

Economic Reform

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Ronald Burgess

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LECTURE NOTES

Unemployment - Who is Being Fooled?

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“Soon or late”, wrote John Maynard Keynes forty-six years ago in the final sentence of his *General Theory*, “...soon or late, it is ideas, not vested interests, which are dangerous for good or evil.”¹

Soon, rather than late, the *General Theory* revolutionised academic thought. From this victory in the field of theory, the ideas of Keynes filtered through to dominate politics, and public policy - the so-called Keynesian revolution. But within ten years Keynes could come out of a conference room in the United States and remark, “I was the only non-Keynesian there” - an amusing aside, but covering a pointed comment. Even in so short a time the so-called Keynesians were shattering the coherence of his *General Theory*.

On the monetary side, the first rumble of a counter-revolution came ten years after the death of Keynes. In 1956 the University of Chicago published Professor Friedman’s essay, “The Quantity Theory of Money - A Re-statement.” This was essentially a generalisation of Keynes’ theory of liquidity preference - a small part of his *General Theory of Employment, Interest and Money*.

The Chicago school, as it was then known, had nothing to say about output or employment and did not represent a serious challenge to Keynesian dominance until, in December 1967, Professor Friedman used the occasion of his Presidential Address to the American Economic Association to put forward his own monetarist theory of employment. With this combination of ideas monetarism gained academic adherents rapidly, particularly amongst the then up-and-coming members - Laidler, Minford, Parkin, Walters, et al.

1 Quoted from the *General Theory of Employment, Interest and Money*, 1936.

From a position of academic supremacy based on success in the realm of theory, the ideas of monetarism, as had the ideas of Keynes decades earlier, filtered through to dominate politics and public policy. Today we live with the result.

Today also the results of monetarist policies are encouraging Keynesians to react with aggressive noises, and last year 364 varieties of academic Keynesians signed a document which asserted monetarists' policies to have no foundation in economic theory. But to agree on no more than an assertion is to admit impotence.

Last month three of the signatories, including a former chief of the Government Economic Service, published a detailed alternative policy package. Professors Hopkin, Miller, and Reddaway proposed a cut in interest rates, more subsidies to nationalised industries, more government spending, a policy of wage restraint, and a devaluation of the pound. Yet throughout the fifties, the sixties, and the early seventies these policies were tried repeatedly - and they failed repeatedly. This is no battle of ideas - it is a reaction of academic vested interests.

Bankrupt businessmen and the unemployed know, as a fact of their own experience, that present policies are not working - they do not need to be informed by academics.

The concern of academics must be, first and foremost, ideas "which are dangerous for good or evil." Their immediate concern must be the matter of employment theory. The monetarists' theory of employment is the idea which has added to the social evil of Keynesian persistent inflation, the social evil of prolonged mass unemployment. It is this crucial theoretical issue of employment theory, applicable to the 1980s, that I wish to consider tonight.

We may begin the story in November 1958 with the publication of a well researched paper by Professor A. W. Phillips, "The Relation between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom - 1861 to 1957." In this paper Professor Phillips applied to the U.K. labour market a

prediction derived from the well established theory of supply and demand. He assumed money wage rates to be the price of labour and the unemployment rate to be a measure of the pressure of demand in the labour market. On these assumptions, he argued, the theory of supply and demand predicts that the lower the rate of unemployment the faster will be the increase in money wage rates.

Professor Phillips plotted his observations on a series of charts similar to Figure 1. Along the horizontal axis he measured, by convention, the assumed independent variable - the rate of unemployment. Along the vertical axis he measured the assumed dependent variable - the rate of change of money wage rates. The calculated line of average relationship between his observations described a curve, as is shown on Figure 1.

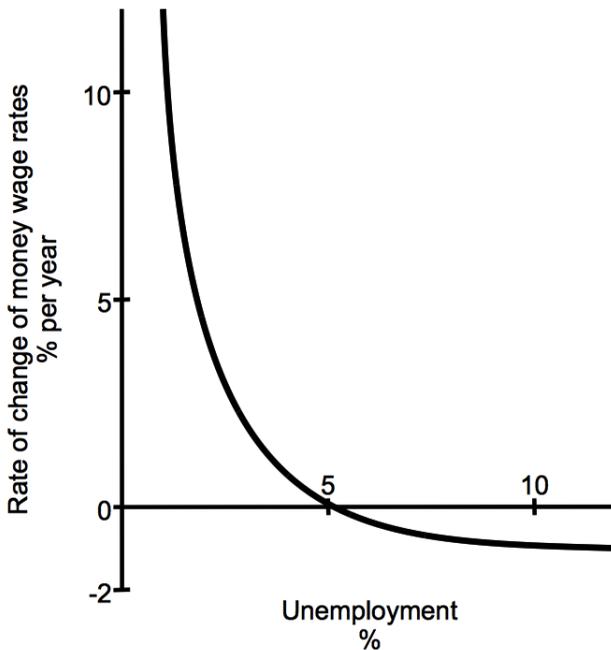


Figure 1

This curve became known as the Phillips curve. The results appeared to fully confirm his predictions from the theory of supply and demand. As the unemployment rate falls, the rate of increase in money wage rates accelerates; as unemployment rises, the rate of increase in money wage rates slows down. At a certain level of unemployment money wage rates stabilise.

Macro-economists accept in general that one can move easily from the rate of change of money wages to the rate of change of prices - the two rates of change usually move together in step, and tend to be of similar magnitudes.

Thus the Phillips curve hypothesis of a stable functional relationship between the rate of unemployment and the rate of change of money wage rates offered a non-monetary explanation for inflation. By substituting prices for wages on the vertical axis of Figure 1, the assumed dependent variable, the hypothesis could be interpreted as stating that there is a stable functional relationship between the rate of unemployment and the rate of inflation. As unemployment falls inflation accelerates, and as unemployment rises inflation decelerates.

To governments of the western industrialised nations the theory offered policy alternatives relevant to immediate public issues - then and, as some still argue, now. Either a government can fix a relatively high unemployment target which will bring down the rate of inflation automatically or, if they fix a lower unemployment target, then a prices and incomes policy is necessary in order to restrict the otherwise inevitable rise in money wages and prices.

At universities throughout the world Phillips' paper stimulated extensive research and spawned a vast literature. It soon became apparent that the crude Phillips curve was of doubtful validity and, in particular, the functional relationship was found to be unstable. Nonetheless, the majority of influential economic opinion held that, in some more sophisticated form, the Phillips curve hypothesis was valid. The rate of unemployment was held to be a significant factor determining the rate of inflation in any economy

allowing free wage bargaining.

It was in the guise of offering a non-monetary explanation for inflation that the Phillips curve hypothesis came into direct conflict with the emerging Chicago school. Professor Friedman and his followers asserted that inflation was “always and everywhere a monetary phenomenon” and that to halt an inflation not only was a restrictive monetary policy necessary but also it was sufficient. The Chicago school could not co-exist with an idea that provided a non-monetary explanation for inflation. Professor Friedman, in his Presidential Address to the American Economic Association, launched both a successful theoretical attack on the opposing idea and at the same time formulated a monetarist theory of employment.

Later, in the early seventies, Professor Friedman came to London and gave a similar lecture to an invited audience of academics and government advisors. My references will be to that London lecture at which I was present.

“Phillips’ analysis”, said Professor Friedman in London, “seems very persuasive and obvious, yet it is utterly fallacious. It is fallacious because no economic theorist has ever asserted that the demand and supply of labour were functions of the nominal wage rate. Every economic theorist from Adam Smith to the present would have told you that the vertical axis should refer not to the nominal wage rate but to the real wage rate.”

What Professor Friedman was saying in terms of Figure 1 is that along the vertical axis the rate of change of money wage rates must be divided by the rate of change of prices. But when this adjustment is made the figure says nothing about inflation. A change in the dependent variable might be as a result of a change in money wages, or of a change in prices, or any combination of the two. Thus, with one shot, Professor Friedman killed the Philips curve hypothesis as a non-monetary explanation for inflation.

Refutation may be possible but certainly not easy - it requires arguing through to a successful conclusion that, “every economic

theorist from Adam Smith to the present” is wrong.

Professor Friedman proceeded, and presented us with an illustration similar to Figure 2. “Suppose, to start with” he said, “the economy is at point *Eo*, with both prices and wages stable. Suppose something, say, a monetary expansion, starts nominal aggregate demand growing, which in turn produces a rise in prices and wages at the rate of, say, 2 per cent per year. Workers will initially interpret this as a rise in their real wage - because they still anticipate constant prices - and so will be willing to offer more labour; employment grows and unemployment falls. Employers may have the same anticipations as workers about the general price level, but they are more directly concerned about the prices of the products they are producing, and are far better informed about that. They will initially interpret a rise in the demand for and the price of their product as a rise in its relative price implying a fall in the real wage rate they must pay measured in terms of their own product. They will therefore be willing to hire more labour. The combined result is a movement, say, to point *F*, which corresponds with ‘over-full’ employment, with nominal wages rising at 2 per cent per year.”

“But, as time passes”, continued Professor Friedman, “both employers and employees come to recognise that prices in general are rising. As Abraham Lincoln said, you can fool all of the people some of the time, you can fool some of the people all of the time, but you can’t fool all of the people all of the time. As a result, they raise their estimate of the anticipated rate of inflation, which reduces the rate of rise of anticipated real wages, and leads you to slide down the curve back ultimately to the point *Eo*. There is a short-run trade-off between inflation and unemployment, but no long run trade-off.”

All this, as Professor Friedman said of Phillips’ analysis, seems very persuasive and obvious. I would ask you to note that at this stage of his argument Professor Friedman assumes not only that there is, in the long-run, a particular rate of unemployment towards

which an economy tends automatically, the 'natural' rate E_0 , but also that this particular long-run 'natural' rate of unemployment is uniquely related to a stable rate of real wages, as shown in Figure 2 by the horizontal line corresponding to the zero measured along the vertical axis.

Moreover this diagram, as presented by Professor Friedman, is at best misleading. Employees may be prepared to accept more jobs when they expect their real wages to rise but employers, as Professor Friedman stated, are more likely to offer more jobs when they expect real wages to fall. That is, when they expect prices they receive to rise faster than the money wages they pay out.

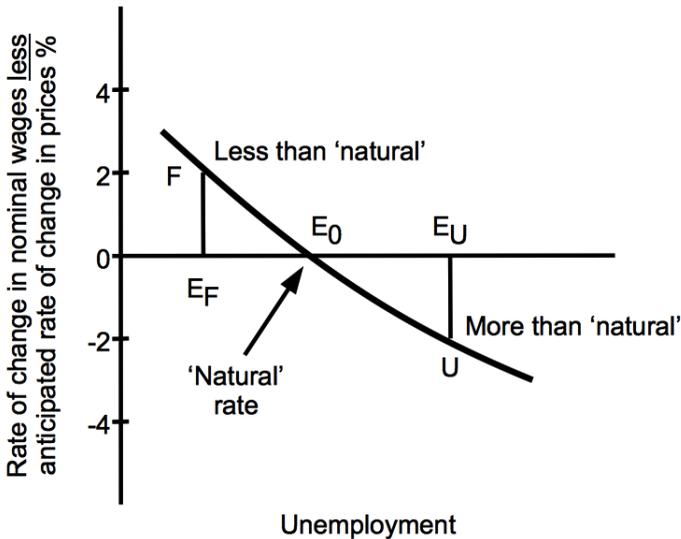


Figure 2

Figure 3A is, I consider, a more accurate representation of Professor Friedman's argument. The employers' curve is the inverse of the employees' curve. The employers' curve rises from left to right. The employees' curve falls from left to right. The point to which an economy tends automatically is determined by

the intersection of the two curves. Given Professor Friedman's implicit assumptions, this happens also to co-incide with the horizontal line corresponding to zero measured along the vertical axis of Figure 3A.

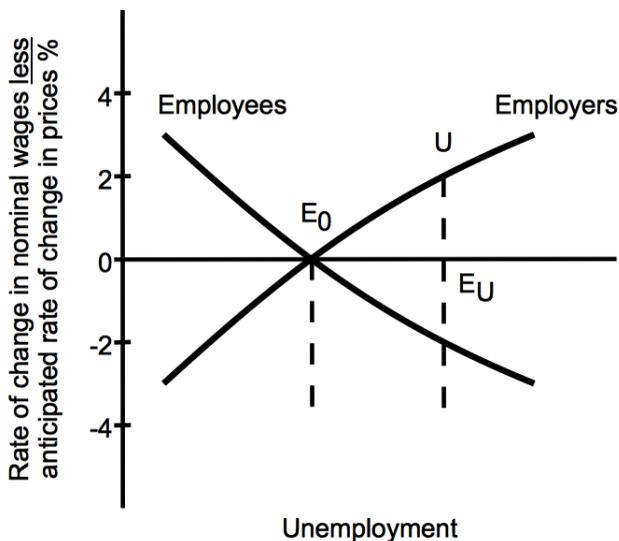


Figure 3A

However, more of this anon; in London these issues were not raised, and so Professor Friedman's story flowed on. Professor Friedman went on to produce a figure which reverted to the original Phillips scheme - similar to Figure 4.

Along the horizontal axis is measured the assumed independent variable, unemployment. Along the vertical axis is measured the assumed dependent variable, the rate of change in nominal wages. The original Phillips curve is represented by the lower continuous line, marked $P = 0$.

Professor Friedman moved now towards his conclusion. By deduction from his argument so far, this original Phillips curve implicitly assumes inflationary expectations to be zero - it assumes

that both employees and employers anticipate a stable general price level. This assumption was now made explicit by incorporating price expectations into the curve (as shown on Figure 4 by the case where $P = 0$). From this it follows that the curve is essentially a short-run curve, holding only for so long as inflationary expectations remain zero.

Next, we were asked in London to suppose, for some reason nominal wages and prices begin rising at a rate of 2 per cent per year. Initially both employees and employers will interpret this as being to their advantage, since they anticipate stable prices. So the economy expands and unemployment falls from a 'natural' rate E_0 to full or over-full employment corresponding to E_f , as there is a movement up the short-run curve to a new point of intersection, F .

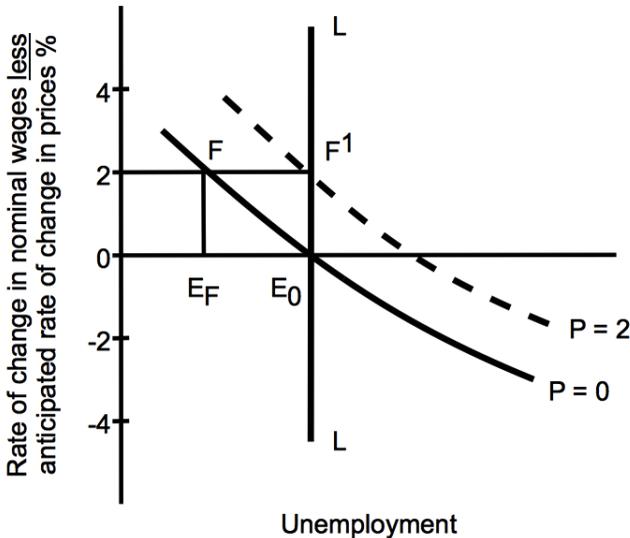


Figure 4

As time passes people adjust their inflationary expectations to their continuing experience, that is, they begin to expect an inflation rate of 2 per cent per year. This change in inflationary

expectations Professor Friedman illustrated by drawing another short-run curve incorporating inflationary expectations of 2 per cent. As the annual 2 per cent rise in nominal wages and prices becomes fully anticipated unemployment rises from the low of E_f back to the level where it started before the inflation, the natural rate of unemployment E_o . This new point of intersection is given by the new short-run curve incorporating inflationary expectations of 2 per cent shown on Figure 4 by the broken curve marked $P = 2$.

A long-run Phillips curve is to be described by a line joining the points of intersection on a series of short-run curves - shown on Figure 4 by the vertical line $L-L$. In the short-run, argued Professor Friedman, it may be reasonable to expect that unanticipated inflation will result in a trade-off between the rate of unemployment and the actual rate of inflation, but in the longer-run any economy will tend automatically towards a rate of unemployment that is independent of any actual rate of anticipated inflation. This concluded Professor Friedman, "is entirely consistent with what any reasonable man must expect; which is that, since you can't fool all the people all the time, the true long-run Phillips curve is vertical."

What had Professor Friedman achieved by this disquisition in the realms of employment theory?

First, he had successfully disposed of the crude Phillips curve hypothesis as a non-monetary explanation for inflation. Second, he had formulated a monetarists' theory of employment which was consistent with his Re-stated Quantity Theory of Money, and made his proposals for halting inflation by a restrictive monetary policy politically acceptable - in the longer run, the rate of unemployment towards which an economy tends automatically is independent of monetary policy and the rate of inflation.

This monetarists' theory of employment has become known as the 'natural' unemployment rate hypothesis. If the true long-run Phillips curve is vertical, then for any economy there is a unique rate of unemployment - the 'natural' rate - towards which that

economy tends automatically when the actual rate of inflation neither accelerates nor slows down relative to expectations. It follows, when an inflation is halted by a restrictive monetary policy then the actual rate of unemployment will not be different in the long-run from that which would prevail given a persistent inflation rate of 5, 10, or 20 per cent. The long-run choice, argues Professor Friedman and his followers, is not between unemployment or inflation but between a 'natural' rate of unemployment with inflation or a 'natural' rate of unemployment without inflation.

In the face of the monetarists' natural rate hypothesis, the alternative policy detailed by Professors Hopkin, Miller and Reddaway collapses. Not only is their policy based on ideas which have persistently failed in the past, but they claim for their proposed reflation of the economy no more than, that it will produce nearly $\frac{1}{2}$ million new jobs within 15 months. Against this the monetarists can demonstrate conclusively that of the present 3 million unemployed about 2 million are the lagged result of inflationary policies pursued by previous governments. Further, an additional $\frac{1}{2}$ million, it can be argued, are the result of an intensive worldwide depression. So the policy dispute turns on about $\frac{1}{2}$ million new jobs.

The Keynesians argue that these $\frac{1}{2}$ million jobs were lost as a result of a deflationary monetary policy and can be recreated within 15 months by pursuing a Keynesian reflationary policy. Against this, given the idea of a natural rate of unemployment, monetarists can admit that their deflationary policy has caused a temporary rise in unemployment, say $\frac{1}{2}$ million, but this year they can argue we may expect unemployment to begin falling and within 15 months the temporary hump will have vanished. The present policy dispute between Keynesians and monetarists offers to government a choice: change to Keynesian reflationary policy and within 15 months unemployment will be down to no more than $2\frac{1}{2}$ million but with a higher and possibly rising rate of

inflation. On the other hand, continue with deflationary monetary policies and within 15 months unemployment will be down to 2½ million with a lower and possibly falling rate of inflation.

Unless the ‘natural’ unemployment rate hypothesis is first refuted who can deny the assertion “there is no alternative policy”? For macro-economists at this time to slap each other's faces with the red herrings of alternative policies seems to be little more than a way of avoiding the immediate issue that confronts them in the academic sphere of ideas: is the ‘natural’ unemployment rate hypothesis valid?

From what I have said to you tonight the answer to this question must be: the hypothesis is of doubtful validity at best.

As I pointed out earlier, Professor Friedman began his London lecture by implicitly assuming a ‘natural’ rate of unemployment which is uniquely related to a ‘natural’ real wage rate. It was this implicit assumption that enabled him to construct, as shown by Figure 4, the series of short-run Phillips curves which yield the vertical long-run Phillips curve, and it is the vertical long-run Phillips curve that leads to the conclusion that there is a ‘natural’ rate of unemployment, *Eo*. Briefly, from an implicit assumption that there is a ‘natural’ rate of unemployment Professor Friedman arrived at his conclusion that there is a ‘natural’ rate of unemployment. Not a method of reasoning which inspires confidence.

But of greater importance to us in the U.K. today is not the question of validity, rather, it is whether the ‘natural’ unemployment rate hypothesis may be regarded as a working hypothesis. That is, is it a hypothesis that may answer for present practical purposes? Can it be applied to a contemporary industrialised economy such as the U.K.? My answer to these questions is a definite negative.

How are we to interpret the assumed independent variable measured along the vertical axis - nominal wages? I admit that all economic theorists “from Adam Smith to the present” have used

and still use this term, but I argue that, without qualification the term has been meaningless for all practical purposes for at least the past forty years. All contracts of employment, in this country and most other western industrialised countries, attract taxation. This taxation drives a wedge between what the employee receives in return for his labour - his take-home pay - and what an employer must pay out for that labour - the employers' labour cost. Does nominal wages refer to employees' take-home pay, or does it refer to employers' labour cost? Professor Friedman does not specify.

Today, in this country at least, the pay bargain tax wedge - the difference between take-home pay and employers' labour costs - is a very important item. It yields 50% of all government tax revenue. It is the equivalent to a VAT rate of 40% on take-home pay - for every one pound an employee takes home the employer has to pay on average an additional 40 pence to the tax collector.

Over the past 25 years nominal take-home pay has multiplied 10 times whilst nominal labour cost has multiplied 12½ times - a difference in the rate of change of 25 per cent. It makes a great deal of difference to the measurements on the vertical scale of Figures 2, 3 and 4 whether one interprets wages as take-home pay, or employers' labour cost. Given Professor Friedman's definitions, then for an economy such as the U.K. the 'natural' unemployment rate is indeterminate - one may come up with any number of answers - and so the hypothesis does not serve for present practical purposes.

As a working hypothesis the monetarists' theory of employment has to be rejected. But, if we reject the monetarists' idea of a 'natural' rate then the present government's medium term financial strategy is without theoretical foundations. There is no basis for predicting that in the medium term the strategy will permanently reduce the rate of inflation without permanently affecting the volume of output and employment.

The nub of the immediate issue is not monetary policy, or monetary theory - it is employment theory. Professor Friedman's

theory of employment is logically unsound and does not even serve as a working hypothesis. Yet the 'natural' rate idea has captivated the contemporary monetarists. In turn the monetarists have fooled the present government. Even the Keynesian opponents of monetarism have been fooled. They have been drawn into disputing policy issues, where they represent no immediate threat, whilst an idea powerful for social evil has been allowed to dominate public policy.

However, although the 'natural' unemployment rate hypothesis has to be rejected as a working hypothesis, it can be developed to shed some light on immediate issues. If we accept that Professor Friedman's argument implicitly assumes a condition of no pay bargain tax wedge - that is, that take-home pay and employers' labour cost are identical sums - then, given that assumption, we can accept that the true long-run Phillips curve - shown as $L-L$ on Figure 4 - is indeed vertical. That is, assuming conditions of no pay bargain tax wedge, then there is for any economy a 'natural' rate of unemployment determined by real factors. But we are not immediately concerned with such an economy and, therefore, as a first step towards drawing policy implications from the theory we must drop the assumption. Now, given the introduction of a pay bargain tax wedge, the question is: Does the pay bargain tax wedge increase employers' labour cost?

To answer this question we can, as did Professor Friedman, call upon the authority of Adam Smith, the grand-daddy of all macro-economists. Adam Smith concluded that employees shifted all taxes imposed upon their income on to their immediate employers. This conclusion reached some 200 years ago is fully supported by recent research results from many parts of the world, and the OECD has admitted that net of tax wage bargaining is common to all western industrialised economies. Thus we may predict with confidence that in the longer run the introduction of a pay bargain tax wedge will increase employers' labour cost by the full amount of the tax imposed.

Let us go back to my fuller representation of Professor Friedman's intermediate diagram. Figure 3A assumes that the 'natural' rate of unemployment E_o is uniquely related to a 'natural' real wage rate. The point of intersection of the employees' and employers' curves corresponds to a certain stable rate of real wages, marked zero on the vertical axis. It also assumes implicitly that there is no pay bargain tax wedge.

Now, the introduction of a pay bargain tax wedge will force the zero for employees apart from the zero for employers and, according to both theory and empirical studies, it will do this in a way that forces the employers' curve down along the whole of its length. This is shown by Figure 3B. It follows, if the employers' curve is driven downwards by taxation, then the rate of unemployment towards which an economy tends automatically will increase. As, from the employers' point of view, the pay bargain tax wedge is added on to the so-called 'natural' real wage then it is to be expected that the resulting rate of unemployment will be in excess of the so-called 'natural' rate of unemployment.

But in saying this we turn the whole picture round. Both Professor Phillips and Professor Friedman assumed free market conditions in which the theory of supply and demand predicts that the forces of supply and demand will determine the market price. For this reason both assumed unemployment to be the independent variable measuring the forces of supply and demand, with wages as the dependent variable measuring the resulting price. Against this we have reasoned that the introduction of a pay bargain tax wedge effectively simulates monopoly market conditions. In monopoly market conditions the theory of supply and demand predicts that it is the forces of supply and demand which adjust themselves to a fixed monopoly price. Things work the other way round in a monopoly market as compared to a free market. In this country the pay bargain tax wedge determines what is for employers effectively a fixed monopoly price for labour.

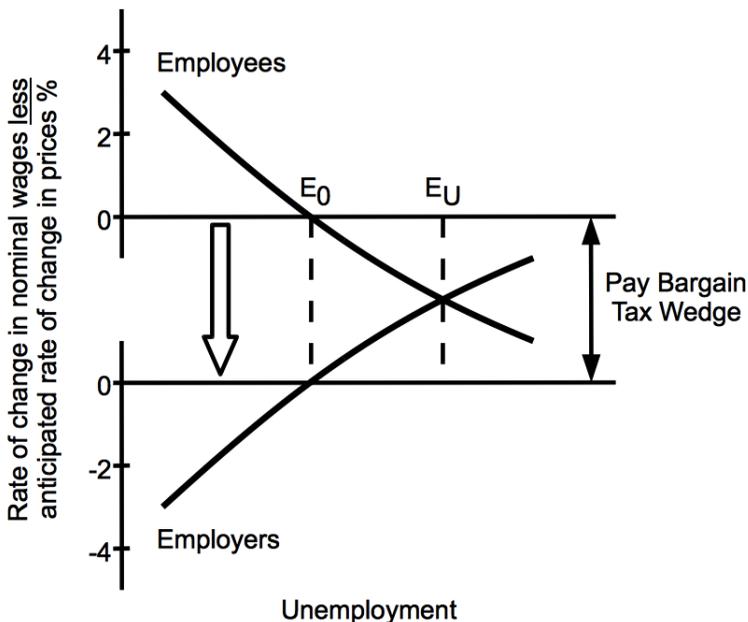


Figure 3B

We have concluded, by prediction from the theory of supply and demand as it applies to contemporary labour market conditions, and by deduction from Adam Smith’s tax analysis fully confirmed by recent research results, that in the longer run the size of the pay bargain tax wedge will effectively determine employers’ labour cost, and that unemployment will adjust accordingly. This conclusion requires the rejection of the monetarists’ employment theory and takes us back to Keynes’ General Theory, published forty-six years ago. Unemployment is a dependent variable. Unemployment is dependent upon government fiscal policy - that is on general government’s taxing and spending.

Regression analysis based on recent experiences provides the supporting evidence for my conclusion from theory. The rate of unemployment lagged 15 months is a function of the pay bargain

tax wedge. On Figure 5 I have plotted U.K. evidence over the past 25 years on a scatter diagram similar to those used by Professor Phillips and Professor Friedman. However, Figure 5 shows a very different picture.

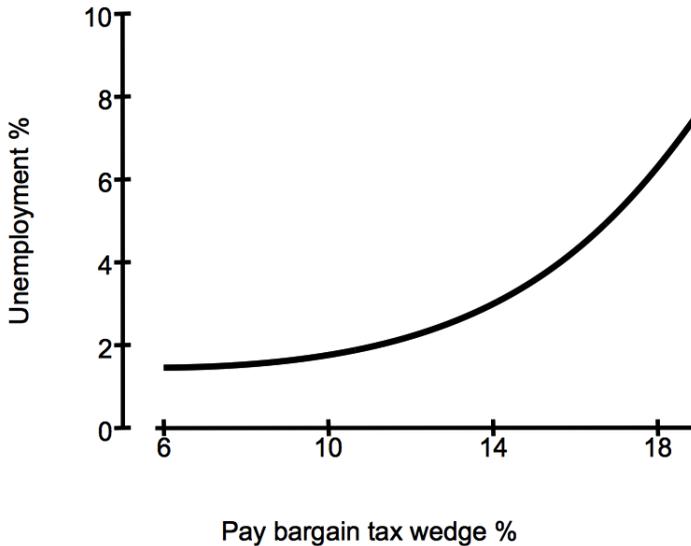


Figure 5

The unemployment rate, lagged by 15 months, is now the dependent variable and so is measured along the vertical axis. The independent variable is the pay bargain tax wedge measured in real terms - in the case of Figure 5 as a percentage share of the product.

The dots show the observed data, and the curve represents the calculated line of average relationship between the plots. By inspection U.K. experience is shown to be consistent with my prediction from theory. As the pay bargain tax wedge is increased then about a year later unemployment tends to rise - when the pay bargain tax wedge is cut then a year later unemployment tends to fall. Over the full 25 years the coefficient of correlation has a value of over 0.9 - any value over 0.4 would be statistically significant.

Directly, Figure 5 tells us much about the relationship between government tax decisions and the rate of unemployment; it does not tell us much directly about the rate of inflation. However, as the pay bargain tax wedge pushes up labour costs it is reasonable to deduce that rising labour costs will tend to push up prices. As tax-inflated labour costs lead to rising prices then in the medium term - say 2 to 4 years - monetary policy will determine the precise trade-off between the rate of inflation and the rate of unemployment. This conclusion is wholly consistent with our current experiences although it is inconsistent with contemporary monetarists' predictions from their 'natural rate' hypothesis.

"Soon or late, it is ideas, not vested interests, which are dangerous for good or evil." How is it that in the 1980s macro-economists appear unable to distinguish between ideas that are forces for good and ideas that are forces for social evil? The theories, the evidence, the technology for treating the evidence, are for the first time all readily available. Forty-six years ago Keynes brought together monetary theory and output and employment theory into a coherent whole. His General Theory was not the last word but the first word. Those who have followed have spent their energies in pulling asunder what he had put together.

The so-called Keynesians with their 'real income and expenditure' and 'demand management' approaches have developed one part of the General Theory. They can say much about output and employment but nothing about inflation in a society with any semblance of freedom. The continuing social evil of persistent inflation brought the contemporary Keynesians into disrepute.

The Chicago school developed another part of the General Theory. They can say much about inflation but nothing about output and employment. The monetarist's theory of employment is, as I trust I have demonstrated to you tonight, misleading nonsense having no relevance to present day conditions. The re-appearance of the social evil of mass unemployment is already

bringing the monetarist school of thought into disrepute.

In the absence of a John Maynard Keynes what remains? He did leave us his General Theory. Macro-economics can go back and start again by developing Keynes' ideas as a coherent whole. It is ideas that bring about fundamental change.

There is no solution to our present predicament through the creation of new political parties², or through changing governments; not even through changing policies, so long as incomplete and false ideas in the academic sphere continue to dominate. Mass unemployment is not the result of economic forces beyond the control of government any more than is persistent inflation. Today, in the western industrialised countries, there is no 'natural' rate of unemployment any more than there is some 'natural' rate of inflation. Both theory and the facts of experience combine to tell us that governments cannot spend what they like, they cannot tax as much as they like, how they like, and at the same time be a force for good.

To eradicate the social evils of inflation and unemployment governments must accept both monetary and fiscal discipline. Once this idea is accepted by academics and government advisors and permeates Parliament, then, for a free society, the road to full employment with stable prices will be open.

Let us not be fooled by superficial disputes about passing policies. It is false ideas that create social evils. It is good ideas that have the power to carry us through to Social Justice.

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2 A reference to the formation of the SDP as a new political party in March 1981. This talk was given in January 1982.