Employment, real wages and unemployment in the United Kingdom

Note of a meeting of the Bank's Panel of Academic Consultants

The Bank's Panel of Academic Consultants met on 26 October to consider linkages between real wages, employment and unemployment in the context of labour market trends in the United Kingdom over the last thirty years. Two principal papers, one by Professor J R Sargent, who currently holds the Houblon-Norman fellowship in the Bank, the second by Sir Bryan Hopkin, were presented for discussion. They will shortly be issued as Panel Paper No. 24, available from the Bank at the address given on the reverse of the contents page of this *Bulletin*. An additional note by J C R Dow, amplifying some of the lines of thought in Hopkin's paper, and a summary of recent econometric research by Professors Layard and Nickell were also circulated to the Panel.

Both Sargent and Hopkin note the return to popularity of the notion that high real wages can lead directly to unemployment. While Sargent develops a neoclassical model to investigate the effect of a range of factors on both employment and wages, Hopkin concentrates on the hypothesis that there is a causal link between higher real wages and lower employment. Both authors follow theoretical sections with surveys of appropriate historical data.

Both Sargent and Hopkin observe that there may be considerable divergences between real wages to the worker and the real cost of hiring a worker as seen from the firm's viewpoint. The real product wage (money wages plus associated payments such as national insurance contributions, divided by an index of nominal value added per unit of product) is the important quantity to examine in relation to the demand for labour.

Sargent employs a neoclassical model to shed light on the behaviour of real wages and manufacturing employment in the last thirty years: while the real product wage has consistently risen (though at different rates), employment rose up to 1964 and has subsequently fallen at an accelerating rate until 1983. Starting with a two-input production function, and profit-maximising conditions, Sargent derives a system of equations which he then solves to give two equations relating the rate of growth of real wages to the rate of growth of employment. These, the 'market constraint' schedule and the 'marginal productivity' schedule are affected by such factors as the cost of capital, 'wage push', the growth of effective demand and the tax system, and Sargent indicates how the equilibrium point might move with changes in these. He then splits the post-war period into five phases in which different combinations of factors affected employment and real wages, and concludes that a range of influences is needed to explain events fully.

Hopkin examines the hypothesis that there might be a causal link between high real wages and low employment. He considers in detail the formation of real wages as the ratio between a nominal wage, set through collective bargaining between firms and unions, and the prices set by firms. The outturn for real wages depends on prices which are often set after the nominal wage deal has been concluded. If firms do not fully pass on cost rises in an effort to maintain market share, then real wages rise to the detriment of the profit share. This cutting of margins, stemming from the desire of firms to maintain their market share, would not reduce output in the short run, but might have a longer-term effect on firms' demand for labour. If firms simply pass on cost rises, accelerating inflation may result, but, if monetary demand does not increase (ie if the rise in prices is not accommodated by government policy), a deficiency of effective demand could result. Hopkin concedes that high real wages can lead to lower employment through the channel of international competitiveness. But in order to refute the concept of generalised 'high-wage-induced-unemployment' in the UK economy, he cites profit shares and rates of return for the period since 1972. He concludes that profits were never so low as to deter producers from supplying at the then current rates of wages and prices.

The meeting discussed theoretical, empirical and policy-related questions, including the evolution of the aims of trade unions, measures to free the labour market, and how to influence real wages. The experience of other industrialised countries was also mentioned. Most Panellists agreed that no single factor could explain the behaviour of employment in the last thirty years and that any description of labour market trends must allow for a range of influences.