

## The Labour Market & Welfare Induced Rigidities

### INTRODUCTION

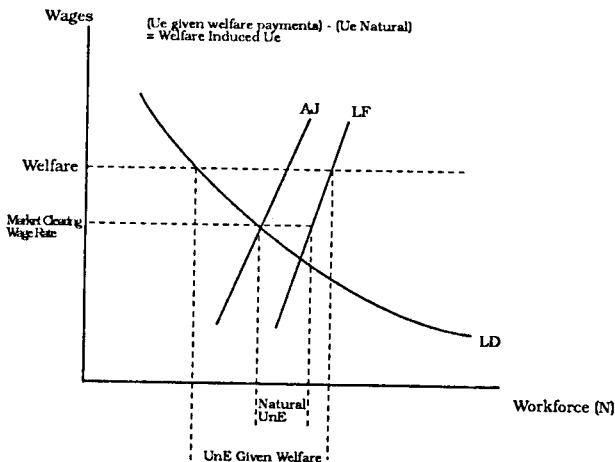
As a small open economy with, therefore, in at least all traded sectors, a theoretically given wage rate, Ireland has been dogged by persistently high rates of unemployment for the past 10 years, and especially so since the inflation conscious Germans have asserted their authority over European economic issues. So, is a high level of unemployment an inevitable consequence of technological advancement and increased productivity, or can it in some way be designed out of the system?

The purpose of this essay is to explain why Ireland has persistently high levels of unemployment. Attention will be focused on our social welfare system and its complexity as the major cause, and one major alternative will be suggested - the Basic Minimum Income - as a more rational approach to social welfare.

The Concept of the Basic Minimum Income is, at its theoretical level, delightfully simple, as will be shown. Its implementation, and especially the necessary transition period may not be so. However, this difficulty should not take away from the overall concept. Where possible, this essay will be kept free of specific references to Ireland, as the concept is capable of implementation under any social system.

### THE WELFARE TRAP

In an effort to explain how a significant proportion of Ireland's 18% unemployment level is caused by our social welfare system, there are two basic assumptions which will be made. Firstly, reasonably, many of those who are currently registered as unemployed cannot hope to attract the average industrial wage due to a lack of education and/or scarce skills. Secondly, and perhaps more controversially, work in itself is a utility provider, and a person will work provided there is no direct economic loss involved in doing so.



It is a combination of these two assumptions that lead us to our problem. Under our current Social Welfare System, and increasingly so given successive governments' "generosity" to the long term unemployed, it has been argued forcibly that for low skilled people the replacement ratio, defined as the ratio of welfare benefits to earnings, is in excess of 1 when monetary and non monetary

benefits are included. One must clearly include both monetary and non monetary benefits accruing to welfare recipients when calculating replacement ratios. The difficulty in giving a monetary measurement to free health care, education, fuel etc. is real, but scarcely a reason for ignoring them in calculations. They still, after all, represent command over resources. The crux of the matter is that many of these benefits, and all of the monetary allowance, is lost on taking work. Hence, for a low skilled person, the real difficulty is one of finding work which will pay in excess of the monetary value of the welfare benefits lost. Added to this must be travel, clothing and food expense directly incurred in working.

This brings us to what is today called a Welfare or Poverty Trap, and which is no more than a classic rigid inflexibility in the labour market.

AJ: Those accepting jobs. LF: the labour force. The horizontal distance between AJ and LF represent those who for reason of job search or for welfare registration purposes are registered as unemployed. LD: labour demand curve. Ue: the level of unemployment.

### IS THERE A PROBLEM?

Well, some would argue that there is not. The very existence, it is claimed, of high levels of unemployment, allows employers to resist wage increases by pointing to a readily available workforce who will take work at the going wage rate. This is a spurious argument. Given the strength of unionised labour, especially in the non-traded public sector, and linked pay rounds carrying over into the traded sector, this argument carries little weight. Furthermore, this argument ignores the differing skill requirements of employers. With an internationally mobile labour force, for example in the construction industry, one can see that available wages in, say, London, must be approximated during periods of investment expansion at home. Hence Dr. Garret FitzGerald's recent call for tax breaks for returning construction workers in order to avoid an inflationary pay round at home due to competition for a diminished labour resource.

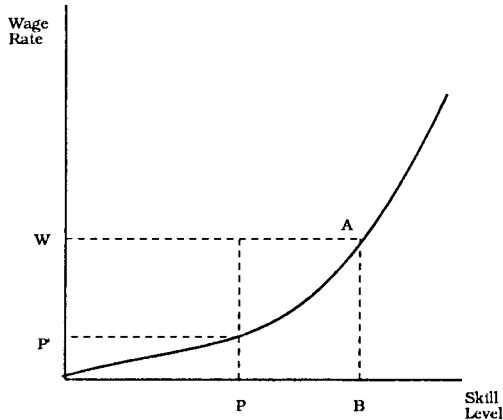
So, there is a problem. Essentially, there is an enormous economic cost involved in allowing our present social welfare system to continue. This comes in three main ways. Firstly, through the output lost through the inefficient use of the labour resource. Secondly through increased labour costs due to high levels of taxation needed to maintain the system. Thirdly, and most often forgotten, through the hysteresis cost of an erosion of human capital due to a loss of self esteem, and in the long run, a move away from an enterprise culture towards a culture of social dependency.

### SOME ALTERNATIVES.

In a modern world, the Malthusian solution of allowing a life sustaining labour market clearing wage rate evolve through death by starvation and thus a shift left in the labour supply curve is hardly arguable. The current practice in Ireland, characteristically, is a piecemeal "fiddling around on the margin" approach. Family income supplements, whilst at least a recognition of the existence of the problem, are not effective. The level of replacement supplementary income is too low, and through its complexity, the take up rate is miniscule. Allied to this is the apparently irresistible temptation of successive Ministers for Finance to make the situation worse by allowing proportionately more benefits to the long term unemployed, far outstripping inflation and average pay increases, and thus raising yet further the replacement ratio faced by work seekers. Clearly a fresh approach is needed.

### THE BASIC MINIMUM INCOME - A SOLUTION?

Below find a graphical representation of a labour market, showing the relationship between the amount of skill possessed by the individual worker, and the market wage rate this level of skill will attract.



A worker, and all workers with greater than the level of skill indicated at 'B' above, will take work given that wages in excess of the welfare rate can be earned, and that work, in itself, is a provider of utility. Clearly, the cost to society of preventing an individual worker, and hence all workers with skill level less than 'B', from taking work is

$$(\text{Number with skill level} < \text{'B'}) \cdot (\text{OW})$$

This cost can be thought of as the area OWAB. If an employer willing to pay  $OP'$  for a worker at skill level  $P$  was operating in a free labour market, he would be in a position to offer employment. Quite simply, what the Basic Income proposes is that such an employer would pay  $OP'$ , and the state, instead of paying  $OW$  to keep the potential worker idle, would now pay  $P'W$  and gain a saving in welfare cost and a certain amount of output.

Aggregating, the gain to the state can be thought of as the area OAB. Welfare payments, previously represented by OWAB are now OWA. The area OAB, further, can be thought of as representing extra output, previously lost. Under this analysis, the gain to the state, and the individual, is clear. Arguments that the Basic Income System would cost too much are groundless.

#### SOME PROBLEMS.

Clearly, we cannot expect the state to "top up" wages on an individual basis. The cost in administration alone would be enormous, as would the temptation on employers to understate the amount they are willing to pay for the services of the individual worker. The economic rationale outlined above leads to the practical concept of the Basic Minimum Income.

The proposal envisages that the state would pay everyone, at a level determined only by age, a basic minimum income whether they are employed or not. Electronic technological advances, especially in the area of funds transfer, makes this feasible at reasonable cost. The individual is then free to seek extra pay through employment, or to maximize employment prospects through further education or training, without being hindered by loss of income. The system would be financed by higher gross income taxation. It should, at this point, be stressed that the net amount payable by the state in welfare payments, and hence the taxation liability on society generally, would be less than as under our present system.

#### THE ADVANTAGES OF A BASIC INCOME SYSTEM.

The main advantages of such a system lie in economic efficiency. As the system involves releasing previously welfare bound workers into the labour

market proper, these benefits are clear. Currently depressed, labour intensive industries would be able to find employees willing to work without having to match social welfare rates of payment.

Some arguments against such a system are put forward, and whilst it is impossible to anticipate them all in this essay, for completeness some of the more common are answered below. A fuller debate would be best served in the form of a follow up essay perhaps in response to a critique.

The arguments against the Basic Minimum Income System lie chiefly in costs and incentives to work. In answer to this one should be reminded to compare like with like. To say that the system would be expensive to operate is indeed true, but this is to ignore the enormous cost involved in operating our current system. It is important to remember that targeting of benefits costs money, in means testing, checking up on claims for qualification purposes, and through the employment of large numbers of civil servants as administrative staff. Arguments concerning the level of Public Sector Share can be dismissed outright. If the State does not have control over the spending of the money involved in welfare payments, it can hardly be argued that it is increasing its share of control over National Output. A more rational approach to calculating Public Sector Share lies in deducting from Public Sector expenditure and revenue accounts, cash payments to the Private Sector.

A major argument lies in the incentives to attempt to defraud the state. Whilst it may be true that the possible benefits to the individual from not declaring earned income are significant, they are surely not significantly greater than they are today. The problem becomes one of tax evasion from one of welfare fraud. The proposed system should not be expected to solve all revenue/welfare problems at a stroke. The economic efficiency benefits, alone, tend to recommend its further study and debate.

#### CONCLUSION

In this essay it has been argued that due to the operation of our Social Welfare System, a rigid inflexibility is prevalent in the Irish labour market. As a direct result of this inflexibility, significant inefficiencies are reducing the potential output of the state.

It has been shown that a fresh approach to the social necessity of a state welfare system, through a Basic Income System would result in vastly improved pareto efficiency.

What must be avoided, on this issue as on many others, is allowing the idea to be designated "left wing", and thus consigned to the scrapheap. For too long, emigration has been used as a safety valve, allowing policy makers ignore the structural inadequacies of our administrative system. Thus by 'benefit' of this historical quirk, when others move on, Ireland seldom sees the need. However, despite emigration, unemployment levels remain stubborn. If it doesn't work, to misquote US Senator Robert Byrd, maybe we should fix it?

**Billy Stamp**

