The Centre for Policy Studies

second thoughts on full employment policy

Samuel Brittan

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FOREWORD TO SAMUEL BRITTAN'S PAPER
BY SIR KEITH JOSEPH

As founder and Chairman of this Centre I welcome the privilege of writing this brief foreword to our first publication. It is especially fitting that our first author should be Sam Brittan. No one in this country has done more than he – in his books and articles – to explain the social market concepts which animate our thinking. All who know Sam Brittan must relish the contrast between his gentle, modest character and the vitality of his written analysis and argument. Lucid and humane, penetrating and civilised in his judgements, his comments have been and are a continuing guide to better prospects. I am glad of the occasion to pay him this tribute.

Keith Joseph.

Editor's Preface

As our name indicates, the Centre has been set up to study policies: their genesis, rationale, validity and effects, in all matters for which Government exercises a measure of power or responsibility. Our objective is to re-shape the climate of opinion. At present, it is largely favourable to the state direction and appropriation which have generated the social and economic environment in which we now find ourselves. We wish to create a climate more conducive to the renaissance of personal responsibility and initiative which we consider essential to a healthy economy in a healthy body politic, and which can best be generated by socially responsible market policies.

Experience and logic combine to convince us that by working with and through the market our society can maximize welfare, liberties and control over our own destiny.

Conversely, arbitrary intervention motivated by short-term political expediency and usually designed to tackle symptoms rather than underlying causes wreaks economic havoc and intensifies the very social and political tensions it is designed to reduce.

The quest for full employment by Government *fiat* and demand manipulation is central to the Western world's economic predicament. There have been strong emotionally-generated inhibitions to frank appraisal of its theoretical basis and practical effects. Policy-makers and opinion-formers who pressed these expedients for years, sometimes for decades can hardly be expected to admit with good grace that they had misled us, so long as they can ward off criticism.

But we cannot afford to allow their *amour propre* and political preoccupations to perpetuate ruinous fallacies and go on throwing our good money after their bad. The Centre proposes to fight vigorously on this front of the battle of ideas.

We are fortunate in obtaining a writer of Samuel Brittan's authority to treat the subject for us and set the tone for our series of *Policy Studies*. Like many of his generation, who learned their economics in the heady climate generated by Keynesianism triumphant, Mr Brittan expounded and applied the new orthodoxies until the accumulating weight of evidence impelled him to re-think his position *ab initio*. We are privileged to publish the fruits of his second thoughts systematically expounded.

He is not alone in his second thoughts. But the thoroughness of his exposition, together with his undiminished and uncontested commitment to the well-being of the poorer fraction of the community who figure most in the unemployment statistics, may encourage others who already have their doubts to break away from outworn orthodoxies which manifestly no longer serve to interpret events as a guide for policies but still exert powerful emotional and idealogical attractions. For the time-lag exists in the realm of ideas no less than in monetary phenomena.

Our study can be expected to promote controversy, which will be all to the good. I can only hope that it is directed towards our ideas and propositions, rather than accusing us of wanting unemployment, lack of compassion, 'right wing attitudes'. Our author explains in considerable detail his view that policies followed since the war have ineluctably increased long-term unemployment; as Sir Keith Joseph argued when he broached the issue last year in his Preston speech, increased unemployment was not a prescription but a prediction. In subsequent publications, we shall discuss ways in which the underlying unemployment rate between cycles can be lowered. Mr Brittan argues that the policies followed with best of intention helped bring about stop-go cycles with a rising level of intra-cyclical unemployment, and that it was precisely those marginal to the labour market who suffered most as a result.

And is our thesis really right-wing? (whatever right-wing might mean). I do not see how. Our author does not consider himself to be right-wing, and has written a book to explain why. He is not a member of any political party. Any Government, whatever the colour of its politics, must try to contain inflation in the interests of the national economy and of all classes.

Inasmuch as it transpires that deficit financing to expand demand has been a major cause of accelerating inflation, and hence has undermined full employment in the long run by weakening the economy, anyone committed to sustaining a high level of employment, prosperity and economic advance, must question these policies.

There is nothing quintessentially right-wing in wishing to have coherent, consistent policies. It would be truer to say that by an historical accident, the left in this country happens to have been frozen into attitudes adopted in the nineteen thirties. This is surely carrying conservatism too far. They are bound to break away from their fixation sooner or later and come to grips with reality. I hope that our *Policy Studies* can help expedite this process of liberation.

June, 1975

ALFRED SHERMAN
Editor, Policy Studies

Author's Preface

One of the main reasons I took up the study of economic problems was indignation at the absurdity of unsatisfied wants side by side with idle hands willing to work which I believed existed before the Second World War. This feeling persists. While both price stability and high employment are, in the last resort, means to human contentment and not ends, I still attach more value to avoiding the wastes of large-scale unemployment than I do to price stability as a proximate objective. I also attach more value to 'growth' than to price stability, provided that it is the growth in the output of goods and services (including leisure and amenity) that people want rather than in the products that some political leader, technologist or industrialist has decided are good for us.

The principal reason I have partially changed sides and moved nearer to the 'sound money' school is that I no longer believe that conventional 'full employment' policies pursued through monetary expansion and deficit finance help either growth or employment in the sense I had in mind. On the contrary, they are likely to bring about an ever more rapid inflation, which has many severe disadvantages of its own, not least of which is a much greater likelihood of heavy unemployment when the rate of inflation has eventually to be checked, as ultimately it must.

My slowness in seeing the light was explained, though not excused, by the fact that the case for 'sound money' was usually stated in terms of misconceived objectives, such as the maintenance of the sterling exchange rate or the sterling area. Moreover the distinction between a steady inflation and an accelerating inflation, and the likelihood of 'full employment' policies producing the latter, were rarely stressed by sound money men, who were too shocked by the very idea of inflation to go much further into the matter.

It was Professor Milton Friedman who removed the scales from my eyes – not by his more technical views on money, but by his analysis of the effects of demand management on unemployment. He did so in one single paper: his 1968 Presidential address to the American Economic Association.[1] It did not take Milton Friedman to make me understand the connection between capitalism and freedom, and why true libertarians, radicals and iconoclasts should be on the side of capitalism, although not necessarily of capitalists. But Friedman did show, for instance in his opposition to the U.S. military 'draft', that the link could be a living one and not just an arid logical connexion. (How many English 'liberal' economists campaigned against peacetime conscription in this country in a similar way?) It is for both these reasons that I dedicate this essay to Milton Friedman, without permission and certainly without any intention of implicating him or anyone else in the views or interpretations expressed.

In the preparation of this Paper I am extremely grateful to Professor Harry Johnson for his helpful and forthright comments on earlier drafts. I am also grateful to Professors David Laidler and Michael Parkin for personal help in keeping me in touch with the University of Manchester's inflation research project and for allowing me to reproduce a few of their charts. Throughout the period of composition I have been discussing these problems with Mr John Flemming of Nuffield College, and some of the better ideas in it undoubtedly originate from him. Mr Peter Lilley has also been extremely helpful both in exchanging views and in supplying information.

Finally I must thank Sir Keith Joseph for his interest and for encouraging me to take the argument wherever it led. The usual qualification about my taking the full responsibility for everything expressed applies with particular force in this emotional minefield.

The present essay is in part a simplification and in part a further development of a Paper I presented at a Royal Economic Society Conference, held in Durham in March

1 'The Role of Monetary Policy'. Now reprinted in *The Optimum Quantity of Money,* Aldine Publishing Co., Chicago 1968. He has brought his analysis up to date in *Unemployment versus Inflation?* I.E.A., 1975

1974. The proceedings, entitled *The Concept and Measurement of Involuntary Unemployment* (ed. Worswick and Thomas), are due to be published by Allen and Unwin later in 1975. I am indebted to everyone concerned with the conference volume for permission to draw freely on my contribution. The conference volume contains a great deal of analysis, comment and information from diverse points of view on the subjects discussed in this Paper.

1. Introduction and Theme

Since the last war, governments have tried to 'manage demand' in order to maintain full employment with a minimum of inflation. The objectives and means were laid down as early as the 1944 White Paper on Employment Policy; and subsequent changes have been mainly of detailed technique.

These once-radical methods have been subjected to increasing criticism, some of which is associated with the unfortunate word 'monetarism'. It is important to distinguish as far as we can between technical issues and more fundamental matters of political economy although, like most distinctions, this is one of degree. Orthodox 'demand management' has been based on the view that governments have the power to fix the amount of unemployment at a politically chosen level by monetary and fiscal policy. The most fundamental of the 'monetarist' contentions is that governments do not have such powers. The minimum sustainable level of unemployment is, on the contrary, determined by the functioning of the labour market. Attempts to push the unemployment percentage below this sustainable level will lead not merely to inflation, but to an increasing rate of inflation and ultimately to currency collapse.

Whether demand is best regulated by monetary or fiscal policy is a subordinate, technical question in this context. Whether it turned out that Budget deficits were more or less important than the growth of the money supply in influencing demand, the essential criticisms of post-war orthodoxy would still hold. They would also hold if both monetary and fiscal policy were found to be of comparable importance, or if they could not be separated. The importance of the distinction is further reduced by the fact that the most important influence on the money supply has usually been the public sector borrowing requirement (roughly equivalent to the combined deficits of central and local government and nationalized industries). The inflow of oil producers' funds has changed and complicated, but not destroyed, the relationship.

Thus in the narrow sense the issue of 'monetarism' is one which politicians and commentators are wise to leave to experts. It is, however, worth pointing out that ordinary citizens can probably best understand excess demand in terms of 'too much money being spent', and deficient demand in terms of 'not enough money being spent'. This is a perfectly natural and proper way of regarding the matter and does not prejudge whether the money is being put into circulation through the Budget or the banking system.

The fundamental proposition is that the level of unemployment cannot be determined by the Chancellor of the Exchequer or the Governor of the Bank of England, whether by monetary or by fiscal policy, for more than a temporary period. The commitment to a 'full employment target', to be achieved by either Budget deficits or credit injections, is the main reason why the money supply has been allowed to increase too quickly.

The recent world inflation was, it is true, international in character – probably having its origin in the creation of dollars by the U.S. authorities to finance the Vietnam War and the consequent expansion of the world money supply under the old fixed exchange rate system. But the bi-partisan British post-war 'full employment commitment' prevented the UK from trying to insulate herself in the way that Germany partially did, and later caused this country to superimpose a domestic monetary expansion over and above the inflationary impulses from overseas.

The dominance of employment policies cannot be over-stressed. Anybody who has learnt the patter can say that 'more emphasis should be given to the money supply' or that 'all available weapons should be used'. It requires neither insight nor courage to talk in this vein. But if priority is given to the full employment commitment – *and to achieving it through financial policy* – brave intentions will be of no avail and mysterious 'special factors' will always be found *ex post* to account for the rise in the money supply that has occurred.

Of course, policy-makers should be concerned with the availability of jobs for people seeking them. The real burden of

criticism is that it is futile, and ultimately self-defeating, to attempt to remedy the defects of labour markets by the use of the 'printing press' or deficit finance. More fundamental measures are needed. Similarly, whatever the merits and defects of income controls, they do not have the slightest chance of working if the authorities are using monetary and fiscal policy in an attempt to maintain employment at a wishfully determined level.

Thus the argument of the critics of post-war orthodoxy is ultimately about the nature of labour markets and the limitations of conventional full employment policies.[1] As the basic issue is whether market forces apply to labour and wages, the critics may best be described as 'market economists'. Those on the other side are often called 'Keynesians', but I am quite unwilling to use this label, as it is highly uncertain whether its bearers do really represent the outlook of Lord Keynes, let alone the attitude Keynes would have taken had he lived another 30 years while retaining the alertness of his prime. The best term I can find is 'the post-war orthodoxy', with a warning that in other countries this orthodoxy has never been taken to the extremes it has reached in the U.K.

Market economists would argue that the main effect of demand management on output and employment is to influence variations around an underlying trend determined by more deep-seated forces. Many, but not all, of them would also argue that demand management has been destabilising in addition to its inflationary bias. The basic judgment is that the lags in diagnosis, in political action, and in the operation of policy, are such that actions intended to offset booms and slumps are likely in practice to aggravate them.

Such discretionary intervention is often labelled 'fine-tuning', a term originally coined by Walter Heller as President of the Kennedy-Johnson Council of Economic Advisers. Nowadays almost no-one admits to a belief in 'fine-tuning', which is misinterpreted to mean trying to regulate economic magnitudes to

1 Obviously I cannot commit anyone else to this interpretation. But the effect of demand management on labour markets did emerge quite clearly as the key analytical issue at an I.E.A. seminar on inflation, attended by Professor Milton Friedman and some of the most distinguished monetarists (See *Inflation: Causes, Consequences and Cures*, I.E.A., 1974).

several decimal points. But most 'practical men' do, whatever they say, believe in fine-tuning in the sense in which Heller had in mind. That is they believe in adjusting policy 'pragmatically' to the situation they happen to face at any particular time, and are instinctively opposed to a policy of stable long-term guidelines for monetary and fiscal policy, with the minimum of interference with the controls.

Critics of post-war orthodoxy differ among themselves about the role of trade union power in the inflationary process. The best way to look at the matter is to say that if unions have a *direct* impact it is on unemployment and not, as popularly supposed, on wages and prices.[2] Trade union behaviour would thus affect inflation indirectly via the reaction of governments and central banks to the unemployment threatened or brought about by union action. Important as this influence is for policy, the impact of the unions will be no more than touched upon in this *Paper*. My excuse for this cursory treatment is that the effects of conventional full employment policies provide more than sufficient material for one essay and call for urgent re-examination whatever our theories or policies on union behaviour.

Even if the unions disappeared, persistence with attempts to reduce by fiscal or monetary policy the unemployment percentage below the sustainable minimum would still lead first to inflation, then runaway inflation, and ultimately to a collapse of the currency. Moveover, whether or not unions 'cause' inflation, inflation undoubtedly increases the role and strength of the unions, as more and more people resort to collective action to try to prevent their own earnings falling too far behind the escalating price levels. Thus the single most important step towards reducing union influence would be to avoid the inflationary financial policies undertaken in the name of full employment.

2 The expression 'best way of looking at' deliberately begs the question of causality. If the unions, by pricing their members out of jobs or by any other method, put successful pressure on governments to increase the money supply, it is a semantic question whether or not they 'cause' inflation. Whether union behaviour *is* of this kind is *not* a semantic but an empirical question, on which 'monetarist' critics of post-war orthodoxy themselves disagree. For an elucidation of the semantic and real differences of opinion see *Inflation: Causes, Consequences and Cures,* a symposium published by the Institute of Economic Affairs, (I.E.A. Readings 14) especially the discussion provoked by Peter Jay and the interchanges with Milton Friedman near the end of the volume.

Whether or not it affects the rate of inflation, the use of union monopoly power does enormous harm in other ways and is one of the greatest threats – both political and economic – we face today. As Professor Friedman wrote in *The Economist,*[3] 'unions restrict the employment opportunities available to the most disadvantaged citizens'. They price people, often poor people, out of favourable job opportunities and force them either into worse employment than they might otherwise have had or out of the labour market altogether. They reduce real national output and income by distorting the distribution of labour between jobs, as well as by restrictive practices within them. By the use of their strike-threat power and political influence they push governments into short-sighted policies of intervention, price controls, price subsidies, confiscatory taxation, as well as inflationary finance, which undermine both prosperity and liberty.

Above all the pursuit of self-interest by rival coercive groups, of which the unions are the leading example, is a threat to political and social stability. If such groups together try to enforce demands which add up to more than 100 *per cent* of a country's output, an explosive situation can be generated. We must distinguish sharply between the individual pursuit and the group pursuit of self-interest. The former is no threat to a free society and is indeed a positive stimulant; if an individual decides that he has a non-negotiable demand for more than he can earn in the market, there is very little he can do about it beyond leaving his job and attempting to live on social security or his friends or family. With a coercive union it is quite otherwise; it can withdraw output and 'black' the transport and sale of imports or substitutes until representatives of the public sign an agreement to pay more.

There is nothing to guarantee a stable equilibrium arising from the threat-power of these rival groups. Indeed, the real tensions would be more visible if there were no inflation and the conflict over the division of the spoils became an open one rather than being buried beneath arguments about responsibility

3 *The Economist,* September 28, 1974.

for rising prices. The inflationary subterfuge works only so long as people are fooled by the belief 'that a pound is a pound is a pound', and do not start bargaining in 'real terms' (i.e. stable purchasing power). But now that 'money illusion' has practically vanished, inflation has become a pretty threadbare disguise and the conflicts are out in the open.[4]

A final warning is necessary before the detailed argument. The self-defeating attempt to spend ourselves into ambitious and politically-determined employment levels has been the main reason for rapid and potentially runaway inflation in this country in recent times. It has also been an important reason in the U.S.A. and Western Europe, although not quite as important as in the U.K. In the U.S.A. wishful thinking about the cost of the Vietnam War and a desire to disguise its burden were important, while on the Continent – contrary to popular belief – theory and doctrine have a smaller influence on policy than in Britain.

Most of the great inflations in history took place, however, before anyone had heard of full employment policies, and for totally different reasons. The one general explanation is that money demand increased much faster than output. It does not matter all that much whether we use the terms 'excessive Budget deficits' or 'excessive money creation' to describe the debasement of the coinage to pay the Imperial Roman army, or the printing of marks to meet the gaping excess of expenditure over tax receipts in Germany in the 1920s. But there are some cases, such as the sixteenth century inflation associated with the influx of precious metals from the New World, or the rise in prices after the Black Death, which cannot be connected with excessive government spending or borrowing. The most general explanation of rapid or sustained inflation is in terms of a substantial change in the quantity of money per unit of output.[5]

Unfortunately, the more general a theory the less it explains about specific episodes or periods. The deeper causes of rapid or runaway inflation lie in whatever lies behind the excessive

4 Readers who want to pursue this matter are referred to my article 'The Economic Contradictions of Democracy' in the April 1975 issue of *The British Journal of Political Science.*

5 For a concise statement of the general 'quantity' theory see Friedman, *The Optimum Quantity of Money*, ch. 9

expansion in monetary demand; and this may vary from time to time and from country to country. Overwhelmingly the most important reason why the British monetary authorities have stimulated demand excessively, or not resisted external stimuli, has been the commitment to 'full employment policies', which is by no means absent in other advanced industrial countries. That explains why this *Paper* focusses on such policies.

Let me again emphasize that no attack is being made on the aim of ensuring not merely a job, but a choice of jobs, for everyone willing to work. I personally put this objective above simple price stability. So long as there are unsatisfied human wants – which means as far ahead as we can see – it is scandalous that human beings able and willing to help satisfy such wants should be kept out of jobs. My attack is directed at the simple and beguiling view that the way to tackle the problems is always through deficit finance or the injection of money through the banking system.

Such conventional methods are more appealing to a government than the unglamorous and politically thorny task of breaking down restrictions on entry, abolishing absurd occupational demarcations, modernizing training and apprenticeships, encouraging mobility through re-establishing the market in rented accommodation, ceasing to support 'lame duck' industries and firms, and tackling union monopoly power. There is nothing inherently wrong in taking the easy way out, provided it works. The danger arises when those who run our affairs persist in that way when it plainly no longer works. It matters little whether they do so from self-deception or from fear of the union battalions.

The chapter immediately following briefly outlines the conventional wisdom against which this *Paper* is directed. The subsequent chapters discuss the differing human conditions concealed beneath the label of 'unemployment' and the underlying 'real' influences which determine supply and demand for jobs. Chapter 5 analyses some misleading aspects of the official unemployment statistics. Chapter 6 examines the assumptions behind 'demand management' and contains my central argument against post-war 'full employment policies'. I cannot pretend that this chapter is all easy reading; but I hope that the opening paragraphs and the summary it contains will convey to most readers the gist of my argument. There follow two very short chapters in which I examine Britain's comparative record on employment and prices, and show that, contrary to received opinion, the balance of payments is *not* at the root of any of our employment or inflationary difficulties.

The final chapter indicates some elements of the new approach to full employment we shall be compelled to adopt when politicians fully grasp the lethal limitations of continuing monetary stimulation. It ends with some thoughts on the combination of near-slump and inflation prevalent at the time of writing. But this is somewhat of a postscript.

My main theme is not how to get back to price stability now that we are close to Latin American rates of inflation. It is to point out the mistakes in employment policy which have landed us in this position, and to indicate better ways of influencing the minimum amount of unemployment we can sustain in the long run without currency collapse or political breakdown. I am too old a hand to suppose that every reader will read every page of this *Paper.* But the nature of the argument does not permit of easy encapsulation in opening and closing chapters, and its flavour cannot be captured without at least sampling some of the pages in between.

2. The Post-War Orthodoxy

Richard Cobden once remarked that men who had accomplished one revolution were most unlikely to be the leaders of a new era of reform. He was giving a warning against expecting the old members of the Anti-Corn Law League to become the pioneers of the new cause of Parliamentary Reform.

The same remark applies in a different context to the economists, civil servants, politicians and commentators who presided over the inauguration of post-war 'full employment' policy; and it also applies unfortunately to many of a younger generation brought up and taught by them. What was once a bold, radical – and necessary – onslaught on the inter-war belief that depressions were Acts of God about which man could do very little had become by the 1960s and 1970s a fossilized orthodoxy of its own. This penetrated, as Keynes remarked of the earlier orthodoxy, 'into every corner' of the minds brought up in it, and a further change will require 'a long struggle of escape'.[1]

Back to 1944

It is difficult to depict any orthodoxy without the charge of caricature. This is particularly so with 'demand management'. Although the current orthodoxy originated in the 1944 Employment White Paper, traces of earlier pre-war thinking were strongly present in that White Paper and lingered on right through the 1940s and 1950s. It was not until the 1960s that the post-war orthodoxy finally triumphed and its true nature became apparent. As with all orthodoxies, many who held it did so with one or other reservation; and by the time it can be set out for criticism in a semi-popular publication such as this, it has probably passed the zenith of its influence.

1 See Preface to *The General Theory,* Macmillan 1936, New Edition, 1973.

Nevertheless, as the evidence to the Commons Expenditure Committee showed,[2] it is still influential enough to do harm; and some simplification of its main tenets is required to set out the issues clearly.

The 1944 White Paper listed four main methods of achieving a 'high and stable level of employment':

(a) influencing the location of new enterprises in areas of high unemployment;
(b) encouraging mobility between areas and occupations;
(c) retraining of labour;
(d) using government spending, taxation and monetary policy to maintain 'aggregate demand' or 'total spending' at high enough levels to maintain employment.

A good deal has been done in the first three directions – regional policy, mobility and training. One might criticize the techniques or the balance between the three types of measure, but the root of our present troubles lies in the fourth direction – the attempted use of budgetary and monetary policy to maintain target levels of employment.

Assumptions Behind 'Full Employment' Policy

Modern 'demand management' starts from a forecast of total spending on goods and services measured at constant prices, *i.e.* in 'real terms', which brings together total consumer and government spending, exports, fixed investment and stock accumulation, *minus* imports. The inter-relation between these aggregates is recognized, but the final forecast is presented as the sum of them, as shown in Table 1 from a recent Financial Statement.

The change in real *demand* is identical in this framework of analysis with the change in *output*, which in turn determines the movement of unemployment, after making allowances for productivity trends, demographic movements, time lags, and similar complications.

The offical demand managers have at the back of their mind a target level of unemployment which is not always disclosed. It used to be around 1¾ *per cent* but, with the change in the relation between unemployment and unfilled vacancies, it was changed to around 2–2¼ *per cent*[3] at the end of the 1960s, equivalent to about 500,000 apart from the seasonal peak. When unemployment is forecast to rise above target, the authorities try to boost demand by tax cuts, increased government spending, credit relaxations, hire purchase relaxations, or similar means. Their belief is that a sufficient boost will raise output and reduce unemployment until the target level is achieved.

Basically, the strategy is as simple as that. The fact that such boosts have tended to take a budgetary form, with the money supply responding passively, is a secondary matter. The same underlying philosophy could just as well be allied with planned changes in the money supply if that were thought the appropriate weapon. One difficulty of this short term 'fine-tuning' is that, if the forecasts are inadequate or if the lags between diagnosis, political action and the main effects of corrective action are of the wrong length, it can aggravate fluctuations of output and employment instead of damping them down. The expression 'policy cycles' long ago entered the economic literature.

But even fine-tuning is not the heart of the matter: one could imagine (with some effort) the exercise being operated with longer time horizons and less impatience for quick results. The real weakness of orthodox British demand management lies in the following two fundamental assumptions:

(a) It is assumed that the level of unemployment can be maintained at any chosen target within a very wide range; that the only inherent obstacles are the technical difficulties of forecasting; and that the level of unemployment is closely related to other labour market indicators as well as to the degree of utilization of

2 *Ninth Report from the Expenditure Committee*, 'Public Expenditure Inflation and the Balance of Payments', Session 1974, HC 328.

3 The figure of 2¼ *per cent* seasonally adjusted is mentioned in a 1974 memorandum by Lord Kahn and Michael Posner to the Commons Expenditure Committee. (Mr Posner was due to become Deputy Chief Economic Adviser to the Government from July 1 1975). It is given as the estimated percentage below which 'a general decline in the pressure of demand' would 'result in a significantly lower rate of increase of money wages'. *Ninth Report from the Expenditure Committee*, 'Public Expenditure, Inflation and the Balance of Payments', Session 1974, HC 328, 1975, p.73, para. 38.

Table 1 Short-term Forecasts of Economic Activity: Forecasts of Expenditure, Imports and Gross Domestic Product(1)

£ million at 1970 prices, seasonally adjusted

			Public expenditure on goods and services										
		Consumers' expenditure	Public authorities' consumption	Public investment	Total	Private fixed investment	Exports of goods and services	Investment in stocks	Total final expenditure	*Less* imports of goods and services	*Less* adjustment to factor cost	Gross domestic product at factor cost	GDP index 1970 = 100
1972		34,150	9,750	3,950	13,700	5,850	12,350	−50	66,000	12,500	8,550	44,950	104.1
1973		35,750	10,100	3,950	14,050	6,250	13,500	650	70,200	13,900	9,000	47,300	109.6
1974		35,700	10,300	4,050	14,350	5,900	14,250	−50	70,150	14,000	8,900	47,250	109.5
1975		36,350	10,800	4,000	14,800	5,550	14,350	−400	70,650	13,650	9,100	47,900	110.9
1972	1st half	16,800	4,850	2,000	6,850	2,850	6,200	−150	32,550	6,100	4,250	22,200	102.8
	2nd half	17,350	4,900	1,950	6,850	3,000	6,150	100	33,450	6,400	4,300	22,750	105.4
1973	1st half	17,850	5,000	1,950	6,950	3,100	6,700	350	34,950	6,800	4,500	23,650	109.6
	2nd half	17,900	5,100	2,000	7,100	3,150	6,800	300	35,250	7,100	4,500	23,650	109.6
1974	1st half	17,650	5,100	2,050	7,150	2,950	7,150	−200	34,700	7,050	4,400	23,250	107.7
	2nd half	18,050	5,200	2,000	7,200	2,950	7,100	150	35,450	6,950	4,500	24,000	111.2
1975	1st half	18,250	5,350	2,000	7,350	2,800	7,150	−300	35,250	6,750	4,600	23,900	110.7
	2nd half	18,100	5,450	2,000	7,450	2,750	7,200	−100	35,400	6,900	4,500	24,000	111.2
1976	1st half	18,250	5,550	2,050	7,600	2,700	7,550	−100	36,000	7,100	4,600	24,300	112.6
Percentage changes													
1st half 1973 to 1st half 1974		−1.0	2.0	3.5	2.5	−4.0	7.0		−0.5	3.5	−2.0	−1.5(2)	
2nd half 1973 to 2nd half 1974		1.0	2.0	—	1.5	−6.5	4.5		0.5	−1.5	0.0	1.5	
1st half 1974 to 1st half 1975		3.5	5.0	−2.5	2.5	−5.0	0.0		1.5	−4.0	4.0	2.5(2)	
2nd half 1974 to 2nd half 1975		—	4.5	1.0	3.5	−5.5	1.0		—	−1.0	0.5	—	
1st half 1975 to 1st half 1976		—	3.5	2.0	3.0	−4.0	5.0		2.0	4.5	—	1.5	
Percentage changes at annual rate													
2nd half 1973 to 1st half 1975		1.5	3.0	—	2.0	−6.5	3.5		—	−3.0	1.5	0.5	
2nd half 1974 to 1st half 1976		0.5	4.0	1.0	3.0	−5.0	4.0		1.0	1.0	1.5	1.0	

(1) All figures in Table 3 are based on 'compromise' estimates of gross domestic product.

(2) Affected by fuel shortages which reduced output early in 1974.

Note: Figures in £ million are rounded to £50 million. Percentage changes are calculated from unrounded levels in £ million and then rounded to 0.5 per cent. The GDP index in the final column is calculated from unrounded numbers.

Source: *Financial Statement,* April 1975 physical capacity. This complex of indicators is labelled 'the pressure of demand'.

(b) It is further assumed that, within a very wide range, the pressure of demand and the level of unemployment make practically no difference to the movement of money wages and therefore to the domestic causes of inflation. According to this view, wages depend almost exclusively on institutional factors, such as union aims and attitudes, the success of government wage controls, voluntary 'incomes policies' or attempts to reduce union militancy by 'social justice' measures. Demand management, whether in real or money terms, has almost no part to play.

It is usually admitted that there is some level of unemployment which would have a decisive influence on wages, but this is pitched well into the 'politically impossible' range at several millions. It is also admitted that there is a minimum feasible level of unemployment below which output would be hampered by bottlenecks and shortages and which would generate wage inflation whatever happened on the union front. This minimum is usually pitched at a low level, such as 2¼ *per cent,* which is below anything achieved for long since early 1967. This view was expressed by Sir Kenneth Berrill, until recently Chief Economic Adviser to the Government and now head of the Central Policy Review Staff, when he told the Commons Expenditure Committee that at points above the 'low level of unemployment' existing at the end of 1973:

If you take a wide band until you get to a very large level of unemployment, we assume that there is not a big reaction in the change of wages and prices.[4]

Such considerations led Lord Kahn and Mr Michael Posner to tell the same Committee that:

To cope with the problem of cost inflation, in the sense of rapidly rising money wages and prices, and with the consequent problems of the balance of payments, we regard statutory control of money wages (as well as of other incomes and of prices) as absolutely vital.[5]

4 *Ninth Report from the Expenditure Committee,*Session 1974, p. 136. Q 465

The Balance of Payments Alibi

The one obstacle which prevents the demand managers from trying to reduce unemployment to target rates by increasing spending power is the balance of payments. Exports are important both as a component of demand and as a key element in the balance of payments. The prevailing orthodoxy believes them to be determined mainly by world demand, which is outside British Government control, and by the movement of British wage costs relative to those of other countries, which cannot – it is thought – be influenced by internal financial policy. Since, however, demand management can directly influence imports, which are directly related to domestic output and employment, it is concluded that unemployment may have to be kept wastefully high to limit imports to what we can earn or borrow abroad. These considerations lie behind the sentence in the 1975 Public Expenditure White Paper: 'World conditions may make it impossible to maintain a rate of growth of output similar to the rate of growth of productive potential.'[6] It is not surprising that economists concerned with demand management often display a yearning for import controls.

The market recipe for a payments deficit, which holds domestic output and employment below an otherwise attainable level, is currency depreciation[7] which makes exports cheaper or more profitable and imports less attractive. Between 1949 and 1967, exchange rate changes were not employed because of the fetish surrounding the $2.80 to the £ parity; and more recently governments and their advisers have often been reluctant to let the pound sterling fall to its market value because of the effect

5 *Ibid.,* p.74, para. 41.

6 *Public Expenditure to 1978-9,* H.M.S.O., 1975, Cmnd. 5879.

7 If you believe that the government is better at guessing the right exchange rate than the foreign exchange market, then a straight devaluation is indicated. If you believe the opposite, a 'clean float' is indicated. The present 'dirty float' is a compromise between the two viewpoints.

in raising import prices and therefore wages. Thus the myth has taken root that only an abstraction called 'the balance of payments' prevents governments spending their way to any level of employment and business activity they choose.

The absurdity of this view can be seen if we look at the world as a whole. An exchange rate change which means depreciation and (allegedly) rising prices for one country must mean appreciation and falling (or less rapidly rising) prices for other countries. Exchange rate changes cannot be inflationary for the world as a whole; and there cannot be a balance of payments problem for all countries taken together. Thus the basic argument about whether orthodox demand expansion ultimately affects output and employment, or merely causes accelerating inflation, reappears on the international level and cannot be dodged by invoking the graven image of the balance of payments.

The basic weakness of post-war orthodoxy is the failure to see that monetary and fiscal policies based on arbitrarily-determined full employment targets are likely to lead to accelerating inflation with little (or even negative) lasting benefit in job creation. To explain the reason it is necessary to analyze the underlying labour market conditions which influence unemployment rates. People have become so used to think of unemployment as something the Chancellor can turn on or off, that the more fundamental real world forces which severely limit what can be achieved by 'demand management' in any country are too often neglected even by professional economists.

3. The Nature of Unemployment

'I am unemployed, you are workshy, he is a scrounger.' Unemployment is inherently a subjective notion and its measurement a matter of statistical convention. The official definition, unaltered since 1922, is that 'the statistics cover all those unemployed persons who are registered as seeking employment and who are classified by the staff of the Employment Offices as being capable of and available for work . . . based on the case law developed by national insurance decisions.'[1] The definition is easier to criticize than to improve.

We are on firmer ground if we begin with employment, although even here the convention that confines the employed to people who work for cash excludes housewives and others who are hardly unemployed. In June, 1973, the latest date for which comprehensive figures are available, the total population of Great Britain aged 15 and over was just over 41 million. Of these 22.5 million worked for an employer or were in the Forces and 1.8 million were self-employed, giving an 'employed labour force' of 24.3 million. Why was this total not higher or lower?

1 'The Unemployment Statistics', *Dept. of Employment Gazette,* March, 1975, para.6(a). It is necessary to register for employment both to draw benefit and also to obtain credits against National Insurance contributions. On May 1, 1972, 81 *per cent* of the unemployed on the register were receiving unemployment benefit or supplementary benefit; about 5½ *per cent* had a claim which was not yet decided; another 5½ *per cent* had exhausted their claim to unemployment benefit (payable for only a year); a further 1½-2 *per cent* were married women not entitled to benefit; the remainder of only 6 *per cent* included those who were disqualified. Thus the official register of 'unemployed' is little more than a list of people qualifying for the relevant social security benefits.

economy subject to changing tastes and techniques, shocks, opportunities and imperfect information.

Keynes himself did not believe that all unemployment could be cured by 'demand management' of the kind discussed in the previous chapter.

In a 1942 Treasury Paper,[3] he divided unemployment into five categories:

(a) the hard core of 'unemployables';
(b) the seasonally out of work;
(c) transitional unemployment between jobs;
(d) structural and regional unemployment ('misfits of trade or locality'); and
(e) the residue which alone was due to a deficiency in aggregate demand.

The 'normal' level of unemployment under categories (a) to (d), which could not be cured by demand expansion, was put by Keynes at 800,000 – an estimate repeated at various times between 1930 and 1942. This represented 6–8 *per cent* of the prevailing labour force which would imply nearly 1½ million with today's labour force and definitions. In the 1937 boom, when unemployment was still over 10 *per cent,* Keynes was against 'any further general stimulus at the centre' and advised concentration on special measures to assist high unemployment areas.

The terms used by Keynes were conventional usage, but they can be misleading unless we remind ourselves that almost all people would be employable at *some wage.* But not only are employers inhibited from offering wages below accepted subsistence levels; workers would be unlikely to accept a wage below the available social security benefits. On the other hand, 'unemployables' will often find jobs, but will take longer to do so than others on the register.

A Department of Employment survey in June, 1973, showed that (in a year of peak demand for labour) some 30 *per cent* of the unemployed were 'keen' on work but had 'poor prospects' of finding a job (for reasons other than limited local opportunities). A further 30 *per cent* had 'poor prospects' and were also 'somewhat unenthusiastic' towards work, in the subjective judgment of local departmental officers. The practical difference is that, of the good prospects, two-thirds had found jobs by January, 1974, compared with one third of the poor prospects.[4] Thus 'unemployability' is a matter of degree or, to put it the other way, some people are more employable than others.

The most important variables determining how long a person is unemployed are age, skill and health. Frequent appearance on the unemployment register is only one episode in a pattern of life which often includes low pay, lack of skills, high sickness rates, job uncertainty and poverty in old age. Many of these people in their younger days drift in and out of dead-end jobs.[5] It would indeed be surprising if such human handicaps could be cured by financial manipulation by the Chancellor of the Exchequer or the Governor of the Bank of England.

How Much Voluntary 'Unemployment'?

There is also a real wage at which the others of Keynes' categories could be priced into employment. In the absence of union prohibitions the seasonally unemployed could price themselves into out-of-season employment by accepting lower wages, although it may not be worth their while. Likewise, the transitionally unemployed could find jobs more quickly; and those suffering from regional or structural unemployment could price themselves into a job by changing their occupation or location. None of this means that it would always be sensible for workers to make the sacrifice or for the authorities to force them to do so by refusing unemployment benefit. I would personally oppose any such 'tightening up', but the price for avoiding such harshness is higher 'unemployment' statistics in the headlines.

How much unemployment should be regarded as involuntary? In one sense all unemployment could be regarded as *voluntary* because there is some wage level at which almost any individual could price himself into a job. Even if union rates or conventional minimum wages prevent him from entering the most obvious trades, there is almost certainly some non-

3 Cited in Lord Kahn's chapter 'Unemployment as seen by Keynesians' in *The Concept and Measurement of Involuntary Unemployment* (ed. Worswick) to be published by Allen & Unwin in 1975.

4 *Department of Employment Gazette,* March 1974.

5 *Men Out of Work,* M.J. Hill, *et al,* Cambridge, 1973.

unionized work in some part of the country which an unemployed man could perform. But to say this is not very helpful and leads us into the thorny theoretical analysis of what would happen if every unemployed person tried to price himself into a job at a time of deficient aggregate demand of the kind envisaged by Keynes. The theoretical debate is summarized in an appendix to this chapter.

Even if we regard all unemployment as voluntary, some is clearly more voluntary than others. There is obviously a difference between a person who, having lost or left his old job, refuses alternative offers involving accustomed skills and rates of pay, and a willing searcher who can find work only at a subsistence wage by moving to a sheep farm in the Hebrides. Involuntariness is a matter of degree. The more a person is prepared to accept a diminution in any aspects of the work bargain – pay, conditions, distance from home, etc. – the more involuntary is his unemployment.

The test of 'genuinely seeking work' was abandoned as a criterion for U.K. benefit in 1930 and was replaced by a number of reasons for disqualification from benefit. In 1972 total disqualifications for benefit amounted to 12.7 *per cent* of all claims. As in other years, by far the most important category, accounting for 7.8 *per cent* of disqualifications, was 'for leaving voluntarily without cause'; a further 4.4 *per cent* were disqualified 'for losing employment through industrial misconduct'; while only 0.5 *per cent* were disqualified 'for refusing suitable employment'.[6]

There is an interesting distinction between those dismissed or made redundant, and those leaving a job of their own accord who can in the simplest sense be said to be clearly 'voluntarily unemployed'. A P.E.P. survey by W. W. Daniel in October, 1973, during a period of peak demand for labour, showed that 47 *per cent* of a sample of unemployed came into this latter category. Another 48 *per cent* were 'redundant' or 'dismissed' (and the remainder retired).[7]

6 *Unemployment Statistics*, H.M.S.O., 1972, Cmnd. 5157

7 *A National Survey of the Unemployed*, P.E.P. Broadsheet No 546, October 1974. The criticisms I make in a later section of some Mr Daniel's interpretations in no way detract from the value of the useful information he has unearthed.

Nevertheless, the 47 *per cent* leaving 'of their own accord' is both too large and too small to be a sophisticated measure of the voluntarily unemployed. It is too large from the point of view of eligibility for benefit, since people in this category were able to satisfy officials that they did not leave 'without just cause'. On the other hand, from a strictly economic viewpoint, many of the 48 *per cent* who were dismissed could probably have found a new job by accepting some sacrifice in wage, conditions, or type or place of employment.

Since the longer a person is out of a job the more concessions he is likely to make in these directions, there is a rough and ready relation between duration of joblessness and the degree of involuntariness. This link is reinforced by the attitudes of the officials concerned with unemployment and Supplementary Benefits. The longer an active person remains out of work, the more stringent are the conditions for receiving benefit and the greater is the pressure applied to take a job involving a drop in wage or status.[8]

This link between duration and involuntariness is far too loose for the two to be identical. Official pressures on the unemployed to take work do not go as far as insisting on a geographical move; and the pressures are very much weaker in the depressed regions. For some people in such regions unemployment has, however, become a way of life and affects their attitude to job-seeking. The official survey of the characteristics of the unemployed in June, 1973, showed that only 9.2 *per cent* of the men were 'willing to work beyond daily travelling distance'. Even many of the short-term 'unemployed' in London during periods of boom are pretty obviously near the voluntary end of the spectrum.

Thus, although there can be no objection to talking about voluntary and involuntary unemployment on a commonsesnse basis, the distinction is not very useful as a means of statistical classification.

8 See the Fisher Committee Report: *Abuse of Social Security Benefits*, Cmnd. 5228, 1973, especially para. 137.

How Much 'Demand Deficiency'?

The weakness of Keynes' five categories of unemployment is that the proportion of people in each of them varies with the state of the economy, moving up and down with the trade cycle. Thus, in a boom, unemployment goes down in the depressed regions, the duration of transitional unemployment is reduced, and even the 'poor prospects' find jobs more easily. Indeed, there is no specific category of unemployed due to 'demand deficiency' either in the statistics or in the consciousness of individuals. Demand deficiency reveals itself in longer transition between jobs, a worsening of regional and structural problems, lesser readiness on the part of employers to take on the physically or psychologically disadvantaged, and so on.

On the other hand, when the general level of demand and activity is higher than average, it is much easier to find jobs for hard-core cases. If there are labour shortages, employers will ask fewer questions about whom they engage. In boom periods there is of course more investment to direct to the depressed regions, and firms have an incentive to make maximum use of their facilities there. In other words, it seems at first glance that many 'socially difficult' cases, as well as the regionally unemployed, would be found jobs if we could have a policy of permanent boom. Special 'policies' for handicapped people or regions would be less necessary but more successful. Like the rocks on the sea coast, these specific categories of unemployment are covered by higher tides.

I myself once believed in the merits and possibility of a permanently high level of demand. But unfortunately the tide cannot always be at high water. Even during recessions there are some labour shortages because wages are fixed below market-clearing levels. As activity increases, more and more shortages of labour (and goods) appear until, by the time demand is high enough to float off into employment the problem cases and the victims of structural or regional changes, the shortages become disruptive. In other words the economy becomes 'overheated'.

Like other shortages, labour shortages and 'overheating' in the goods market are fundamentally the result of underpricing. In the absence of continuing injections of monetary demand, such underpricing would be transitory since real wages would rise, the boom peter out and, if the correction is overdone, a recession would follow.

Suppose, however, the authorities try to keep the boom going by stimulating demand in the conventional way. The economy will suffer the symptoms of 'overheating'. Money (or 'nominal') wages and prices will rise continuously, the change in real wages depending on the relation between the increases in nominal wages and prices. But whichever rises most, the effect on real wages is likely to be small in relation to the changes in nominal magnitudes. As the domestic value of the pound falls, its exchange is likely to depreciate so that import as well as domestic prices will be on an upward path.

It is wishful thinking to regard the process as no more than sacrificing price stability for the sake of fuller employment. On that basis the exchange or 'trade-off' might be worth making. The real snag is that, so long as the general labour shortage persists, workers will take account of the expected increase in prices in their wage demands; and employers operating in a seller's market for their products will have every incentive to do the same in their wage offers. So long as demand is maintained at overambitious levels, the expected rate of price inflation is that much higher each time round. If the authorities persist in pumping more and more money into the system to maintain an overall shortage of labour, the result – in the absence of draconian controls (and perhaps even with them) – will be not inflation but runaway inflation and ultimately currency collapse.

How Many Vacancies?

Unfortunately, there is no simple way of reading off from the labour market statistics the point where labour shortages and labour surpluses balance each other in sustainable fashion. The old idea that the labour market is in balance when unfilled vacancies and unemployment were approximately equal has proved too simple-minded.

It is known that many vacancies are not notified to official Employment Offices (formerly known as 'Labour Exchanges'). The one piece of evidence on the extent of under-recording is a special study of 34 companies carried out for the Department of Employment which showed that only 32 *per cent* of their vacancies were notified to Employment Offices. The timing of the survey – September, 1973, when labour was very scarce nationally – may have exaggerated the average degree of under-recording. On the other hand, the geographical bias of the survey – seven areas of above-average unemployment – may have led to an understatement. Clearly more surveys are required with more comprehensive coverage and at different points in the trade cycle. On the basis of present knowledge, multiplying the official unfilled vacancy figures by three would be better than taking them at face value.

Even if we knew the unemployment-vacancy ratio accurately, it might still be a treacherous guide to policy. Both figures are snap-shots on particular dates, akin to 'stocks' in economists' jargon. Instead, we need to compare the flow of people onto the unemployment register in any given period with the number of current and desired placements by employers. Even then 'labour' is not homogeneous, and a shortage of 200,000 skilled technicians is not offset by a surplus of 200,000 unemployed 'poor prospects' at the other end of the country. Moreover, if the downward pressures on wages exerted by the out-of-work is weaker than the upward pressure by labour shortages, the labour market will have to balance with the level of unemployed above vacancies. Such 'asymmetry' could result from union resistance to relative wage reductions in the surplus sectors or from the floor provided by social security payments.

Sustainable Rate of Unemployment?

The only way to break out of this impasse is to abandon the search for a magic unemployment-to-vacancies ratio, or a target unemployment percentage. In its place we must recognize that total national demand is neither deficient nor excessive when unemployment has been brought down to the *minimum level that is sustainable by monetary and fiscal policy* (supported if necessary by exchange rate policy). A sustainable level of unemployment (or of 'pressure of demand') is not necessarily characterized by stable prices. It can be accompanied by any rate of inflation, provided that it is a steady rate and neither accelerating nor decelerating.

As already mentioned all categories of unemployment – 'hard core', fictional, structural or regional – are brought down during a boom, defined for this purpose as a pressure of demand for labour above the sustainable rate. But such temporary improvement is likely to be bought at the expense of abnormally severe levels of unemployment during the next recession – defined as a period when demand for labour is below the sustainable rate. Booms are bound to be followed by recessions if governments have any concern – however spasmodic – for the price level (or exchange rate) and are not content to see a continuing acceleration in the rate of inflation.

The minimum sustainable rate of unemployment seems to correspond to Keynes' own idea of the absence of demand deficiency – and also to Professor Milton Friedman's concept of the 'natural rate' of unemployment. The latter is, however, an unfortunate name since there is nothing natural (let alone optimal) about that rate. It will depend on the efficiency of the official Employment Offices and other agencies, the pace of change in skills demanded, the availability of retraining facilities and the use made of them. It will depend on the geographical balance between areas where work is available and where the unemployed live, on the willingness of the unemployed to move to different, lower paid or geographically distant jobs. It will also depend on the extent of union power and the uses made of it. Thus the minimum sustainable rate is not given in heaven but can be influenced by labour market policies. The point is that it cannot be reduced simply by injecting more spending power into the economy.

APPENDIX:
NOTE ON KEYNESIAN DEBATE ON DEFICIENT DEMAND

Keynes was concerned in his *General Theory* to show that unemployment due to a deficiency of demand (category (e) above) could be an equilibrium condition and not dependent on union or other institutional wage rigidities. Very briefly, the argument was that, if wages were perfectly flexible downwards, purchasing power would also fall and there would be no net change in the demand for goods and labour. Admittedly, as income and prices fell, the real value of any given quantity of money would increase. This would tend to drive down interest rates, stimulate investment and thus output and employment, although at the expense of lower real wages. But there might be a limit to the level to which interest rates could fall, below which people would hold more and more money without attempting to convert it into bonds, equities, or real assets (the 'liquidity trap').

The 'classical' economists retaliated by discovering the so-called 'Pigou' or 'wealth' effect. As the real value of money balances rises, it becomes rational to spend more and save less out of a given money income, thus increasing real demand until full employment is restored. The Keynesians did not fail to remark that a world of very rapidly falling wages and prices would in practice be one of severe depression and bankruptcies, even if not in 'equilibrium'. The empirical researches of the monetarists on the other hand cast doubt on the existence of the 'liquidity trap'. (The 'liquidity trap' is certainly a non-existent danger today in an inflationary world where it is all too easy for real interest rates to fall to negative levels if this is necessary to restore a savings-investment balance).

As far as the main controversy is concerned, demand deficiency can clearly exist if for any reason money demand is too low to purchase available output at existing prices, and if there are obstacles to the downward movement of wages and prices (or even to downward movements in their rate of increase). There clearly are such obstacles and demand deficiency can exist; but there is no longer the keen theoretical interest that existed in the 1930s in establishing that this is an 'equilibrium' condition.

4. Some Influences on the Job Market

It will help to bring the discussion down to earth to list a few of the many influences on the sustainable level of unemployment. Most discussion of employment policy concentrates on overall demand management. But there are most fundamental "real" forces at work which should be listed first. We should not be so preoccupied with the ebb and flow of the tide that we forget to chart the position of the shore.

In discussing the real forces it is important to remember that not everything which reduces unemployment as conventionally registered is good, nor everything that increases it necessarily bad. The abolition of unemployment pay would certainly reduce drastically the unemployment rate, and so would the reintroduction of the Press Gang. Neither is a good idea. Manna from heaven in all our gardens every morning would increase the unemployment figures. I would nevertheless be happy to see it.

Effect of Minimum Wage Laws

As employment depends on the level of real wages, measures which force wages above their market levels produce unemployment. This piece of standard analysis is not a long-term prescription for low wages, as it will undoubtedly be misinterpreted as being. It simply reminds us that the technology, labour skills, savings habits and other key characteristics of the economy determine at any one time the pattern of real wages consistent with balance in the labour market. As the productivity of the individual worker rises,[1] so will the level of real wages that can be paid without causing unemployment.

Thus minimum wage laws, *if effective*, can be guaranteed to raise unemployment. In a flexible labour market there can be

1 Or, more strictly, the marginal productivity of each kind of labour.

"equalizing differences"[2] which allow the marginal, fringe or disadvantaged worker to price himself into a job. It does not matter if these are real disadvantages, or prejudices existing in the minds of employers or customers. Minimum wage laws, or enforced non-discrimination in pay where the desire to discriminate remains, will suppress adverse pay differentials at the cost of increasing unemployment for the disadvantaged groups.

U.S. experience with minimum wage laws, both in a Federal and a State context, confirms that their introduction raises unemployment rates. Their influence is eroded as the general level of wages (both money and real) continues to rise, so that the minimum wage becomes a smaller proportion of general earnings levels and its unemployment effect also tends to disappear. When the minimum wage is raised the whole cycle begins again. The Report of the U.S. Council of Economic Advisers refers to the minimum wage laws in explaining the differentially high teenage unemployment rates in 1974 – 14 *per cent* for white youths and 33 *per cent* for black youths, compared to 3.8 *per cent* for all males aged 20 or over. The truth is that "some adults, but even more teenagers, do not have the skills to command a wage that equals or exceeds [the] minimum cost of employing them for other than peak periods of demand in the business of a particular firm."[3]

Similar analysis applies to efforts to give preference to the "lower paid" in the formal and informal "incomes policies" in recent U.K. experience. It is not clear whether this preference has had any effect in the face of pressures to maintain customary differentials. But, if it did, it would prevent the less fortunate workers from offsetting their disadvantages by accepting lower pay and so force them on to the dole.

This does not mean that workers with low earning power should be left to fend for themselves. "Topping up" of wages by family allowances or any form of negative income tax can

2 The concept of 'equalising differences' and the general economics of labour markets are discussed comprehensively and well in *University Economics* by A.A. Alchian and W.R. Allen (Prentice Hall, London 1974). This is admittedly an undergraduate textbook, but it emphasises points overlooked elsewhere.

3 *Economic Report of the President,* U.S. Government Printing Office, Washington, 1975, p 91.

raise their living standards as far as the real generosity of their fellow citizen will allow (as distinct from the sham generosity of passing laws which appear to cost us nothing). Best of all would be help for such people to acquire aptitudes and qualifications which will raise the *market value* of their services – admittedly easier said than done.

The analysis can also be applied to "equal pay" legislation. If employers, rightly or wrongly, believe there is a difference between men and women in particular occupations they can offset it in their wage offers. If such "equalizing differences" are forbidden, they will employ fewer women. The result will be that women are crowded into "women's occupations" or into occupations where the sexes are traditionally considered equivalent – thereby reducing their real wages or, if wages are held up whether by convention or by unions, reducing their prospects of employment. The latter effect may not show up in the official unemployment figures, since women are much less prone to register (married women are often ineligible for unemployment benefit).

It should not be assumed that the prejudices in question are necessarily those of some remote boardroom figure. In the retail and service trades the employer may be no more than reflecting the prejudices of the customers who come into direct contact with his employees; and in industrial and commercial concerns he may be reflecting the prejudices of other employees. These effects emerge more clearly by considering racial as well as sex discrimination. The 1975 Report of the U.S. Council of Economic Advisers cites studies of the effects of equal pay laws which varied from State to State before the 1964 Civil Rights Act.

These show that State equal pay laws reduced the gap between the wage rates of equally skilled blacks and whites, but increased the difference in unemployment rates.[4] This is not necessarily an argument against the laws. As the C.E.A. Report states, "the wage effect was greater than the unemployment effect". But the fact remains that if the community confines itself to passing laws prohibiting wage discrimination without

4 p 113

eliminating the underlying attitudes and prejudices, *de facto* discrimination will show itself in some other form, such as in the unemployment figures.

Effect of Trade Unions

The effect of unions is similar to that of partially enforced minimum wage laws. A strong union, like any other monopoly, can enforce a higher unit price for its members' services at the expense of a lower volume of sales. In other words it secures higher real wages for smaller numbers employed. About 50 *per cent* of the U.K. labour force belongs to unions of varying degrees of effectiveness. The non-unionized and members of weaker unions are "crowded" into fewer occupations by the restrictions imposed by their stronger brethren, so that wages are lower, employment is less, or there is a mixture of both effects.

In a purely static situation with no changes in markets, products, techniques, or degree of monopoly power, the main effect of unionization would probably be on the structure of relative wages. A person with potential earning capacity as a musician or printer, but lacking both a union card and the talent to earn more elsewhere than he could obtain on social security, would be unemployed. Such cases would probably be rare, although not negligible.

But in a dynamic world the union effect is likely to be much more important. Because of changes in techniques, tastes (both foreign and domestic), and shifts in the terms of trade with the outside world, workers will frequently have to accept *lower* relative wages or lower employment in particular industries, firms or occupations. Even if unions did not exist, unavoidable "frictions" would prevent instant adjustments in relative wages and so lead to unemployment – side-by-side perhaps with some unfilled vacancies elsewhere. Union activity intensifies these frictions; by resisting the fall in relative wages in the industry facing a declining labour demand, it leads to a larger exit of workers from that industry or lower recruitment. Moreover, where the industries into which the excluded workers tend to move are themselves unionized, there will be further resistance to the changes in relative wages required.

Apart from increasing the frictional unemployment following industrial change, union activity can be an independent cause of such unemployment. This can happen if an increase in the power of a union, or in the use made of that power, leads to an increase in the relative wage of one sector and a consequential reduction in the labour force and a greater need for people to price themselves into employment elsewhere. A stock example was the effect on unemployment rates in the U.S. Appalachian region in the 1950s and 60s, when unions pushed wages and fringe benefits in the coal mines substantially above the competitive level and thus encouraged greater mechanization – despite a decline in the demand for coal and the unsuitability of the region to alternative industries.[5]

Unions do seem to be more interested in raising wages than maintaining employment, although ideally they would like to do both. The members receiving wage increases normally outnumber those losing their jobs. This is especially so in "normal" times when a reduction in the labour force is achieved mainly through lower recruitment rather than through visible pools of unemployed – who anyway do not have a union to take their interests into account. (Even if they remain union members, the unemployed are much less influential than those who attend shop-floor meetings). These observations may have diminished force during a period of depression, or threatened depression, when the bulk of the labour force may recognize the danger of pricing themselves out of a job. But I have no doubt that, over a period, unions increase the minimum sustainable rate of unemployment.

Effect of Price Controls

A further sure way of increasing the unemployment rate is by an effective system of price controls. A price ceiling that squeezes profits in relation to wages is, from the employer's point of view, equivalent to an increase in real wages. It thus becomes less profitable to employ as many people as before. The value of the product of the marginal worker is reduced below his wage. A "shakeout of labour" and a general attack

5 See C.E.A. Report, p 90.

on overmanning can then be expected. The ability to generate internal funds or raise external funds for investment is reduced, and so is the incentive to do so while price controls remain.

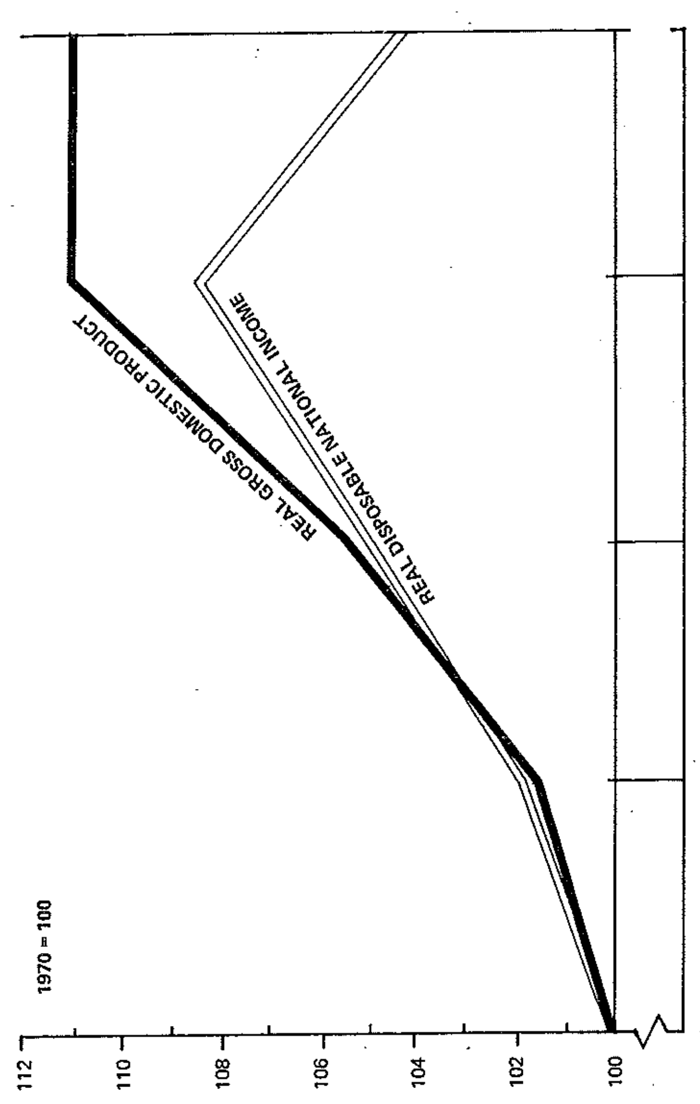
The situation is sometimes described as a "liquidity crisis", but the crisis is basically one of profits. It was in the face of a threatened collapse of employment of this kind that the Labour Government eased price controls and gave firms backdoor relief through tax concessions on stocks in November, 1974. Something akin to self-imposed price control occurred with similar consequences in 1970-71. Faced with a sudden acceleration of money wage increases following the abandonment of incomes control, employers became less confident about passing them on in higher prices – partly because the effect of Roy Jenkins' monetary restraint was still being felt, but also because they were unsure how their competitors would react to an unprecedented situation. The result was an increase in the share of wages relative to profits, above what was normal in the downward phase of the cycle, and a level of unemployment in the winter of 1971-2 that surprised the official forecasters.

The adverse effect of price controls on employment has very little to do with the capitalist system. If state-owned enterprises are really trying to produce 'what the people want', their production and employment programme will also be guided by the profit yardstick (as many East European economists have urged). If price ceilings are imposed, state enterprises will either have to dismiss workers or rely on public subsidies to cover their loss-making activities, without any longer knowing whether they are in the social interest or not.

A particular cause of U.K. wages being 'too high' from 1973 onwards was the sharp rise in primary product prices which reduced the exchange value of British wages. A given volume of home production was worth 5½ *per cent* less in 1974 than in 1972.[6] As output rose by about 5 *per cent,* there was a fall of about ½ *per cent* in earning capacity. Yet the real value of *pre-tax* earnings (which is what employers had to take into account) rose by nearly 8 *per cent* over the period.

6 Compare the movements of gross domestic product and real national disposable income, *Economic Trends,* April 1975.

Chart 1



Source: Economic Trends January and April 1975

These rough and ready figures underline the warning of Sir John Hicks:[7] "When the real demand for labour falls (as it has fallen), then traditional theory says that either there must be a fall in real wages or there must be unemployment". Writing at the turn of 1974-75, he talked about people being "nominally employed" because "their employers [had] been prevented from declaring them redundant" at the cost of a possible rescue operation for their firms later. One wonders how much unemployment will still be concealed by such devices as 1975 proceeds.

If real wages are kept "too high" over a much longer period by a combination of union pressure and government control of margins, such investment as takes place will have had an artificially large labour-saving bias. Eventually there might not be the capacity to keep the labour force employed. The result would be a kind of high-level 'under-development' in which it would not be possible to price into employment all those seek ing it without a fall in real wages to below conventional (or perhaps actual) subsistence levels. This is reminiscent both of earlier epochs in Western economies, before they reached maturity, and of the contemporary situation in the developing areas.

It is doubtful if this nightmare will come about, because it is unlikely that unions have the combined industrial and political power over enough industries and occupations to raise *real* wages sufficiently for this to happen. Moreover, in a modern diversified economy there are likely to be enough small-scale industries and services, with flexible capital to labour ratios, and opportunities for self-employment, to enable most of those who wish to price themselves into employment to do so at above subsistence rates.[8]

7 *Crisis '75 . . . ?*, pp 17-25, Institute of Economic Affairs, 1975

8 Union over-pricing of jobs could, however, be a contributory factor to the dual labour market said to exist by some sociologists. According to this view the labour market is divided between a prosperous majority sector, with reasonably steady employment at or above the national average wage, and a depressed minority sector, where workers drift into and out of employment at a 'poverty' level of earnings.

Effects on Supply Side

The emphasis so far has been on the demand side, that is on the effect of real wages on the number of jobs employers are prepared to offer. The real wage also has an important effect on the supply side, that is on the amount of labour offered. For the supply of labour depends among other things on the difference between real wages and the income available when unemployed. The key variable is the cost of not working.

A higher ratio of benefit to wage income will increase the attractiveness of leisure relative to employment. It will also encourage people to spend more time on "search" between jobs, both by searching less intensively and by being more particular about their choice of new employment. The "search" and "leisure" effects may be impossible to distinguish statistically, or even in the minds of some of those involved. The average wage earner is most unlikely to be induced to stay unemployed indefinitely under present arrangements. Tax rebates, which are often a major source of income support, eventually run out. Earnings-related supplement is not paid after 26 weeks. "Search" for preferred job-offers runs, after a time, into diminishing returns per unit of effort. Moreover, as has already been mentioned, the longer a person is out of work, the more pressure the social security authorities will impose to take an available job.

Generous social benefits will thus not necessarily put an end to the effort to find a job eventually, except among some at the lower end of the scale where people are little if any worse off on supplementary benefits than at work. As the Fisher Committee remarked "It is undeniable that for some unskilled men, particularly those with families, the financial incentive to work rather than to rely on benefits is slight."[9]

This simple exposition of rational behaviour often generates absurd hostility. Unnecessary heat is generated because of the moralistic assumption that economists who point to the relationship between unemployment rates wish to cut benefit or to hound "shirkers". This does not follow. But those of us

9 *Report of the Committee on Abuse of Social Security Benefits*, Cmnd. 5228, 1973, para 240.

who want to treat the unemployed, especially the older and less fit, more generously must accept that it will increase the number of "unemployed" unless the present conventions of measurement are amended.

Unemployment clearly changed its significance as a labour market indicator between the early 1960s and the early 1970s. This was most obvious in the boom year of 1973 during which unemployment averaged 2.6 *per cent,* which would have signified a major recession a decade previously. Yet, quite early on in the year, the economy ran into labour shortages and supply bottlenecks; the C.B.I. reported a level of capacity operation equivalent to the previous period of peak "overheating" in 1964-5; and notified unfilled vacancies rose by the end of the year above 300,000, by far the highest ever recorded. On the basis of earlier relationships it would have been associated with an unemployment rate well below 1 *per cent.*

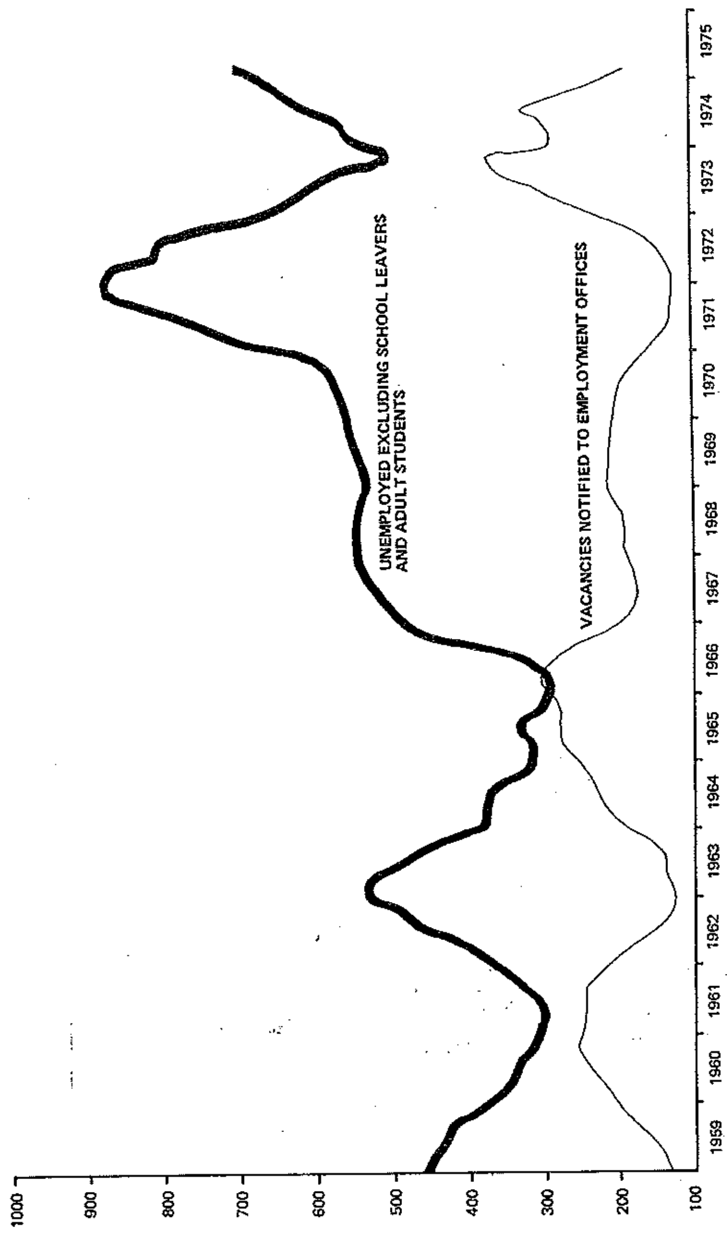
Social Benefits and Taxation

The change in the relation between vacancies and unemployed followed the coming into force of the Redundancy Payments Act in December, 1965, and the earnings-related supplement to unemployment benefit in October, 1966. As Chart 3 shows, net benefit as a proportion of net earnings for a family with two children rose from an average of 40 *per cent* in 1960 to 70 *per cent* by 1967. There was also a more gradual increase in supplementary benefits, which for a family with four young children rose from an average of 52-55 *per cent* of average net weekly earnings in 1954-7 to 65-70 *per cent* in 1965-73.

Another influence, higher up in the income scale, has been the increased involvement of manual workers with a cumulative P.A.Y.E. system, which provides a cushion of repayments for those who lose or leave their jobs. The weekly rate of income tax rebate to which a married man with one child was entitled in 1974-5 was approximately £7.[10] As Table 3 shows, such rebates could run for well over six months, depending upon

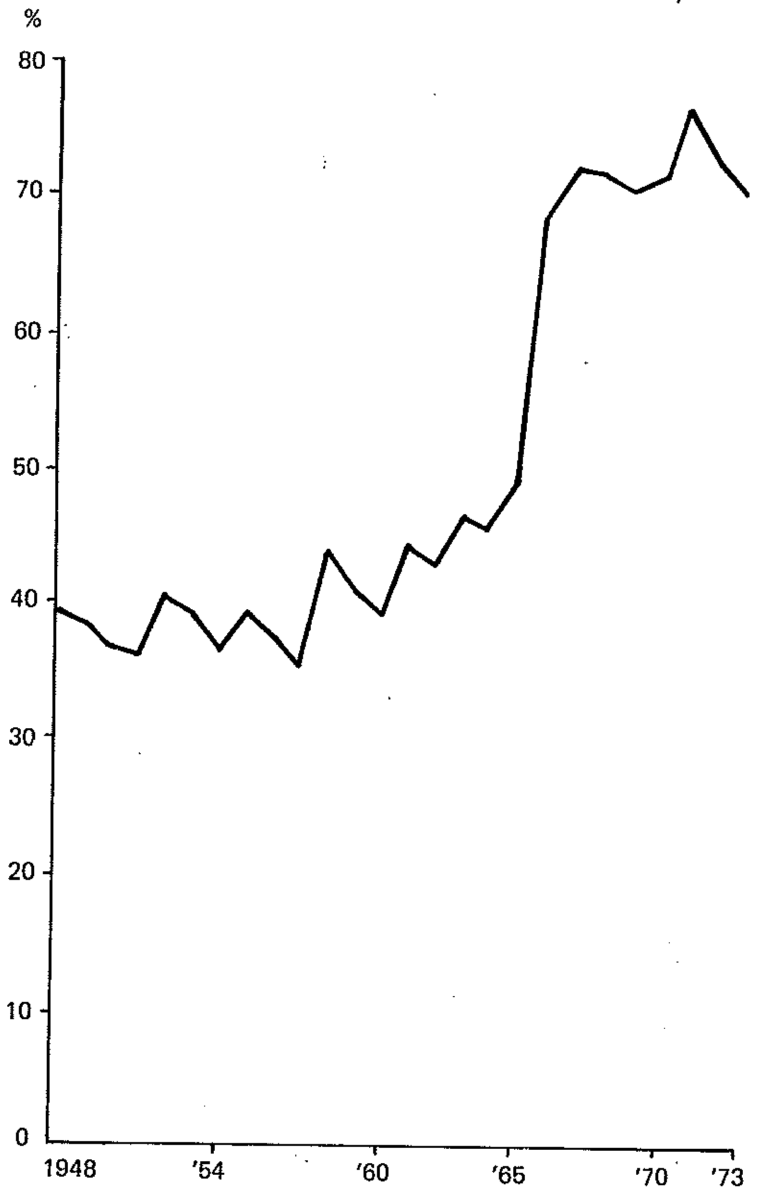
10 *Hansard,* Written Answer by Mr Robert Sheldon, November 21 1974, Col 513.

Chart 2 Unemployed and Vacancies: Great Britain



Source: Department of Employment Gazette

Chart 3 Benefit Relative to Net Income: Married, 2 Children



Source: Social Security Statistics.

Table 2 Ordinary Supplementary Benefit Rates (including rent) as a percentage of average net weekly earnings of male manual workers in October*

Year	Single householder	Married Persons: Without children	Married Persons: With 2 children (both aged under 5)	Married Persons: With 4 children (two aged under 5 and two aged 5-10)
1954	26.7	39.7	46.7	55.1
1955	26.5	38.9	45.8	54.7
1956	27.4	39.9	46.9	54.9
1957	26.6	38.6	45.2	52.6
1958	30.3	44.2	51.2	59.0
1959	31.0	45.9	53.7	61.9
1960	29.6	43.5	50.9	58.3
1961	31.1	45.3	52.9	60.3
1962	32.2	46.6	54.2	61.7
1963	34.1	48.5	55.9	64.4
1964	32.1	45.9	52.9	60.1
1965	36.1	51.7	59.0	66.7
1966	37.8	53.9	61.2	68.8
1967	38.9	55.5	62.9	70.2
1968	38.6	55.1	63.3	70.4
1969	37.8	54.2	62.4	69.7
1970	37.0	52.9	61.4	69.4
1971	37.6	53.9	61.9	69.2
1972	35.3	51.1	59.6	67.6
1973	36.0	49.3	59.3	65.7

* Taken from inquiries conducted by the Department of Employment
Source : Hansard

Table 3 Tax Repayments

Weekly earnings £	Maximum number of weeks for which rebate will run
20	*
25	7
30	15
35	20
40	24
45	27
50	29
55	31
60	33

* No tax payable
Source: Hansard, November 21 1974, Col 513

previous earnings and taxes paid. Tax rebates added to (untaxed) unemployment pay mean that many unemployed well above the supplementary benefits level receive for several weeks or months at least as much as their previous net (taxed) income from employment. This in no way means that they are free of anxieties about the future. The implications for policy are discussed on p. 115. Here I wish merely to emphasize the simple logical point – neglected by governments no less than their critics – that such payments raise the sustainable unemployment rate and must be taken into account in interpreting the official statistics.

An attempt to measure the effect of higher benefits on the sustainable unemployment rate has been made by D.R. Maki and Z.A. Spindler as part of an international investigation directed by Professor Herbert Grubel.[11] They estimated that unemployment in Britain over the period 1967-72 was 0.86 *per cent* (of the labour force) higher as a result of the increase in the benefit-to-earnings ratio. Such a percentage represents nearly 200,000 workers on a seasonally adjusted basis (and

11 *The Effects of Unemployment Compensation on the Rate of Unemployment in Great Britain,* Discussion Paper 74-1-3, Simon Fraser University British Columbia; Department of Economics and Commerce.

Table4 Minimum pay required in new job, 1973
(related to benefit income and previous earnings)

Previous earnings	Present level of benefit income: £10 or less	£10-20	Over £20
£20 or less	18	22	27
Over £20-35	22	25	29
Over £35	33	34	33

Source PEP

more at the peaks on an unadjusted basis), which is almost exactly the difference between the seasonally adjusted level of less than 300,000 reached at the unemployment low points of both 1961 and 1966, and the 500,000 level reached at a later low point at the end of 1973.

Such econometric estimates should not be treated as gospel. Errors in estimating cyclical variations, or in pre-1966 relations, would affect the results; and part of the effects attributed to higher benefits could have been due to other variables. But confidence that the Grubel investigations have picked up a genuine causal relationship is increased by parallel investigations carried out by him in the U.S., which found that unemployment was greater in States where benefit was high in relation to earnings, holding other variables constant; and also in Canada, where a large increase in benefit levels in 1972 was associated with an increase in unemployment, similar to that experienced in the U.K. when benefit levels were increased.

Survey data are sometimes cited to show that men who receive the earnings-related supplement do not stay out of work longer than those who do not. This argument overlooks the fact that we are dealing with two quite different categories of people. Since 1966 the supplement has been equal to one-third of weekly earnings between £9 and £30, with smaller supplements at higher levels.[12] It is not paid for the first six weeks to anyone who has left voluntarily or was sacked for a misde-

12 A further 15 *per cent* was added from January 1974, for earnings between £30 and £42. The upper limit of this higher band was raised to £48 at the beginning of 1975. It is due to go up to £54 in 1976 and £69 in 1977.

Table 5 Wages: Expected and Minimum Required, 1973
Those Unemployed but Seeking Work

		Previous Earnings								
		£15 or less	Over £15-£20	Over £20-£25	Over £25-£30	Over £30-£35	Over £35-£40	Over £40-£45	Over £45-£60	Over £60-£80
Mean average expected	£	20.1	24.1	26.4	29.4	32.0	34.7	37.2	42.7	47.4
Mean average minimum		18.3	21.1	22.1	25.8	28.0	31.4	32.2	36.2	37.8
Difference between expected and minimum	%	−9	−12	−16	−12	−13	−10	−13	−15	−20
Difference between minimum and previous earnings	%	+22	+21	−2	−6	−14	−16	−24	−31	−85

Source: PEP

meanour. Irregularity of past employment or very low earnings can also affect entitlement to the supplement. In other words, the sort of people who receive benefit tend to be those who are in any case more attractive to potential employers and/or keener to find work than those who do not. A cross-section study among *different* types of people cannot show the effects over time of the introduction of new benefits for *comparable* groups of people – a point explicitly recognised by A. Hill, the co-author of one of the best of such studies.[13]

Benefits v Wages

The relationship between benefit levels and unemployment has also been disputed in the P.E.P. study by W.W. Daniel[14] on the basis of a questionnaire study showing that even the short-term unemployed report financial and other sacrifices. It would be surprising if some did not do so, since benefits remain in most cases less than both previous and expected earnings, while tax rebates are of limited duration. This in no way disproves the relation between the size of benefits and the readiness to settle for new employment. One only has to imagine what would happen if there were no benefits and tax repayments, or at the other extreme if benefits were maintained forever equivalent to past earnings in real terms.

Unfortunately, the strident assertion of the P.E.P. study that high benefits do not prolong unemployment is contradicted by one of its own findings. For incomes below £35 (in 1973 pounds), Table 4 shows that there is a clear correlation between the level of benefit and the minimum earnings sought in future jobs.

13 See his Chapter in *The Concept and Measurement of Involuntary Unemployment*, Allen & Unwin, 1975.
For this reason even as careful a cross section study as that of D.I. MacKay and G.L. Reid for the period 1966-68, covering the introduction of new benefits, may be somewhat misleading. This came to the conclusion that every £1 of extra benefit was associated with an increase of 0.42 weeks in the average length of unemployment, but nevertheless found that the statistical explanatory power of this variable was weak. ('Redundancy, Unemployment and Manpower Policy', *Economic Journal*, December 1972).

14 *National Survey of the Unemployed*, P.E.P., 1974

This finding should be considered alongside Table 5 which shows the relationship between the previous earnings of the unemployed and the minimum earnings they look for in new jobs. It confirms that, understandably, unemployed people will not take anything offered, but require a minimum that varies with previous earnings. Such findings suggest that it is meaningless to talk about "unemployment" except in relation to acceptable rates of pay, the likely gains from "searching around" and the costs of not working.

It is easy to agree with Mr Daniel that 'rather than worrying about the effects of benefit levels, we should be devoting more attention and resources to measures that help and equip workers to find jobs.' But such measures – which will fly in the face of union opposition – will not work overnight. Meanwhile, we must recognize that the higher the benefit levels the higher is likely to be the 'unemployment' percentage in any given state of the labour market. Unemployment of several hundred thousand can coexist with a severe nationwide labour shortage. Daniel himself emphasises that in 1973 when unemployment was still well over 500,000 (or 2½ *per cent*), 'there was a desperate shortage of labour', but he fails to draw the implication that pumping money into the economy was the wrong way to tackle the prevailing variety of joblessness. In February, 1975, when the adjusted unemployment figure for Great Britain was 703,000 or 3.0 *per cent* (and the unadjusted U.K. figure was headlined as 790,000), the Chancellor of the Exchequer remarked: 'Some sectors of industry are held back by the shortage of supply of skilled workers even now'. He also mentioned that 'even in the present recession our engineering industry is not able to meet all the demands on it.'[15]

It is as certain as anything can be in political economy that the unemployment statistics have had a changing significance as a labour market indicator and have thereby become a less reliable indicator. The difficulty is not in finding an explanation of the changes but in deciding the weight to give to the different possible explanations, which are mostly compatible with one another.

15 Speech to a Labour Party meeting in Lewes, reported in *Sunday Telegraph*, February 23 1975.

Other Influences

The real criticism of the studies showing the impact of improved benefits is that they may have inadvertently included other influences tending to raise the unemployment-to-vacancies ratio. One known influence has been the effect of the post-war baby boom. This led to a bulge in the 'inexperienced' 20 to 24-year old section of the labour force, which would have been more difficult for employers to absorb at standard wage rates because of its lower productivity. Such a demographic change is distinct from any influence of benefits on the efforts of the unemployed to find a job; but it is equally distinct from the shortfall in the demand for labour during a recession. The presence of these extra inexperienced young people meant that, at a given state of the business cycle with given unfilled vacancies and shortages of skilled and experienced workers, there would be a higher total of registered unemployed.[16]

The proportion of 20 to 24-year olds in the labour force remained unusually high in the early 1970s, well after it could have been accounted for by demographic forces alone. The main reason seems to have been that an unusually large number of older people left the labour force permanently, thus prolonging the effect on the age distribution. This may have been related to a reduced tendency to hoard labour, which many economists and industrial observers diagnosed in the late 1960s and early 1970s; and there was a tendency for the effects of this dis-hoarding to be concentrated on workers near retirement and therefore more likely to leave the labour force for good.

Up to the middle 1960s a good deal of the impact of fluctuations in the demand for labour was reflected in what was known as the 'internal labour market'. When demand rose, the first reaction was more intensive use of the existing work force; and it was only in the later stages of an expansion that outside workers were recruited and unfilled vacancies shot up. Even when the economy as a whole was in a boom, many employers were still holding on to more workers, especially those of an 'overhead' kind, than they absolutely needed.

16 See J.I. Foster, 'The Relationship between Unemployment and Vacancies in Great Britain 1958-72' in *Inflation and Labour Markets* (ed D. Laidler and D.L. Purdy), Manchester University Press, 1974.

There is a good deal of indirect statistical evidence that labour hoarding declined, both in recessions and over the longer haul, at least up to the early 1970s.[17]

These changes would not have been surprising in view of the rise in effective real wages (in relation to value added) that employers have had to pay (reflected in the pressure on profit margins), and the series of economic crises that undermined confidence in long term expansion. Although there may have still been a good deal of overmanning by the standards of the best industrial practice, the result was that there was a much smaller hidden reserve of usable labour waiting to be brought into operation whenever the economy went into a boom phase. By the early 1970s, unfilled vacancies soared at a much earlier stage of the economic upswing, despite the existence of a larger pool of unemployed workers who lacked the skills, or experience, or inclinations that would have made them worth hiring at conventional wages.

Much of the argument about the effect of improved financial arrangements for the unemployed on their attitude to job search has been at cross purposes. The evidence purporting to show little change in attitudes largely relates to redundancy payments under the 1965 Act. This is quite easy to accept. To an employee, a fixed capital sum is surely different in impact from continuing weekly payments. Moreover, at least until recently, only a minority of redundant workers benefited seriously from such payments (14 *per cent* according to the P.E.P. survey). The argument about the effect on job search is based on *continuing* cash flow benefits, such as unemployment pay, tax rebates, and social security payments.

The real importance of the Redundancy Payments Act is on employer attitudes, and thus on the demand side, by providing a deterrent to dismissing workers. But once a decision has been made the State provides more help in payments to older people. (This bias towards shedding older workers was reduced in the Amending Act of 1969, but probably not eliminated altogether).[18]

17 See Foster, *op cit,* and Jim Taylor: *Unemployment and Wage Inflation,* Longman, 1974.

18 See Foster, *op cit,*

Apart from redundancy payments, several developments since the beginning of 1974 have made it more difficult for employers to dismiss workers. These include much increased political and union pressure against redundancies since the change of government in March of that year, and the Employment Protection Bill of 1975 which provides, *inter alia*, for longer notice to both workers and unions of impending dismissal, as well as guaranteed pay for a longer period. This longer notice is in principle desirable. It could even, in a more favourable environment, help to reduce unemployment by facilitating search for new employment opportunities before leaving the old job. On the other hand, it will increase the effective cost of employing workers at any given real wage; and, if union negotiators refuse to take this into account in their demands for take-home pay, employers will think twice before taking on more labour. Thus the effect of the new measures and attitudes could be to lower unemployment in the early stages of a slump, but to increase it in the later stages when reduced intake has had time to make a major impact on the unemployment figures, and also to increase it over the cycle as a whole.

A potentially much more sinister aspect of the Employment Protection Bill is the power that the proposed Central Arbitration Committee will have to force employers to bring pay into line with that paid by their competitors for supposedly similar work within the same area. As at present drafted it could lead, for example, to small engineering companies having to raise their pay levels to those of the best-off in a local car factory. This will provide a further impediment to the 'equalizing differences' discussed earlier in this chapter which enable workers to price themselves into jobs. This provision, if it is enforced, is one of the surest ways I know of increasing the sustainable unemployment rate.

A further influence tending to increase the unemployment percentage, for which there is strong impressionistic evidence, is an increase in structural unemployment of a purely industrial kind – Keynes' 'mismatch' between skills available and those demanded (at prevailing wage differentials). It was noticeable that in 1972, not long after the headlines about one million unemployed, businessmen could be heard complaining that they wished they knew where they could find some usable extra workers. Unfortunately, the statistical evidence reflecting these industrial changes is almost impossible to disentangle from that reflecting changes in law, benefits and political pressures which have been discussed. But, for a combination of reasons, there has been an increase in older and long-term unemployed as a proportion of the total.

In the 1950s those out of work for more than 52 weeks varied between 9 and 14 *per cent* of the total jobless; in the early 1970s it ranged between 16 and 27 *per cent*.[19] The absolute magnitudes make the point even more strongly: between June, 1960, and July, 1973 (broadly comparable periods in their cycles) total unemployment nearly doubled from 290,000 to 555,000, while the number out of a job for more than 52 weeks almost trebled from 58,000 to 151,000. The trends are illustrated in yet another way in Table 6. It shows that the percentage of unemployed for more than 26 weeks averaged about ¼ *per cent* of the labour force in the 1950s, ½ *per cent* in the early and middle 1960s, and fluctuated around 1 *per cent* by the early 1970s.

Such trends reflect the disparities between the demand and supply of different skills rather than any worsening of regional problems. Contrary to what is often supposed, there has been no increase in the regional spread around the national unemployment average. The two worst regions (leaving aside Northern Ireland) have in recent years been Scotland and the North, where unemployment has oscillated around 175 *per cent* of the national average, while the South East has been around 60 *per cent*. Relative regional disparities have not been very sensitive to the economic cycle and have even shown a slight tendency to narrow in the recessionary phase. Over the period from the early 1950s to the early 1970s, there was a modest secular tendency for the rate of unemployment percentages in different regions (apart from the favoured South East) to converge towards the national average.[20]

19 See Table 1, *D.E. Gazette*, February 1973, p 112. The comparisons are for mid-year.

20 See Fig 2, *D.E. Gazette*, March 1973, p 249.

Table 6 Unemployed in Great Britain

	a Males unemployed for more than 26 weeks as a percentage of all male employees	b Females unemployed for more than 26 weeks as a percentage of all female employees	c Total unemployed for more than 26 weeks as a percentage of all employees
September 1948	0.5	0.1	0.3
September 1949	0.4	0.1	0.3
September 1950	0.4	0.1	0.3
September 1951	0.3	0.1	0.2
September 1952	0.3	0.2	0.3
September 1953	0.3	0.2	0.3
September 1954	0.3	0.1	0.2
September 1955	0.2	0.1	0.2
September 1956	0.2	0.1	0.2
September 1957	0.3	0.1	0.3
September 1958	0.5	0.2	0.4
September 1959	0.6	0.3	0.5
September 1960	0.5	0.2	0.4
September 1961	0.4	0.2	0.3
October 1962	0.6	0.2	0.5
October 1963	0.8	0.3	0.6
October 1964	0.6	0.2	0.4
October 1965	0.5	0.2	0.4
October 1966	0.5	0.1	0.3
October 1967	0.8	0.2	0.6
October 1968	1.0	0.2	0.7
October 1969	1.0	0.2	0.7
October 1970	1.1	0.2	0.7
October 1971	1.5	0.3	1.1
October 1972	1.9	0.4	1.3
October 1973	1.3	0.3	0.9
October 1974	1.3	0.2	0.9

Source: Hansard, February 17 1975

5. Interpreting the Figures

The 1944 White Paper warned that it would be a 'disaster' if 'the expansion of total expenditure' were used to attempt to cure short-term unemployment due to job changes, or 'longer-term structural unemployment due to shifts in the requirements for different products and industries'. During the past 30 years such disasters have taken place repeatedly; encouraged by the popular interpretation of the unemployment figures. Although no amount of juggling with the unemployment statistics can indicate the lowest sustainable level of unemployment at which it is possible to run the economy, analysis of the jobless figures, together with those of vacancies, can help us guard against the misinterpretations most common to both the media and politicians.

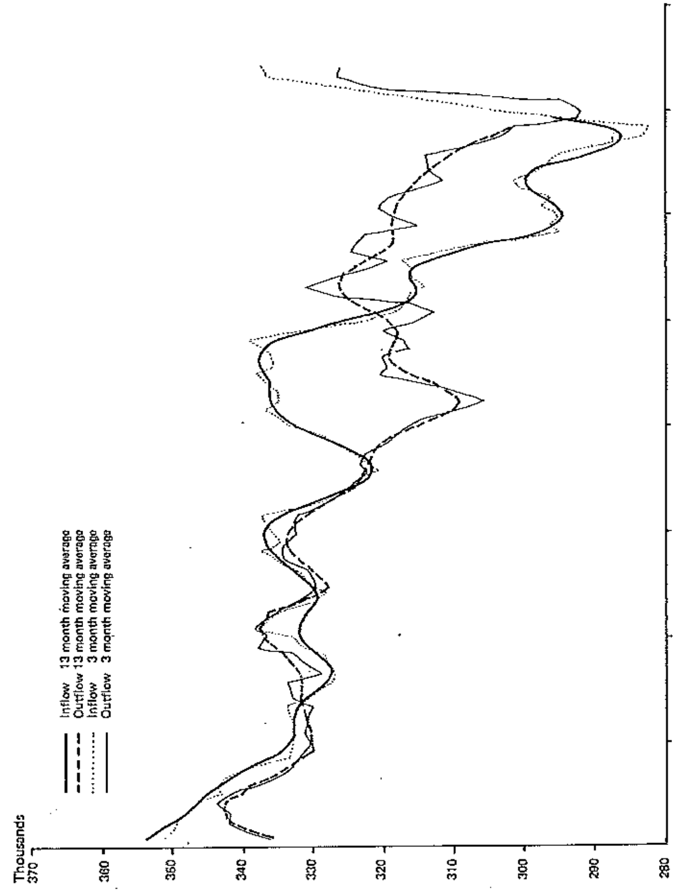
A Monthly Snapshot

The unemployment figures represent a snapshot of the register one day a month and convey a highly erroneous picture of a static 'pool' of unemployment. In fact there are about 9 m. departures from jobs every year, of which some 4 m. lead to people entering and leaving the unemployment register. The remainder go straight into new jobs, retire, or leave the labour force. As the chart shows, moderate and temporary differences between inflows to and outflows from the employment register were sufficient to account for both the 1971-2 recession and the 1973 boom.

The latest available calculation suggests that 50 *per cent* of those who register on any one day find a job within two weeks and 75 *per cent* within eight weeks.[1] For obvious arithmetical reasons, the longer-term unemployed are more heavily represent-

1 *D.E. Gazette*, May 1974

Chart 4 Trends in monthly flows on and off the monthly register – Adults, Great Britain



Source: Dept. of Employment Gazette, Sept. 1974.

ed in the snapshot figure, since many who find new jobs quickly will have disappeared from the register by the day of the count. Another misleading aspect about the monthly 'snapshot' of the labour market is the number of vacancies, with which the unemployed are often compared and which we have seen is understated by a factor of perhaps 3 to 1.

In attempting to make adjustments to the unemployment figures to make them more useful as an indicator, it is important to be clear what is, and is not, being attempted. Changes in employment have in the past been about twice as large as changes in unemployment, because in recessions some workers leave the labour force and may not even be shown in sample surveys of 'unregistered unemployed'. The existing unemployment figures understate rather than overstate the swings from boom to recession, as is obvious from looking at other indicators such as profits, share prices, output, or capacity utilization.

Aggregates Misleading

However we try to adjust them, the unemployment figures are not the best available guide either to the state of the labour market or to the pressure of demand in the economy generally. For the former purpose the vacancy figures should be given more weight, although they also need to be watched for changes in employers' inclination to register jobs available – on which we have little evidence either in the long run or over recent cycles. As a guide to the economy as a whole, labour market indicators need to be combined with other evidence such as C.B.I. figures of capacity utilisation and the behaviour of the trade balance (making what allowance one can for over- or under-valuation of sterling and world trade).

It is easy enough to see that unemployment figures understate the degree of slack in a recession, because of withdrawals from the labour force, short-time working and under-utilization of staff. But it is also probable that they understate the degree of strain during periods of boom. Not everyone who comes into the labour force during a period of peak demand, or who works more overtime or at a faster pace, would necessarily want to continue to do so indefinitely.

Unemployment levels of ½ *per cent* were reached in both World Wars, when people were under legal or moral compulsion to work for national survival. A peacetime society cannot function without some reserves of labour, as well as of physical capacity to cope with unexpected demands and challenges. Without such reserves we would need a frictionless flexibility of wages and prices, and a degree of occupational and geographical mobility which would be neither feasible nor desirable.

The practical value of 'dis-aggregating' the unemployment total is to distinguish those who are changing jobs, or who suffer from personal handicaps associated with skill, age, or temperament, and who are best helped by measures other than a general demand boost. The element of exaggeration in the aggregate figures can best be gauged by comparing recent boom and recession years.

Moreover, in considering policy objectives, it is important not to confuse a historically high, but fairly stable, unemployment percentage with a recession such as we are facing in Britain in 1975. The extensive short-time working, exceptional under-utilization of labour, and withdrawals from the labour force associated with an economic downturn, need not occur in a normal year exhibiting a similar official unemployment percentage; and this should be borne in mind in studying Table 7 and in assessing the current economic situation. In a recession it is particularly difficult to obtain new industries for the regional black spots, to place handicapped or disadvantaged workers, or make progress on any other front. On the other hand, a lower but stable 'pressure of demand' is consistent with steady economic growth in which all these things are possible. Indeed, a less ambitious 'demand management' policy is less likely to run into 'stop-go' (more correctly go-stop) troubles, and will therefore be more conducive to the achievement of wider social objectives than highly ambitious growth and employment targets which are guaranteed to produce reversals and 'U-turns'.

The main focus of social concern in the monthly count should be concentrated on those who do *not* succed in getting a job within a few weeks. The proportion of the unemployed out of work for four weeks or less has been gradually dropping, taking boom and recession years together; by March 1975 it had reached 22 *per cent.* But it was still large enough to account for over 170,000 of the Great Britain total. 'Unemployed for four weeks or less' is not an exact measure of short-term or transitional unemployment, as it will include a minority of people embarking on longer spells out of work. But it provides some guide.[2]

Another potentially misleading component is the inclusion of the over-60s who have accounted for well over 100,000 of the unemployed in some recent years. Some 50,000 occupational pensioners aged 60-64 years are estimated to be registered as unemployed.[3] Many of them are far from well-off and, like the rest of the over-60s, might accept jobs on suitable terms. But as Chart 5 shows, people of this age group do take a long time, are more difficult to place, and should be treated as a special category.

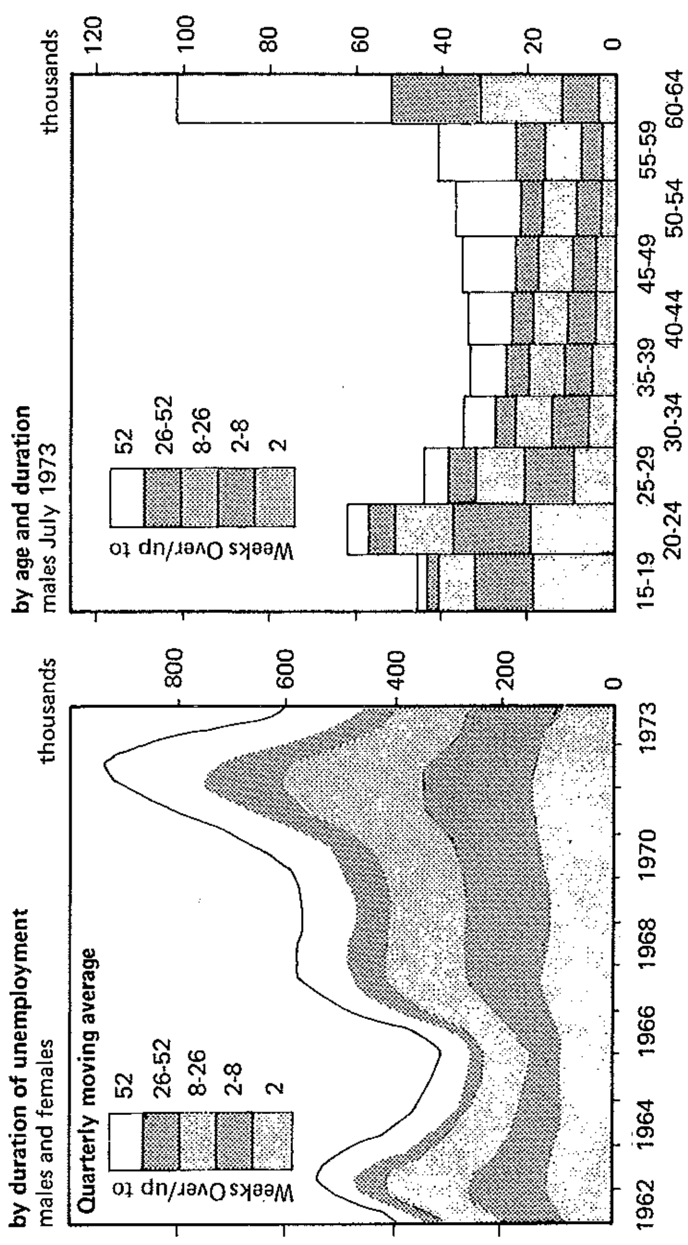
Another element that swells the unemployment figures is the inclusion of approximately 30 *per cent* of the unemployed who have been classified as both 'poor prospects and unenthusiastic', meaning not that they are strictly unemployable but that they take longer to obtain jobs and find it more difficult to hold on to them. The purpose of trying to estimate their number is not to minimize their plight or question their right to benefit, but to emphasize that they provide a misleading guide to the state of the labour market and therefore to monetary and fiscal policy.

A minor complication, which serves to swell the unemployment figures, is the treatment of Northern Ireland. For the purpose of manpower statistics, 'Great Britain' is the normal reference area; and the Department of Employment's analyses are mostly in 'British' terms. Constitutional niceties and statistical convenience happen to make good political and economic sense as well. But in the recession of 1971-2, the Press began to include Northern Ireland in the reported total. The

2 Actuarial calculations based on the experience of 1961-65 suggest that the number now on the register who *have been* on the register for less than four weeks is approximately equal to the number now on the register who *will have been* on it from anything between 0 and 11 or 12 weeks by the time they leave. Similarly, the number who *have been* on it for eight weeks is approximately equal to the number now on the register who *will have been* on it for up to 20 weeks by the time they leave. See *D.E. Gazette,* March 1975.

3 *Unemployment Statistics,* para 425.

Chart 5 Unemployment by age and duration: Great Britain



Source: Social Trends 1974

addition does not normally exceed 50,000; but without it newspapers could not have had their beloved headline of 'million on the dole' in the winter of 1971-2 (except during the dislocation caused by the coal strike).

Until recently a further complication was the inclusion of the 'temporarily stopped'. Following a pioneering study by the Institute of Economic Affairs,[4] an official Working Party recommended that this category should be dropped from the official unemployment total.[5] The reason was that their number can reflect a variety of conditions, ranging from short-time or temporary suspension to bad weather or the effects of strikes, so that the category did not necessarily correspond to the public idea of joblessness. The 'temporarily stopped' were however still in the total during the 1971-2 recession and added nearly 50,000 to the Great Britain total compared with what would be shown under today's conventions.

Another complication is the treatment of students and school-leavers. Although still included in the official grand total, they are excluded from the basic series used by the Department of Employment to assess the trend for a seasonal adjustment. School-leavers are an insignificant category, except in the late summer and early autumn when they can add over 50,000 to Great Britain total. Students have taken on a new importance following the growing practice (encouraged by the N.U.S.) of registering as unemployed during vacations. The peak month appears to be April, when in 1975 over 90,000 unemployed students were registered. During the summer months a substantial number have also been registering, but the number has been small during the rest of the year.

A more serious distortion of popular discussion results from the omission of the Department of Employment's seasonal correction, which can lead to an overstatement of the true position by up to 60,000 in January and an understatement of up to 60,000 in July. Thus a spurious trend of 120,000 can be created by nothing more than the succession of the seasons in a stable economic situation. The populist who mocks 'Tell a man that seasonally adjusted he's got a job' should be asked

4 *How Much Unemployment?* John B. Wood, I.E.A., 1972

5 *Unemployment Statistics,* H.M.S.O., 1972, Cmnd. 5157

'Do you blame the Government for the onset of winter, or praise it for the arrival of summer?

'Falsely Unemployed'

Two controversial, although offsetting, sources of distortion are 'false unemployment' and 'unregistered unemployment'. The Fisher Committee was satisfied that 'non-disclosure of regular and substantial earnings' occurred to a significant extent (para 492), and gave a list of occupations, ranging from building-site work to window-cleaning, which offered most scope for 'concealed self-employment or working without a card'. The planned abolition of National Insurance cards in 1975 may make it easier for people to draw benefit while having jobs. On the other hand, the attempts of the Labour Government to eliminate the "lump' in the building industry could act in the other direction. (The possible benefit abuse does not, however, justify blatant attempts to ban self-employed 'unregistered labour' just to protect union monopoly).

If a person is out of work at least two days a week,[6] it is perfectly legal for him to draw unemployment benefit on the remaining days. Some who appear as unemployed on the day of the count come into this category. The P.E.P. survey, based on questionnaire answers unlikely to lead to understatement, suggested that 6 *per cent* of the unemployed could obtain earnings of this sort. Average pay from part-time jobs was reported at £9 (in 1973 values). A tiny minority reported earnings above £20, but rather more refused to give a figure. The term 'falsely unemployed' is useful as it covers both the legal and the illegal recipients of benefits. Any figure of 'falsely unemployed' can only be a guess, but if we think that the figure is higher than 0 and less than the total register we ought to make such a guess. John Wood's estimate of 100,000 seems more likely to be right for this broader concept than a lower or higher figure.[7]

6 Regular part-time workers are excluded. Benefits are on the basis of one sixth of the weekly rate for each day of unemployment.

7 See *How Much Unemployment?,* p 59.

'Genuine but Unregistered'

An opposite bias comes from non-registration. It is well known that countries such as the U.S.A., which base their unemployment statistics on sample surveys, show higher unemployment percentages than countries such as the U.K. which rely on registration. This is hardly surprising. With a test as arbitrary as 'being capable of and available for work', individuals assessing themselves are likely to put a lower threshold on the degree of inconvenience, travel or cut in pay they will accept to obtain a job than is a registration agency responsible for benefit. Sample surveys can still give an idea of unemployment trends; but they give an upward bias to the totals.

Such labour force surveys are now becoming available in the U.K. through the General Household Survey and the E.E.C. Labour Force Survey. The first thorough analysis was that the Population Census for 1971 which showed 70,000 males and 230,000 females as seeking work, but not registered as unemployed or sick. Some were waiting to take up employment, but we cannot know how many because the question was not asked in the 1971 Census (as it was in the 1966 Census when the figure was about half). The optional exclusion of married women from the National Insurance scheme means that their incentive to register is less. In the words of an official report, some of the married women concerned 'can only be unemployed in a restricted sense' because they attach conditions such as 'working hours to suit domestic circumstances, ease of travel, availability of nursery schools and so on.' The correct question to ask is: 'If they were eligible for benefit and registered at Employment Offices, would they have met the criterion of being capable of and available for work?'

As with falsely unemployed, estimation is a matter of guesswork. But on this criterion my own hunch is that the amount of unemployment among men and women unregistered in 1971 would have been about 100-150,000. The General Household Survey, which corresponds roughly to the U.S. concept, showed a smaller discrepancy – 0.4 *per cent* or some 90,000 – compared

with the official unemployment figures in 1972.[8] Since knowledge of both 'falsely unemployed' and 'genuine but unregistered' is too uncertain to allow systematic 'correction' to the official figures, neither is taken into account in the adjustments that follow.

What Becomes of that 'Million on the Dole'?

The following tables attempt to enumerate, without double-counting, the other principal elements which helped to swell the unemployment figures during two recent contrasting periods of relatively high and relatively low unemployment. During the 1971-2 recession the last headline about 'a million unemployed' appeared in March 1972, which is a convenient month to take because it was the worst point of the recession and also a month when the seasonal correction (which is not available for the more detailed breakdown) is fairly modest.

Let us first deduct Northern Ireland, 'temporarily stopped' and school-leavers, which brings the basic wholly unemployed Great Britain total down to 915,000 (3.9 *per cent*); this compares with notified adult unfilled vacancies of 119,000, which even allowing for under-recording of 3 to 1 would still have been under 360,000. The picture is undoubtedly one of recession; but a breakdown of the wholly unemployed total brings its dimension into less exaggerated focus. Thus if we exclude the over-60s, those unemployed for four weeks or less and the 'poor prospects' who were also unenthusiastic, we are left with a total of a little over 500,000 or 2.4 *per cent* of what might be called 'long term unemployed among the active population'.

Table 8 relates to July, 1974, when unemployment still reflected the boom conditons of the end of 1973. The under-

8 *Hansard*, December 3 1974. Written Answer by Mr John Fraser. A table prepared by the official U.S. Council of Economic Advisers shows that the conversion of the U.K. unemployment percentage to an American basis would have added 0.4-0.6 *per cent* at various periods between 1969 and 1974. By contrast a conversion to U.S. rates partially based on an article by C. Sorrento in the *Monthly Labour Review* (U.S. Dept. of Labour, Bureau of Labour Statistics, June 1972) suggests an addition of 1.4-1.9 *per cent*. This latter source is used in *There's Work to be Done*, by S. Mukherjee, published by the Manpower Services Commission, 1974.

Table 7 Unemployment, March 1972 (not seasonally adjusted): 000s

'Headline' total for UK	1,015
Deduct	
Total for N Ireland	46
School Leavers	7
Temporarily stopped	47
Wholly Unemployed, Gt. Britain	915
Deduct:	
Unemployed 4 weeks or less	173
Over 60, unemployed more than 4 weeks	110*
'Poor prospects and unenthusiastic' (aged under 60 unemployed for more than 4 weeks)	100+
Total long term unemployment among active population	532 (2.4 pc)

* Average of January and July breakdowns.

\+ This figure has been obtained by taking the 30 per cent estimate of the official June 1973 survey and applying it to the unemployment figure for that period.

NB The figures in Tables 7 and 8 have not been rounded to secure consistency and to make use of official data. But this is not intended to give an impression of greater accuracy than the more approximate figures in the text.

lying upwards trend in unemployment that had already established itself was more or less offset by the usual summer seasonal improvement, so that it provides a representative recent period of high labour demand.

The deduction of Northern Ireland, school-leavers and students reduces the official unemployment figure from just over 600,000 to just under 530,000. At the same time notified adult vacancies were running at 330,000 which, applying the 3 to 1 ratio, gives nearly a million unfilled jobs. Thus, with only the simplest and least controversial adjustments, we are left with about two unfilled jobs for every unemployed person.

The removal from the wholly unemployed of the short-term jobless, the over-60s, and the 'poor prospects' brings the long-term unemployed total among the active population down to

Table 8 Unemployment July 1974* (not seasonally adjusted): 000s

Total 'Headline' figure for UK	601
Deduct:	
N Ireland	35
School Leavers and Students	39
Wholly unemployed in Gt. Britain	527
Deduct:	
Unemployed 4 weeks or less	149
Over 60, unemployed more than 4 weeks	87
'Poor prospects and unenthusiastic' (aged under 60 unemployed for more than 4 weeks)	100
Total long-term unemployed among active population	191 (0.8 pc)

* For some important footnotes see Table 7

just under 200,000 or 0.9 *per cent*. (Even if the correction for 'poor prospects' is rejected, the adjusted total is still under 300,000 or about 1.3 *per cent* of all employees).

Advantages of Better Presentation

These two tables are merely first approximations upon which the official statisticians could undoubtedly improve if given the right brief. The major improvement needed is to link the analysis by age, duration and 'prospects' with regional sub-divisions, without producing so many categories as to make the summary table useless for analysis or policy. The tables as they stand understate the size of the regional unemployment problem. In the official survey there is a suspicious similarity in the proportion of the unemployed regarded as poor prospects in regions with widely differing unemployment percentages, implying that in more depressed regions expectations develop which lead otherwise employable people to see themselves – and be classified – as outside the labour market. On the other hand, Tables 7 and 8 overstate the long-term percentage unemployed in the rest of the country where three-quarters of the population live and which would suffer 'overheating' from any *general* boost to demand.

To avoid voluntary or involuntary misunderstanding, I should make it clear that my suggested series for 'long-term active unemployed' is meant to supplement and not to replace the official total. Most opposition to 'doctoring' the unemployment figures is based on a confusion of individual cases with estimates of totals. To publish an adjusted figure, from which 'poor prospects' or 'over 60s' are excluded, does not imply that Employment Service officials should be any less zealous in their efforts to find ways of helping people in these categories. Adjustment would require no snooping, but simple standard statistical techniques.

How far would a more sophisticated presentation and interpretation of the unemployment figures help improve policy? After all, I have already emphasized that no particular ratio of unemployed to vacancies, however defined, can be equated with 'full' or 'sustainable' unemployment or with the absence of 'involuntary' unemployment. Moreover, all categories of unemployment, and especially the long-term active, rise during the recession, which is usually associated with a reduction in the employed labour force twice as large as the rise in the registered jobless.

Improved presentation would certainly give politicians, officials and 'opinion formers' a better idea of the base line from which they were starting during periods of recession, threatened or actual. One reason for the short-term and self-defeating monetary and fiscal boosts which governments have inflicted on us is that they have taken the unemployment figures at their face value as a guide to the state of the labour market (as distinct from changes in it). They have failed to recognize that total 'unemployment' figures of 500-600,000 can coincide with an intense shortage of labour; and this has led them to exaggerate enormously the degree of slack in the labour market when unemployment has risen above this level.

Of course, the economy was in recession in early 1972. But a picture (to use round numbers) of a little over 500,000 active and readily employable in the labour force might have redressed the political hysteria produced by the 'one million' syndrome. The Heath Government had already stimulated spending power in the March, 1971, Budget and the mini-Budget of July 1971. A couple of months of patience would have confirmed (what the official unfilled vacancy figures were already suggesting) that the economy was on the turn and that unemployment was about to decline without the need for public expenditure increases, the 'stimulus' of the March, 1972, Budget, or the interventionist Industry Act. It was surely worth exercising a little self-restraint before rushing into still further injections of extra spending power which led directly to the debacle of 1973-4.

Statistical Deceptions

But perhaps the greatest value of an improved presentation would be in years of average or relatively high labour demand. The picture revealed by Table 8 applied with minor variations to the whole period of labour market overheating in 1973-4. Would governments at such times have been quite so determined to persist with policies requiring £4 billion of public sector borrowing, a widening trade deficit, and a depreciating exchange rate (all evident before the oil price explosion in the autumn of 1973) if they had not believed that there was a great deal of slack in the labour market which justified a 'dash for growth'? Would economists and commentators have been quite so prepared to dismiss as 'anecdotal' tales of the extreme difficulty of obtaining some of the simplest kind of labour (already evident in the South East in 1972) if they were looking at a breakdown along the lines of Tables 7 and 8, and had taken into account unfilled vacancies (and allowed for their well-known under-recording) as well as unemployment?

At the risk of labouring the point, I must again emphasize that I am not denying that some of the short-term unemployed suffer hardship, psychological as well as financial, especially during a period of recession. I am simply denying that flooding the economy with money is the right way to deal with their plight. The official survey finding that one in four of the short-term unemployed had two previous bouts of unemployment within the previous year surely suggested that the basic problem is often the difficulty of fitting certain individuals into the labour market. W. Daniel's P.E.P. survey showed that 28 *per cent* of his sample of unemployed (of all durations) reported some disability (some 19 *per cent* had health problems and a quarter were over 55 years old). It should be possible to get across the message that these were neither 'scroungers' nor victims of 'deficient demand' but in a separate category altogether.

Nor is it maintained that intervals of short-term unemployment are the ideal form of job-changing. A better situation might be one in which manual, like professional, workers usually have a new job fixed up before they leave their old one – if this is what they really want and are not glad of a break in which to look around. But this state of affairs, which already applies to half the total of job changes, can be extended only by direct improvements in the labour market, 'good employer' practices, and so on. It cannot be brought about by over-ambitious demand management policies inspired by a misinterpretation of what the unemployment figures are telling us about the labour market as it now is.

No one who has studied the statistics will dispute that all categories of unemployment go down in a boom, that the 'poor prospects' become easier to place, and that regional problems appear less intractable. It is also clear that where the demand for labour at going wage-rates is brisk, either regionally or because of national conditons, people become more readily employable both in their own eyes and in those of officials classifying them. Nor is it disputed that between one cycle and another, the number of long-term jobless has gone up, together with the average unemployment rate.

The real issue between the conventional 'demand-management' school and market economists is: does government have the power to create a permanent labour market boom by monetary and fiscal stimulation? If it does, we have an indirect means of alleviating many social and structural problems – although perhaps at the expense of some inflation. If government does not have such power and the sustainable unemployment rate depends on more fundamental factors, the jobs created during 'go' phases are more than lost during the subsequent and inevitable 'stop'. The process then becomes a cruel deception on those whom it is designed to help. It makes their condition worse by creating fluctuations, during the downswing of which the most disadvantaged are the worst hit.

6. Demand Management and Unemployment

It is no longer possible to postpone consideration of the central issue of the relation between unemployment and inflation that lies at the heart of this *Paper*. The main proposition is that there is nothing surprising about 'stagflation' – the combination of inflation and recession – because the state of the labour market affects not the absolute level of wages and prices but their rate of change. A moment's reflection suggests that this is simple common sense. If wages are rising by 8 *per cent,* productivity by 2 *per cent* and there are no other disturbances or fundamental changes, there will be a steady 6 *per cent* rate of inflation. If the demand for labour is raised to an abnormal level the rate of inflation will increase; just as an abnormally low demand (associated with heavy unemployment rates) will produce a deceleration in the rate of inflation. But knowledge of the labour market tells us nothing about the rate of inflation around which these variations take place.

The same proposition can be looked upon from the side of employment policy. There is at any time a minimum sustainable level of unemployment, which is liable to change in the longer run as a result of underlying factors discussed in earlier chapters. A boost to monetary demand can temporarily reduce unemployment below this sustainable level. But its effects wear off in time and we are left with a faster rate of inflation, with little, if any, employment benefit to show in return. The repetition of this process, under the influence of short-run politics and short-run economic thinking, takes us to successively higher inflation rates with no ultimate gains to set on the other side.

Indeed the consequences are positively harmful to employment prospects for two reasons. The first is that, if the Government eventually does decide to reduce the rate of inflation, a period of 'transitional' unemployment well above the otherwise sustainable minimum will be required. The severity of this unemployment will depend, among other things, on the size and speed of the reduction in the inflation rate required. Secondly, high rates of inflation well into double digit percentages themselves have damaging consequences for unemployment, because, for instance, governments try to deal with the symptoms by controls over prices and profits. For both these reasons it would be better not to have embarked on the demand-boosting route. The Romans said: 'if you want peace, prepare for war.' A modern version might read: 'if you care for jobs, prepare to resist inflationary policies'.

Unemployment v Inflation?

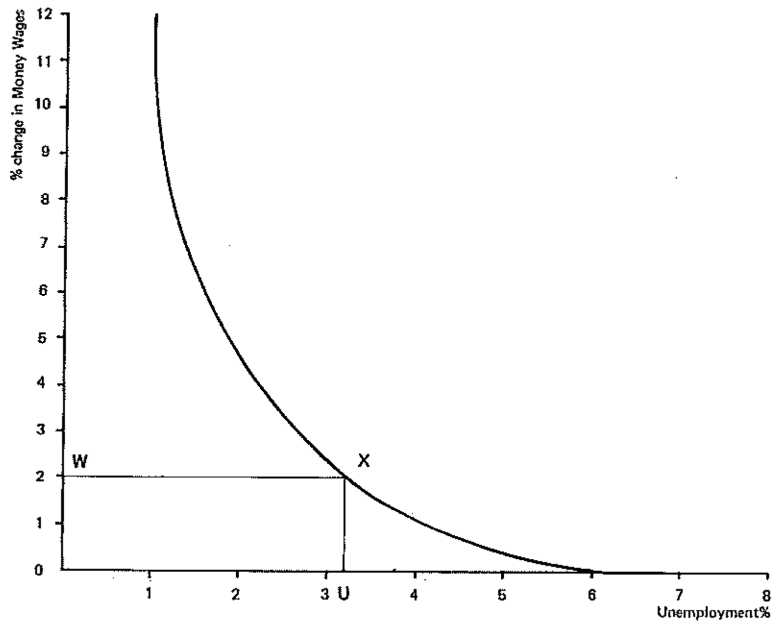
The crucial issue of the relationship or 'trade-off' between varying levels of unemployment and inflation used to be discussed in terms of the 'Phillips Curve',[1] although recently it is supposed to have gone away and in the process destroyed the whole of market economics.

The argument really begins with the observation on p. 33 that wages are not fixed at a level which will clear all labour markets, so that labour surpluses in some areas and trades coincide with shortages in others. It is reasonable to suppose that, other things being equal, the higher the national unemployment percentage, the more labour surpluses will predominate; and the lower this percentage, the more labour shortages will predominate. As labour shortages tend to exert an upward pressure on wages, it is tempting to say that the lower the national unemployment rate the faster wages will rise, and illustrate the relation by a curve such as that of Chart 6, which I have labelled 'the naive Phillips Curve'.

This particular way of illustrating the relationship between wage changes and the demand for labour was invented by

1 I have put most of what few observations I have to make on the more technical issues in the Appendix, at the end of which I have offered a very simple diagram which I believe brings out the underlying issues more directly than the Phillips Curve itself.

Chart 6 The "naive" Phillips Curve



Professor A.W. Phillips in 1958[2]. The chart shows the form in which Phillips believed it to apply to post-war Britain. He had also fitted a remarkably similar relationship to data from the period 1861-1913. This notable pioneering effort soon became world famous. Policy-makers believed they had a menu of choices between different combinations of inflation and unemployment, while economists wrote learned articles on the optimum compromise to adopt.

As is so often the way with these things, no sooner had the Phillips Curve become part of the stock-in-trade of policy-makers than it collapsed dramatically. The relationship suggested in the chart looked ludicrous in a world where high

2 'The Relationship between Unemployment and the Rate of Change of Money Wage Rates in the U.K., 1861-1957', *Economica*, vol. 25 (1958), pp. 283-99. Reprinted in *Inflation* (ed. Ball & Doyle) Penguin, 1969.

unemployment rates by post-war standards were combined with inflation rates above 10 or even 20 *per cent*. Academic researchers also found it very difficult to fit 'Phillips curves' to places and periods other than the U.S. and the U.K.[3] It was this experience that convinced the orthodox proponents of demand management, whose views were outlined in Chapter 2, that wage inflation was largely an institutional matter beyond the influence of normal economic policy.

On from the Phillips Curve

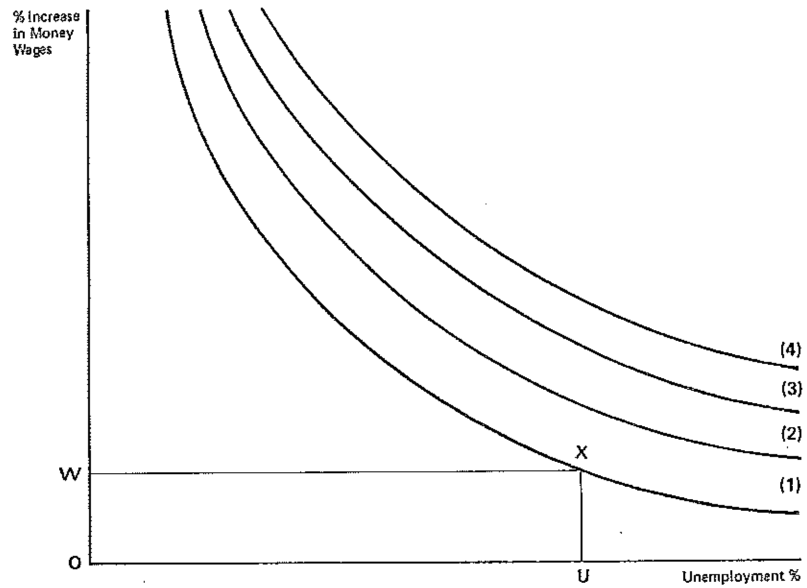
Unfortunately, the baby was thrown out with the bathwater. It was right to reject the original naive Phillips curve, but ludicrously wrong to come to the conclusion that changes in the rate of wage inflation had little to do with the state of the labour market, and that monetary and fiscal policy influenced only real output and employment.

The fallacy of the original Phillips curve is blindingly obvious – once stated. Let us assume that the economy is at point X on Chart 6, operating at the sustainable rate of unemployment U, and a stable rate of increase in money wages W. If the government then aims at a lower unemployment rate by boosting demand, the result is a shift along the curve upwards and to the left. Unemployment is reduced but at the expense of a faster rate of wage inflation, which may be regarded as a fair exchange or 'trade-off'. This situation, however, is stable only so long as the faster inflation remains unanticipated or, to use different language, if 'money illusion' persists and workers continue to think in money rather than real terms.

But, other things remaining unchanged, this situation cannot go on indefinitely. If the ratio of wages to prices remains stable over a period, each 1 *per cent* rise in money wages will be reflected in a 1 *per cent* rise in prices, thereby cancelling the gain in real wages. Eventually this realization is bound to be reflected in the market behaviour of both workers and employers. Let us assume that prices were stable with a sustainable level of un-

3 For the full story and analysis employing a minimum of technicalities, see *Unemployment versus Inflation?*, by Professor Milton Friedman, Institute of Economic Affairs, 1975.

Chart 7 The Phillips Curve under different rates of inflation

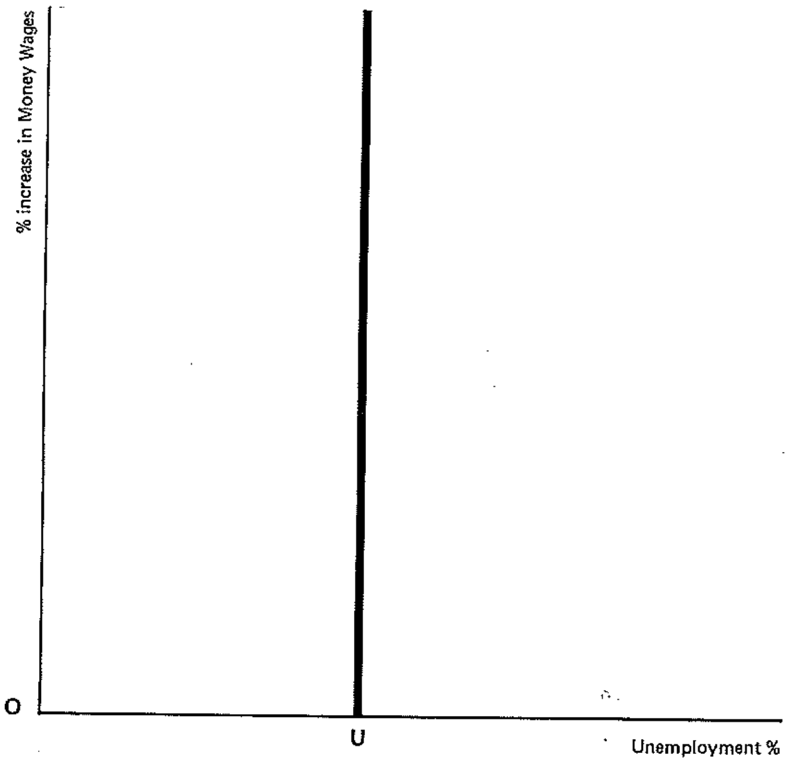


OU is the unemployment percentage at which the rate of inflation does not change.
The different curves show the "Phillips" relation under different sets of inflationary expectations.

employment and with a 2 *per cent* rate of wage increase. Now the labour market tightens sufficiently for workers to obtain 5 *per cent* increases. Once these wage increases have worked their way into prices, the value of this 5 *per cent* will be rapidly eroded until prices are rising at 3 *per cent*. If the tightness of the labour market remains, workers will still want their 5 *per cent* in real terms, and employers will be willing to concede it to them in the expectation of passing the cost on by raising prices. The stage is thus set for an 8 *per cent* increase in nominal wages in the next round.

If follows that the Phillips Curve is essentially a temporary or short-run relationship. Its position, as shown in Chart 7, will shift with changing expectations about the movement of the price level. It also follows that any attempt to maintain 'too low' a level of unemployment (less than U in Charts 6 and 7)

Chart 8 The long run vertical Phillips Curve



The rate of inflation (including wage inflation) depends in the long run on the rate of change of monetary demand. Unemployment is determined by more fundamental forces and cannot be permanently shifted below OU by demand management.

will lead not simply to inflation but to accelerating inflation. The long-term trade-off is not between unemployment and inflation, but between unemployment and accelerating inflation. Thus at any given time there is a rate or range of unemployment consistent with any stable rate of price change, of which zero inflation is only one possibility.

This situation is summarized by economists in the hypothesis of a 'vertical Phillips Curve' (shown in Chart 8). It means that there is a minimum sustainable rate or range of unemployment which has little to do with 'demand management', so that the long-run effect of monetary and fiscal policy is almost entirely on the price level and hardly at all on the level of employment. (When we remove a few of the over-simplifications from this analysis in the Appendix, the counter-productive nature of conventional 'full employment' policies will be seen to be even stronger). The real (non-monetary) forces that influence the minimum sustainable level of unemployment have been discussed in earlier chapters, from which it is clear that they are not fixed in heaven but are amenable to specific policy measures aimed at removing avoidable defects in the operation of the labour market.

Summary of Argument

The argument so far can be summarized in the following propositions.

1. Because wages and prices do not adjust instantly to clear the market, a boost to monetary demand will lead to a temporary drop in unemployment and a spurt in the growth of output. But unless unemployment happens to be abnormally high, the boost will wear off and the main effect will be to raise the rate of inflation.

2. Because of this same stickiness of wages and prices, once a given degree of inflation has become embedded in the system it may take a long or severe period of deficient demand, *with unemployment well above the minimum sustainable level,* to reduce the rate of inflation by any target amount.

3. One effect of unions is to increase this downward stickiness in money wages, and thereby to increase the cost in temporary unemployment of any target reduction in the rate of inflation. Another is (probably) to increase the minimum sustainable rate of unemployment, accompanying *any* constant non-accelerating rate of inflation.

4. The rate of wage inflation depends on:
   (a) the expected rate of price increase;

(b) the excess demand for labour (measured by unemployment, vacancies or any convenient batch of indicators) above the maximum sustainable level; and
(c) the rate of change in the demand for labour away from or towards this sustainable level.

Responsiveness to Expansion

The above summary raises more questions than I can answer. The most obvious is: how long can the temporary boost to employment from the expansion of monetary demand above the sustainable level be expected to last? My guess is that it may now be not more than two years.[4] The boost was probably longer in the 1950s, when people were more easily taken in by the money illusion. At the other extreme, Latin American experience suggests that, once a very rapid and volatile inflation is reached, the results of demand stimulation are so well known and quickly discounted that the entire effect is on the rate of inflation and there is not even a temporary boost to output and employment.[5] In other words the long run is getting shorter!

Looking back at the summary on the previous page, the key issues for the functioning of an economy are the way in which price expectations behave and the precise degree of stickiness of wage movements. If any chance increase in the price level creates the expectation that it will continue indefinitely into the future, and if changes in demand pressures are slow to influence wage movements, the outlook is pretty bleak. Any sudden shock to price level will generate inflationary expectations, and monetary and fiscal policies to check these expectations will involve prolonged and severe periods of 'transitional' unemployment.

An example of fairly benign behaviour of expectations was the French reaction to the wage explosion of 1968, following

4 Unemployment was probably higher than necessary to prevent accelerating inflation in the winter of 1971-2. It fell to unsustainably low levels some time in the recovery of 1972-3, but is again likely to rise to abnormally high levels in 1975.

5 See Robert E. Lucas: 'Some International Evidence on Output-Inflation Tradeoffs'; *American Economic Review*, June, 1973.

the demonstrations by workers and students against the de Gaulle regime. It led to a once-for-all increase in the price level and devaluation, after which the French inflation rate fell back in line with other countries without the need for a prolonged period of high unemployment. The responsiveness of German wages to changes in demand pressure is proverbial: the recession in the winter of 1974-5 was sufficient to reduce the many key German wage settlements to the 5-8 *per cent* range – which is the reason Germany seemed likely to recover more quickly than most other countries.

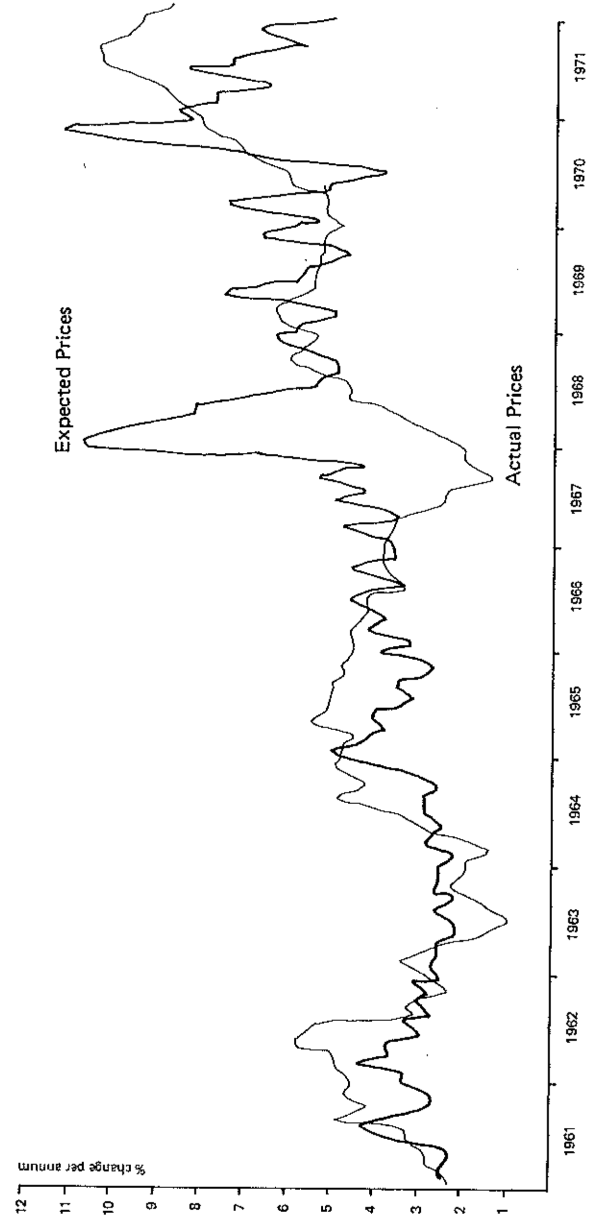
There is no denying the greater stickiness of British wages in the face of recession, or the importance of the difference between German and British trade union psychology in such situations. But on price expectations, British opinion may not be as obstinately immovable as sometimes supposed. Chart 9, which has been derived by Professor Michael Parkin and Mr. John Carlson from public opinion poll data, shows price expectations to be pretty volatile. Expectations of sharply higher prices increased after the 1967 devaluation and again after the 1970 election (which was fought on rising prices), but in each case subsided within a very few months. This suggests that the removal of distortions caused by subsidies, price controls or overvalued exchange rates, need not have the catastrophic effects on economic management so often feared.

Impact of 'Shocks'

The influence of 'price increases', past or expected, on the going rate of wage inflation in a given state of the labour market is indeed a shorthand way of summarizing a variety of factors. Anything which influences the expected real value of a given rate of pay will affect employees' behaviour, and anything which affects the market value at which the product can be sold affects the employer. An undervalued exchange rate, which raises export profits, will weaken employer resistance to wage claims. An increase in the proportion of income going in tax will increase wage pressure in a given state of the labour market. and thus increase the unemployment rate required to hold wage increases to a desired level.

One of the most important influences on the real value of

Chart 9 Inflationary expectations



Source 'Inflationary Expectations' by John A. Carlson and Michael Parkin, University of Manchester Research Paper, 73/05

money wages is the 'equilibrium' terms of trade, that is the terms of trade prevailing when the exchange rate is neither overvalued nor undervalued and overseas payments are in balance without drawing on the reserves or official overseas borrowing. The large deterioration in the prevailing terms of trade (and even greater in the equilibrium terms) following the 1972-74 commodity boom and the oil price explosion is an outstanding example. This led to a reduction in the real wage at which a given level of employment could be provided. Resistance to the required reduction in real wages was bound to lead to a rise in the unemployment rate, however hard British Governments tried to postpone the issue by overseas borrowing and income transfers from other groups to manual workers. It is extremely difficult to believe that the behaviour of trade unions has not increased this resistance and therefore raised the unemployment rate.

The Government may attempt to spread the required reduction in real wages over a period of years by foreign borrowing,[6] it may legitimately allow a temporary or even once-for-all increase in the rate of inflation to cushion the effect on unemployment. But if it insists on trying to achieve by monetary and fiscal expansion a pre-determined employment target, it risks imposing a runaway and uncontrollable inflation on top of the difficulties with which it is already confronted.

To put the matter another way: external shocks of all kinds, or internal power shifts, or changes in the balance between take-home pay and taxation, certainly present difficulty but can eventually be absorbed, provided that deliberate control is placed on the growth of monetary demand. A 'full employment' target, which may have no relation to the rate of employment sustainable at prevailing real wages, poses a risk of a different order. For if a government is to attempt to achieve such a target, it will have to abdicate control over monetary demand; and there is then nothing to prevent a runaway inflation, which

6 An operation which can be jeopardized by wishful thinking about the extent of the required adjustment and about future favourable developments such as 'North Sea oil'. Such spreading of the burden is in my opinion less risky and crisis-prone if left to the private international capital market under a freely floating exchange rate.

will not only fail to achieve its employment objectives but is likely to leave the unemployment situation worse than before.

Unemployment and Wage Demands

A more controversial question is whether the rate of increase in money wages, in any given state of the labour market and of price expectations, can be influenced by the degree of union wage-push. This is best treated as an example of a shock to the system of the kind already discussed. An existing degree of union monopoly power or strike-threat power, affects the distribution of *relative* wages between different sectors. Wages will be higher and employment less in the more effectively unionized sectors than they would be in a competitive market, while wages will be lower and employment higher in the less effectively unionized or non-unionized sectors. But there is nothing here to start off an inflationary trend or aggravate an existing trend.

Suppose, however, a union — or group of unions — increases its degree of monopoly power or makes more use of its existing power. It will cause a diminution in employment and an increase in the price level of its own sector, and a corresponding expansion of employment and reduction in relative wages and prices elsewhere. If the actions of the unionized 50 *per cent* of the labour force, or even the most powerful among that 50 *per cent*, are highly interrelated — say through the process of following 'leading wage settlements' — this could lead to quite a large increase in 'transitional' unemployment. The reason is that it would take time and effort for the displaced workers to find suitable jobs in the non-unionized or less-unionized sectors, and to price themselves into them. The effect of unions in this case is to create unemployment. Nevertheless, if we follow the Commons Expenditure Committee in defining inflation as a *sustained* increase of the general level of prices, inflation follows only because the Government expands monetary demand to mop up the unemployment thereby created — with the dubious longer-term results already discussed.

Although this hypothetical scenario cannot be ruled out *a priori*, some 'monetarist' economists are convinced that it is largely mythical and that the various 'wage explosions' which

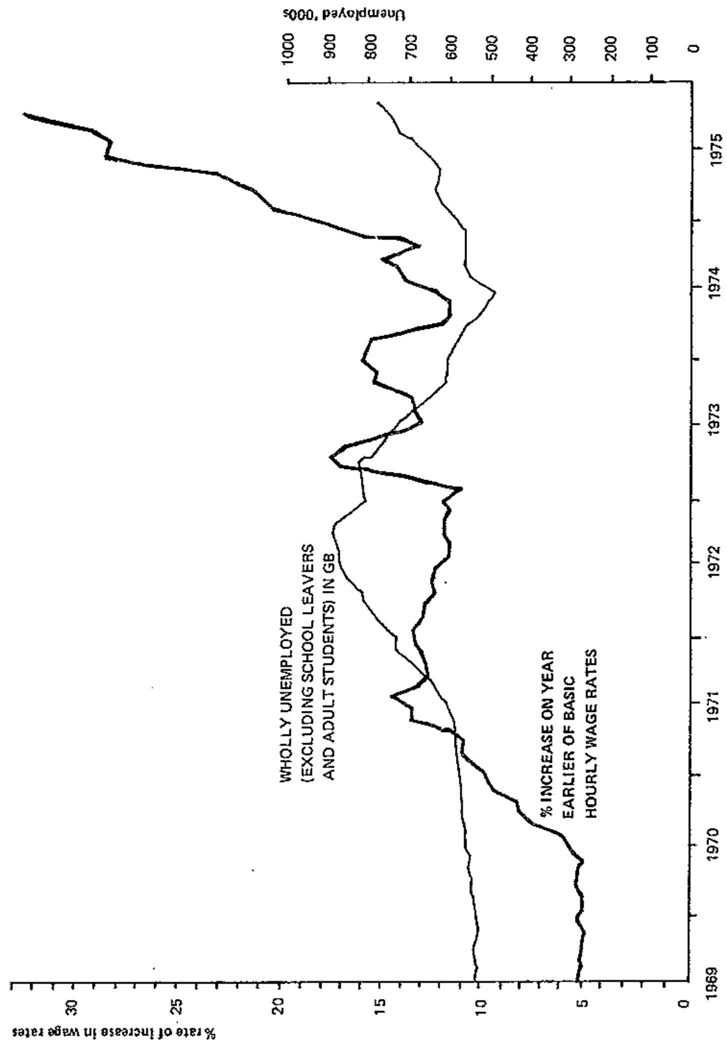
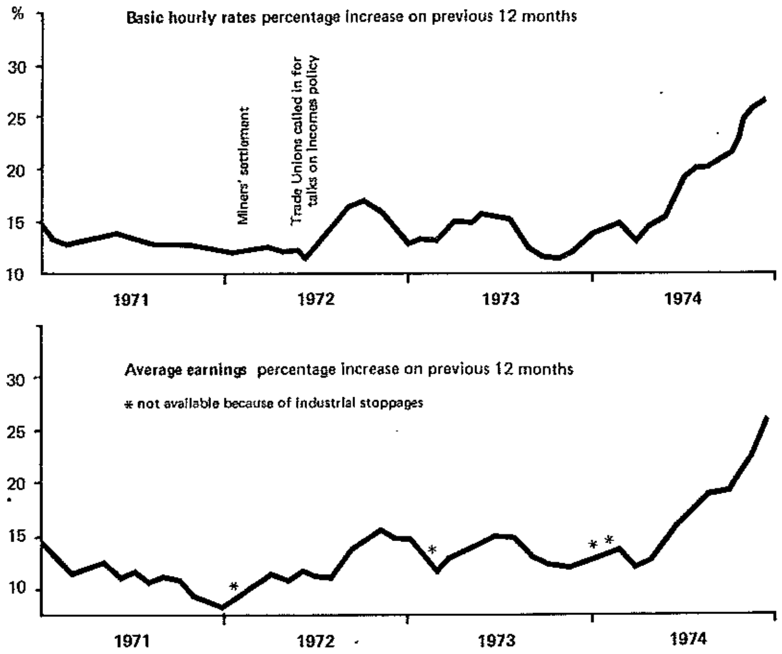


Chart 10 Increase in wage rates and unemployment

Source: Peter Lilley: "Lessons for Power" 1974

Chart 11



have taken place can be explained without invoking a union wage-push factor. The two crucial episodes for this argument are 1969-70 and 1972. As Chart 10 shows, a wage explosion began in the winter of 1969 when there was no marked change in the demand for labour. It is possible to attribute this to the delayed effects of the November, 1967, devaluation and of the subsequent indirect taxes on the retail price index (the length of the lag being due to the Jenkins wage control legislation of 1968-9, which postponed but did not prevent the feedback into wages). The 1972 experience is even more difficult to interpret with any finality. Chart 11 suggests that the rapid rise in unemployment from mid-1970 up to the spring of 1972 did bring about a very gradual reduction in the rate of wage increase. The very slow and sluggish response could perhaps be explained by the rapid acceleration in the increase of retail prices from 5 *per*

cent per annum in mid-1970 to a temporary peak of 11 *per cent* at the end of 1971.

A more debatable point is whether wage inflation continued to decelerate after the miners' victory in February, 1972. The index of hourly rates suggests that it did very slightly – until the Prime Minister's July talks with the unions at Chequers on wage restraint led to a series of pre-emptive settlements. The earnings index suggests that the change in trend took place a good deal earlier. Neither index is a good measure of the current settlements, although the rates index may have been slightly better for that period. I prefer to suspend judgment until another major wage push or deceleration of an unambiguous nature is foreseen by economists before the event.[7]

Minimum Sustainable Level of Unemployment

It would obviously be desirable if we could discover how high the 'natural' level of unemployment – or the minimum sustainable rate, as I prefer to call it – is in practice. It is unfortunately impossible to do more than guess because it is liable to change while unemployment fluctuates around it. We might suppose that this level had been achieved if the rate of inflation were stable for a prolonged period; but this has not happened for quite a long time past.

7 There is surely no reason why market economists should rule out of court the impact on markets of political shocks such as the confrontation between General de Gaulle and the unions and students in May, 1968. The increased union militancy in Britain of recent years could be a factor of this kind. But equally, there is no reason why they should not attempt a market-place explanation of these political events, instead of treating them as random shocks. This would be a perfectly legitimate 'historical interpretation', that is a writing of history from 'the point of view which interests us'. (The idea of 'historical interpretation' is derived from Sir Karl Popper's *Poverty of Historicism*, pp. 147-52, Routledge, 3rd edition, 1961). These 'points of view' are usually irrefutable; and, as they are also unavoidable, there is no reason why we should not make them as explicit as possible and take them as far as we can. From one point of view we may be interested in the market forces behind political events; from another, how political events, including the influence of charismatic individuals or more gradual changes in the public mood, influence the reactions of men and organizations to market forces.

The best we can do is to look at unemployment levels when the rate of wage inflation was accelerating or decelerating and make some allowance for time-lags. Thus the gradual decline in wage inflation in the winter of 1971-2 gave ground for hoping that the minimum sustainable rate might be lower than 3.8 *per cent* or 850,000 seasonally adjusted (equivalent to just under the one million peak in headline writers' non-adjusted terms). The signs of deceleration of private sector wage increases at the time of writing, with unemployment rising towards comparable levels, point in a similar direction.

Examination of the charts, in conjunction with what we know about 'shocks' and lags (including those introduced by pay controls) and inflation suppressed in the form of payments deficits, suggests that wage inflation is likely to accelerate if adjusted unemployment is below 700,000 or 3 *per cent*. But we do not know to what extent the de-escalation of wage inflation in the periods mentioned was due to *higher* unemployment and to what extent to *rising* unemployment. For this and many other reasons, I attach as little value to the above guess of between 700,000 and a million for the minimum sustainable unemployment rate as I do to other people's guesses that the sustainable percentage would be in the 'low millions'.

The difficulty of making any such estimate can be seen from the shift of official views. With the experience of 10-20 *per cent* unemployment rates of the inter-war period behind them, policy-makers at the end of World War II regarded a 3 *per cent* rate (just under 700,000, seasonally adjusted, on today's figures) as utopian. By the 1950s and early 1960s the pendulum had swung completely round and 3 *per cent* was regarded as intolerable recession. Since the late 1960s the pendulum has begun to swing back under the influence of events.

Lessons for Demand Management

There is, however, no need to guess the sustainable level of unemployment in advance, since the main point of the concept is to emphasize that it is not controllable by variations in demand management. If the Treasury and the Bank of England had a long-term target for the average growth of total monetary demand, taking one year with another, we would *discover* the

sustainable level of unemployment by looking at the average around which the level fluctuates in practice. This is probably as much as the authorities can do to stabilize unemployment while at the same time avoiding runaway inflation. If the unemployment rate that emerges is unsatisfactory, something should certainly be done about it – but by means other than injecting more money into the economy. The target growth of monetary demand should be fixed in line with the long-run trend of output growth augmented by whatever rate of inflation is thought tolerable. (If we are starting from an intolerably high level of inflation, which has to be brought down, this formula will not work; and crisis medicine of the kind touched upon in the concluding chapter will be required).

The authorities, of course, control money demand indirectly through monetary and fiscal policy. Their aim, according to this approach, should be to secure a given target growth of money National Income (or 'nominal GNP'). They are best likely to achieve this aim if they set themselves a target average annual rate of growth of the money supply and maintain the public sector deficit at a roughly stable proportion of the national income.[8]

If the Government could 'fine-tune' the economy enough to damp down and not accentuate business fluctuations, temporary variations in either direction from the targets would be permissible. The important point is that an expansion one year must be balanced by a contraction in another year if we are to avoid an accelerating inflation without any lasting benefit to employment.[9] Because it is politically much easier to relax constraints one year than to tighten them in a fully offsetting way in another, we should remain suspicious of discretionary variations.

8 The deficit should be determined in relation to the amount of debt that can be sold outside the banking system in a typical year without producing undesired effects on the interest rate structure.

9 The Budget should be on what the Americans call a 'full employment' basis. This is not a particularly well-chosen name; but it means that the permissible deficit should be related to revenues and expenditure at some hypothetical level of unemployment rather than to actual revenues and expenditure. Thus taxes would not be raised to offset a deficit due to a recession; and would not be lowered because of the improved balance achieved during a boom.

Any discretionary changes that we do have to have around these targets should be confined to fiscal policy, of which the independent impact – if any – is fairly quick and is likely to wear off in the absence of supporting monetary action. Variations in the money supply have much more delayed effects and are therefore more likely to become destabilizing. Bearing in mind that nominal interest rates tend to fall pretty sharply in recessions and to rise pretty rapidly in booms, even if a rigid money supply policy is followed, it is doubtful wisdom to accentuate these variations even further for so-called 'stabilization' purposes. Above all, a steady course for the money supply will do something to offset perverse fine-tuning on the fiscal front, or errors in the calculation of the adjusted public sector deficit.[10]

Sticking to the Guidelines

Stable long-term fiscal and monetary guidelines provide a framework for handling many otherwise intractable problems. Thus if the government introduces subsidies such as a regional employment premium to stimulate activity in the high unemployment districts, such expenditure should be switched from other areas of high labour demand or covered by higher taxes, and not simply added onto the Budget deficit. If it works, the minimum sustainable national unemployment rate will be seen to fall.

A similar issue is whether subsidies should be given to protect existing employment during a recession, or in the longer term to protect firms and industries that might otherwise run down their labour force. Such Luddite practices are a most inefficient way of cushioning workers from the effects of change, and they hold back the general standard of living. Nevertheless, if the community wishes to give priority to security of existing employment rather than to change and adaptation, it can do so without runaway inflation provided the sums needed for the purpose are raised from taxation or switched from other expenditure.

10 Explained in previous footnote.

A more difficult question is whether the monetary and fiscal guidelines should be maintained in the face of various shocks which lead to explosions in money wages. Many such shocks are home-made and avoidable. They include holding up an overvalued exchange rate and then letting it drop suddenly; or wage controls which simply dam up claims which workers are in a strong enough market position to obtain; or sudden increases in the proportion of personal income going in tax. But there will always be policy errors, as well as unavoidable external shocks such as world commodity booms or military events affecting our overseas supplies. An independently generated increase in union militancy would come into this category.

Reactions can range between two extremes. The most lenient is to accept the new level of money-wage increase and the corresponding increase in inflationary settlements as a datum, raise the guidelines, and be content to stabilize the rate of inflation at the new and higher rates. So long as there still are guidelines, and no attempt is made to predetermine real magnitudes such as employment by monetary measures, there should be little danger of currency collapse. At the other extreme, the old guidelines can be maintained firmly. This would mean that a faster growth of money wages will collide with a firmly controlled rate of total national expenditure, so that unemployment may rise well above the minimum rate for quite a long 'transitional' period until labour market influences have checked the rate of wage inflation.

We have never in practice had a policy of long-term monetary and fiscal guidelines (although we looked like approaching them for a brief period at the end of Roy Jenkins' Chancellorship in 1969-70). But if we ever did, there would obviously be some compromise between the two extremes in the face of such a dilemma. The important lesson is that a guideline policy, however flexible, can be maintained only if the shocks under discussion are clearly identified on rare occasions. If the guidelines are allowed to give way with every passing inconvenience, we will be back with the post-war conventional wisdom of no guidelines, and dependent on luck to avoid currency collapse and the associated politicial dangers.

The optimum solution would be to induce a more flexible response by the labour force and the electorate in the face of an occasional temporary cut in living standards or the rate of growth, so that they would not price themselves out of jobs for years on end or force the government to underwrite enormous increases in the inflation rate. The contrast is clear with a country such as Germany where external shocks are (for all Herr Schmidt's rhetoric to the contrary) allowed to work themselves out in a sharp brief rise in unemployment, which in turn has a quick moderating impact on wages. In this way inflation is kept to a low level without prolonged stagnation. It becomes increasingly difficult to believe that union behaviour has nothing to do with the differing flexibility of the German and British economies.[11]

A Note on the Phillips Curve

Is the long-run Phillips Curve strictly vertical? Some economists maintain that, after all adjustments have been made, there is still some trade-off between unemployment and inflation. On the other hand it is frequently stated, with some plausibility, that the biggest danger of unemployment comes from inflation itself. In other words, the long-run Phillips Curve actually slopes in a perverse way, with higher inflation associated with higher unemployment. My own view is that both contentions are correct, but apply to different rates of inflation and different stages in the inflationary process.

While inflation is at moderate but increasing levels, there is scope for real wages to rise at the expense of owners of fixed interest securities or recipients of non-indexed pensions. Thus although the larger part of any wage increase resulting from a tightening of the labour market is lost in higher prices, part is not. Thus the long-run Phillips Curve may be much steeper than the short-run curve, but not literally vertical as in Chart 8.

This is a dangerous trap for policy-makers. For during the interval, while expectations are being adjusted, it looks as if they can 'buy' a reduction in unemployment with a smaller

11 Reasons for pessimism, both about the prospects of the monetary guidelines policy being followed and about a reform of trade union behaviour, are given in my article *The Economic Contradictions of Democracy*, British Journal of Political Science, April, 1975.

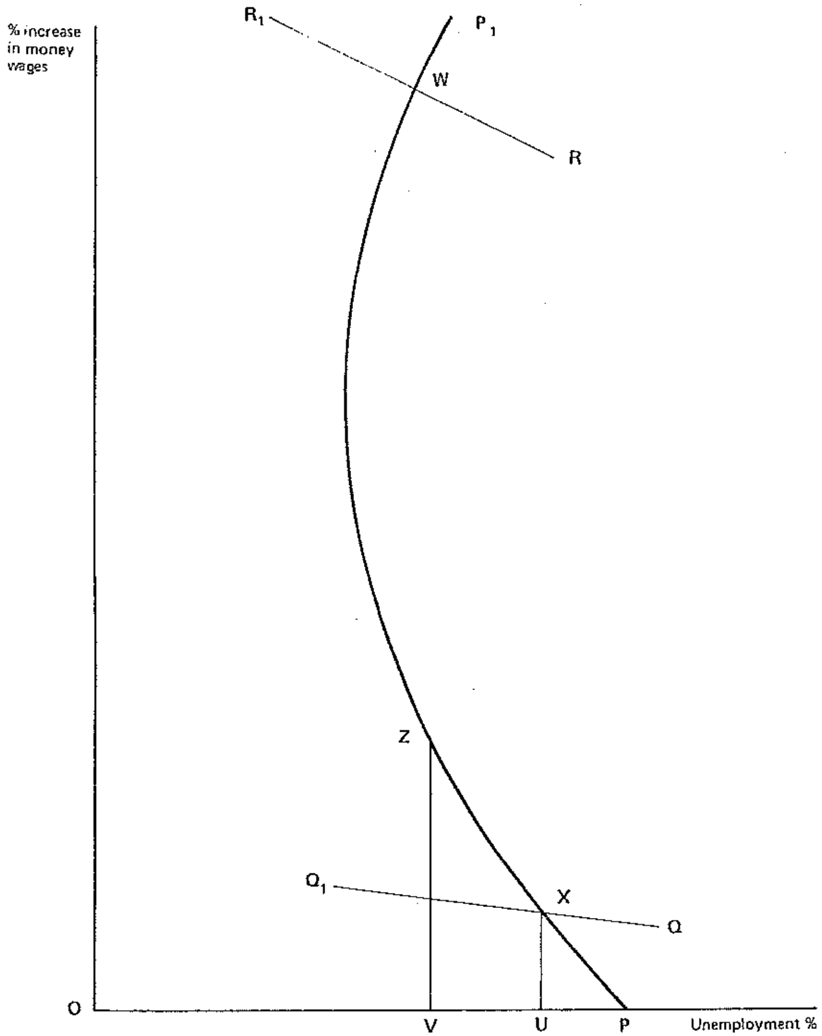
increase in the inflation rate than proves to be the case. They are then in the unenviable position of having to tolerate a higher rate of inflation than they bargained for if they wish to keep unemployment at the new level. There is likely to be a compromise, and a temporary resting place may be reached higher up the long-term Phillips Curve with unemployment a little less than before the demand boost, but inflation much higher. In view of the low short-term inflationary costs there is in due course likely to be another demand boost, followed by a move to a still higher inflation rate. There will be an unfortunate learning process as people become accustomed to higher rates of inflation and eventually become prepared to tolerate a faster increase in the general price level than would have been 'politically possible' to contemplate in the earlier stages.

At very high rates of inflation the long-run relation between unemployment and inflation is likely to become perverse. The political temptation to resort to price controls and other anti-profit policies becomes difficult to resist. Illusory paper profits arising from inflation are taxed; and, price control aside, there is a lag in adjusting corporate pricing policies to inflation. Thus real wages and taxes pre-empt a larger proportion of corporate output, and the amount of employment it pays to offer – or is possible to finance – declines. As rapid rates of inflation are in practice also uncertain rates of inflation, and likely to be punctuated by periods of severe credit stringency, the capital market will dry up for long periods at a time so that fixed investment becomes riskier. Thus, whatever may be the case with a textbook stable rate of rapid inflation to which everything is perfectly adjusted, in the real world very rapid inflation brings with it higher unemployment,

We are then in a position we should never have reached. To improve employment prospects, as well as for other reasons, it is essential to reduce the rate of inflation. But to do so will involve a substantial transitional increase in unemployment. We can settle for higher rates of both unemployment and inflation, hoping to stabilize the position with indexation. Alternatively, we can try shock treatment – or hope for good luck from the outside world – which may alter the position of all the curves on the chart.

If the reader suspects that the whole apparatus of Phillips

Chart 12 Short and long run Phillips curves



Because the short-run Phillips curve Q_1Q is fairly flat, it looks as if it is possible to reduce unemployment from U to V at a very moderate cost in wage inflation. But if the authorities are determined to keep unemployment down to V, they will have to be prepared to let wage inflation rise to Z, thus moving along the long-run Phillips curve P_1P_1

At the much higher rate of inflation represented by W, the only way to secure a permanent reduction in unemployment is to reduce the rate of wage inflation. But this can only be done at the expense of an increase in transitional unemployment bv moving to the right along the upper short-term Phillips curve R_1R.

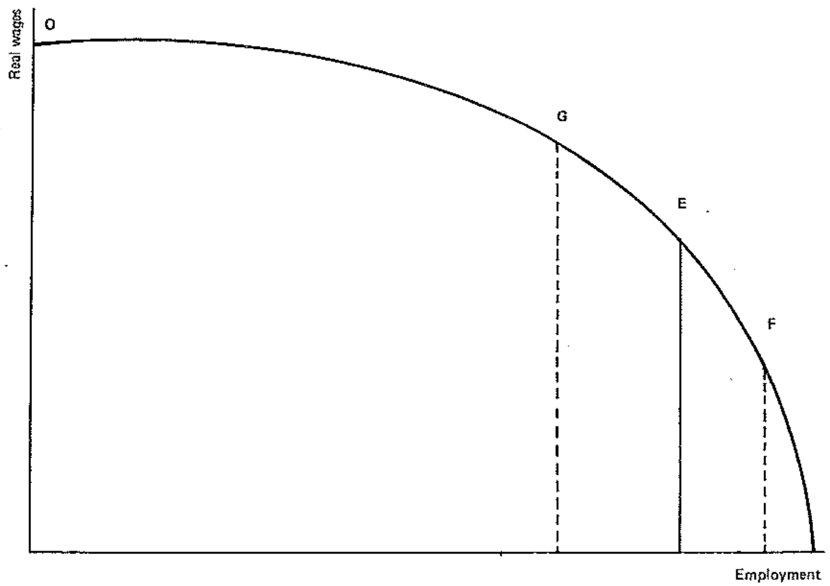
Curves is not very useful for policy, he will find me in cordial agreement. There are not just short- and long-run Phillips Curves, but innumerable ones depending on the time-scale in mind. All the curves shift in position: the shorter-term ones shift because of the effects of price expectations; the longer-term ones shift because underlying labour market conditions change too frequently for their position to be established or to remain unaffected by attitudes, confidence factors and 'structural' policies. Moreover preoccupation with the Phillips Curve can lead to a diversion of energy into unreal problems.[12]

The Phillips diagrams are a useful way of illustrating the effects of labour markets on wages, showing why the effects of demand boosts on employment tend to wear off unless repeated in ever increasing doses, and explaining why high unemployment can coexist with rapid inflation. But if we are not bothered by these problems, or are no longer puzzled by them, it would be better to jettison the Phillips Curves as the scaffolding is dismantled after the erection of a building.

There is, I now believe, a much simpler way of looking at these matters which can also be illustrated by a diagram. Chart 13 simply plots the relationship, discussed in earlier chapters, between *real* wages and employment offered. This is no more than the elementary schoolboy's demand curve showing that the lower the price of a service, the more of it will be bought. The point E indicates a representative real wage associated with a 'normal' level of employment. If anything happens, such as an unanticipated inflation, which causes workers to be prepared (temporarily) to work for lower *real* wages, employment is boosted to point F. Now let us suppose, to take a contrary example, that they are aware of the available real wage E but become dissatisfied with it, perhaps because it has fallen from previous levels owing to an adverse movement in the terms of trade. If trade unionists stick out for a level of real wage such as G, they will price themselves out of jobs so that abnormal unemployment results. Inflationary policies may make them, for

12 Should the need to adapt to an adverse shift in the terms of trade or to a change in energy prices be regarded as a shift to the right in the long-run near-vertical curve or an upward shift in the short-run curve on which we happen to be? This bothered me for too long!

Chart 13 Real Wages and Employment



a time, believe that real wages are rising, but not indefinitely. In the end, they must either accept the real wage employers can pay them, or improve their contribution to production so that it is worth a higher real wage to employers, or face the prospect of unemployment. I am sorry to end up with these dreadful copybook maxims; but they happen to represent a large part of the truth, and (expressed perhaps in a slightly different language) would apply under any economic system, capitalist or not.

7. Britain's Record on Inflation and Unemployment

The main argument of this *Paper* has been that governments cannot fix the level of unemployment at any level they like, except for a while at the expense of accelerating inflation. If governments believe the opposite, and if in addition the minimum sustainable rate of unemployment has increased as I have argued, what pattern of events would we expect to see? The certain result would be at least a long-term acceleration in the rate of inflation, and probably also an upward trend in unemployment.

Contrasts in prices and unemployment

This has certainly been the British experience over periods long enough to allow for cyclical influences. Retail prices rose by an annual average of over 5 *per cent* between 1948 and 1953, a phase covering both the Korean War and the removal of post-war subsidies. But these shocks were eliminated fairly quickly at fairly low unemployment cost; and over the 14 years from 1953 to 1967 the British inflation rate hovered round an average of 3½-4 *per cent* with a slight tendency to accelerate in the second half of the period. Over the period from 1967 to 1973 (before the oil price explosion had any perceptible effect) the average rate of increase was 7 *per cent* and in 1973 reached 12 *per cent.* By the end of 1974 the rate of inflation had reached 20 *per cent,* an acceleration which could not be blamed entirely on 'oil'.

There were in fact also pronounced increases in the rate of price increases in other industrial countries, but the U.K. remained consistently above average in this league table. There was a further difference. From the end of 1962 to the end of 1969 the industrial world's unemployment rate was abnormally low, while in the U.K. it was on a slightly rising

Table 9 How Inflation Rates Vary

Consumer prices % changes at annual rates

	Average 1961-71 pa	1972	1973	12 months to Dec 1974	Latest* 12 months
OECD Weighted Average	3.7	4.7	7.7	14.1	12.8
USA	3.1	3.3	6.2	10.8	11.1
Germany	3.0	5.5	6.9	5.9	5.8
France	4.3	5.9	7.3	15.2	13.9
Italy	4.2	5.7	10.8	24.5	23.3
Japan	5.9	4.8	7.6	21.9	13.9
UK	4.6	7.1	9.2	19.1	21.7†

These figures show how after the final collapse of the fixed exchange rate system early in 1973, some countries began to deviate far more from both the US and the average international inflation rules than they had done in the past, with Germany falling well behind and Italy, Japan and UK racing ahead.

† To April 1975

Source *OECD, Economic Outlook* December 1975 *To Feb 1975

trend up to the end of 1966 and from then onwards rose more sharply (over the average of a cycle). This suggests that the minimum sustainable rate of unemployment was rising in this country; and the persistence of the authorities with conventional demand management, which did not allow for this change, had a great deal to do with the acceleration of British inflation.

Is Minimum Unemployment Rising?

It is interesting that, despite the steepness of the world boom of 1972-3 and the degree of overheating it generated, world unemployment rates did not fall as much as might have been expected. The O.E.C.D. estimated that, in a sample of advanced industrial countries, unemployment was 1 *per cent* higher than at a similar stage of the previous cycle.[1] Part of the reason may have been the sheer rapidity of the boom. If the same

1 *Economic Outlook*, No. 14, December 1973, pp 32-33. The countries in the sample were Canada, Netherlands, U.K., U.S., France, Belgium and Finland.

change in output, relative to trend, had been spread over a longer period, there would almost certainly have been less overheating and less acceleration in wages and prices.

But I doubt if this provides the complete explanation. Without some change in the structure of the labour market unemployment would surely have fallen further under such intense demand pressure. It looks as if some of the same influences which raised the minimum feasible unemployment rate in the U.K. in the second half of the 1960s were operating in other countries in the first half of the 1970s. The O.E.C.D. mentions, for instance, the increased availability of social benefits in Canada and the Netherlands, demographic changes in the U.S. labour force, and a variety of possible structural explanations.

The most puzzling aspect of the record is that the U.K. could maintain such historically low average unemployment rates throughout the 1950s and the first part of the 1960s, together with a moderate non-accelerating rate of inflation. If wage increases depend both on the state of the labour market and on the expected take-home value of the pay packet, the latter component was certainly favourable. In the heyday of the 'Never had it so good' period during 1952-1959, output rose by 20 *per cent* but personal disposable incomes rose by 28 *per cent*. The two main reasons for this piece of good fortune were an unusually sustained improvement in the terms of trade and the rundown of the large Korean defence programme – the first a temporary, and the second a once-for-all, source of gain.[2] The structure of the labour market, including the costs of being unemployed, was also very different during that period for reasons discussed extensively in Chapter 4. But I suspect that both organized and unorganized workers, still suffering from 'money illusion', did not fully take account of the 3 *per cent* creeping inflation, and accepted jobs at lower real wages than they could have obtained in the prevailing state of the labour market.

2 See S. Brittan, *Steering the Economy*, Pelican 1971, pp 424-7

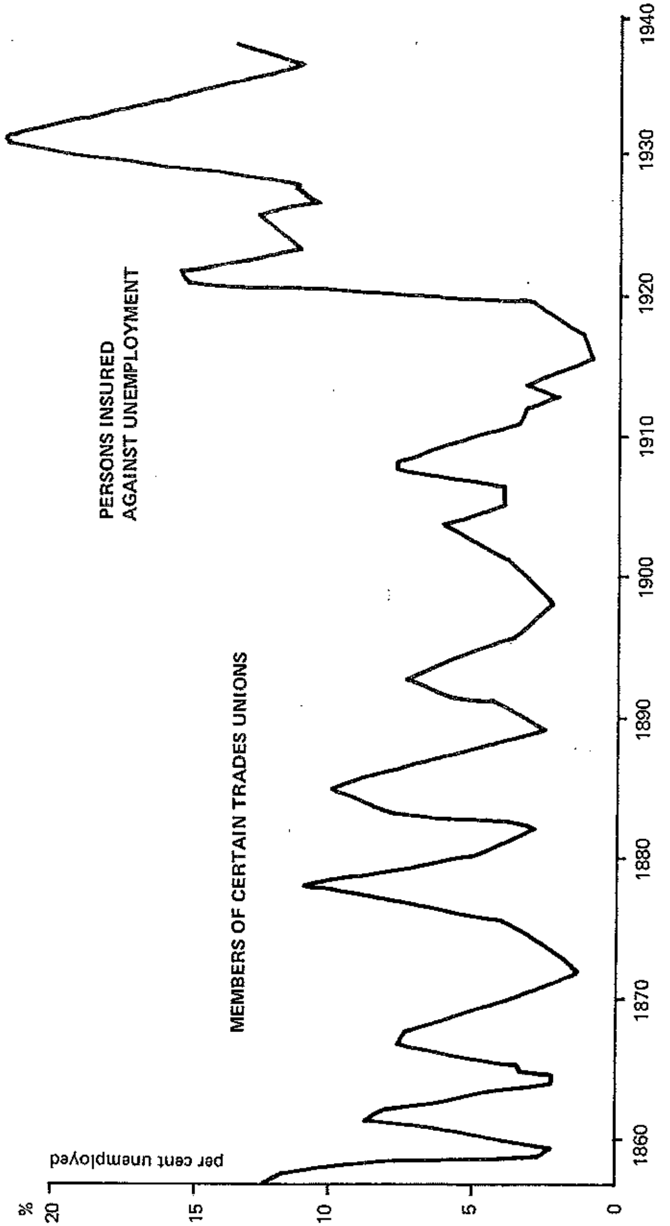


Chart 14 Unemployment in Great Britain 1858-1938

Source Employment Policy HMSO 1944

Historical Foretaste?

Finally, on the historical record, I cannot resist reproducing Chart 14 of U.K. unemployment from 1860 to 1940, despite all the imperfections of the earlier figures. It is clear that unemployment was abnormally high in the inter-war period (for reasons connected with the return to gold at the wrong parity in 1925 as well as the Great Depression). But, compared with the half-century from 1860 to 1910, the two decades following 1945 would appear to be marked by an unsustainably low unemployment level hovering around the lower end of the 0–5 *per cent* range. The result has been an accelerating inflation, the reaction to which – in conjunction with labour market changes – has pushed up average unemployment levels towards the 5 *per cent* mark around which the figures fluctuated for the half-century up to World War I.

We may hope that we will be spared repetition of the wide fluctuations around that level experienced in the 19th century, which may have been exaggerated by the use of an index of union members heavily concentrated in the highly cyclical capital goods industries. The remarks earlier in this *Paper* about the changing meaning of the unemployment percentages should prevent anyone from taking the exact figures in this historical sketch too seriously. But as a thumbnail picture it may not be too far off the mark.

8. The Graven Image of the Balance of Payments

The inflationary impulses which have produced temporary phases of excess demand and abnormally low unemployment, followed by price explosions and higher unemployment, have clearly been international in origin. The biggest single influence has been the fluctuations in U.S. monetary policy, which have transmitted themselves to the rest of the world through the inflow of dollar reserves into countries linked with the dollar. This link has been lessened, though not yet broken altogether, by the adoption of 'managed floating' early in 1973.

'Tell It Like It Is'

Recognition of these international influences should be sharply separated from the obsession with the balance of payments which has dominated British discussion of policy for so long. The conventional answer given by most politicians, officials and mainstream economists to the question 'Why can't the Chancellor expand demand to reduce unemployment to some target level?' is 'Because of the effects on the balance of payments'. The mechanism by which excessive wage settlements are said to price workers out of jobs is also explained in terms of export costs on world markets.

It is probably the case, as a matter of expediency, that a Permanent Secretary has a better chance of persuading a Chancellor to refrain from increasing monetary demand by flesh-creeping references to the balance of payments and the possible 'collapse' of sterling than by any argument about accelerating internal inflation. This may also be an easier line to put across to Parliament and on television, if only because the tune is so familiar. It is nevertheless neither quite true nor quite honest. In the not-so-long run it may be better to 'tell it like it is'. The story about disaster through pricing ourselves

out of world markets has already been told too often to carry conviction. There were such warnings as long ago as the 1954 Economic Survey at the height of the Butler boom, not to speak of the still earlier and sterner warnings of the Crippsian period.

Governments can always create a payments deficit by supporting the pound, from the reserves or borrowed funds, at a higher exchange rate than it commands on world markets. If the price of any commodity is pegged above its market level there will be a surplus; if it is pegged too low there will be a shortage. This applies to sterling no less than to butter or sugar, although money obviously has many characteristics which distinguish it from these commodities.

Case for Clean Floating

Why then cannot the government reduce unemployment to any desired level and deal with the payments consequences by allowing the exchange rate to depreciate? The most fashionable answer today is that it would be inflationary to do so. This is, of course, the wrong way round. It is inflation which causes a supported exchange rate to become overvalued; supporting the exchange rate is a way of suppressing the symptoms by insulating import prices from the effects of domestic inflation. Admittedly, if the exchange rate is held sufficiently far above its market value, a sudden drop in the rate can give a new impulse to inflationary expectations (as with the 1967 devaluation) which must increase the problems of domestic monetary management. This is an argument for free or 'clean' floating, not for persisting with a policy that will make the eventual shock all the greater. [1]

There is, however, no need to dispute the official argument for my present purpose. If it is argued that the main reason for limiting internal demand is to prevent a sharp fall in the exchange rate, and that this fall would be undesirable because it is supposed to be inflationary, then my essential point has been conceded. The ultimate reason why 'demand' cannot be increased to any desired level is that it would risk setting up a runaway inflation which would ultimately undermine employment itself.

1 The hoary old fallacy that exchange rate changes 'don't work' is exposed in my book: *The Price of Economic Freedom*, Macmillan, 1970.

If a single country has a current account deficit higher than it can safely finance, real domestic demand has to be held back by tight fiscal and monetary policies to release resources for the balance of payments. An exchange rate depreciation then makes it profitable to transfer the resources released from the domestic market to both exports and import substitution. This combination of policies provides the best chance of keeping unemployment down to the minimum sustainable level – which will itself probably be higher than before because of the need to make a large shift in the use of resources in a short period. The biggest danger of prolonged and excessive unemployment above the feasible minimum does not come from 'monetarism' or scepticism about conventional full employment policies, but from maintaining an artificially high exchange rate. This was true in early 1975, as it was during the previous Labour Government's fight to preserve an overvalued parity in 1964-7. Indeed, the fondness for overvalued parities is a recurring theme in British history, going back to Ramsay MacDonald's defence of the parity in 1929-31, to Winston Churchill's return to gold at the wrong parity in 1925, and even to Robert Peel's resumption of gold payments in 1819-23.

9. Some Concluding Thoughts

The main conclusion of this *Paper* is that the post-war approach to full employment policy has run its course and that we need to look at the subject in a new way. Discussion about the 'pressure of demand' or 'target level of unemployment' as criteria for economic policy has now become a dangerous diversion. Although perverse monetary, fiscal and exchange rate policy can make unemployment unnecessarily high, we do not possess the power to choose any desired level of unemployment at will and maintain it by demand management. The attempt to 'manage demand' to secure a wishful and pre-determined unemployment percentage will not succed in its object, but will risk setting off an accelerating inflation – and would do so even if the trade unions did not exist. Other methods must be tried if unemployment is persistently excessive.

Look to Obstacles and Incentives

A shift from the *simpliste* approach to full employment is in any case likely. The only question is whether we make a deliberate move to more fundamental economic and social objectives, or whether we are to remain so attached to once-radical orthodoxies that we are swept impotently along by events. If we wish to take lasting measures to improve the unemployment situation we must re-examine the forces impeding the successful operation of the labour market, such as inadequate training, obstacles to mobility, insufficient information on job opportunities and the location of potential workers, and trade union and other rigidities which prevent relative wages responding to changes in supply and demand. It is not the object of this *Paper* to outline a complete labour market policy, but to explain why there is no short-cut through 'demand management'.

Even in trying to improve the working of the labour market, it does not follow that the lowest sustainable level of unemployment is necessarily the best or most humanitarian policy. It has already been mentioned that the reintroduction of the Press Gang or the abolition of unemployment pay would lower the unemployment rate. Neither is recommended. The Employment Protection Act, apart from establishing legal privileges for union monopolies, is, in its provision for uniform local pay norms, potentially the biggest *employment destroying* force on the horizon. (See pp 62-3). Its drastic amendment is recommended.

On the other hand, there have been desirable measures, such as the abolition of the wage-stop (limiting social security payments to a person's normal earnings when employed), which have probably raised the unemployment rate. Some 50,000 working families were below the Supplementary Benefit level in 1972; and the experience of earlier years would suggest that perhaps 250,000 were no more that £2 above it. There can be little doubt that the abolition of the wage-stop would have been a disincentive to work for some of the 300,000 concerned or, to the extent that it caused employers to raise wages, would reduce the amount of work on offer. One may believe that the social gain will now be worth the loss of output. But those of us who take this view should recognize that, as with other worthwhile reforms (such as earnings-related unemployment benefits), one likely result is to raise the percentage of registered 'unemployed'. An uncritical preoccupation with minimizing statistical unemployment is as much the enemy of enlightened social measures as of sound economic policy.

A more difficult issue is the high level of payments, compared to previous earnings, which can arise in the early weeks or months of unemployment as a result of the combination of earnings-related benefit, tax rebates and lump-sum redundancy compensation. If the system were biased the other way, with less help for the short-term and more for the long-term unemployed, the unemployment rate would almost certainly fall as a result. The benefits would then be concentrated on people who were more difficult to fit into the labour force, and whose unemployment was to a larger degree involuntary — while the more readily employable would have an incentive to

find a job quickly. I would personally not be willing to go too far along this road because dismissal from a job (and even in some cases 'voluntary' departure) is a financial and psychological shock, and it is neither humane nor in the national economic interest to force people to take the first job offered.

An element of unintentional discrimination in favour of the short-term unemployed compared with wage earners arises, however, from the fact that unemployment benefits are not taxed. Even earnings-related benefits are not so generous that they would attract appreciable tax on a weekly basis. But what can put an unemployed person in a favourable tax position is the 'cumulation' of earnings over a year. This means that of two people receiving the same annual sum, a person who has a mixture of taxed earnings and untaxed social benefits can be in a better position than another relying wholly on taxed earnings. It would surely be reasonable to put the two men on a more equal tax footing. One method would be to tax benefits. Another would be to abolish 'cumulation' (as in the Conservative tax-credit scheme) so that tax is paid on a weekly or monthly basis with no subsequent refunds (except rectification of errors).

Subsidizing Young or Old?

Larger issues are raised by the proposal by Santosh Mukherjee for subsidizing 'jobs in the community' for those in the under 25 and over 60 age groups.[1] The former group makes up about 23 *per cent* of the unemployed and the latter about 14 *per cent.* Their combined total of 37 *per cent* is far higher than the proportion their age groups bear to the total of population of working age; and there may be a case for regarding them as an 'outer labour market' in some ways different from that of workers in their prime.

1 *There's Work to be Done,* Manpower Services Commission, 1974. It is a pity that Mr. Mukherjee weakens the force of his own analysis by his insistence that unemployment arises basically from demand deficiency and that labour market reforms are very much a second or third best. One also looks in vain for any recognition of the relation between real wages and the employment opportunities available to people of differing skills and aptitudes.

Mr. Mukherjee advocates that people in the outer labour market should be able to opt for community projects of their own choice and organization, and receive 50 *per cent* above the normal level of security benefits from the state. It might indeed be possible to design such a scheme so that it cost less than £100 million a year and reduced the statistical unemployment rate. But this does not establish a case for it. The danger is that young people would have an artificial deterrent to train for jobs which the community really wanted – in the direct sense that it was willing to pay for them. When so many marketable skills are still in short supply in most years, is this really the time to attract young people into glorified dead-end jobs?

The case is stronger for the 60-year olds. It is certainly better that those just below (or for that matter above) pensionable age should have an opportunity to lead active and useful lives than be passive recipients of social security payments. There might be a case for extending any special scheme to the young in the high unemployment areas during a deep recession (when other opportunities are not available), automatically terminating it with economic recovery. Even then, however, why limit the scheme to non-profit activities for which no-one outside government will pay? If we are to proceed along these lines there is more to be said for wage subsidies for workers over 60. The difficulty would be to prevent employers deliberately sacking their existing older workers and taking on others in receipt of the subsidy. But the principle of subsidizing older or disadvantaged workers to increase their employability at going wage rates and so reduce the burden on social security is worth exploring.[2]

Travelling, Training and Moving House

Encouraging the mobility of labour, occupational and geographical, is a more orthodox way of reducing unemployment. Yet small shifts of work location still come up against all kinds of barriers. When 2,000 workers became redundant at Upper Clyde Shipbuilders in the two years before the 1971 crisis and attempted liquidation, Scott Lithgow on the Lower Clyde were short of workers but received very few applications from the former U.C.S. employees.[3] It is not clear whether the obstacles were inadequate transport, unwillingness to move home, or an unwillingness of U.C.S. workers to retrain for the skills required at Scott Lithgow. Nor do we know why only 4 *per cent* of the redundant U.C.S. workers applied to a Government Training Centre (nor why the success rate there was negligible); nor why the possession of some existing skill was considered a sufficient reason for not applying. Nor do we know the role of unions at shop-floor level in discouraging changes of skill in adult life. All these are examples of questions the new Manpower Services Commission might profitably investigate.

The provision of training is an activity where the 'invisible hand' clearly needs to be supplemented, because an employer knows that a high proportion of the men and women he has trained will leave and a large part of the gain will 'spill over' to others.[4] But present Training Board arrangements have failed to remove the cobwebs from this neglected part of the educational system. The Chancellor announced more funds for training in his April, 1975, Budget. Meanwhile, the latest Manpower Services Commission estimate of 100,000 as the maximum number of training places in prospect compares abysmally with Swedish provision where, in a country with a seventh of the British population, 79,000 people were in 'training or public employment programmes' in 1973.

Even here a word of warning is necessary. Without some labour surpluses at some time or in some areas to offset shortages in others, there would be no brake at all on the continuous acceleration of wage inflation. Payments to workers in training reduce the force of that brake; and for a given anti-inflationary goal we require a larger total of unemployed plus trainees than

2 Such subsidies have been proposed in the U.S.A. for 'disadvantaged' workers generally. See articles by Feldstein and Thurow in the Fall, 1973, issue of *The Public Interest.*

3 See *Labour Market In Crisis,* by Frank Herron, Macmillan 1975, and the review in *The Economist,* February 8 1975.

4 In a properly functioning economy the worker would probably finance his own training from loans, which would give him more control over the quantity and quality of the training. But this proposition can hardly be put forward for the industrial worker so long as it is ruled out of court for students who have a higher lifetime income expectancy.

of unemployed alone before the training scheme was introduced. To the extent that training programmes provide alternatives to unemployment, it is important that there should be a substantial gap for most people between what they are paid in them and what they can earn in a normal job.

Successful regional policies do help keep the sustainable rate of unemployment down by securing a closer geographical match between jobs and available workers. A point can, however, easily be reached where the extra gains from fuller utilization of the labour force are more than offset by the losses from high-cost and inconvenient locations. Although it may be possible to improve their form, I doubt if it is wise to 'intensify' (*i.e.* spend more on) such policies. The time has surely arrived to re-examine the impediments to geographical mobility which arise not from any sentimental attachment to home, but from the paralysis in the market for rented dwellings. Rents pegged far below market values impose a double cost on mobility: the loss of a valuable property right in the old location and the extreme difficulty of finding accommodation in the new.[5] Even for those who can afford house purchase, inflation imposes a very heavy mortgage burden in the early years — which could be spread more evenly if indexed mortgages were available.

Minimising Cost of Reducing Inflation?

This *Paper* has so far not been concerned with immediate issues of economic strategy, which are liable to fade into history all too quickly. Is there nevertheless anything that can be said about the current problems of 'inflationary recession'?

Most contemporary discussion of unemployment confuses two different unemployment levels: the level of unemployment which could be sustained without causing an acceleration in the rate of inflation; and the (higher) transitional unemployment which might accompany the reduction of present inflation to an acceptable rate. Similarly, there is confusion between

5 For one or two ideas for improving tenant mobility see my Hobart Paper, *Participation without Politics*, Institute of Economic Affairs, April 1975.

inflation and the rate of change of inflation. There is in fact no choice between a high rate of inflation with a low rate of unemployment, and the opposite state of affairs. It is only if we are prepared to tolerate an *increase* in the rate of inflation that we can have in return a temporary reduction in unemployment; and it is only a *decrease* in the rate of inflation that requires a temporary rise in the unemployment total above the sustainable level.

How then can we minimize the intensity and duration of this transitional unemployment? Unfortunately, there is very little that can be said in general terms. There have been drastic reductions in the rate of change of prices which have involved little or brief transitional unemployment. There have been other episodes where moderate reductions have required high and prolonged transitional unemployment. The large fall in the U.S. price level in 1865-79, associated with the return to gold convertibility, brought little unemployment and was associated with the fastest rate of economic growth of any decade in U.S. history. In France in 1925 the inflation rate was reduced sharply with little extra unemployment. In the U.K. in the 1920s, on the other hand, the desire to return to the pre-war gold parity required a 10 *per cent* decline in prices which led to high and prolonged unemployment. In 1974-5 attempts in the U.S.A. and continental Europe to reduce the rate of increase of prices from double-digit to single-digit percentages required increases in unemployment which were sharp by post-war standards.

Experience after the great German hyper-inflation of 1919-23 was complicated. The complete destruction of the old currency itself led to massive unemployment. Currency reform at the end of 1923 was followed by a big improvement in employment and production. There was a sharp, short recession in the middle of 1924 when the Reichsbank curbed credit to make the currency reform stick. Employment then returned to normal levels; but there was then another bad slump which lasted for about a year in 1925-6, associated with the liquidation of businesses which had mushroomed in the inflation, followed by a quick recovery which lasted until the onset of the international depression.

Perhaps the most favourable recent episode was the de

Gaulle-Pinay measures taken at the end of 1958 to stabilize the franc, involving both financial curbs and a devaluation. This led to a reduction in the annual rate of increase of consumer prices from 16 *per cent* in 1957-8 to 4 *per cent* in 1959 and 3½ *per cent* over the average of the succeeding four years, at the expense of a negligible increase in unemployment and accompanied, after a mild one-quarter downturn, by a boom in industrial production.[6]

Wage Demands and Unemployment

'How large and how long would be the transitional unemployment required to conquer our present inflation?' is not a question which can be answered by anything resembling scientific calculation. The de Gaulle example underlines that the answer depends largely on leadership, personality, presentation, psychological atmosphere and general confidence. It is odd that politicians who normally stress precisely these aspects should be so insistent on a calculation which, in the nature of the case, cannot be provided even approximately.

Whether or not the unions have a large role in the generation of inflation, their resistance to reduction in the growth of money wages can increase the intensity and length of the transitional unemployment required to restore price stability or to reduce the inflation rate to a tolerable level, even to a point where such stabilization efforts are abandoned or reversed. (In both France in the later 1950s and in Germany at the time of the currency stabilization the trade unions were weak for a combination of political and industrial reasons.)

The acceleration of the rate of increase in prices up to 1974 in countries with very different degrees of unionization, union militancy, and wage bargaining systems is evidence that union monopoly power is much less important than I once thought in the generation of inflation – even by the indirect route which

6 Sources drawn upon in these paragraphs include I.E.A. *Inflation* (Readings 14,) 1974, especially Professor Friedman's remarks on p 96; C. Bresciani-Turroni, *The Economics of Inflation* (a study of German experience), third English impression, Unwin 1968; O.E.C.D., *Main Economic Indicators*, Historical Series, 1955-71; and O.E.C.D., *Inflation, A Report*, December 1970.

'monetarist' economists would concede as a theoretical possibility. On the other hand, the U.K. has clearly had especial difficulty in reducing its inflation rate; and there are signs that most other countries will be back to single-digit inflation rates in the present cycle, after nothing more than a short sharp shock on the unemployment front. Both these phenomena suggest that union power and behaviour do have an influence on the ease of the descent to lower inflation rates.

Although I have no magic formula for reducing union monopoly power or changing union attitudes, we can start by avoiding certain unnecessary policies which increase the obstructive power of unions – and therefore the unemployment cost of any given anti-inflation goal. There is the well-known fact that the U.K. is one of the few countries to subsidize strikes by social security payments to strikers' families. If these payments were transformed into loans, recoverable through the tax system, the government would not be vulnerable to the charge of 'starving the workers into submission'. But of at least equal importance are the tax rebates, already discussed. The least provocative method of eliminating them would be to change from the cumulative to the pay-as-you-go system in the administration of PAYE.

One of the strongest encouragements to unions in resisting anti-inflationary monetary policies is probably, as Wilfred Beckerman, has pointed out,[7] repeated assertions by Ministers that all employment is sacred. In the winter of 1974-5, the Prime Minister and Chancellor seemed at the same time to be warning unions against pricing members out of jobs whilst assuring their listeners how they had rejected 'deflation' or any thought of allowing unemployment to be used as an anti-inflationary weapon. The Secretary of State for Industry even went so far as to imply that he would intervene wherever he could to save jobs threatened by redundancy, irrespective of causes. Such statements – by encouraging union leaders to think that they will be bailed out if they price their members out of jobs – must increase the unemployment consequences of any degree of effective monetary restraint. So must 'rescue

7 "How Sacred is Full Employment?", *New Statesman*, November 1, 1974.

operations' such as that announced for British Leyland. Paradoxically, leaders who have given sound money top priority irrespective of the unemployment consequences, like Dr. Schacht in 1923-4 and General de Gaulle in 1958, and who manage to retain political credibility, stand a much better chance of avoiding unemployment than the conventional politicians who parade their concern about it.[8]

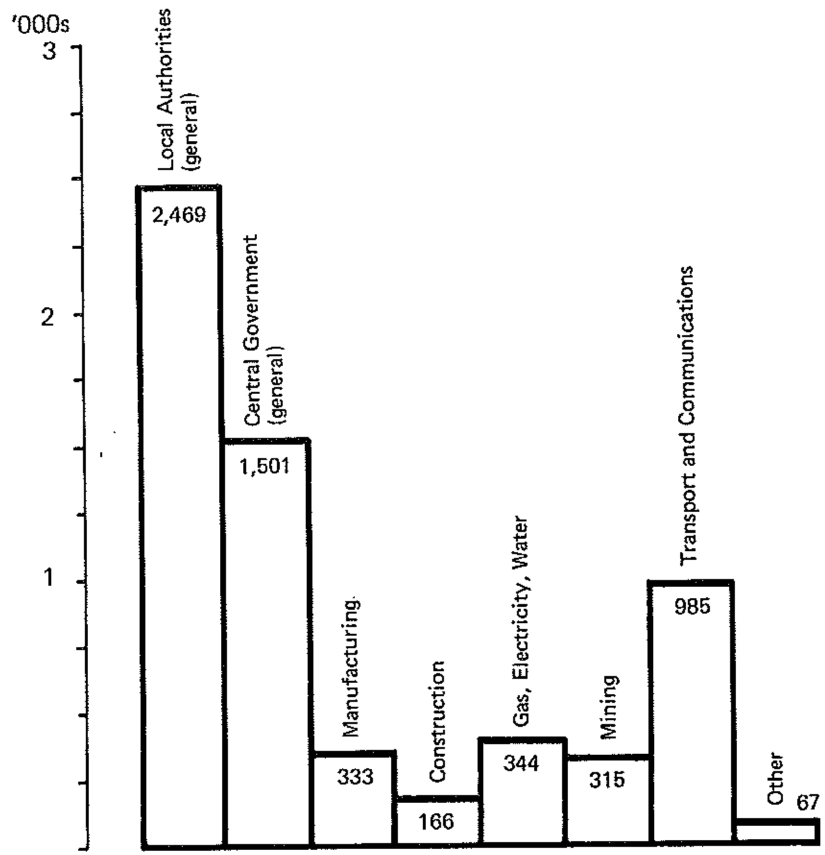
Public Sector as Pace-setter for Inflation

Another important factor, which increases the unemployment cost of a reduction in the rate of inflation, is the size of the public sector and its comparative insulation from market forces. On the latest count, it comprized in Britain 27 *per cent* of employees outside the Armed Forces. The insulation varies in kind and degree. Employees of the nationalized industries are, in principle, liable to price themselves out of jobs by insisting on excessive wage increases (or to price other people out of jobs where the elasticity of demand is low and the consuming public has less money to spend). But the knowledge that a subsidy (perhaps labelled 'temporary') could always in the last resort be provided must influence bargaining attitudes. A declared policy of directly passing on in prices the cost of all nationalized industry settlements might marginally affect both the bargaining atmosphere and the attitude of public opinion to strikes in the state sector. But I am pessimistic whether such a policy would stick in the face of short-term political temptations to keep down the retail price index in 'special case' situation.

The attitudes of the six million workers shown in Chart 15 as employed by public agencies – whether consultants, dustmen, teachers, coalminers or officials – is surely influenced by the

8 Indeed once hyper-inflation is reached and the velocity of circulation itself starts increasing rapidly, there is no alternative to such shock tactics. Even a total freeze on the money supply will be no good at that stage. What is by then all-important, as the so-called 'miracle of the Rentenmark' showed, is to convince people that new money will not be created in the future beyond announced limits, irrespective of the tensions, crises or bankruptices that such a refusal might engender. I am not necessarily prescribing such a policy; I am simply saying that, if the rate of inflation carries on escalating from one cycle to the next, we will reach a situation where there is little choice in the matter.

Chart 15 Public sector employees, June 1973



Total Public sector	6,180
Private Sector	16,482
Total employees in employment	22,662

Source: Economic Trends Jan 1975

knowledge that their employer has no profit-and-loss criterion to meet and can draw on the taxpayer or the printing press. This insulation from payroll considerations is very much increased by the practice of controlling public expenditure in 'real terms' – which counts an increase in the numbers employed, but not an increase in pay per head, as a rise in expenditure. Thus the normal trade-off between the two is weakened in the public services. A worthwhile reform would be to go back to controlling spending in current money rather than in 'funny' money. Overspending which reflected unexpected increases in the general price index might still be permitted, but not overspending resulting from differential cost increases facing a particular department or organisation.

The adverse effects of the size of the public sector go still deeper. The basic evil is that industrial and commercial decisions become political issues.[9] The political battle is not so much with the government (as appears on the surface), but with other groups of workers. Because of the more formal and centralized public pay arrangements, the unpublicized shop-floor adjustments or local variations by which market forces can be recognized covertly in the private sector are effectively barred. Above all, considerations of face-saving become all-important, and the danger of the government being tempted into an unproductive show of strength or suffering a humiliating defeat (or going through both phases in succession) is always present. These considerations alone provide sufficient argument against increased state involvement in industry, whether through equity or subsidy, and for abolishing the statutory monopoly powers of nationalized industries so as to allow private firms to compete with them.

Can the 'Social Contract' help?

The idea of a deal or pact between government and trade union leaders is often advanced as a substitute for the control of monetary demand and the maintenance of an appropriate balance in the labour market. Even those who realize that it can be no such thing may be tempted to support such a pact as an adjunct to demand control and as a means of reducing the cost of transitional unemployment in lowering the rate of inflation.

My view is best expressed by sticking to some passages I had in draft before the February 1974 election was announced, rather than applying hindsight to subsequent experience with the 'Social Contract'.

9 This aspect is a positive attraction for those who would like to 'politicize' most of human life.

The trouble with the pact suggestion, apart from all the many other difficulties, is that each individual union leader has very little incentive to observe it. Most of the gains from price stability and fuller employment spill over to members of other unions and the general public, while the costs of settling for less than he could obtain are highly concentrated among his own members. (This is no more than to say that stable prices and high employment are 'public goods', which by definition will not be provided by the forces of self-interest.)

It is often argued that unions and their members would become less self-regarding in their aims if governments pursued 'social justice' or 'fairness'. At its most primitive level such thinking assumes that 'social justice' and 'fairness' are natural qualities like redness or hardness, which are either present or not. A leading sociologist, Mr. John Goldthorpe, has stressed that there is little consensus on what ought *to determine relative income levels. 'Given the diversity of moral positions that are tenable in the existing state of public opinion, virtually any occupational group seeking a pay increase can find some legitimization for its case!*[10] *But I do not agree with Mr. Goldthorpe's contention that a 'social' incomes policy, consciously tailored to egalitarian objectives, would help to create the missing consensus.*

Why should one suppose that the adoption of any target reduction of inequality (however defined), or of the share of property incomes, would induce greater restraint in union wage claims? The more that policy concentrates on eliminating disparities and differentials, the greater the sense of outrage likely to be engendered by those that remain. Moreover, the smaller the financial contrast between the mass of wage-salary earners and the wealthy minority, the greater the attention that is likely to be paid to relativities among workers. As it is, 90 per cent *of consumer spending comes from wages, salaries and welfare payments, and the annual wage round is to a large extent a contest between different groups of workers for relative shares. It is one of the defects, both of formal incomes policy – with its norms, criteria, exceptions,*

10 'Political Consensus, Social Inequality and Pay Policy', *New Society* January 10 1974.

and regulatory Boards – and of an informal 'compact', that each group becomes much more keenly aware of what other groups are obtaining; and this increases rather than diminishes the ferocity of the struggle.

Most of the plans for 'taxing excessive wage increases' are simply statutory pay controls imposed by different methods, with all the difficulties and dangers of statutory wage controls – plus added administrative disadvantages of their own. (There is one exception, the 'Elkan scheme', which is extremely unlikely to be adopted except in such a bowdlerized form as to do more harm than good).[11] General tax increases to finance cost-of-living subsidies simply suppress the symptoms of inflation, distort the allocation of resources, and are inefficient as a method of redistributing incomes. They are, moreover, most unlikely to reduce the transitional unemployment cost of moving to a lower rate of inflation.

Indexation?

General indexation is highly desirable as a way of mitigating the consequences of inflation. Wage indexation is with us to stay, in the sense that price expectations already play a clear part in wage bargaining. There is nothing to be lost by making their role formal and explicit. But I doubt very much if wage indexation can do much either to reduce inflation or to mitigate the unemployment costs of so doing. The unemployment problem arises because trade unionists are slow to modify their real income demands in line with labour market conditions. Indexation can help on occasion when unions anticipate too much inflation and pitch their demands higher than if they had some cost-of-living guarantee. But these are likely to be balanced by other occasions when they pitch their demands too low because they fail to anticipate future price increases adequately. Cost-of-living clauses or thresholds can be advocated as a way of enabling contracts to be concluded in an

11 The scheme is analyzed and advocated by Maurice Scott in the April, 1974, issue of *The Banker.* Some reasons for political hostility to the scheme in any worthwhile form are given in my article 'The Illusory Dreams of Taxing Inflation', *Financial Times,* January 30 1975.

inflationary age and of minimizing social tension, but not for their effects on inflation or unemployment.

Indeed, it is an open question whether the gradualist approach favoured by many 'monetarists' can succeed, with or without indexation, in taking us down from present rates of inflation to something even remotely approaching price stability. The rate of money wage increases depends, *inter alia,* on the state of the labour market and (for a given tax-take) on price expectations. The gradualist approach involves keeping unemployment higher than the minimum sustainable level for an extended period so that wage increases are reduced. This feeds back into prices and price expectations, and the cycle is then repeated.

This is sensible if we are starting from a moderate rate of inflation which we wish to reduce. It is much more questionable when we are starting from 20 *per cent* or more. To achieve anything remotely approaching price stability might require so many years of demand deficiency and excess unemployment, discouraging business as well as labour, that it would not be possible to see it through to success in a democratic country.

Brazil is often cited as an example of the success of gradualist monetary policy combined with indexation, but it is not a valid comparison. Wage indexation in that country was not voluntary, but was the basis for legal controls over wages imposed with all the apparatus of a police state. Furthermore, the environment was one of rapid growth which gave plenty of leeway for an increase in real incomes.

In the U.K. an indexed wage *freeze* might work for a temporary emergency if the timing were well-chosen. The prospects do not, however, appear promising in current circumstances. Any benefit would be entirely confined to the reduction of inflationary expectations during the period of the freeze – which with tolerably good luck might last six months and extreme good fortune nine to 12 months. It would be most dangerous to combine an indexed wage freeze with an outright price freeze, which would mean asking employers to absorb cost increases in the pipeline at a time when real profits were already perilously low if not negative. The difficulties of holding prices would be increased by the planned removal of nationalised industry subsidies and the probability of a sterling depreciation made necessary by past inflation. Thus the one influence acting to reduce inflationary expectations would be the above-normal unemployment; and we have already seen that this acts slowly in the U.K., while all the other influences would be in the other direction.

An Iron Chancellor?

The over-riding argument against any form of even emergency wage or price controls is that they would lead in practice to a relaxation of fiscal and monetary restraints – because of a feeling that inflation was being tackled in some other way – and thus do more harm than good. The one circumstance in which I would recommend a freeze would be if we had a politically credible Iron Chancellor committed to cutting the Budget deficit and the growth of the money supply sharply, come what may. Even in these circumstances a freeze might not be necessary if employers and unions had already got the message.

Short of such a draconian and unlikely course there is no easy technical way of getting rid of inflation awaiting discovery. The first and most important action for a Chancellor of non-ferrous, but reasonably tough, material should be to announce medium-term fiscal and monetary guidelines restrictive enough to ensure that inflation does not rise *above* its present underlying rate. These guidelines should be observed almost whatever the cost, since any gain to employment or output won by departing from them would be ephemeral in the extreme. Secondly, any piece of good fortune – such as an improvement in the equilibrium terms of trade or a reduction in the proportion of the national income spent by government – which reduces price expectations, or increases the expected value of a given wage packet, should be seized upon to move to new and less inflationary financial guidelines. This should be a one-way street so that bad luck is not used as a pretext to relax them.

It would be rash to be optimistic about even such a modest anti-inflation policy producing moderately quick results – even if it were strictly observed, which is a very big 'if'. In the meanwhile, it would be absurd not to use indexation, inflation-proofing, and constant purchasing power contracts to

reduce the inequities and inefficiences of inflation. To refuse to do so is to continue knocking our heads against a wall in the hope that the wall will go away. Wage indexation will come of its own accord – in one form or another. The main fields for government action are the indexation of the tax system, to stop taxation without representation, and the provision of indexed bonds on a much larger scale than the paltry one at present planned, to prevent people from being defrauded of their new savings as they already have been of their old.

The Real Choice

We have come to our present pass through the pursuit of the noble objective of 'full employment' by the wrong means. We have seized on policies with temporary and fleeting effects, resulting from the slowness of human beings to adapt to changing opportunities, and elevated them into fundamental truths of economics. The new challenge is to provide and extend employment opportunities by means other than manipulating the monetary system. There are many helpful lines of action, some of which will increase and others reduce the present statistical measure of unemployment over a run of years. They should, however, not be judged by any such *simpliste* test, but by their effects on human beings whether included in or omitted from the arbitrary measures of 'unemployment'.

There is a balance to be drawn between increasing total wealth and protecting the victims of change. There is another balance between encouraging people to concentrate their efforts on their own and their fellow citizens' welfare, and state action to provide a decent minimum for those who cannot, or do not wish to, contribute in a conventionally recognised way. I have said enough to indicate that I would draw the balance differently from Samuel Smiles or Gladstone, or even from many who would agree with the principal arguments of this *Paper*. But whatever our personal values, we will stand a better chance of realising them if we can reduce the present obsession with statistical 'unemployment' and face without illusory crutches the real choices and the real problems.

Bibliographical Note

The subject of this *Paper* touches on so many areas of economics – and of history – that it would be absurd to attempt a bibliography. All I can do is to list a few proximate sources which will lead the interested reader to a plethora of further references, which he will have to follow up very selectively if he is not to drown.

There are three main bodies of literature immediately bearing on the subject of the *Paper*: – the critique of 'Keynesian' full employment policies emanating from 'monetarist' studies; the application of the elementary theory of market behaviour to unemployment; and statistical and institutional studies of the British data.

The first of these three streams starts, as far as I am concerned, with Professor Milton Friedman's lecture 'The Role of Monetary Policy' reprinted with a great deal of other interesting material in *The Optimum Quantity of Money,* Chicago, Aldine Press 1969. Professor Friedman's latest summary of the debate can be found, with numerous references to other contributions, in *Unemployment versus Inflation?,* I.E.A., Spring 1975. But probably the most approachable introduction for the general reader is the Institute of Economic Affairs Seminar Report, *Inflation: Causes Consequences and Cures,* Readings 14, 1974.

This work has been further developed and applied to the U.K. and world economy by the Manchester University Inflation Project, directed by Professors David Laidler and Michael Parkin. A brief account of their findings, together with opposing views, and a useful set of definitions by Professor Alan Walters, can be found in the *Ninth Report from the House of Commons Expenditure Committee,* Session 1974, 'Public Expenditure, Inflation and the Balance of Payments'. Some of the more detailed papers are being published in a series of books published by the Manchester University Press:

(a) Parkin and Sumner (eds), *Incomes Policy and Inflation,* (1972).
(b) Laidler and Purdy (eds), *Inflation and Labour Markets,* (1974).
(c) David Laidler, *Essays on Money and Inflation,* (Spring 1975).
(d) Parkin and Zis (eds), *Inflation in the World Economy,* (Summer 1975)

A survey article covering the work is to be published soon in *The Economic Journal.*

The locus classicus for the application of rational market behaviour to unemployment problems is E.S. Phelps and others: *Microeconomic Formulations of Employment and Inflation Theory,* Macmillan 1971. A simpler exposition of these ideas can be found in *University Economics,* A.A. Alchian and W.R. Allen, 3rd edn, Prentice Hall, 1974, which is suitable for students of all ages.

Understanding of British labour market data has been immeasurably advanced by a series of studies instituted by Roger Thatcher, the Director of Statistics at the Department of Employment. Apart from a White Paper on Unemployment Statistics (Cmnd. 5157), published in November 1972, the studies have appeared in the Department of Employment Gazette. Subjects include the duration of unemployment (February, 1973, issue), a new occupational analysis of the unemployed (started in February, 1973), a long-term study of trends in the composition of the unemployed (March, 1973), the flows of unemployment and vacancies (September, 1973, and September, 1974), the results of a special survey of characteristics of the unemployed (March, 1974, May, 1974, June, 1974), a vacancy study (March, 1974), general analyses of the unemployment statistics (May, 1974, and March, 1975) and labour turnover (January, 1975). It is hoped that the *Manpower Services Commission* will ultimately become a major source of intelligence.

A special mention should be made of John Wood who did so much to stimulate the probing of the official statistics in his pioneering *How Much Unemployment?,* I.E.A., 1972.

On the social side I found of special value *Men Out of Work,* M.J. Hill, *et al,* Cambridge, 1973; and there is a good deal of useful information in W.W. Daniel's *A National Survey of the Unemployed,* P.E.P., 1974.

For a much more comprehensive and 'balanced' series of analyses and references the reader should consult *The Concept and Measurement of Involuntary Unemployment* (eds Worswick and Thomas), forthcoming Allen & Unwin, 1975.

At least as important as any of the above is for the reader to familiarise himself with the major and minor inflationary episodes in history, and the attempts to regulate pay and prices from Diocletian to the Black Death and onwards. A highly sophisticated but very readable study of the German experience in the 1920s is Bresciani-Turroni's *The Economics of Inflation,* Allen & Unwin, Third English Impression, 1968.