

File

30 May 1985

MR ADDISON

THE DORNBUSCH LECTURE

I attended this lecture at your suggestion, the first of the Charter for Jobs campaign.

Dornbusch's arguments were in part helpful:

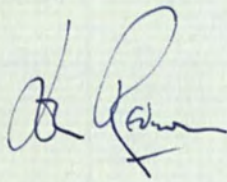
1. He firmly rejected import controls and argued for free trade.
2. He agreed that perhaps 4% or 5% of our current level of unemployment is attributable to micro-economic inefficiencies - the labour market doesn't work after all.
3. He accepts that of all the actions open to Government, the cheapest by far in terms of cost per job created is some kind of Special Employment Measure along the lines of the Community Programme or Benefit-Plus Schemes.
4. He was firmly of the view that sterling's value had to be held, and that to do this money policy had to remain very tight. He was even prepared to countenance a continuing high level of real interest rates to avoid a rekindling of inflation to any great extent.

He was less helpful from the Government's point of view in arguing the following:

1. There was inadequate demand in the economy. He deduced this from taking a 2% per annum trend rate of growth, and drawing attention to the gap between current output and where we would have been had that trend line remained intact throughout the late 1970s and 1980s.
2. To compensate for this lack of demand, he suggested a 3% of GNP fiscal stimulus administered over a 2-year period and then withdrawn. The money would be spent in three ways - tax cuts; Special Employment Measures; and public sector investment.
3. He argued strongly and even more illogically for special incentives for investment. He did not address himself to the problem that, because the UK industrial and commercial sector has been investing so heavily in labour-saving equipment, we have continued to lose jobs from the industrial sector against the background of a reasonable recovery in output.

The lecture was attended by many of the Policy Studies Institute/Charter for Jobs campaigners, and had all the atmosphere of a political programme. There were side digs at the expense of Milton Friedman, Alan Walters and monetarists in general. When asked about the new temptation

for monetarists like Sam Brittan to talk in favour of a national income target rather than a money target, he quipped that it is better to lead a monetarist away from money targets to a nominal income target, if only because then you might persuade him to give up that as well.



JOHN REDWOOD

# Wage Fixing Loses 230,000 Youth Jobs

Stanley Siebert

*The Government has announced its intention to modify, perhaps even abolish, the Wages Councils which help determine minimum pay for the under-20s, and a Department of Employment Consultative Paper has called for views on the potential for improvement in the labour market. Stanley Siebert of the University of Birmingham presents evidence that the Youth Wages Councils combine with union restrictive practices to throw around 230,000 teenagers on the dole.*

No policy is neutral. All policies bring losses to some groups, and gains to others. In deciding among alternatives, the task is to assess for which alternative the gains outweigh the losses. Let us apply this procedure to the question of what rate of minimum wage, if any, should be set by Wage Councils and trade unions.

26 Wages Councils set wage minima for about 2½ million workers, mainly in clothing, catering and retailing. The weekly wage minima they set might seem quite low, between £40 (for 16-year-olds) and £70 (for the highest paid adults). Nevertheless the minima appear to be above the market equilibrium rate, at least for young workers. This is demonstrated by the many young workers who are prepared to enrol on the Youth Training Scheme for only £25 per week. There is also evidence that, since the late 1960s, rises in youth wages have been associated with falls in youth employment.<sup>1</sup> This is consistent with the view that youth employment is now determined by demand (that wages are above the intersection of the supply and demand curves - box). Moreover, the age at which young people are required to receive adult rates (including union rates) has been reduced from 21 to 18 over the years, again increasing the minimum for young workers. The British Government wants a more flexible labour market, and is considering abolishing the Wages Councils.

Broadly two groups gain from higher wage minima, and three groups lose. Those who gain are:

- (a) the workers who remain in work at the new, higher, wage - the higher quality unskilled, married women instead of teenagers, and those with some experience rather than the novices; contrary to the belief in some quarters (analysed below), it is the most 'vulnerable' workers who will lose their jobs first;
- (b) more skilled workers (generally unionised), whose wage and security of employment is less likely to be undercut by cheaper, unskilled, workers as minimum wages are raised.

This might seem a cynical motive to apply to the strong union push for higher wage minima which is generally defended as being in the interests of a 'living wage'. Nevertheless it is logical: how can high

wage minima which disproportionately cause young people from poor backgrounds to face a higher risk of unemployment contribute to a 'living wage'? We might also note that union members have tended to oppose such initiatives as the Youth Training Scheme which tries to price young workers into a job by subsidising their pay, on the grounds that this is a 'cheap labour' scheme.<sup>2</sup>

The groups losing from higher wage minima are:

- (a) workers displaced as a result of the higher wage. They become unemployed, or move out of the labour force, or find work in industries not covered by the minimum. They are effectively forbidden from selling their labour on the terms they wish. In addition, they lose training opportunities. They are forced into an alternative (like taking unemployment benefit) which has a lesser value to them.
- (b) the employers in the industry, whose profits will be lowered. The less efficient of these firms, which would only survive with low rates of pay ('cowboy' employers in union circles), will close down. All firms will cut back on unskilled labour employed, generally by 'doing without', sometimes by using more machinery and/or skilled labour instead. This cut-back will not be large if the firms have some monopoly power, and can easily pass the wage increase on in the form of a price increase. Generally however, this is not thought to be true of industries employing much unorganised labour such as catering and retailing. Indeed, this is one reason why the labour in that industry remains unorganised - because the disemployment effects of a wage increase are too high for 'monopoly profit' to absorb the impact of the union wage;
- (c) the public also lose. Higher wages mean higher prices and/or lower quality of service since catering and retailing establishments do without the lower-grade employees.

The composition of the Wages Councils reflects these interest groups, though it is possible that orga-

<sup>1</sup> This evidence is reviewed in William Wells, 'The Relative Pay and Employment of Young People', *Research Paper No. 42*, Department of Employment, January 1984, p. 51.

<sup>2</sup> Cf., for example, P.O. Faces Union Ban on Youth Training Scheme', *Financial Times*, 15 May 1984. American data indicate that a 10% increase in unionisation causes a 4% increase in wage minima (J C Cox and R L Oaxaca, 'The political economy of minimum wage legislation', *Economic Inquiry*, October 1982, p. 547). In the UK unionisation has increased from 43% in 1965 to 59% in 1979 - suggesting a 12% increase in wage minima if we use the American number. The establishment of Industrial Training Boards in the mid-1960s might also have given more say in raising youth wages.

nised labour is more powerful than the other groups. Both unions and employers have representatives on the Councils; and three independent members might be thought of as taking into account the interest of unorganised workers (both the lucky ones who retain jobs, and the unlucky ones who are laid off). Organised labour is probably most powerful because the only other organised group, the employers, is divided. Some managers of highly unionised firms, whose skill is specific to these firms, would rather have low-wage firms eliminated than see their jobs evaporate due to 'competition from sweat shops'. The power of organised labour is likely to lead to minima being set well above the market rate therefore. Indeed, in America the (national) minimum has even been pegged to average wages in manufacturing which is, to put it mildly, inappropriate. Wage increases in manufacturing reflect the higher productivity growth there, which is not typical of minimum wage sectors.<sup>3</sup>

It is often wrongly thought that the imposition of a minimum wage in some sense defends the living

standards of all unskilled workers. Wages are pictured as falling almost without limit if no floor is placed beneath them. The Director of the Low Pay Unit believes that the consequence of abolishing Wages Councils would be 'not only a reduction in wages for some of Britain's most vulnerable workers, who are already among the lowest paid', but also 'unfair competition based on wage undercutting, a deterioration in industrial relations and a decline in economic efficiency'.<sup>4</sup> In truth, living standards depend on higher productivity and labour mobility - not wage laws.

It is so difficult to estimate the gains and losses from setting minimum wages that economists have generally concentrated on showing how much employment falls when minimum wages are raised, and avoided

<sup>3</sup> James Hughes and Richard Perlman, *The Economics of Unemployment: A Comparative Study of Britain and the USA*, Wheatsheaf, Brighton, 1984, chapter 5, p. 109.

<sup>4</sup> Letter to *The Financial Times*, 13 April 1984.

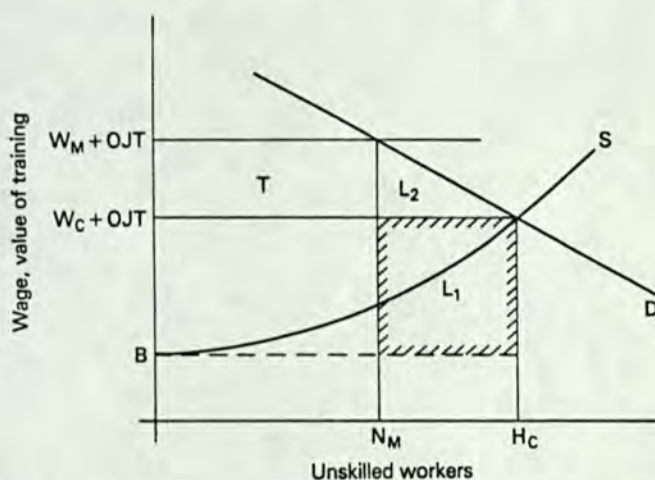
One way to consider the consequence of abolishing Wages Councils and union-imposed youth minima is to use a supply and demand diagram (Figure 1). The downward-sloping demand curve illustrates how employment opportunities increase as wages (including training costs) decline. We have already pointed out above how the employment increase is likely to be quite large in the service industries, since they are not monopolistic, and consumers can easily do without their products. The demand curve should therefore be given a shallow slope.

The supply curve is drawn sloping upwards and is a function of the 'full wage', that is, the current wage plus the value of training opportunities. Its height is determined initially by the level of welfare payments (B) payable to the unemployed. Another factor which will influence the height of the curve is alternative opportunities as a self-employed person (for example, car repair, furniture removals, taxi-driver, sales representative, housewife). As wages rise, more workers are hypothesised to be drawn into the unskilled workforce - out of the household, school, apprenticeship and the various forms of self-employment. The market-clearing full wage is given by  $W + OJT$ , where supply and demand are equal, and a certain value of on-the-job training (OJT) is being provided.<sup>5</sup>

A minimum wage ( $W_M$ ) has been illustrated. At this wage employment of unskilled labour will be less than at the competitive wage. The number of workers so displaced will be larger the more nearly horizontal is the demand curve, as shown. Those remaining in employment will earn somewhat higher full wages, and have a gain (mainly taken from profits) shown by area T. These workers are likely to be the *better-qualified* among the unskilled - not the 'most vulnerable' as the Low Pay Unit contends.

It is the 'most vulnerable' workers who lose from the policy, because it is they who are displaced. They might drop out of the work force (further

Figure 1  
Gains and Losses of Minimum Wages



education), or move into self-employment or into non-covered sectors (family businesses, agricultural work). But most likely they will end up receiving welfare payments at rate B. The cost to these workers of the minimum wage policy is represented by the shaded area  $L_1$ . Area  $L_1$  will be larger the more workers are laid off, and the higher the competitive full wage, including the value of training, above the income received on welfare. (In the next section we attempt to give a numerical magnitude to area  $L_1$ .)

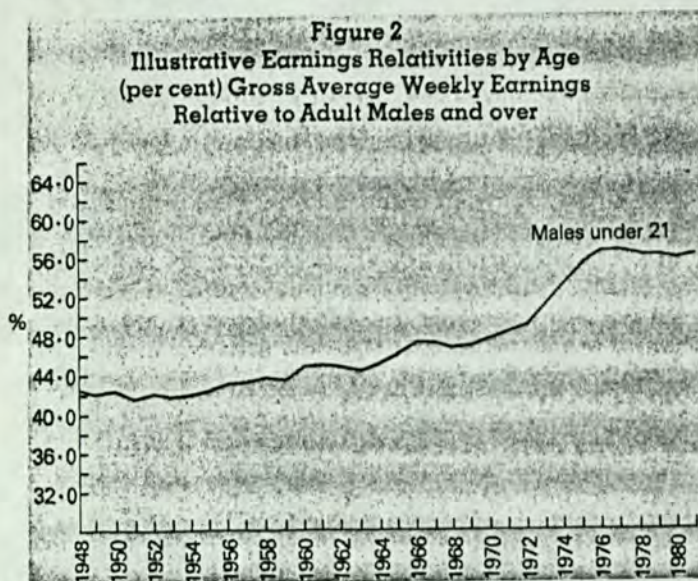
Firms also lose profits, and unions gain when minimum wages are imposed. The effect on union wages (which cannot be shown on the diagram) will depend on the extent to which unskilled, non-union-labour-using industries contract relative to union industries. But the effect on profits can be demonstrated. Firstly there is the transfer to higher-wage workers (area T, less training benefits). Then there is the deadweight loss, related to triangle  $L_2$ . As the wage bill rises the surplus available for distribution as profits falls; that is, the area between the wage line and the demand curve falls.

<sup>5</sup> M. Hashimoto, 'Minimum Wage Effects on Training on the Job', *American Economic Review*, December 1982.

putting numbers on the ensuing loss of output.<sup>6</sup> Nevertheless, since the analysis bears on the employment and unemployment of so many young people, it seems important to make an attempt to work out the likely order of magnitude of some of the gains and losses.

The picture of relative earnings of youths is shown in Figure 2.<sup>7</sup> Most of the increase in relative pay occurred in the late 1960s and early 1970s, partly because of a lowering of the age at which adult minima became payable and partly because of increases in the minima for very young workers as well. In April 1970 only 12% of those aged 18 were receiving adult rates of pay, but by April 1980 the figure had risen to 53%.<sup>8</sup> But there have been large relative wage increases for 16- and 17-year-olds – for which unions and Wage Councils must bear responsibility. Unions became much stronger in the 1970s, and Wage Councils more assiduous (e.g., wage inspections were more thorough).<sup>9</sup>

Table 1 presents data for teenagers and adult males for the years 1965 and 1979. 1965 was chosen to represent a competitive period, and 1979 an excess supply period. An advantage of choosing 1979 rather than a later date is that MSC work-programmes, which blur the line between employment and unemployment,



were not so extensive then. Table 2 presents similar data for teenage and adult women. Unfortunately 1971 is the earliest year for which data are available, and data are not available for the whole teenage female group (16 to 20) until even later.

Table 1 shows that in real terms teenage male pay grew by 57% between 1965 and 1979, while adult male pay grew by only half this proportion, 28%. Teenage male employment fell from 1.64 to 1.31 million over the same period, and teenage unemployment (measured as a residual) rose from 50,000 to 210,000. Table 2 shows the picture for young women. A similar pattern of marked relative wage increase coupled with falling employment can be seen.

What would teenage employment and pay have been had relative wages not risen by so much? The details of the calculations are rather technical, and so

<sup>6</sup> C Brown, C Gilroy and A Kohen, 'The Effect of the Minimum Wage on Employment and Unemployment', *Journal of Economic Literature*, June 1982, p. 496.

<sup>7</sup> Reproduced from William Wells, *op. cit.*, Table 10.

<sup>8</sup> *Ibid.* Table 7.

<sup>9</sup> Cf. 'The Wage Inspector Cometh', *Department of Employment Gazette*, February 1977.

Table 1  
Wages and Employment of Men aged 16-20,  
compared with Adult Men

	1965		1979	
	Nominal	1975 prices	Nominal	1979 prices
1. Gross Pay <sup>a</sup> , males < 20	£9 p.wk	20.9	54.5	32.8
2. Gross Pay, males > 20	£19.6 p.w.	45.6	96.9	58.4
3. Supplementary benefit, scale rate, 18-20	£2.6 p.w.	6.0	12.4	7.5
4. Unemployment benefit, scale rate, 18-20, plus ¼ ERS	£4.0 p.w.	9.3	17.5	13.7
5. Employees, 16-20	1.64 m.		1.31	
6. Employees, >	12.81 m.		11.79	
7. Population 16-20	2.11 m.		2.19	
8. Population > 20	14.39 m.		14.67	
9. Males 16-20 in education or army	0.42 m.		0.67	
10. 7-5-9 = residual (unemployment)	0.05 m.		0.21	
11. 1 + 2	45.8%		52.6	

Notes: (a) Gross pay relates to full time employees in Index of Production industries.

Source: William Wells, *op. cit.*, data appendix.

I have summarised the results in Table 3. To arrive at these estimates, I have had to make certain assumptions as to the elasticity of demand and as to what wages would have been without union and Wage Council effects, but the results are likely to indicate the orders of magnitude.

The estimates of Table 3 indicate that the 'full' wage, including an allowance for training, was £63.60 a week for male teenagers. It was about £10 higher than it would have been without Wages Councils and trade union minima.

Welfare benefits were lower than 'full' wages: according to the table the replacement ratio was only about ½, much lower than commonly quoted estimates which fail to allow for the value of training. Employment is estimated to have been about 150,000 less than it would have been without the higher wages. For girls the effects were somewhat smaller, but in the same direction.

The weekly transfer to the youths remaining in employment (area T in Figure 1) is valued at £13.10

Table 2  
Wages and Employment of Women aged 16-17, and 16-20,  
compared with Adult Women

	1971		1979	
	Nominal	1975 prices	Nominal	1975 prices
1. Gross Pay <sup>a</sup> women 16-17 (per week)	£9.2 p.w.	15.6 p.w.	35.6	21.4
2. Gross Pay, women > 17 (per week)	19.8 p.w.	33.6 p.w.	66.0	39.8
3. Employees, 16-17 (16-20) (million)	0.44 (1.20)		0.33 (1.14)	
4. Employees > 17 (>20) (million)	7.69 (6.93)		8.98 (8.18)	
5. Population 16-17 (16-20) (million)	0.97 (1.81)		0.87 (2.09)	
6. Population > 17 (>20) (million)	14.09 (13.25)		14.61 (13.39)	
7. 1 + 2	46.4%		53.8%	

Note: (a) Gross pay is from the New Earnings Survey, and relates to full-time non-manual employees. Pay for the age group 16-20 is not available until 1973.

Source: Wells, *op. cit.*

Table 3  
Summary of Estimated Competitive and Actual Wage and  
Employment Values, 1979  
Money values in 1975 prices

	Youths 16-20	Girls 16-17	16-20
W <sub>M</sub> : current wage (per week)	£32.8	21.4	n.a.
WM + OJT: 'full' wage (per week)	£63.6	42.8	n.a.
W <sub>C</sub> : competitive wage (per week)	£26.8	18.4	n.a.
W <sub>C</sub> + OJT: competitive 'full' wage (per week)	£53.6	36.8	n.a.
B: welfare benefits (per week)	£10.6	8.3	10.6
N <sub>M</sub> : current employment (millions)	1.31	0.33	0.87
N <sub>C</sub> : competitive employment (millions)	1.46	0.37	0.95

Source:

OJT - the average teenager gains a 10% wage increase after a year's employment, owing to the acquisition of on-the-job experience. OJT = the capital value of this increase discounted at 10%.

W<sub>C</sub> - calculated by assuming that youth wages would have gone up by the same proportion as adult wages in the absence of minimum wage increases. Assuming W<sub>C</sub> = 20.9 in 1965 (in 1975 prices), then W<sub>C</sub> in 1979 = 20.9 × 1.28 = 26.8.

N<sub>C</sub> - calculated by assuming an employment elasticity of -0.4. The wage increase of 22.3% for males thus gives an employment decrease of 150,000. Further details of the calculations are available from W. S. Siebert, Dept. of Industrial Economics, University of Birmingham, Birmingham B15 2TT.

million (about £10 million after tax, assuming a 24% tax rate). The current wage component of this is a transfer from profits, reducing weekly profits by £7.86 million. To this should be added the weekly dead-weight loss of £.23 million. The transfer to the 16-20 age group of women, assuming the whole group had the £6 increase in full pay of the 16-17 group, is valued at £5.22 million (£4 million after tax), of which £2.61 million is a transfer from profits.

But the wage gains of those remaining employed are not only financed by a transfer from profits, since there are the losses of the disemployed (area L<sub>1</sub> of Figure 1) also to consider. For youths, these weekly losses are valued at £6.45 million (£4.9 million after tax). The equivalent weekly figure for girls is £2.10 million (£1.6 million after tax).

Thus in 1979 the post-tax gains to male and female teenagers of minimum wage constraints were about £14 million a week (£18 million before tax), of which £11 million came from profits and £5.5 million was the penalty (after tax) imposed on unemployed teenagers - or £9 million before tax. To this should be added the gains and losses of other groups, in particular skilled workers and consumers, which I do not go into here. But it is doubtful if consideration of these other effects would overturn our conclusion that the benefits of Wages Councils and union youth wage minima are bought at too a heavy cost.

## Some objections refuted

*Teenage relative wages are not high.* Our means of evaluating what the competitive wage 'would be' is rough and ready. It might be objected that this leads to an overestimate of the extent to which unions and Wage Councils have independently raised youth pay. But a recent comparison of trainee wages in the UK and Germany bears out the impression that UK youth rates are high. In Germany in 1979 apprentices received 19% to 38% (depending on industry) of adult skilled workers pay over their four-year apprenticeship period. Corresponding figures for Britain are

much higher, 55% to 83%.<sup>10</sup> Moreover there is increasing recognition that youth wages have been too high: in the construction industry it has been reported that parents are offering firms £1,000 to obtain apprenticeships for their children.<sup>11</sup>

*High teenage wages do not cause unemployment.* We have assumed that all workers disemployed as a result of increases in minimum wages became unemployed. But it might be that they leave the work force, find jobs at less than the minimum or continue in education, so that the assumed welfare benefit figure understates their incomes. Nevertheless the estimated unemployment figure of 150,000 (to take youths) seems realistic given that youth employment has fallen by twice this since 1965. Also the figure of 150,000 falls well within the estimated unemployment figure for 1979, which was 210,000 after allowing for increased numbers in education (Table 1).

*Higher youth unemployment means lower adult unemployment, or higher adult wages for given employment.* This would provide an offsetting benefit, but it would not alter the estimated size of the burden borne by teenagers. Moreover, the harm done to business reduces investment and this has unemployment consequences for adults.

Minimum wage legislation is often defended as protecting unskilled workers' living standards. But it does so by harming the least skilled or unskilled workers, helping skilled workers, and harming business. My calculations,<sup>12</sup> based on realistic assumptions, reveal that for the 16-20 age group, the weekly benefits of rises in minimum wages during the 1970s (including a valuation of training benefits) to those remaining employed were approximately £18 million (£4 million after tax). The costs were a transfer of £11 million from employers, and up to 230,000 unemployed teenagers. The weekly loss to these teenagers, including their estimated training loss, is approximately £9 million (£5.5 million after tax). How long will they have to bear it?

Young persons' wages are nowadays about 20% higher relative to adults' than they were 20 years ago. This is partly because of Wages Councils, but it is also a consequence of unions and of the imposition of 'adult' rates on even younger workers. While Wages Councils are not solely responsible, abolishing them or reducing their scope (e.g., to over-23s, as proposed in the Consultative Paper), would bring youth wages 'back into competition'. In this way lower youth rates in the non-union sector will exert downward pressure on rates in the union sector and act to restore our damaged wage structure. [E]

<sup>10</sup> Ian Jones, 'Pay relativities and the provision of training', mimeo, NIESR, London, 1984, Tables 2 and 3.

<sup>11</sup> '£1,000 Bait for Jobs', *Daily Telegraph*, 28 September 1984.

<sup>12</sup> For 1979, using 1975 prices.

### LOW PAY OR NO PAY?

A review of the theory and practice of minimum-wage laws

by DAVID FORREST

Lecturer in Economics University of Manchester

with a critique of the Low Pay Unit by S. R. DENNISON

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