Unemployment: Subsidies and Minimum Wages

by Sir Alan Walters

The author outlines the 1981 'Youth Workers Scheme' he devised, and contends it was both successful and cheap. Minimum wages and wages councils are pernicious, the first ensuring that young people are priced out of jobs and the second leading to the suppression of competition.

The Jobs Summit in Detroit was really a showcase for Presidents Reagan and Bush rather than President Clinton. But no matter: compared with the rest of the world, the United States has been an enormous success in providing employment. Over the last eight years, unemployment in the EC or Economic Union has hovered between 8 and 11%, whereas in the US it has been between 5·5 and 7·5%. In the Reagan years the US created 12 million jobs whereas sclerotic Europe created little more than a million.

True, these new jobs were filled largely by unskilled and low paid non-unionised workers in the service industries. Employment in manufacturing, particularly the unionised sector, actually declined. But all these changes point to the enormous *flexibility* of the American economy and labour markets compared with those in Europe. Here myriads of entrepreneurs profited by providing low-price services and so created low-wage jobs which could be filled by the supply of unskilled workers. In Europe they chose a miserable alternative – the dole.

Nine Million Extra Jobs

President Clinton has promised to create nine million extra jobs by 1996. And Secretary Reich has asserted that there should be a massive enhancement of the skills and motivation of the work force. His solution is to spend more tax-payers' money on improving the schooling and honing the skills and technical training of workers. There we demur. Over the last few decades, more and more public money has been poured into education. It has produced lower and lower standards of civility, morality, literacy and numeracy. We fear more of the same.

This does not mean that education and training could not be vastly improved. It could. By prizing schooling out of the grip of the teachers' unions and bureaucrats and by giving parents the right to choose, a decent and efficient education system, rather like that with which we were blessed in the 1940s and 1950s, could arise again. But this could be achieved only by neutering the teachers' unions, and this administration is not about to confront such a powerful lobby whose votes are needed in elections to come.

But whether or not Labour Secretary Reich pursues his labour-quality-enhancement programme, it will have no discernible effect on delivering the nine million jobs promised over the life of the government. The real causes of job loss can be summed up in terms of two syndromes: 'Why work?' and 'Why hire?' – the supply and demand sides of the labour market.

The 'why-work?' syndrome arises because, taking into account taxes on wages and the loss of welfare benefits and leisure time, many workers find it hardly

Sir Alan Walters is Vice-Chairman, AIG Trading Group, Inc., Washington DC, and an Honorary Fellow of the IEA.

worthwhile to get a job. They swell the welfare rolls. This 'why work?' disincentive will be much enhanced by the minimum 12 percentage points increase in marginal tax rates envisioned in Hilary Rodham Clinton's plans for health care financing. (But the people and their representatives seem to be disenchanted with the First Lady's proposals, so, for the time being, health reform goes back on the shelf.) Why work indeed when you will be paying 60 cents in taxes out of every additional dollar you earn?

But, you may say, such people may nevertheless choose to work because they know that a period of employment will enable them to get a step on the employment ladder and soon, after they have proved themselves, they will get promotion and a rise in income to lift them more or less permanently out of 'why work?'. And we must give the administration its due because it has talked about workfare and other methods of propelling people out of this trap...but so far the result is mere rhetoric and advice to the states to experiment. Little or nothing has been done to trim federal welfare programmes to set the poor free from these miserable traps. And Congress seems only too willing to promote the interests of the myriad of well-healed poverty fighters who staff the welfare bureaucracy.

The 'Why Hire?' Syndrome

Even worse, the administration hits employment with a virulent 'why hire?' syndrome. By greatly increasing the minimum wage of those whose skills and reputations are minimal, particularly young black and Hispanic males, those at the bottom of the heap find it increasingly difficult to get a job. 'Why hire?' indeed. At a stroke the government raises the first rung of the ladder to success so that it is well out of the reach of millions of those poor aspirants. Many worthy applicants would accept a starting job at a wage well below the legal minimum, but which corresponded to their low productivity as a learner.

Small wonder that exclusion from legal employment of many of these youths promotes crime and the break-up of families. Indeed, denying a prospect of rising incomes removes them as potential providing husbands. To the girls in the ghetto, it is not surprising that, through the AFDC programme, they choose to have illegitimate children and 'marry' the state as the more reliable support. Then the father must never get a job!

An even more important element in the 'why hire?' syndrome is the targeting of income tax increases against the 'rich' (those with earnings above $100,000). These 'rich' include the vast number of small firms that have been the source of 65% of job creation over the last 12 years. The rich will rightly spend more time enjoying their leisure and avoiding taxes rather than providing jobs.

In sum, a government committed to job creation has proposed policies of job destruction. Apparently well-meaning programmes to promote welfare and incomes will in fact produce the opposite effects. Over many decades in virtually all countries, minimum wages and high welfare payments have promoted job losses.[1] Fortunately, most of these policies have yet to be legislated or implemented. And, as we know, they will take some years to have their full effects. Meanwhile, with the legacy of the Reagan years and the careful monetary policies of Alan Greenspan, the American economy has solved many of the problems which seemed so urgent when the Detroit summit was planned.

The Youth Employment Measures of 1981

The problem of dealing with unemployment – particularly the long-term jobless and the unemployed young – has given rise to several suggestions for subsidising employment. The methods of subsidy vary enormously; some offer retraining grants, others a straight cash payment for a limited period, some involve a continuation of a fraction of the unemployment pay, yet others excuse social security contributions...and so on.

It would be boring and unrewarding to examine all these schemes, delimiting their pros and cons. But in assessing what will and what will not 'work' usefully in practice, it may be of interest to assess a subsidy scheme which I designed in 1981, and which was implemented for more than a year before it was metamorphosed into the Youth Training Scheme promoted by David (now Lord) Young.

Jobs in Britain

In 1981 there was a serious problem of youth unemployment. Their unemployment rates far exceeded all other groups. The incidence was especially severe among those seeking their first job. The causes of the differential between the unemployment rates of youths and adults lay partly in the decline in the standards of school education. The provision of social security benefits to those who had never been employed or had only been in a job for a short period also contributed to the 'why work?' syndrome. But it was also clear that the wages of youths were being artificially held high by a combination of trade unions and minimum wage legislation. Union negotiators were proud that youth wages were fixed only slightly below those of adults. High youth wages, however, were not much of an advantage to a boy or girl if that wage was too high, relative to those of adults, for him or her to gain employment. High wages are little comfort if there are no jobs. The comfort came to the adult union members – who of course dominated the unions. The adults could ensure there was no competition from appropriately low-priced youth labour, so they restricted the effective supply of labour and ensured higher wages and more adults in employment.

Legally enforced minimum wages also contributed to unemployment. Wages councils fixed and administered minimum wages in a variety of trades, including the whole of distribution. The councils were dominated by the large employers' and trade union representatives. The coalition of interests was to prevent small firms creating jobs by cutting wages and prices in competition with the unionised firms. Again, the councils fixed youth wages far above many youths' productivity, and so the young workers were sidelined in the welfare system.

Politically, there was little dramatic that could be achieved. Trade unions were still mighty powerful (this was before the implementation of the union reforms). Although Mrs Thatcher longed to rid the economy of antediluvian wages councils, it was difficult to abolish such legal entities – and they had solid support among big business. But there was a pressing need somehow to reduce the *wage costs* of employing youths. Furthermore, in the context of the disinflationary policy, there was an urgent need to put downward pressure on all wage costs. So I chose to have a go.

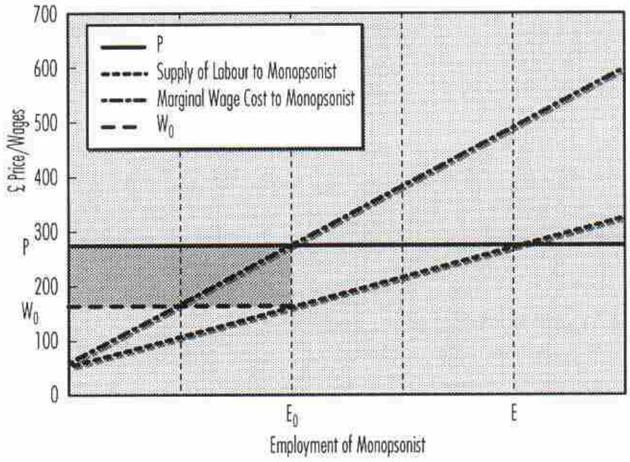
The 'Walters Scheme'/YWS

In what came to be called, first, the 'Walters Scheme' and later the 'Young Workers Scheme', I proposed that we pay an employer of a youth £10 a week, provided that the wages were less than £40 a week. The subsidy lasted for only one year but could be extended at half rate for another year.

This scheme was clearly designed to bring youth wage costs down. The employer had an incentive to offer less than £40 a week to qualify for the subsidy. It appealed to the small non-unionised firms that could take advantage without the constraint of union and minimum wage restrictions. (In this sense it incurred the calumny of some large employers.) The scheme also was intended to influence the judicial and bargaining processes of the councils and trade unions.

There was a differential effect of the scheme – it benefited small competitive firms and many new firms much more than the large, well-established unionised corporation. We judged that no fault in the rigid hierarchy of industrial Britain. Secondly, we knew that it might have the effect of simply substituting youths in jobs which had hitherto been the preserve of women and part-timers. But this substitution seemed no bad thing if it put new feet on the employment ladder. And in any case it was clear that the effect would not be entirely substitutions of this kind; the lowering of

Figure 1: Conditions for Monopsonist Exploitation?



wage costs would actually *create* jobs and, from various studies, we could get a rough idea of the quantitative effect.

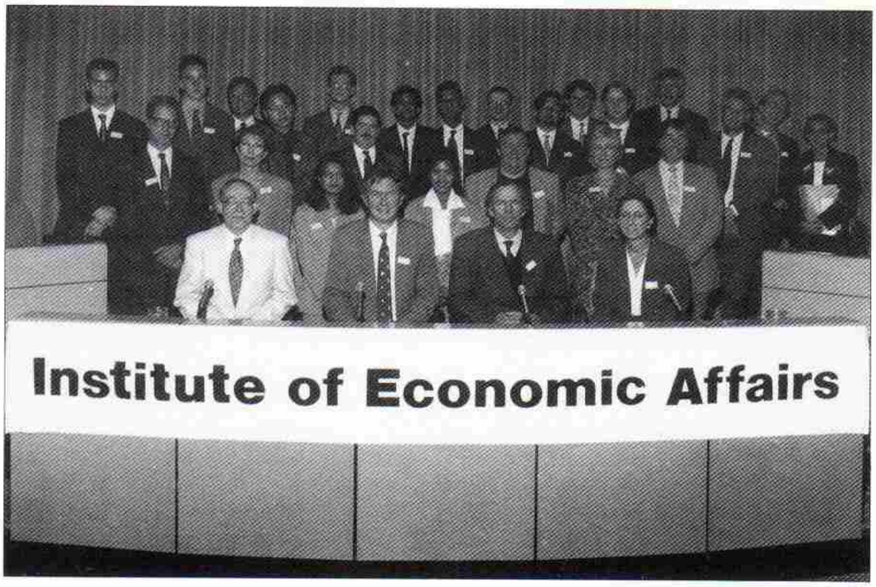
These were the economic considerations. But they were only part of the story. One main advantage of my scheme was that it could be implemented under existing legislation – indeed under laws which were passed by the preceding Labour government! The fact that we could tuck it into existing law meant that it could be implemented very quickly. The long process of legislation was duly bypassed. The Labour government, of course, never meant to use their Act in the form of my scheme, but that was water under the bridge because the Act was on the statute book and so could be used to legalise my scheme.

Keeping Bureaucracy Out

It was also important to keep bureaucracy out of the scheme. It was designed to be simple and avoid the need for any but the most rudimentary administrative apparatus. For example, I did not want to specify any 'training' requirements for the recipients. No inspectorate would be needed to supervise any attendance or schooling requirements. It was a straight cash transfer with only the £40 wage conditionality. In the event the scheme was administered by no more than four civil servants. Its overall cost was debatable since there were numerous offsets in the form of lower welfare payments, etc. The cash cost was suitably small and well within my *ex ante* estimates. Furthermore, the YWS had a sunset condition built into it. There was to be no permanent wage subsidy.

The moral position of Mrs Thatcher became ever stronger on this scheme. Not only was it built on Labour legislation, but it was a wage subsidy to a poor youth in order to obtain a job, usually his first. It was peculiarly difficult for the opposition to condemn sub-

The IEA's 6th Annual State of the International Economy Conference, on Thursday 20 October 1994, at the City Conference Centre. Between sessions, 25 National Westminster Bank Fellows – all students and teachers at European institutions of further and higher education – joined Rupert Pennant-Rea (front row, centre right), Deputy Governor of the Bank of England, and John Blundell (front row, centre left), General Director of the IEA.



sidies to the poor unemployed! Even the trade unions' objections were muted – in fact, the issue of the scheme was withdrawn from the agenda of the Trades Union Congress. Mrs Thatcher could strike a high moral tone and decimate any opposition. In a sense it was quite out of character for Mrs Thatcher (or me) to be proposing a subsidy. That certainly wrong-footed the opposition. And it is perhaps not surprising that the scheme was received well in the media.

As programmed, the YWS was in operation for about two years. Then it was developed into a much larger, and much more expensive, programme of youth training. So it is difficult to isolate the YWS and perform a cost-benefit study on the outcome. There was general agreement, however, that it was a useful scheme, and certainly the differential unemployment rates began to close and wages became much more flexible from 1982 onwards. But we cannot make any firm attribution to the YWS.

The Prime Minister was not only supportive but also an enthusiast for the scheme. I believe it was not only the unassailable moral position of 'subsidising poor lads and lassies in their first jobs', but also she was attracted by the knock-on effects on the wage bargaining arrangements. There was little opposition and some considerable support from the civil service, since it was no great burden and fitted well into their existing routines and administrative arrangements. Furthermore, the scheme was cheap and at worst would impose little burden on the Treasury. (Indeed, I got Treasury agreement in principle before I floated the idea.) And even if the worst possible conditions held, no jobs were created at the lower wage costs and all that occurred was a subsidy to small non-unioned business, then most people agreed that this was not a bad thing.

On a personal note, this scheme helped to modify the image which had been widely put about in the media that I was a hard-bitten monetarist imported by Mrs Thatcher in order to get a grip on the Bank and the Treasury. The YWS was a modest but useful change in micro-economic policy.

'Benefits' of a Minimum Wage

The abolition of the wages councils in 1993 with the implementation of the Trades Union Reform and Employment Rights Act should have been welcomed by economists.[2] As I have already argued, fixing minimum wages constituted pernicious discrimination against the poor and ill-trained workers – often youths or disadvantaged people. For a youth whose productivity is only £2 an hour, a minimum wage of £3 condemns him to a *de facto* minimum wage of zero – he cannot get a job. Yet good performance in a low-pay job is the main qualification for getting a higher-pay job, and so the danger of the vicious circle of unemployment and dependency.

In attempts to rescue respectability for minimum wage conditions, claims have been made about the relationship between low wages, poverty and productivity. But they have been largely discredited by empirical observation. For example, low wage earners are likely to be members of a large family with many wage earners and which is not in a state of poverty. The association of poverty and low wages is weak.

In this paper, however, I avoid these issues, however contentious they may still be, and concentrate on the jobs issue, particularly in the private sector. Recently there have been revisionist studies on minimum wages which show that, suitably administered, minimum wage conditions may promote employment, increase the wages of the workers, and merely result in a reduction of profits of employers. The argument is a very old one, aired by Pigou, Austin Robinson, and countless others. It postulates that the buyer of labour services is a large firm with considerable monopsonistic power in the labour market. It is so large, relative to the labour market, that in order to hire more workers it must offer higher and higher wage rates – which, since it is assumed not to be able to discriminate, it must offer to its existing employees as well as the additional workers. Consequently, because the supply curve of labour facing the firm is upwards sloping, its *marginal wage costs* are considerably more than the going wage. The commanding monopsonist will maximise profits when the marginal wage cost is equal to his marginal revenue (which in a competitive products market is equal to the price).

For older economists, this can be represented as in Figure 1, measuring in £ sterling wages and prices on the vertical axis and employment on the horizontal axis. Assume that labour is the only input to our monopsonistic firm and that it can sell as much as it likes at price P. But it faces a rising supply curve for labour, with marginal wage costs always exceeding the wage. With these monopsonistic conditions the firm will hire labour of Eo at wage Wo and marginal wage costs will be equal to the price at P. The firm would enjoy 'exploitative' profits represented by the shaded rectangle. (Note that if the firm had some monopoly power in its product market then there would be an additional effect lowering output and employment, and that could, again in principle, be taken out by a suitably pitched *maximum* price for the product.)

Thus, in principle and with adequate foreknowledge, any social engineer could impose a minimum wage, increase employment, reduce the profits of exploitation and thus redistribute income from employers to workers. Any minimum wage which exceeds Wo and is less than P will do the trick. If, of course, the social engineer got it wrong and fixed the minimum wage above P, then *all* the existing jobs would be lost. If, *per contra*, he fixed the minimum below Wo, then it would be otiose.

From Model to Reality

So much for the model; now for the reality. The first point is that the basic conditions for the application of monopsony exploitation must be the existence of a single employer (or effective cartel of employers) which dominates the (local) labour market. For the most part, wages councils have applied mainly to retail trades (including shops, catering and hairdressing) and to the clothing industry. None of these trades is characterised by monopsony; they consist mostly of small firms which cannot affect the overall wage rate by variations in their relatively small labour forces.

True the grocery business had become concentrated more and more in the supermarkets. If two or three supermarkets dominated a limited labour market and perhaps reinforced this with a cartel agreement 'no poaching of labour', then there is the possibility of monopsony and of the large supermarkets enjoying monopsonistic profits. Then one would expect these supermarkets to be opposed to any minimum wage legislation that infringed on those profits. Alas, however, for the monopsonistic theory, precisely the opposite is true. In all the wages councils I investigated in 1981–84, the large employers were all enthusiastic supporters of the wages councils. If the monopsony explanation were true, then by supporting high and effective minimum wages, they would be reducing – indeed, in principle eliminating – their profits.

The explanation lay in the fact that the large employers – often partly or wholly unionised – had conceded wages which exceeded those of their small competitors, mainly, one suspects, immigrant family-owned shops often staffed with family labour. Their wage costs were low and they competed for a sizeable marginal business. These small competitors were adamantly opposed to minimum wage rules which may have bankrupted them and reduced employment and at least inhibited their (albeit mostly modest) expansion plans.

Wages Councils Suppressed Competition

The wages councils were structured around an independent chairman – often an academic – and 'representatives' of mainly large firms and trade unions. Interested parties such as consumers – who may value the all-hours service of the small shops – were not consulted: presumably their views were to be represented by the chairman. However, it seems to me quite fanciful to suppose that wages council processes and procedures were directed towards eliminating some hypothetical monopsonistic exploitation. The obvious explanation is that they were being used by both labour unions and large employers to suppress competition from the small shop owners.

But suppose, *per contra*, that they genuinely were seeking to eliminate monopsonistic profits (and, of course, supposing that such profits really did exist), would they have been able to identify these efficient minimum wages? Could they have measured the shape and position of the constantly changing labour supply curve? Could they have immediately identified shocks both on the demand and the supply side that would require nice adjustments of the minimum? Could they have taken on board the flow of Gujiratis, Sikhs, Pakistanis, and so on, which would much affect conditions in the industry? The answer to all these questions is surely a resounding 'no'. In my observation (in 1981/82), the actual deliberations of the wages councils were in terms of following precedent, splitting the differences, trying to rally around a consensus. It had more to do with local politics and power plays than economic analysis.

Up to 1986, the councils fixed minimum wages not only for occupations but also for different regions and for age groups. In principle this seemed a good thing – since it was unlikely that, were they pursuing the anti-monopsony policy, the appropriate efficient minimum wage that maximised employment would be the same for all. But from 1986 onwards they were legally required to set only a single rate. Any suggestion, however implausible, that the monopsony-control argument was then being applied disappeared – with the wages councils themselves from 1993 onwards.

Now, however, the Labour Party has resuscitated the idea of a *uniform national* minimum wage – the trade unions would like a minimum wage to be set at half the median male earnings, giving a rate of £4·15 per hour. (An earlier claim for a minimum wage by Fred Mulley, a Labour minister, specified that 'no-one should earn less than the average wage' – possible, I suppose, but difficult.) In the United States the average minimum wage is only about 32% of the median wage, so the job destruction would be considerably more in Britain than across the Atlantic.

I suspect that, instead of the nice adjustments present in the theoretical model with all its fine-tuning to individual abilities, markets, etc., the reality of a uniform minimum wage would be a very blunt axe indeed. The combination of ignorance and politics would hardly be the stuff of subtle intervention.

A final word: in *Free to Choose*, Milton and Rose Friedman remarked on the very wide agreement among economists of all political persuasions on the view that minimum wages were wrong.[3] It is remarkable to observe, albeit in the most extensive econometrics forms, arguments that perhaps minimum wages help destroy monopsonies and promote employment and welfare. Then, no ideas die, they merely skulk around until the right environment appears for them to emerge once more.[4] ea

[1] For a contrary view, see Richard Dickens, Stephen Machin and Alan Manning, 'The Effects of Minimum Wages on Employment: Theory and Evidence from the United Kingdom', *NBER Working Paper 4742*, New York, May 1994. They claim that 'if anything the relationship between minimum wages and unemployment is positive'. I return to this later in my paper.

[2] I should declare an interest here. During the time I was in Number Ten, I strongly supported the abolition, or at least neutering, of wages councils. As we shall see, opposition to such policies came from unexpected sources.

[3] M. and R. Friedman, *Free to Choose*, London: Secker and Warburg, and New York: Harcourt Brace Jovanovich, 1980.

[4] As an epilogue, I would not be surprised to see the old 'kinked' demand curve resuscitated to show that minimum wage legislation will, even where the supply of labour to the firm is horizontal and there is no monopsony, not result in any loss of jobs – only in higher wages and reduced profits. Perhaps some modellers will take up this challenge.