EMPLOYMENT REGULATION: Who pays the price?

When governments require employers to provide benefits such as paid holidays, security of employment and maternity leave, it must be a good thing. Employers have to provide them and employees benefit – or do they? PROFESSOR LEN SHACKLETON details the damaging aspects of employment regulation in the UK

Many people think the United Kingdom's labour market is an unregulated 'Wild West' environment where employers can do as they want and employees are downtrodden and exploited.

Granted, UK regulation is less than in some other European economies such as France and Italy, where tight employment restrictions are arguably one of the main causes of their poor economic performance. But it is nevertheless substantial, and has been growing sharply recently, as the table (overleaf) shows.

Why regulation?

Why do governments lay down rules about employment? The benefits which flow from voluntarily-negotiated contracts are essentially the same as those flowing from free trade between nations: we specialise in what we are good at and 'trade' with others in competitive markets. Both employers and employees gain from freely-negotiated contracts.

Textbooks point to possible 'market failures' in employment – things like monopsony (where workers face a single employer who dictates pay and conditions); externalities (where employer decisions, for instance about training or redundancies, impact on other people or businesses); and information problems (as when employers know more about work dangers than employees).

However the evidence that these problems are of much significance is slight: more commonly government interventions are proposed on redistributive grounds. The argument is that market outcomes are held to be 'unfair' in some way, and an intervention will improve matters. This is the justification used for, say, a minimum wage.

However, economics students will be aware that things are not that simple. A pay increase for low-paid workers benefits some workers who are not poor (as they live in households with other income sources), but penalises other poorer people who can no longer get entry-level jobs as employers cut back on their workforce, substitute machines for staff and become more selective in the criteria they use to pick recruits.

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Who bears the costs?

The subtler effects of other types of employment regulation are often missed by politicians and the general public. A fundamental issue is the question of who bears the cost of regulation.

The complaints of business people against excessive regulation concentrate on the short run impact of a measure on their bottom line. These complaints are often dismissed as special pleading. Businesses can bear these costs, it is claimed.

But the longer-term impact of a measure does not fall exclusively on the owners of a business. Its impact is rather like the effect of a tax on the consumption of a product where the business may pay the government the monetary value of the tax, but its incidence – who bears the burden – is less clear. The same applies to a regulatory measure.

Take as an example a 'mandated benefit', a government obligation for employers to offer a benefit to employees.

A hypothetical example might be a requirement to give all workers free annual visits to a health spa. Of course, this example is not realistic, but there are very many government mandated benefits under UK employment law.

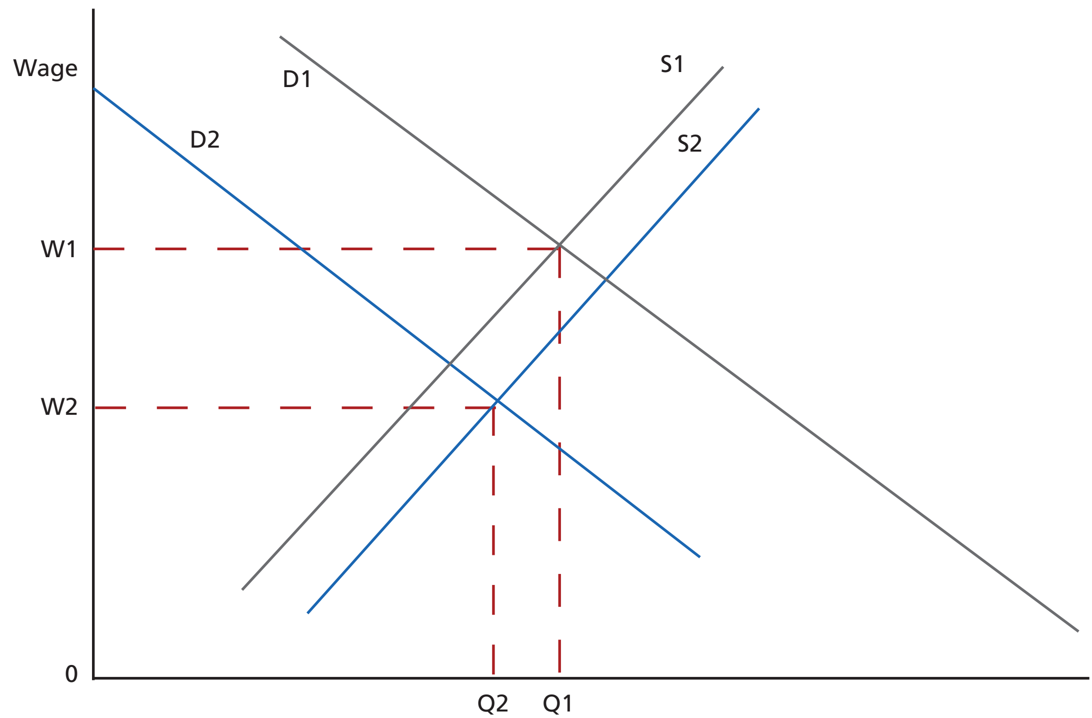
The cost might appear to be borne by the employer. However, in the long term the extra cost would reduce profits and lead businesses to switch resources to another use.

They will therefore try to pass the cost on through higher prices (or, equivalently, lower quality at the same price) to the consumer. This is likely to lead to some fall in the quantity demanded of the product or service, and thus output and employment.

But, in a competitive environment, where international competition for traded goods means that the scope for price increases is limited, what is more likely to happen is that the cost of the benefit is shifted to the workers themselves.

A simple diagram shows how this works. Initially the demand curve for this type of

Figure: The impact of a mandated benefit



labour is D1 and the supply curve is S1. The wage rate is W1 and employment is Q1.

The mandate to provide health spa holidays is introduced and this raises the cost of hiring labour. The demand curve shifts to the left, as it is less profitable to employ a given amount of labour at any given wage rate. The mandate's cost per unit of labour is shown by the vertical distance between demand curve D1 and the new demand curve, D2.

The supply curve will also shift if the employee values the mandated benefit, because at any particular wage rate the job is now a bit more attractive. The vertical distance between supply curve S1 and supply curve S2 represents the employee's valuation of the benefit.

The figure illustrates one possible outcome, where employees value the mandate less than it costs the employer to provide (this can often happen when governments impose mandates which reflect the choices of political activists rather than employees themselves).

In this case the wage rate tends to fall (from W1 to W2), but not to the full extent of the cost of providing the benefit. Part of the cost is borne by the employer, and thus profit-maximising employment falls from Q1 to Q2.

If, however, the employee were to value the benefit at exactly what it costs to provide, the wage would fall to the full extent of the cost.

As the employer would then bear none of the cost, it would be just as profitable to the employer to employ the same amount of labour. Demand would be unchanged and employment would remain constant. Employees would be just as 'well off' as before, only now part of their remuneration would be in the form of the benefit rather than cash.

A final possibility is that employees value the benefit at more than it costs the employer to provide, which could arise if the provision of the benefit was subject to considerable economies of scale.

In such a case we get the odd prediction that wages would fall by more than the cost of the mandate and employment would actually increase. This is unlikely to arise in practice, because if it did the employer would already have had an incentive to provide the benefit without being required to by law: it would

Table: An A-Z of new employment regulation since 2010

This is a partial listing of new requirements placed on business since the 2010 general election. Some result from UK legislation and regulations, others from the European Commission, the European Court of Justice or decisions by employment tribunals or other UK courts.

Requirement	Comment
Abolition of default retirement age	Employers cannot oblige you to retire at a particular age.
Adoption leave extended and pay increased	
Agency Workers Directive implemented	Agency workers given employee rights after 12 weeks
Annual reports on whistle-blowing required	
Anti-slavery statements required annually	Medium-size and large firms
Apprenticeship levy	0.5% on wage bills over £3 million. Apprenticeship title legally controlled.
Auto-enrolment in pension schemes	Rising employer contributions over time to 3% of payroll
Director of Labour Market Enforcement appointed	
Fines for employers in tribunal cases	In addition to costs and payments to employees
Flexible working request rights extended to all employees	Employers have to justify why they cannot allow employees to change hours of work
Gangmasters and Labour Abuse Authority given extended remit and new powers	This is to tackle 'modern slavery'
Gender pay gaps required to be published by larger organisations	'League tables' to be published
Holiday pay extended to cover sales commission	Compulsory holiday pay increased
Jail sentences for employers of illegal immigrants	In addition to heavier fines
Levy on employing non-EU nationals	£1000 per year
Minimum wage non-compliance: stricter penalties	
National Living Wage introduced	For all over-25s, rising over time to 60% of median earnings
Obesity now classified as a disability and thus a 'protected status'	Discrimination based on obesity illegal
Occupational regulation extended	E.g. Childcare workers, private investigators now effectively licensed by the government
Parental leave sharing and extension to grandparents	
Part-time education or training compulsory for school-leavers up to age 18	
Recruitment advertising restricted outside UK	
Wider definition of employee	Tribunal cases have found some 'gig' workers (e.g. Uber) are employees and thus entitled to a range of benefits
Working Time Directive regulations extended	Restrictions on maximum hours worked
Zero hours contracts exclusivity outlawed	Status of all ZH contracts now under investigation by working party

be cheaper to provide the benefit and pay lower wages.

Many non-pay benefits are in fact provided by employers on precisely such grounds: examples include private health insurance, maternity pay in excess of statutory requirements, season ticket loans and gym memberships.

All three of these scenarios suggest that the equilibrium wage will fall. However, if the existing wage rate is very low, and there is a minimum wage rate, wages will not be able to fall, putting all the burden of adjustment on employment.

Lessons

This simple example shows that there are quite fundamental problems in evaluating the impact of employment regulation.

Rather than ultimately falling on profits, the cost of a mandate normally falls on some combination of consumers (in the form of higher prices or lower quality), employees (in the form of wage reductions and/or job losses) and potential employees (who cannot find jobs as employment opportunities dry up).

But in all cases employment and output decisions are affected, and a large number of such interventions can produce an economy where adjustments to fundamental changes in tastes, technology and international competition are difficult and unemployment amongst vulnerable groups and long-term unemployment increases.

Political discussion of employment regulation ignores this as politicians assume (or pretend) that employers bear the cost of growing regulation and there is no wider impact•

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FOR MORE:

This article summarises the forthcoming IEA book ***Working to Rule: the damaging economics of UK employment regulation***, which will be published this spring and will be available for free download at

www.iea.org/publications