- Costs of administering the Working Families Tax Credit and the Disabled Person's Tax Credit (effective from April 2000);
- Costs of administering stakeholder pensions (in Parliament);
- Costs of administering student loans (announced in March 1999 Budget; regulations yet to be introduced);
- The Minimum Wage (effective from April 1999).

This paper makes no attempt to evaluate the 'New Deal' measures designed to induce the unemployed to take work: the Working Families' Tax Credit, the special inducements (such as child care) for single mothers, and the latest focus on workers and early retirement (except in terms of the administrative burden placed on business). Nor does this paper consider general taxation on business or non-labour market regulation. These areas all give cause for great concern and are appropriate for further study.

Two questions must be asked of the proposed labour market regulations: will they, in the Prime Minister's words, get in the way of enterprise and ambition? And will 'fairness at work' promote or hinder the creation of new jobs?

CHAPTER TWO
THE COSTS OF THE LABOUR MARKET REFORMS

1. THE WORKING TIME DIRECTIVE

The Working Time Directive became law in October 1998.
In its official guidance to the regulations which put the Directive into effect, the Department of Trade and Industry describes this measure as follows:

'The Working Time Regulations give rise to wholly new rights and obligations relating to work and rest. The principal provisions are for :

- a limit on average weekly working time to 48 hours (though individuals can choose to work longer);
- a limit on night workers' average normal daily working time to 8 hours;
- a requirement to offer health assessments to night workers;
- minimum daily and weekly rest periods;
- rest breaks at work;
- paid annual leave.'

Working Time Regulations
Department of Trade and Industry, 1998

The Working Time Directive was brought in under EEC Health and Safety regulations agreed to by the last Conservative Government. Nevertheless its practical implementation is the current Government's responsibility: it has enthusiastically embraced the principle of the directive whereas the previous one vigorously opposed the measure. It is therefore appropriate to include this measure as part of this Government's labour market reforms.
The Department for Trade and Industry published its estimate of the compliance cost of the Working Time Directive in April 1998.

CALCULATION OF COST OF WORKING TIME DIRECTIVE

	No. of workers affected by the Regulations	Compliance Cost (per annum)
Minimum daily and weekly rest periods	2.1m	£1.16 bn
Working time limits for night workers of 8 hours per day	0.3m	£0.18 bn
Minimum annual paid leave	2.5m	£0.47 bn
Working time limits for 48 hours per week	2.7m	£0.06 bn
Health assessments for night workers	3.5m	£0.05bn
Additional week's paid leave (from November 1999)		£0.40 bn
TOTAL		**£2.30 bn**

Source: *Measures to implement provisions of the EC Directives on the organisation of working time (the Working Time Directive) and the protection of young people at work (the Young Workers Directive),* DTI employment relations directorate, April 1998, URN: 98/645, Annex E.

2. COMPENSATION COSTS FOR UNFAIR DISMISSAL

The Employment Relations Bill, given its Second Reading in Parliament on 9 February 1999, includes provisions to raise the limit on unfair dismissal compensation to £50,000, and to be linked from then on to changes in the Retail Prices Index.

Employment Relations Bill – Regulatory Impact Assessment

Department of Trade and Industry, January 1999.

The Department for Trade and Industry published its estimate of the compliance cost of this measure in a Regulatory Impact Assessment in January 1999. This suggested that the measure would only affect those employers who had to award maximum compensation. This was estimated to be 100 employers a year, so that the measure would increase their costs by £1.8 million (the DTI assumed an average payment of £30,000).

This figure is an underestimate. It takes no account of the possibility that the existence of higher awards will encourage more people to claim unfair dismissal. It also ignores the probability that lower awards may also be increased in line with the increase with the maximum award.

To reach an accurate estimate of the likely costs, the following factors need to be considered:

- The number of employees who receive compensation both inside and outside of tribunals.
- The number of cases in which employees receive compensation.
- The average award of compensation.
- The possible increase in the average award given the increase in the limit for compensation.

How Many Employees Receive Compensation?

Many employees receive compensation without going to tribunal. ACAS figures show that two-thirds of applications are settled or withdrawn without recourse to a tribunal. 'Settled' cases are cases in which the employer agrees to compensate the employee without going to a tribunal.

NUMBER OF UNFAIR DISMISSAL CASES

	Cases Received	Settled	Withdrawn	To Industrial Tribunal	Total Completed Cases
1997	42,771	19,284	12,077	15,177	46,538
1996	46,566	19,376	13,064	13,207	45,647
5 year average	44,566	18,898	12,127	13,602	44,627

Source: *ACAS Annual Report 1997* Table 7, p.120

Just under half of tribunal cases are successful for the employee. The Employment Tribunal Service reports that 'in 1996-7, the latest year for which figures are available, the applicant was successful in 45.9% of cases disposed of at a tribunal hearing, compared with 47.56% in 1995-6.'

General information and statistics

Tribunal Service, August 1998

By adding together the number of 'settled' cases to the number of successful cases at tribunals, the total number of 'successful' cases can be estimated:

NUMBER OF CASES WHERE COMPENSATION IS PAID

	Unsuccessful – withdrawn	Unsuccessful at tribunal	Successful – settled	Successful at tribunal	Total successful
1997	12,077	7,588	19,284	7,588	26,872
1996	13,064	6,703	19,376	6,703	26,079

Source: *ACAS Annual Report 1997* Table 7, p.120

What is the Current Cost of Compensation?

The Employment Tribunal records the median award from successful tribunal cases. This is about £2,500. In 1996-7, the median award was £2,575; in 1995-6, £2,499; in 1994-5, £3,289. (It is – conservatively – assumed that the average award at cases settled before tribunals is the same as the average award to successful claimants at tribunals).

General information and statistics

Tribunal Service, August 1998

The total cost of compensation for unfair dismissal can therefore be estimated to be in the region of £67 million, as shown in the following table.

PRESENT COST OF COMPENSATION FOR UNFAIR DISMISSAL

	Number of claims	Total cost (assuming £2,500 average award)
1997 claims settled before tribunals	19,284	£48m
1997 successful claims at tribunals	7,588	£19m
Total 1997 successful claims	26,872	£67m

Source: *ACAS Annual Report 1997* Table 7, p.120; CPS calculations

What Will be the Cost of Increasing the Limit on Compensation?

It is probable that the effect of a higher maximum award will be to increase the average amount that successful claimants receive.

Assuming that the median award will, in time, increase in line with the maximum award – that is, an increase in the ratio £50,000 : £12,000 – the median award would increase from its current figure of around.£2,500 to around £10,400.

In this case, the total cost of raising the limit would amount to £213 million.

ESTIMATED COST OF INCREASING THE LIMIT TO £50,000

	Number of claims	Cost with average award of £2,500	Cost with average award of £10,416	Additional Cost
1997 claims settled before tribunals	19,284	£48m	£201m	£153m
1997 successful claims at tribunals	7,588	£19m	£79m	£60m
Total 1997 successful claims	26,872	£67m	£280m	£213m

Source: *ACAS Annual Report 1997* Table 7, p.120; CPS calculations

A Cautious Estimate

The figure of £213 million is likely to be an underestimate of the probable costs of raising the limit for unfair dismissal compensation as it makes no any allowance for an increase in the numbers of cases. Any increase in the number of cases could increase the cost of the measure.

3. 'FAMILY FRIENDLY' LEGISLATION

An important part of the Employment Relations Bill deals with the extension of rights for family members. Specifically, the Bill provides for:

- Extension of maternity leave from 14 weeks to 18 weeks.
- Extended Maternity Leave after 1 year's service, as opposed to two years at present.
- Parents to be entitled to three months unpaid parental leave subject to their being in a job for more than a year.
- 'Reasonable time off' for family or domestic emergencies.

The third and fourth proposals include measures which will implement requirements of the Parental Leave Directive, adopted through the mechanism of the Social Chapter.

The Department of Trade and Industry has published estimated costs of 'family-friendly' policies in a Regulatory Impact Assessment on the Employment Relations Bill.

COSTS OF FAMILY FRIENDLY LEGISLATION

	Cost
Extension of maternity leave to 18 weeks	£1.8 million
Wider entitlement to Additional Maternity Leave	£14.0 million
Parental Leave	£28.0 million
Right to time off for family and domestic emergencies	£6.9 million
TOTAL	£50.7 million

Source: *Employment Relations Bill – Regulatory Impact Assessment*, DTI, January 1999

4. INCREASE IN ADMINISTRATIVE COSTS

Regulations on Small Business Index (ROSBI)

Mail on Sunday/Chantry Vellacott, October 1998.

Administrative burdens – the costs to employers of carrying out government legislation, such as the requirement to collect PAYE and National Insurance Contributions – are extremely hard to estimate. The best available attempt to cost the regulations currently borne by business noted that 'not even the DTI Deregulation Unit has any idea of what the total cost figure is'

The Tax Compliance Costs for Employers of PAYE and National Insurance in 1995-6

A Report by the Centre for Fiscal Studies University of Bath, Inland Revenue, October 1998

There is a growing awareness however that such administrative burdens are a significant regulatory cost. The Inland Revenue commissioned a major study on the costs of collection of PAYE and National Insurance Contributions from the Centre for Fiscal Studies at Bath University. This showed that it costs employers £1.32 billion to collect around £100 billion in income tax and NICs, or 1.32p for every £1.00 collected.

The Government is introducing the following measures which will increase administrative burdens for business:

- Working Families Tax Credit (WFTC) and Disabled Person's Tax Credit (DPTC).
- Stakeholder Pensions.
- Repayment of student loans through the tax system.

Administration Costs of the Working Families Tax Credit and the Disabled Person's Tax Credit

The WFTC and DPTC will be delivered through the payroll from April 2000.

Both will be burdensome for employers. Although the Inland Revenue will calculate the amount of tax credit due to an employee, employers will have to:

- Calculate the tax credits for a particular pay period from a daily rate, and add the tax credit amount to net pay.
- Enter this amount on the employee's payslip and record the total tax credits paid in a tax year.
- Enter the total tax credits in the year for the employee on relevant forms.
- Enter the total tax credits for all employees in the year on the relevant form, together with the total amount of Inland Revenue funding in that year.
- Inform the Inland Revenue of all details of payment if an employee leaves the firm while in receipt of a tax credit.

The Inland Revenue has produced a Regulatory Impact Assessment for the Working Families Tax Credit and the Disabled People's Tax Credit. This suggests that the extra administrative cost will be around £100 million a year.

Tax Credits Bill and Accompanying Regulations – Draft Regulatory Impact Assessment

Inland Revenue, February 1999

Costs of Administrating Stakeholder Pensions

The Department of Social Security has published estimated compliance costs of Stakeholder Pensions in a Regulatory Impact Assessment on the Welfare Reform and Pensions Bill.

Regulatory Impact Assessment of the Welfare Reform and Pensions Bill

Department of Social Security, 21 May 1999

The recurring costs of the measure are estimated at £4 million for pensions providers from the pensions rule change, and around £15 million recurring costs for every 1 million employees who join a stakeholder pension scheme.

The Government anticipates that 5 million people should acquire a stakeholder pension, in particular those 'on middle incomes (between £9,000 and £18,500 a year)'. This suggests that the recurrent costs of the stakeholder pension scheme will be £75 million (£15 million x 5).

A new contract for welfare: Partnership in Pensions

Department of Social Security, December 1998.

The total annual compliance costs are therefore estimated to be £79 million (£4 million + £75 million).

Costs of Administering Student Loans

The Government is changing the method of repayment for student loans. Until now, students have made repayments directly to the Student Loans Company. Regulations are about to be introduced so that repayments will be collected through the PAYE system. In practice this means that over 90% of those repaying will do so through the PAYE system.

Departmental Report.

DfEE, March 1999

On current trends, the level of repayments by students will reach around £400 million by 2000-1.

ibid.

If the administration of the repayment of student loans imposes the same burden as that of PAYE and NICs, the compliance cost would be 0.13p x £400 million = £5.28 million.

5. TRADE UNION RECOGNITION

The Employment Relations Bill provides for a statutory procedure for trade union recognition applying to organisations employing more than 20 employees. Two methods can be used to force recognition of a union for bargaining purposes:

- A ballot of workers in which there is a simple majority in favour of recognition, and at least 40% of those eligible to vote do so in favour of recognition.
- An automatic route where more than 50% of workers in the bargaining unit are union members.

In order to judge the economic impact of this measure, the number of potential new union members needs to be estimated.

To calculate the impact of the Government's legislation on union membership, the following factors have been considered:

- Current trends in union membership.
- The proportion of companies who expect a claim for recognition.
- The total number of British companies.
- The likely number of companies accepting a claim for recognition.
- The current number of union members.
- The number of extra union members.

An end to falling Union Membership

There are signs that the long-term decline in union membership has bottomed out. The latest figures from the Labour Force Survey show that there are nearly 6.8 million employee union members (equivalent to 30% of all employees). This figure is unchanged from last year. Estimates from the Labour Force Survey (LFS) suggest that the year-on-year decline in membership between 1995 and 1996 was only 0.8% compared to an average of almost 3% over the whole period since 1989.

Union membership is much higher in larger workplaces.

UNION MEMBERSHIP AND RECOGNITION BY SIZE OF WORKPLACE

Workplace Size	% of employees who are members	% of workplaces where unions are recognised
25-49 employees	23	39
50-99 employees	27	41
100-199 employees	32	57
200-499 employees	38	67
500+ employees	48	78

Source: *1998 Workplace Employee Relations Survey*, DTI, 1999

The Trade Union Congress has made strenuous efforts to increase union membership. For example, in 1997, a new organising academy was set up by the TUC and 15 affiliated unions with the aim of training people to help unions organise themselves where there are employees who are not currently trade union members.

Members of the CBI also expect the new legislation to lead to greater union membership: anticipating the introduction of statutory trade union recognition, the CBI asked its members if they expected a claim to be brought 'if Government passes legislation'.

% OF RESPONDENTS EXPECTING A CLAIM FOR TRADE UNION RECOGNITION IF GOVERNMENT PASSES LEGISLATION (1998)

	0-199 employees	200-499 employees	500-4999 employees	5000+ employees
Yes	3	7	17	23
Possibly	16	17	16	24
No	71	63	60	51
Don't Know	10	13	7	2

Source: *CBI/William M Mercer Employment Trends Survey*, CBI, 1998

In 1999, following the introduction of the Employee Relations Bill, the survey was repeated with the following question: 'If the Government passes legislation on statutory union recognition, do you expect a trade union to make a claim for recognition in the foreseeable future?'

% OF RESPONDENTS EXPECTING A CLAIM FOR TRADE UNION RECOGNITION IF GOVERNMENT PASSES LEGISLATION ON STATUTORY UNION RECOGNITION (1999)

	0-49 employees	50-199 employees	200-499 employees	500-4999 employees	5000+ employees
Expect a claim	4	6	11	24	29
Possible claim	5	20	26	21	33

Source: *CBI/William M Mercer Employment Trends Survey*, CBI, 1999

The 1999 results show that more employers now expect a claim for union membership, perhaps suggesting that unions have become more confident since the Government has introduced legislation for statutory union recognition.

New Union Recognitions

The DTI publishes figures on the breakdown of UK employment. These statistics can be compared to the breakdown in the 1999 CBI survey. The number of firms below 20 employees have been excluded since the trade union recognition proposals do not apply to these firms. Unfortunately the DTI figures do not distinguish between firms with more than 500 employees.

NUMBER OF BUSINESSES AND EMPLOYEES BY SIZE

Size (no of employees)	UK Businesses (000s)	UK Employment (000s)
20-49	50	1,539
50-199	23	2,191
200-499	5	1,470
500+	3	7,993

Source: *DTI Statistical Press Release*, P/98/597, 29 July 1999

The results of the CBI survey can be applied to the UK business population. It is assumed that the percentage of firms with 500-4999 employees expecting a claim applies to all firms with more than 500 employees, although, since firms with 5000+ members are more likely to expect a claim for recognition, this underestimates the possible rise in the numbers covered by recognition.

CALCULATION OF THE EFFECTS OF THE CBI SURVEY IF APPLIED TO ALL UK BUSINESS

Size (no of employees)	No .of UK businesses	No. of employees	% of businesses expecting a claim	No. of businesses expecting claim	New employees covered by trade unions
20-49	50,000	1,539,000	4	2,000	61,560
50-199	23,000	2,191,000	6	1,380	131,460
200-499	5,000	1,470,000	11	550	161,700
500+	3,000	7,993,000	24	720	1,918,320
TOTAL	81,000	13,194,000	-	4,650	2,273,040

Number of New Union Members

There is a strong correlation between union recognition and levels of union membership. A DTI study of results of the Labour Force Survey, published in 1998, showed that 82% of those employees covered by collective bargaining agreements are union members. The DTI figure is used to assume that 80% of workers covered by trade union recognition will become union members.

Since many workers, particularly in large firms, are already union members, it is necessary to subtract the number of current union members from the number of potential union members in order to arrive at the number of extra members on account of the Government's legislation.

Trade union membership and recognition 1996-7: an analysis of data from the Certification Officer and the LFS

Mark Cully and Stephen Woodland, Employment Relations Directorate, DTI, published in Labour Market Trends, July 1998

ESTIMATE OF UNION MEMBERSHIP

Workplace Size	New Employees Covered By Trade Union Recognition (A)	Likely Number of New Union Members (80% of A)	Current % of Union Members	New Union Members
20-49	61,560	49,240	23	37,910
50-199	131,460	105,170	29	93,330
200-499	161,700	129,360	38	100,260
500+	1,918,320	1,534,660	48	798,020
TOTAL	2,273,040	1,818,430	-	1,029,520

Union membership is currently around 6.8 million. The estimate suggests that union membership will now rise to around 7.8 million. This would in effect make up for the reduction in union membership since 1993.

A Cautious Estimate

This figure may underestimate the rise in union membership on the grounds that, in the CBI survey, very large companies, with more than 5,000 employees, were more likely to expect a claim for union recognition.

The estimate also ignores those companies which, in the CBI survey, replied that it was 'possible' that they may receive a claim for union recognition.

On the other hand, this estimate may slightly overestimate the impact on large firms since claims for union recognition could be at the level of individual plants and subsidiaries rather than applying to the company as a whole. That decision will lie in the hands of the 'Central Arbitration Committee', a statutory body that will be established after the enactment of the Employment Relations Bill.

CHAPTER THREE
THE ECONOMIC EFFECTS OF THE NEW MEASURES

METHODS OF ESTIMATION

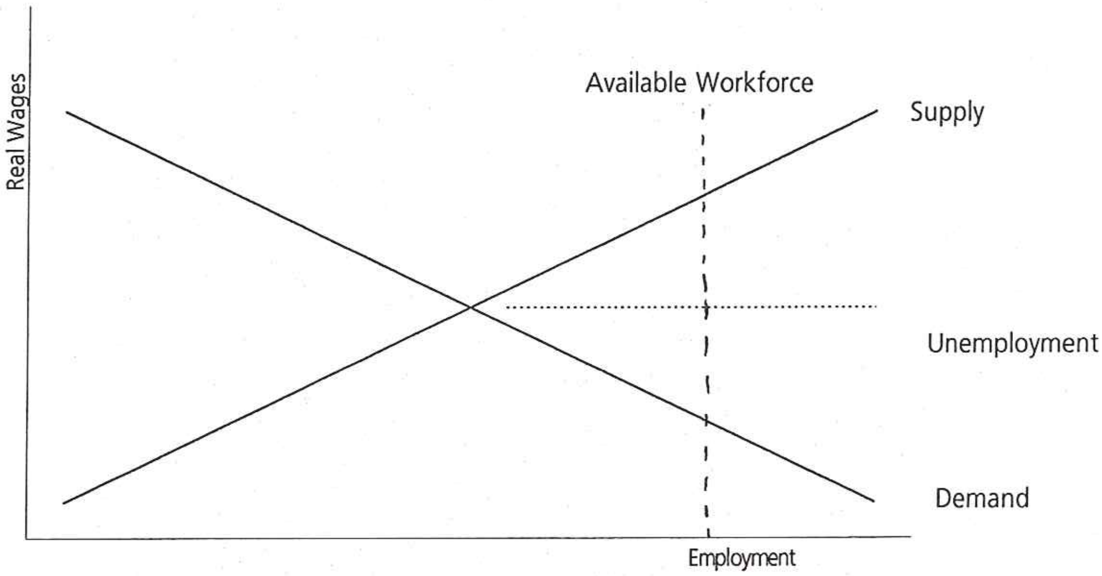
In order to evaluate the economic effects of the labour market reforms, it is necessary to identify similar economic measures whose effects have been analysed. Fortunately much work has been done in the past 20 years – mainly in response to the UK's dramatic rise in unemployment in the early 1980s and the subsequent sweeping reforms of the labour market introduced by the Governments of Margaret Thatcher and John Major.

This work attempted to understand the 'supply side' of the economy – that is to say, the factors enhancing or inhibiting what can loosely be called 'competitiveness', that is, the economy's ability to supply labour, capital and resulting output sustainably. It is now widely agreed among economists that whereas demand stimuli (from interest rates and budget deficits for example) may help to explain the economy's growth and employment in the short run, with effects continuing in a steadily diminishing way for up to five years or so. But the underlying or average ('long run') performance of the economy depends on the supply side. Sometimes this is encapsulated in the concept of the 'natural' rate of unemployment, variously also called 'the non-accelerating-inflation' rate (NAIRU), the equilibrium rate, the underlying rate and other equivalent terms. When the economy is above this rate, various forms of pressure (inflation, trade deficits, falling profit rates, absenteeism and falling productivity) push the economy back down to it – and vice versa.

While models of the UK economy differ to some degree in the way they represent the impact of demand shocks, increasingly they have converged. For example, the NIESR and London Business School models now share with the Liverpool model the assumption which the latter pioneered of 'rational expectations', whereby people use information about economic policy intelligently in forming their expectations. This

implies that demand shocks will die out in their effect over a period of a few years, hence putting the emphasis on the supply side for the economy's average performance.
These major models are also beginning to share an approach to the supply side. Each has an implied natural rate of unemployment which depends on factors that are under government control (such as the tax and benefit system and the level of regulative intervention).
The underlying ideas in this approach can be illustrated by a picture of supply (or wage setting) and demand (or wage offering) in the labour market. The demand corresponds to the productive wage that firms can afford to hire at when the economy is in a 'normal' (that is, non-overheated, non-recessionary) state; higher employer tax and other burdens reduce the wage firms can afford to offer ('shifting the demand curve down and to the left'). The supply curve represents the wages demanded by workers or their representative unions; it will depend on alternatives to work (such as unemployment benefits) and on taxes that reduce the net wage so making those alternatives more attractive and requiring a higher gross wage to compensate. Hence higher benefits or taxes will shift the supply curve up and to the left. Wherever the supply and demand curves intersect sets normal employment; output is then whatever is produced at this employment level.

THE LABOUR MARKET AND THE NATURAL RATE



The Cause of British Unemployment.

R. Layard and S. Nickell National Institute Economic Review, vol. 3, pp 63-85, 1985

For more details on Liverpool model's supply side, see Markets Not Stakes

Patrick Minford, chapter 5 'The remaking of the British economy – the supply-side programme', Orion Business Books, 1998.

The pioneer in these supply side relationships was the Liverpool model. Subsequently essentially the same approach was adopted by Layard and Nickell; they assumed imperfect competition in place of the Liverpool model's use of competition, but the diagram and the rest of the set-up do not change materially in their analysis of the normal or natural equilibrium. Other models have adopted the Layard-Nickell methods. Thus in practical terms, UK models use a broadly common approach to the supply-side. There are many detailed differences (for example, the precise treatment of capital and of particular taxes) as one would expect; but for policy purposes this comes down to generating possible differences in numbers with a similar direction.
This paper uses the Liverpool model, for several reasons. First, its estimates have been used for nearly 20 years and its forecasts have been tested routinely during that time against the UK's experiences. Hence it has been, often controversially, involved in making supply-side estimates for longer than any other model.
Second, over this period, its basic assessments of the UK supply-side have been borne out: namely, that unemployment would stay high in the early 1980s in the absence of

serious reform of the labour market, especially the level and availability of unemployment benefits; and that unemployment would fall steadily to very low levels (virtually 'full employment') as a result of the reform programme of the Conservative Governments from the mid-1980s.

Finally, the Liverpool model is simple, transparent and easy to use relative to other models; the Liverpool Research Group publish estimates of the natural rate monthly in their bulletins and the model's structure is readily available in journal publications.

THE DETAILED METHODOLOGY

The business costs of the labour market regulation measures have been converted into an equivalent rise in National Insurance costs, for whose effects econometric estimates are available. The effects of the Fairness At Work measures on union power are based on the estimated rise in union membership that would arise from the new recognition rights; again, econometric estimates of the effect of union membership on the economy are available. In the labour supply or wage equation, union power raises wages per unit of labour productivity either by explicit wage rises or by preventing productivity gains.

For the Minimum Wage, estimates exist for the direct effect on wages; this has been converted into an equivalent rise in unemployment benefit (that is, the rise that would have the same effect on low wages); again, econometric estimates of the effect, direct and indirect, of a rise in benefit on the economy, are available.

For more details of this methodology, see 'The employment and PSBR effects of the minimum wage'

Paul Ashton, QEB October 1998

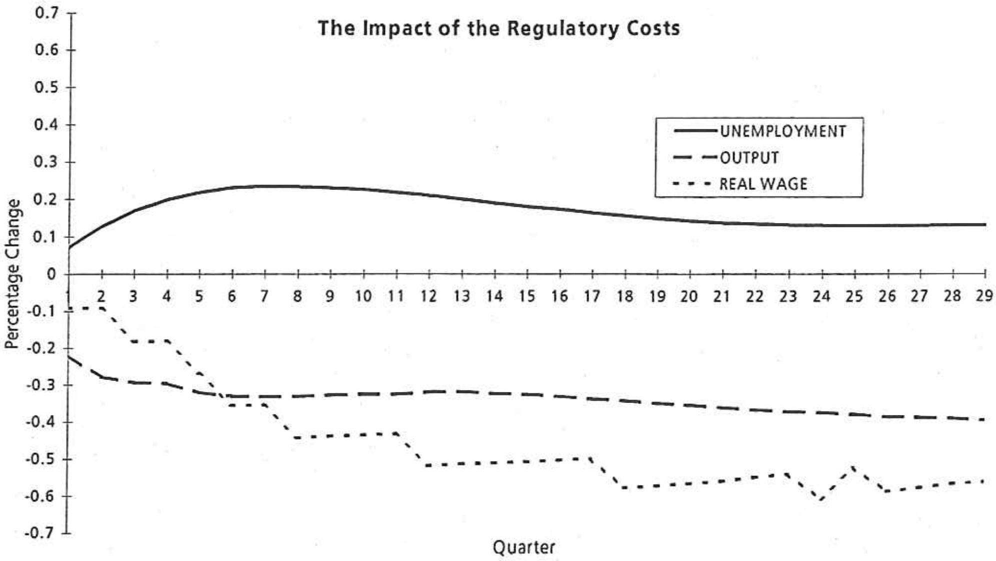
It is necessary to use benefits in place of minimum wages as there is no previous experience of a national minimum wage, only a varying patchwork of industry wage councils whose impacts are in any case difficult to estimate. By contrast unemployment benefits have a long history and their effect on wages is relatively simple to estimate. Higher benefits shift the labour supply curve up and to the left because low-paid workers demand higher wages to compensate for the better alternatives available out of work; if they cannot get them, they remain unemployed until they can get them. A minimum wage forces the supply curve up and to the left because low-paid workers are forced to demand higher wages by law and if their employer will not pay them they remain unemployed until he will.

The practical question is what rise in benefits a given minimum wage translates into: the Labour Force Survey estimates of the percent effect of a minimum wage on the earnings of low-paid workers are applied, and it is assumed that this could also be achieved by the same percentage rise in benefits. It is worth noting that this effect of higher benefits then translates, just as a minimum wage does, into effects on the wages of workers higher up the scale, through 'comparability/differential' effects; such effects are included in the econometric procedure because the benefit variable's impact on wages includes the total effect including that via differentials.

ESTIMATES OF THE EFFECTS ON THE ECONOMY

THE IMPACT OF THE REGULATORY COSTS

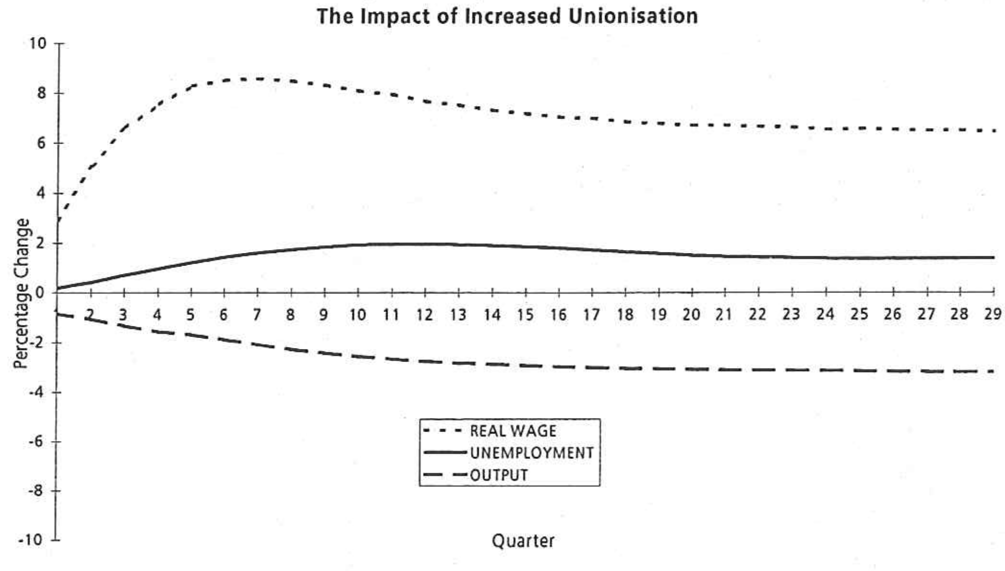
The compliance costs of the new measures, as seen above, come to £2.7 billion, the approximate equivalent to 1% on National Insurance employer contributions. The chart below shows the corresponding effect on the economy. Unemployment rises after a year and a half by some 43,000 before falling back to a long-run effect of 27,000.



THE IMPACT OF THE RISE IN UNION MEMBERSHIP

The estimates in Chapter 2 above have shown how union membership is expected to rise by around 1 million members as a result of the new recognition rights granted under Fairness At Work. The chart below shows the effect of this on its own. Unemployment would rise by about half a million after two years. This may seem surprisingly large. But union power is at the core of the behaviour of unions and employers towards wages and productivity. Union membership is the basis for that power.

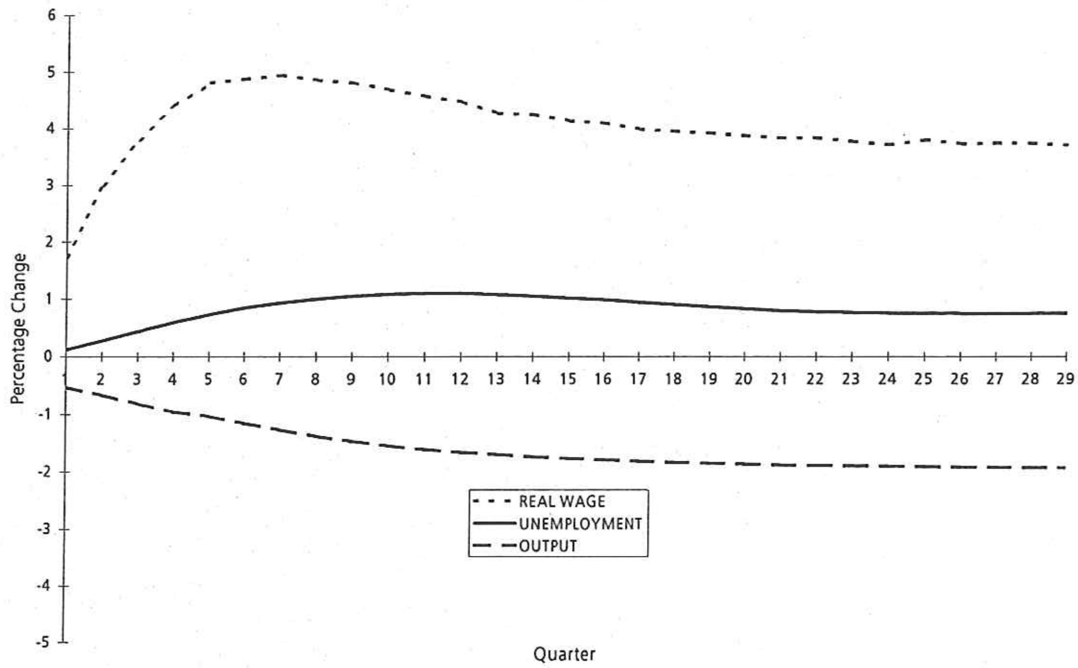
Both unions and business expect that membership will revive. Experience and the evidence of the econometric estimates suggest that membership conveys power: workers and unions are likely to demand higher wages and limits on the impact of technological change because of its effect on jobs. Businesses may then hold back from doing all that is necessary in terms of productivity out of fear of provoking strikes.



THE IMPACT OF THE MINIMUM WAGE

The impact of the Minimum Wage is estimated as the equivalent of some 2% on unemployment benefits (and unemployment income support). The effect of this is shown below – a long-term rise in unemployment of around 220,000 over five years. The effect is undoubtedly large – but it must be remembered that, in addition to the *direct* effect of the minima on low-paid workers below these rates, there is a powerful *indirect* effect on those above them, via differentials. This 'ripple-effect' up the scale is the result both of open union negotiation on differentials; and of supply and demand, as demand shifts away from the now-costlier low-paid labour towards better-skilled labour, and supply of these in turn shifts back down towards the lower-skilled, less demanding and now-better-paid jobs lower down the scale. The resulting excess demand for workers higher up drives up their pay as well. Our model estimates the direct effect on wages of the lower-paid bottom half of the wage distribution at 3.9% but the effect on average wages at 1.9%.

The Impact of the Minimum Wage



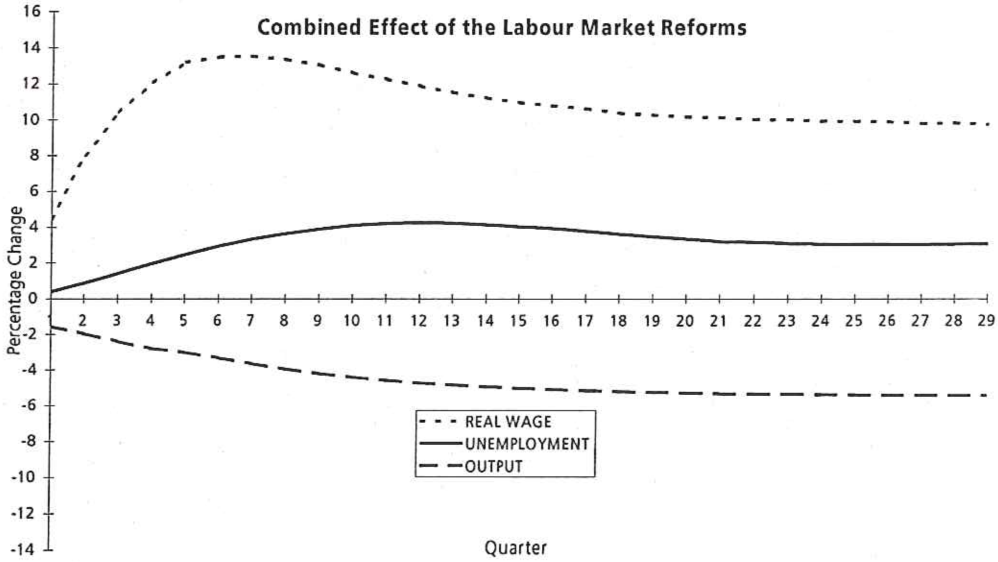
The response of the minimum wage supporters is to cite 'exploitation' of low-paid workers by employers with monopsony power (that is, the power of a small number of employers to select their workforce from a large pool of potential employees); this power is said to drive down the wages of low-paid workers, thereby reducing overall employment by lowering the incentives to work. Hence, they argue, by fixing a higher minimum wage, this monopsony power is removed and employment rises as low-paid workers have the incentive to take more jobs. The difficulties with this argument are:

- That there is no evidence of monopsony power among the firms employing low-paid workers – the sectors involved (such as catering, textiles, and retailing) are highly competitive so that any firm that enjoyed an advantage in hiring from a pool of workers would soon find competitors fishing in the same pool, driving wages up to the competitive rate. There are some US studies that suggest minima did not hurt employment in some cases (fast food in New Jersey is one celebrated case) but there is long-running controversy over these findings for a wide variety of reasons.
- That where minimum wage strategies are pursued seriously and intensively (as in Germany, France and Italy), the evidence of high unemployment powerfully indicates their dangers.

The hope of supporters of the Minimum Wage in Britain is that, by keeping it at a moderate level, these effects will be avoided. One possibility that may favour their argument is evidence that some employers are reducing other elements in the compensation package to offset the wage rise due to the Minimum Wage; should this become the rule then our estimates would indeed be excessive. But such practices will be challenged and may well have to be abandoned. Clearly our estimates assume that the minima are fully implemented and that there is no effective monopsony power among British firms affected by the wage rises.

THE SUM IS GREATER THAN THE PARTS

When all three of these measures are undertaken together, the total effect is greater than the sum of these individual effects, the reason being that as unemployment rises there is a larger pool of low-paid workers on the margin of work and unemployment; the extra measures affect this larger pool and so their effect is larger. Overall these measures raise unemployment by about a million.



CHAPTER FOUR
CONCLUSIONS

These estimates represent the first attempt to assess the future for the British labour market. Yet the forecast damage – an increase in unemployment of nearly 1 million – can be avoided. In particular, the measures in the Employment Relations Bill (including trade union recognition and regulations on unfair dismissal and family-friendly policies) are still under discussion in Parliament. The opportunity exists for Ministers to amend the legislation to reduce the damage to competitiveness and unemployment.

The concern is that the damage will go far beyond the calculations derived from our estimates. The *intangible* effect of these measures cannot be ignored. The labour market reforms are likely to have a real impact on business and worker expectations. As recently as 20 years ago, business in Britain had to contend with an environment hostile to employment creation. The danger is that, without noticing its gradual re-emergence, such an environment could be returning.

In this paper, we have not considered the impact of other taxes imposed on business over the last three Budgets. These additional taxes may also contribute to a different business environment, one based on retrenchment rather than growth.

Concerns on labour market regulation are widely shared among the business community: CBI members (especially larger companies) believe that the Government's legislation will have a negative impact on competitiveness rather than a positive impact.

IMPACT ON COMPETITIVENESS OF LABOUR MARKET REFORMS

No. of employees	% firms replying 'negative/very negative'	% firms replying 'positive/very positive'
0-49	27	5
50-199	20	4
200-499	27	3
500-4999	30	3
5000+	43	9

Source: *1999 CBI/William M Mercer Employment Trends Survey*

These estimates are also a challenge to New Labour. They suggest a more traditional policy trade-off: measures to increase 'fairness' may well significantly restrict 'flexibility'.

If New Labour wishes to honour its manifesto promises, then it should, as a matter of urgency, reconsider its current legislation in order to protect British competitiveness and employment.