PUBLIC FINANCE

Volume 2

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Public Finance

Studies in Economics by

Ronald Burgess

Public Finance

Ronald Burgess practised as an economist for more than fifty years. His aim was to offer practical advice to government based upon study, research, instruction and public speaking.

The editors have drawn upon a collection of manuscripts and recordings to prepare four volumes of his work on public finance supplemented by notes, commentary and references:

VOLUME 1

Economics Now 1979-1980. Ten seminars setting out an approach to macroeconomics with particular reference to government policy.

VOLUME 2

Ten Public Talks 1980-1983. A series of public lectures on topical issues such as monetarism, inflation, unemployment and taxation.

VOLUME 3

Spatial Economics (ten lectures) and **Normative Economics** (six lectures) 1983-1984. Original work on the relationship between the spatial aspects of macroeconomics and the role of the polity.

VOLUME 4

Further Work 1971-1994. A collection of essays and public talks on such topics as privatisation, local government finance, and the economic position of Greece within the European Union.

In 1993, with the support of the Economic Study Association, Ronald Burgess completed and published his book *Public Revenue Without Taxation*. The editors hope that these four volumes will provide a fuller picture of his work and assist the general reader with an interest in public finance.

Volume 2

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Preface

This book contains the transcripts of a series of public talks that were given by Ronald Burgess from September 1980 through to 1983. They have been prepared for this volume by members of the Economic Study Association in London, of which Burgess was the Director from its formation in 1965 until 1992.

During the period covered by these talks the British economy went through a period of great volatility and change. Interest rates rose to 10%. Inflation exceeded 18%, whilst unemployment levels reached 12.5% (3.3 million people). The Thatcher government was first elected in May 1979 and continued in office until November 1990. Under the influence of economic advisers of the day radical changes of government policy were adopted and put into practice.

The public talks given in this period provide a commentary on some of these events and on the policy decisions that were taken by government. They reflect considerable insight and analysis and were based on detailed research and informed opinions of the time.

Footnotes and references have been added throughout to assist the general reader. There is also a bibliography, drawing together the main references used with suggestions for further reading.

For clarity of presentation it has been necessary to reconstruct most of the charts which accompanied the lectures, as the originals are no longer available; in most cases the diagrams shown in the text should be taken as giving only an indication of the original.

Many people have contributed to the preparation of this volume and the editors are pleased to acknowledge the assistance received.

The editors are also grateful to their colleagues in New Zealand for their helpful suggestions and careful proof-reading of the final draft. Any remaining errors or oversights remain the responsibility of the editors.

Historical note

From 1933 until 1971 the price of gold on world markets had been stabilised at around \$35 per ounce. Under the Bretton Woods agreement of 1944 many countries, including the United Kingdom, pegged the value of their currencies to the price of gold.

On 15th August 1971 the United States finally abandoned the gold standard by withdrawing from the Bretton Woods agreement. Other countries, including the United Kingdom, followed shortly afterwards. Over the next few years both the United States and the United Kingdom experienced periods of very high inflation, which seemed to present the only alternative to rising unemployment.

The oil exporting countries soon found it necessary to increase the world price for their oil exports, which were traded in dollars, leading to the first oil price shock in 1973 and a further adjustment in 1979. The price of oil increased fourfold from a typical \$3 per barrel to an average of \$12 in 1974, and almost \$40 in 1979.

The economy of the United Kingdom was then faced with both an energy crisis and rising inflation, and the prospect of increasing unemployment. A three-day working week was introduced and the value of the pound came under intense international pressure.

In September 1976 the UK was obliged to request a loan from the International Monetary Fund of £2.3 billion. To meet the full terms of the loan, the Chancellor of the Exchequer, Denis Healey, enacted severe public spending cuts and other economic reforms.

After the so-called ‘winter of discontent’, marked by a number of public sector strikes, the government of the day lost a vote of no confidence in March 1979. This triggered the General Election of May 1979 which resulted in the Conservative Party forming a new government under Margaret Thatcher, initially with Sir Geoffrey Howe as Chancellor of the Exchequer.

Gold continued to rise in value, from \$35 per ounce in 1971, to a new record level of more than \$800 per ounce in January 1980.

Unemployment had been one of the key election policy issues. It had risen from 300,000 in 1964 to 580,000 in 1970, and then to around 1 million people in 1974. It continued to rise to 3.3 million, or 12.5%, by January 1982, and still exceeded 3 million in 1986.

Western governments looked for new policies. Both the United States and the United Kingdom were drawn towards monetarism, but found themselves in a period of recession with unemployment still at a high level. Inflation rose to a peak of 22% in 1980. This period was labelled 'stagflation'.

The Falklands conflict took place in the South Atlantic Ocean from early April until mid-June 1982.

The Conservative Party, again under Mrs Thatcher, returned to government at the General Election of 1983. The SDP and Liberal Alliance, formed in 1981, finished in third place with 25% of the popular vote but came very close to matching the popularity of the opposition Labour Party.

From 1983 onwards Nigel Lawson replaced Sir Geoffrey Howe as Chancellor of the Exchequer and found it necessary to introduce public expenditure cuts of £500 million almost immediately.

The year-long miners' strike took place from the beginning of March 1984 through to March 1985.

Large-scale deregulation and privatisation continued, however, with the disposal of many former state-owned enterprises, in areas such as telecommunications, vehicle manufacturing, and steel. The gas, electricity, and water supply sectors were also broken up into smaller organisations and transferred into the private sector.

De-regulation of financial markets followed in October 1986. This triggered further dramatic changes, giving rise to a renewed importance for the City of London, major changes in the money supply, and steadily increasing house prices as banks began to lend additional money for mortgages. Many former building societies abandoned their mutual status and acquired banking licences.

The Conservative administration of John Major replaced that of Margaret Thatcher in November 1990.

TEN PUBLIC TALKS

1

Friedman Plus Keynes – a New Equation

13th September 1980

In August 1930 the number registered as wholly unemployed just tipped the two million mark. Twenty-five years later in 1955, after the Keynesian revolution had been accomplished, there were issued the lowest ever unemployment figures for the month of August – 181,000. Then came the counter-revolution in monetary theory, and this August, a further twenty-five years on, the number registered as wholly unemployed tipped the two million mark once again. An historically accurate – though loaded – view of events.

Those of you who read the appropriate columns in the newspapers and journals and tune in to the supposedly more serious radio and television programmes will have been informed by the economic journalists and commentators that during the past ten years there has opened up a great divide amongst academic economists.

On the one side, you will have gathered, are the Keynesians. Their champions are Ricardo, Marx, and Keynes, none of whom can now speak for themselves. The contemporary Keynesians, it would appear, are managed from Cambridge,[1] with public relations organised from London by the National Institute of Economic and Social Research. You will have been informed that Keynesians believe that money does not matter.

On the other side of the divide are the monetarists. They have no need for separate management or public relations, as their champion is alive, well, and living in the United States – Professor Milton Friedman, now a Nobel Laureate. From constant repetition you will know that monetarists believe that money does matter.

1 A reference to the Cambridge Economic Policy Group of the late 1970s.

Admittedly there is a divide, but the mass media view I have just outlined is not only loaded, but also pays scant regard to historical accuracy.

Throughout his life John Maynard Keynes was very much concerned with money matters. Before the First World War he was appointed to the Royal Commission on Indian Finance and Currency – then a most important issue for the government at Westminster. During the final years of his life, at the end of the Second World War, he was concerned with the Bretton Woods Agreement and with negotiating the U.S. loan. The former was a monetary agreement of world-wide importance, whilst the U.S. loan saved this country from financial collapse.

During the inter-war years Keynes published his *Treatise on Money*, which, some argue, is a more important work than his later *General Theory*. David Ricardo too dealt with money and banking issues at great length, and it was in recognition of his expertise in the sphere of monetary economics that he was appointed a member of the Bullion Committee.

From about 1581, when it is recorded that a crude form of the quantity theory of money[2] reached Cambridge from France, all the established economic theorists, right through to the present day, have accepted that over a period of years there is a positive and significant association between changes in the money supply and changes in the general price level.

When the rate of increase in the money supply is persistently in excess of the rate of growth of real output then, inevitably, prices will rise. A stable general price level requires the maintenance of a balance between changes in the money supply and changes in real output. There is no argument about this. Over the centuries the

2 The quantity theory of money is typically represented by the relationship $M V = P T$, where M is the quantity of money, V its velocity of circulation, P the general level of prices, and T the volume of trade, or transactions. The value of V is sometimes derived from observations of the other parameters. In the monetarist view of the theory, emphasis is placed on the demand for money as an alternative to the holding of other types of financial assets.

available evidence from all countries has made the proposition incontrovertible.

The academic divide between contemporary Keynesians and contemporary monetarists did not arise from the rejection by one side, and the acceptance by the other, of the quantity theory of money. The divide arises from a fundamental difference as to the nature, and the causes, of unemployment.

Fundamental to the contemporary Keynesian view is the theory that the volume of output and employment is a dependent variable, determined by factors largely within the control of government fiscal and monetary policies.

That the volume of output and employment is a dependent variable is indeed central to the *General Theory of Employment* as formulated by Keynes in the thirties. He argued that the volume of output and employment is determined by the point of intersection between the aggregate demand function and the aggregate supply function.

Fundamental to the contemporary monetarist view is the theory that the volume of output and employment is an independent variable, in the sense that it is determined by factors that are not susceptible to control by government fiscal and monetary policies.

The policy proposals of the two factions then follow directly from their fundamental theoretical differences. Keynesian policy proposals are directed towards the discharging by government of their responsibilities for sustaining a high level of employment. In the U.K. the government first accepted this responsibility with the publication of its 1944 White Paper on employment.[3] Monetarist proposals are directed towards eradicating inflation.

Presumably both sides would agree, however, that inflation and unemployment together are worse than inflation or unemployment. Moreover, the proposition that one evil is an improvement on two evils commends itself to common sense.

3 The UK government issued a White Paper on Post-War Employment Policy in May 1944, with a view to full employment under post-war conditions.

The differences in policy proposals are, as I have said, the result of a fundamental difference not so much in monetary theory as in employment theory. In any sphere, if a difference is to be resolved, then first it must be seen what that difference is. In this particular case, once the difference between contemporary Keynesians and contemporary monetarists is seen to be in the employment theory and not in whether money matters, or does not matter, or does not matter overmuch – once this is seen, the divide can be bridged.

Indeed, the academic dispute that creates the divide appears to be unnecessary, for it can be shown that the economics of Keynes and the more recent developments in monetary theory are not incompatible, but in combination they point the way to achieving a stable general price level whilst at the same time sustaining a high level of economic activity.

Contemporary monetarism was born out of a clash between what was then known as the Chicago School and a long-running academic dispute about the Phillips curve hypothesis. In 1956 the University of Chicago published a volume entitled *Studies in the Quantity Theory of Money*, a product of that university's workshop in money and banking. The volume was edited by Professor Milton Friedman and he personally contributed the leading essay: *The Quantity Theory of Money – a Restatement*.

According to the late Harry Johnson and others the restatement was essentially a sophisticated version of Keynes's theory of liquidity preference. Professor Harry Johnson was an important figure in the early development and dissemination of the restated quantity theory. As a corporal in the Canadian army he had been a post-war undergraduate at Cambridge, and thus well acquainted with the pre-Keynesian Cambridge quantity equations and with the economics of Keynes. Later, he was a colleague of Professor Friedman at Chicago, and also a Professor at the London School of Economics.

However, regardless of the primary sources of Professor Friedman's statement, it did open the way for fruitful and scientific controversy which led to an important development in monetary theory. The pre-Keynesian quantity theory of money assumed an automatic tendency towards full employment, and as during the thirties this was manifestly in conflict with the facts of experience, the theory fell into disrepute. The restated quantity theory met these criticisms with a counter-contention. According to Professor Friedman, the restated quantity theory is – and I quote – "in the first instance a theory of the *demand* for money" – and he puts the word 'demand' into italics for emphasis. He then goes on: "It is not a theory of output, or of money income, or of the price level."

In other words, the restated quantity theory is not a theory of aggregate response to monetary change. The question of whether an economy responds to monetary impulses by price level, or by output level, is outside of its scope.

By setting itself free in this way the Chicago School suffered a serious shortcoming. Its policy implications were not attractive to governments charged with the responsibility of maintaining a high level of employment. For example, when Professor Friedman visited this country in 1970 as leader of the Chicago School, the label of monetarism was just beginning to gain ground, and in a lecture delivered at the Senate House of the University of London, he formulated what he called 'The eleven key propositions of monetarism'. I quote the fourth proposition in full:

"The changed rate of growth of nominal income shows up first in output and hardly at all in prices. If the rate of monetary growth is reduced then, about six to nine months later, the rate of growth of nominal income and also of physical output will decline. However, the rate of price rise will be affected very little. There will be a downward pressure on prices only as a gap emerges between actual and potential output."

As I understand this proposition, Professor Friedman, ten years ago, was being quite explicit. A restrictive monetary policy will precipitate a slump; providing that slump is sufficiently intensive then, in due course, the rate of price rise will slow down. Not a statement likely to arouse passionate dissension among academic theorists, or businessmen – or, indeed, anybody else. Equally, not a statement likely to appeal to many politicians, even though the established Keynesian orthodoxy was incapable of proposing a solution to the persistent inflation that appeared to be inevitably associated with their demand management techniques.

Or, perhaps more accurately in the light of later events, the Keynesian orthodoxy was unable to propose a solution to inflation acceptable to free trade unions and to a free electorate, as George Brown, Barbara Castle, Edward Heath and Jim Callaghan will testify. But no doubt these defeated politicians will testify also that they would have had no chance of remaining in power on the promise of precipitating a permanent slump in order to eradicate inflation.

The restated quantity theory of money which Professor Milton Friedman was expounding in 1970 is, however, only one of the elements in contemporary monetarism.

Another element, the element that does make contemporary monetarism attractive to politicians, evolved from a long-running academic dispute that followed hard upon the publication of an empirical study by Professor A. W. Phillips. It was entitled: *The Relation between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom: 1861–1957*.

This study was first published in a London journal in 1958, just two years after the publication in Chicago of Professor Friedman's restated quantity theory of money. Professor Phillips hypothesised that there was a negative functional relationship between the unemployment rate and the rate of change in money wages.

As unemployment reduced, the faster money wages increased; as unemployment rose, the rate of increase in money wages slowed until, at a certain level of unemployment, the rise in money wages was halted. With stable money wages was created the possibility of a stable general price level. This relationship became known as the Phillips curve hypothesis.

To beleaguered governments, attempting to maintain a high level of employment by demand management and, at the same time, to keep inflation within bounds, the hypothesis offered the possibility of a trade-off between more or less unemployment, and less or more inflation. Not only were the policy implications of the Phillips curve hypothesis attractive to politicians, but also the hypothesis seemed to provide a theoretical confirmation of the common view that fear of unemployment is a necessary discipline for employees.

This view was not, and is not, exclusive to employers in the so-called right-wing establishment. Mr. Ernie Bevin,[4] as Minister of Labour in the wartime coalition, referred to it as "the most unfortunate discipline of all, the economic whip." Professor Joan Robinson, a founder member of the Cambridge group, who by no stretch of the imagination can be considered a member of any right-wing orthodoxy, wrote in 1942 when the peacetime objective of full employment first came up for discussion: "The first function of unemployment (which has always existed in open or disguised forms) is that it maintains authority of master over man."[5]

She went on: "Unemployment in a private enterprise economy has not only the function of preserving discipline in industry, but also indirectly the function of preserving the value of money. If free wage bargaining, as we have known it hitherto, is continued in conditions of full employment there would be a constant upward pressure on money wage rates... In peacetime the vicious spiral of wages and prices might become chronic. This would only bring a variety of evils in its train... It would make hay of the Social Security programme."

By the mid-sixties, given the impetus of Professor Phillips's study, Professor Paish, to take one of many possible examples, was

4 Mr. Ernest Bevin (1881–1951), Minister of Labour from 1940 to 1945, had previously co-founded the Transport and General Workers' Union in 1922.

5 Quoted from two well-known articles, published anonymously in The Times on 22nd and 23rd January 1943 under the title of Planning Full Employment.

arguing that in the U.K. a 2¼ percent rate of unemployment was sufficient to halt inflation. This could be reduced to a 2 percent rate if trade unions were also restrained.[6] Although the original Phillips curve hypothesis was soon found to offer no general explanation of post-war experience, it spawned a vast literature seeking to explain inflation in non-monetary terms, and in this it was in direct opposition to the assertion of the Chicago School that "inflation is always and everywhere a monetary phenomenon".[7]

Eventually Professor Friedman was moved to attack, and on theoretical grounds he described the Phillips curve hypothesis as being 'utterly fallacious'. He argued that whilst in the short run unanticipated inflation would reduce real wages, and a reduction in real wages might be expected to be related to some expansion of employment, in the longer run the inflation would be anticipated with money wages and prices moving together in step. When this happened both real wages and unemployment would return to their pre-inflation levels. "You cannot fool all the people all the time", echoed Professor Friedman. "The true long-run Phillips curve is vertical", he concluded.

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6 Professor Frank Paish of the London School of Economics, an adviser to the previous Callaghan government, had asserted in an IEA paper in April 1967: "Britain's balance of payments deficits are solely caused by inflation, and inflation in turn is a consequence of an inadequate margin of unemployment. The amount of unemployment needed to eliminate inflation altogether can be confidently put at around 21 percent. From then on, the economy can be allowed to grow steadily in line with the rate of growth of productive capacity – perhaps 3 percent or thereabouts a year – without any fear of a payments crisis. If it were found that wages were still rising too fast with unemployment above 21 percent, restriction of demand (i.e. higher unemployment) would have to be continued to a higher level." The figure of 21 percent was evidently a typographical error, presumably corrected to 2¼ percent at some time after publication of the original paper.

7 Quoted from *The Counter-Revolution in Monetary Theory*, a lecture given by Professor Friedman at the University of London in 1970, and published by the IEA: "Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output."

This conclusion of Professor Friedman's effectively disposed of the Phillips curve hypothesis as a non-monetary explanation of persistent inflation. At first people might be fooled by inflation, and as long as they were fooled, the Phillips curve might provide an explanation of events, but very quickly people would cease to be fooled – they would come to expect inflation. When people cease to be fooled by inflation the Phillips curve ceases to work.

Professor Friedman's method of disposal, concluding the long-run Phillips curve to be vertical, meant that there must be for any economy a certain level of unemployment towards which that economy automatically tended irrespective of the continuing rate of change in money wages and prices. This certain level of unemployment Friedman called the 'natural unemployment rate'.

From this concept there was soon formulated the 'natural unemployment rate hypothesis', now more usually called the 'expectations augmented Phillips curve hypothesis'. Thus, from Friedman's successful theoretical attack on the non-monetary explanation of inflation offered by the Phillips curve, there was added to the restated quantity theory of money, a theory of output and employment, and with this new combination, contemporary monetarism was born.

The amalgam of the restated quantity theory of money and the expectations augmented Phillips curve has a great attraction for any government not seeking to establish a fully controlled or bureaucratic state socialist economy, but nonetheless wishing to eradicate inflation without causing prolonged mass unemployment.

By the siren sounds of contemporary monetarism, politicians were encouraged to believe that the economics of Keynes and the derived Keynesian employment policies of necessity would create inflation, in the absence of extensive government control.

In the short run this inflation might be successful in reducing unemployment to below the natural rate, but in the longer run the inflation would be anticipated, and then unemployment would return to the natural rate, regardless of the continuing actual rate of inflation.

On the other hand politicians were enticed to believe that although monetary policies might cause a temporary hump in the rate of unemployment, in the longer run they would achieve a natural unemployment rate without inflation. Why suffer inflation to no advantage? Sooner or later the economy will return to its natural rate of unemployment regardless of whether monetarist policies are being pursued. All that Keynesian policies offer is the additional disadvantage of persistent inflation.

It is the attractiveness of this argument that has led the present administration to attempt its experiment in monetarism. We may note that the possibility of this experiment succeeding in eradicating inflation at this time, without causing prolonged mass unemployment, rests upon whether the ‘expectations augmented Phillips curve hypothesis’ does in fact work in practice.

I suggest that this hypothesis is little better than a confidence trick worked on politicians and the majority of the electorate by plausible academic theorists. I do not impugn the motives of these academics, for it would seem that in the heat of theoretical dispute, and through the weakness of the opposition, their analytical powers were lulled by the sweetness of their own siren sounds.

Contemporary monetarists argue that an economy automatically tends towards a natural rate of unemployment, and that this natural rate, therefore, is independent of government monetary and fiscal policies. This argument implies a fundamental difference from the theory of Keynes, for the theory of Keynes argues that the rate of unemployment is to a large extent determined by a government’s fiscal and monetary policies. However, I would hold that this apparent fundamental difference applies more in the form of words than in real substance.

Full employment, as the term was used by Keynes in his *General Theory of Employment*, does not mean an absence of unemployment. It was, for the purposes of Keynes’s *General Theory*, a theoretical benchmark. In given conditions the volume of output and employment cannot be expanded *ad infinitum* – that there must be a limit to the expansion is self-evident. This limit Keynes called 'full employment'. One may fault Keynes for using misleading terminology, but in his writings he made his definitions clear. The term 'full employment' may be misleading, but there is no excuse for academics to be misled by Keynes.

The *General Theory* concept of full employment coincided with what Keynes called 'the point of true inflation'. This was a precise and accurate description. At anything less than full employment, any increase in monetary demands would go in part to raising prices, and in part to expanding output and employment, but when full employment was reached, any further increase in monetary demand could not, by definition, expand output and employment; it must therefore go wholly in raising prices.

For Keynes, full employment and true inflation were two ways of looking at the same condition. In Chapter 20 of the *General Theory*, Keynes wrote of this particular condition: "We have reached the situation in which the crude quantity theory of money is fully satisfied. For output does not alter, and prices rise in exact proportion to MV."[8]

Remember, in the *General Theory of Employment*, as it was formulated by Keynes, full employment does not mean an absence of unemployment; it refers to a rate of unemployment that cannot be reduced further by government fiscal and monetary policies aimed at increasing aggregate monetary demand.

The precise rate of unemployment that Keynes considered to be consistent with full employment is now a matter for conjecture. A pointer, perhaps, is that in 1937 when the numbers registered as wholly unemployed had fallen to less than one and a half million – equivalent to a rate of between 9 percent and 10 percent on the basis then used for the calculation – Keynes was arguing in the

8 If the volume of output is fixed, then the relationship MV = PT implies that the level of prices is directly proportional to MV, the product of the quantity of money and its velocity of circulation.

columns of The Times against any additional central government expansion of monetary demand at that time, as a means of achieving further reductions in unemployment.

The pre-Keynesian quantity theory of money assumed an automatic tendency towards full employment by virtue of Say's law.[9] During the inter-war years of depression this assumption was manifestly in conflict with the facts of experience, and the theory came to be considered as "too silly to be worth considering".

Friedman's 1956 essay freed the restated quantity theory of the Chicago School from the charge of being "too silly", and opened the way towards important new developments in monetary theory.

Admittedly the abnegation of responsibility for explaining the difference of the effects of money changes between price and quantity movements was to prove a serious shortcoming for the Chicago School, but by incorporating the expectations augmented Phillips curve into monetary theory the contemporary monetarists have turned full circle.

If the pre-Keynesian quantity theory of money is too silly to be worth considering, then so too is contemporary monetarism.

To argue that an economy automatically tends towards a natural rate of unemployment is not substantially different from arguing that an economy automatically tends towards full employment. Certainly this is so as that term was used by Keynes.

We know that to argue that an economy automatically tends towards full employment is a nonsense; it conflicts with the facts of experience. What then are we to do? Do we reject monetarism? Do we reject also the recent developments in monetary theory? The danger in outright rejection is that the baby tends to go with the bath water.

In developing the theory of Keynes, post-war Keynesians have

9 Say's law suggests that, in a market economy, an increase in the production of outputs for sale is due to a desire to exchange the additional output for an increase of income, which will be then be spent on other products; thus, it is evidence of effective demand. The theory was set out in Say's *A Treatise on Political Economy*, published in 1803; the term was introduced by Keynes.

tended to reject monetary theory, with dire results to the economy when their conclusions were put into practice. Contemporary monetarists tend to reject the analysis of Keynes, and I predict their conclusions will have dire results to the economy if long pursued as practical policies. Yet inflation today is a malignant disease. We cannot afford to reject the lessons of monetary theory, but equally we cannot afford to reject the theory of Keynes. Unemployment is an insidious disease.

Bearing in mind the weaknesses and strengths of the kind of economy in which we live and have to earn our living, it would seem that the right approach is to develop Keynes's *General Theory of Employment* in such a way that it can incorporate the recent developments in monetary theory.

This approach, from where we are now in September 1980, includes the possibility, without any loss of freedom, of proceeding immediately and directly towards the eradication of inflation whilst at the same time sustaining the highest possible volume of output and employment. This approach accords with the objective of political economy throughout the ages.

Amongst those individual economists who have held the liberty of the subject and the free development of human nature in high regard there are many differences of emphasis, and there are many differences in their policy proposals, but these differences do no more than reflect changing conditions; a different starting point, not a different objective. To reach the equator from the Arctic one travels south, but from the Antarctic one travels north.

When Keynes was charged by the academic establishment with changing his views in 1931, he wrote in the New Statesman and Nation: "I seem to see the older parrots sitting around and saying 'You can rely on us. Every day for thirty years regardless of the weather we have said, what a lovely morning! But this is a bad bird. He says one thing one day and something else the next.'" Changing conditions require changes in public economic policies, and these policy changes require the continuous development of economic theory. Academic disputes and divides serve to bring honest differences into the light so that the invalid may be rejected and the valid incorporated into the new. Disputes do not serve this purpose when they descend to strengthening entrenched positions wherein the differences are more apparent than real.

Worse than this, as in the case of the present divide between the contemporary Keynesians and the contemporary monetarists, the strengthening of entrenched positions tends to obscure the real nature of otherwise honest differences and, as a result, prevents new developments. As I have argued this evening, the present differences between contemporary Keynesians and monetarists are not so much a matter of monetary theory as a matter of employment theory. Once this is seen new developments in macro-economic theory become possible.

In the Economic Study Association we have been working for some fifteen years on developing the economics of Keynes so that it can incorporate the recent developments in monetary theory. We have had some moderate success, and this autumn we are detailing our developments in a seminar series. In one Saturday evening lecture you will appreciate that it is not possible for me to go through the results of fifteen years' work. I trust, however, that what I have said tonight will be sufficient to enable us to draw some broad conclusions. In the words of Professor Pigou, "It is for its fruit-bearing qualities, not for its light-bearing qualities, that economic knowledge is worth pursuing."[10]

We may start with a point of general agreement. If inflation is to be eradicated then the rate of increase in the money supply must be brought into line with the rate of growth of real output potential. From this there is no escape outside of a fully controlled economy.

For the past 25 years the rate of growth of real output potential for the United Kingdom, on a full employment basis, has been

10 Arthur Pigou succeeded Alfred Marshall as Professor of Political Economy at Cambridge University from 1908 to 1943. The quotation is from the first chapter of his book *The Economics of Welfare*, published in 1920.

fractionally over 3 percent per year. This, then, must be the final objective of any succession of monetary supply targets.

There are no insuperable difficulties about the government controlling the monetary supply. We live in a monetary economy with a managed currency; government is, as it were, the monopoly supplier of money and therefore has absolute control.[11]

To eradicate inflation government must keep the money supply under control, but in order to do so must give up attempting to exercise other controls. For example, they must give up trying to control interest rates. As any monopolist knows, or is soon taught by experience, he cannot control both price and quantity. In addition, government must also accept certain other disciplines, such as keeping their spending within the bounds of their income. We all have to accept this discipline, so why not governments?

Recent developments in monetary theory are important since they leave no room for reasonable doubt that if the government are to bring the money supply eventually into line with the growth of real output potential, without precipitating a slump, the demand for money also must be reduced. If, through the exercise of their control over the money supply, government create the conditions of a persistent excessive demand for money then they will cause a prolonged slump with mass unemployment.

Now, as I have argued, government can control the money supply, but in a society such as ours they cannot control the demand for money; by developing the analysis of Keynes we find that government can and do exert a significant influence over the demand for money through their fiscal policies.

Thus it follows that in addition to accepting the monetary disciplines necessary to keep control over the monetary supply, government must also accept certain fiscal disciplines so as not to inflate the demand for money.

The theory developed by the E.S.A. predicts that the demand

11 For example, by regulating the capital reserve ratio of the banking system in terms of the amounts of cash and other assets that banks are required to hold.

for money will be persistently inflated by the tax shifting process when government taxing and spending exceeds a certain amount.

This theoretical prediction is consistent with the conclusion Colin Clark deduced from an empirical study published in the Economic Journal of 1945.[12] From this empirical study, based on pre-war evidence, Colin Clark concluded that when the general government tax revenue plus borrowing requirement exceeded a certain proportion of the Net National Income then forces were set in motion which caused a persistent rise in costs and prices.

Clark's empirical study was instigated by the then Labour government of Queensland, to whom he acted as advisor. Keynes, who was editor of the Economic Journal when the manuscript was received, agreed with Clark's conclusion, and expressed the view that it would prove to be the United Kingdom experience in the post-war years.

The preliminary results from E.S.A. statistical researches, based upon more recent data, indicate that for the U.K. what Clark called the upper limit to taxation is today around 32% of the net domestic product at market prices. Throughout the post-war years British governments have persisted in exceeding this limit, and there is a significant and positive relationship between the extent of their excesses and the rate of inflation.

Thus theory predicts and empirical studies confirm that when government taxing and spending exceeds a certain limit then the forces of the tax shifting process will persistently raise the general price level and in this way increase the demand for money. If this tax inflated demand for money is not met by an inflationary supply of money then a slump is inevitable.

Further, if within this overall limit to government taxing and spending the economy is to sustain the maximum volume of output

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12 In *Public Finance and the Value of Money*, by Colin Clark, published in the Economic Journal, Volume 55, No. 220 (December 1945), pages 371–389. In proposing an upper limit of 25%, Clark said: "The limit is approximate, and should be written 24–26%, if not 23–27%. Beyond 27%, there is a high probability that inflation will materialise."

and employment consistent with a stable general price level, then government must accept the additional fiscal discipline of raising their tax revenue in a way that does not inflate the costs to firms of producing any particular volume of output. That is, using the terms of Keynes, government must eschew all taxes which directly inflate the aggregate supply price.

These broad general policy conclusions are derived from incorporating the recent developments in monetary theory into a development of the economics of Keynes.

Perhaps as a final point I can be more specific: What about this country in September 1980? I have argued that monetary policy is not enough. This, however, was Sir Keith Joseph's contention before the election, and now it is rumoured that the Chancellor[13] is producing a Cabinet paper on what assistance he can give to industry. But what can he do immediately?

I suggest the question is better posed as: What can he stop doing immediately? To regain control over the money supply he must reduce the tax-inflated demand for money. To reduce the tax-inflated demand for money he must bring government taxing and spending within the economic limit. This economic limit is a ratio, therefore the Chancellor can move towards getting within the limit by contractionary measures or by expansionary measures.

It is self-evident that the greatest benefits will accrue to all concerned if, so far as possible, expansionary measures are used, and I distinguish between expansionary and inflationary measures. I am not talking of 'Going for growth'; I am talking of deflating the demand for money.

With over two million unemployed and the number still rising,[14] the Chancellor continues to impose employment taxes – P.A.Y.E., Social Security Contributions, the National Insurance surcharge, etc. – that are equivalent to a Value Added Tax (VAT) rate of 40%.

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13 Sir Geoffrey Howe (1926–2015) served as Chancellor of the Exchequer from 1979 to 1983. He was succeeded by Nigel Lawson, and resigned from the Thatcher government on 13th November 1990 over its European policy.

14 Unemployment in the UK rose to over 3 million from 1982 until 1986.

Of these taxes a significant proportion are taxes which directly inflate the aggregate supply price, namely employers' social security contributions and the National Insurance surcharge. By abolishing these taxes the Chancellor would, within six weeks, reduce the aggregate supply price, reduce the tax-inflated demand for money and, by reducing the cost of labour to firms, he would improve the competitiveness of British producers and thus create the conditions for an expansion of output – not, you may note, by increasing monetary demand, but by reducing the demand for money by cutting tax-inflated costs.

If this government is to eradicate inflation without causing prolonged mass unemployment the Chancellor needs to look not to what more he must do, but to what he is doing, and can stop doing immediately.

So far during his term of office he has persistently inflated the demand for money and, as a consequence, failed dismally to control the money supply. His fiscal and monetary policies have been, and continue to be, directly opposed to each other. One way or another these opposing policies must be stopped if the economy of this country is to survive what is now a worldwide depression.

"Milton thou shouldst be living at this hour, England has need of thee." The former Poet Laureate's cry has been answered by a Nobel Laureate,[15] an answer Wordsworth never dreamed of.

We needed a re-emphasis of the importance of monetary discipline, but not at the expense of wholly rejecting that great Cambridge economist who, more than any other, by his theoretical and practical work laid the foundations for twenty-five years of post-war prosperity and growth.

This is a new day and calls for a new equation.

15 Friedman received the Nobel Memorial Prize in Economic Sciences in 1976.

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Monetarism – and Howe?

13th January 1981

Tonight, as my title implies, I shall be concerned with that borderland between theory and practice where, in the battle for political supremacy, the policy implications drawn from economic theory are all too often ranged with lies, damned lies, and statistics.

This present government was elected to office with a known commitment to monetarism – that is, to policies derived from the theories of a particular group of academics led by Professor Milton Friedman.

Its adherence to monetarism led it to believe that inflation could be squeezed out of the system by restricting the rate of increase in the money supply, and that whilst this squeezing out process would be associated with some temporary rise in unemployment, in the longer run, within the usual lifetime of a Parliament, output and employment would return to its 'natural' level.

The public commitment to monetarism is now known as the Medium Term Strategy, and according to Professor Ball, Principal of the London Business School, it is derived from the proposition that in the medium term both monetary expansion and monetary restriction are largely dissipated in price changes with little or no medium term effect on output and employment.

To avoid the emotionally charged judgements inevitably associated with political accusations and counter-accusations the view I shall be describing tonight is from a vantage point firmly centred on theory – the theory behind Professor Ball's proposition – the restated quantity theory of money.

In reviewing the past eighteen months I will accept that the government have a medium term strategy, and I will also accept

Professor Ball's contention that the consequences of that medium term strategy have yet to be seen. I will accept that the evidence of eighteen months is too short a time to support or reject the basic monetarist proposition formulated by Professor Ball.

My concern will be with whether the Chancellor's activities during the past 18 months have been conducive to the successful carrying through of the government's medium term strategy – whether they have been consistent with the policy implications to be drawn from the restated quantity theory of money – and also, whether the theory itself accurately predicts the results, so far, of the Chancellor's actions.

What requires explanation is the fact that this country, although near self-sufficient in energy supplies and with a strong currency (a uniquely powerful position amongst the developed nations of the world), with this great economic advantage, is suffering from the present world recession much more than any other of the less fortunate industrialised economies. Are our present difficulties a necessary passing phase? Are they, perhaps, the inevitable result of monetarist policies?

I will be arguing that the government is not keeping to its post-election medium term strategy; that a slump is unnecessary; that there is a growing danger it will not be a passing phase; and that all this is not so much due to the government's public commitment to monetarism, but rather, the inevitable result of its pursuing ill-timed misconceived policies drawn not from the restated quantity theory of money, but from other theories and from widely accepted economic mythologies.

In the realm of politics the government of the day is blamed for everything that goes wrong, and in politics this is fair play – the government of the day may also claim credit for everything that happens to go right. But from a standpoint of economic theory we must be more discriminating.

From the economic point of view this government cannot be blamed for over two million unemployed. Full employment did not cease suddenly in May 1979. To the contrary, the evidence shows that unemployment in this country has been on a rising trend for more than 25 years, and that between 1955 and 1979 the numbers registered as wholly unemployed multiplied some nine times.

Again, if we are to make an economic assessment of this government's record on unemployment we must take into account the well established time lags. E.S.A. research indicates that it takes some twelve months for a change in employment taxes to be fully reflected in the unemployment figures, whilst Professor Friedman argues that it takes some eighteen months for a change in monetary policy to significantly affect the volume of output and employment. From all this we must conclude that Sir Geoffrey's actions as Chancellor have had little to do with the increase in unemployment up to the end of the summer of 1980, any more than the relatively low levels of unemployment experienced during 1974 had anything to do with the advent of Mr. Healey.

Further, in this matter of unemployment, for an economic assessment we must take into account its cyclical character. The western developed nations are all subject to a 9-year trade cycle. Since the war, this cycle has taken on the form of a 'W' – a major peak followed by a recession, then a minor recovery followed by another recession, before recovering again to a major peak.

The last major peak was in 1973. By May 1979 and throughout 1980 the developed nations were sliding into a recession, which is now tending to bottom out. If past experience is anything to go by, and in this matter there is little else but past experience to go on, from past experience we may expect a recovery to become evident before the end of this year, 1981 – and for the upswing to continue throughout 1982. The unemployment cycle tends to lag some six months behind the phases of this trade and output cycle.

Thus economics leads to the conclusion that when Sir Geoffrey accepted office in May 1979 there was little he could do to stop unemployment in this country touching the two million marker during 1980. From an economic view we observe that by the time of the last General Election in 1979, such a figure had become the inevitable result of our past national policies, reinforced by certain international forces then already in motion.

But Sir Geoffrey could have taken corrective action in his first Budget, and the requested papers on how this might be achieved were delivered[16] on the day this administration took office. He could have taken corrective action in his first budget that would have minimised the recession, and by now we could be looking forward to steady improvements during this year and beyond. Moreover, if this corrective action had been taken in June 1979, it would have assisted the attainment of those publicly declared monetary objectives believed to be essential to the government's medium term strategy.

Turning to counter-inflation policy – the government's first priority – the monetarists' view is, in general, that a government must first establish control over the quantity of money, and then exercise this control to effect a restriction of the money supply.

This view is based directly on the restated quantity theory of money, although there are differences of opinion amongst quantity theorists on issues of practical policy – whether the quantity of money should be controlled through a cash base, or through an eligible reserve asset base, and so on.

There are differences of opinion also as to the speed at which a government should proceed. Professor Hayek favours the 'at a stroke' policy. He asserts that an electorate prefers a 20 percent unemployment rate for a few months to a 10 percent rate for a number of years. Professor Friedman, on the other hand, advocates a more gradual approach to a quasi-automatic monetary policy that would offer, he claims, the opportunity of much growth with little inflation.

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16 Papers offering economic advice were submitted to government by Ronald Burgess at the time of the General Election of May 1979, and received some support from Sir Keith Joseph, but the appointment of Sir Geoffrey Howe as Chancellor of the Exchequer resulted in a very different choice of economic policies than those that had been expected.

But these differences amongst academics about practicalities are in the realms of theory in relation to a review of Sir Geoffrey's first eighteen months as Chancellor of the Exchequer. Although throughout his time as Chancellor the government of today has been publicly committed to monetarist policies, he has failed utterly to control the quantity of money and thus meet the first requirement of the quantity theory.

According to the late Professor Harry Johnson, who was a colleague of Professor Friedman at the University of Chicago, the quantity theory predicts the rate of inflation to be the difference between the rate of increase in the money supply and the rate of growth of real output. Therefore, on the basis of the published evidence, the theory predicts for this country a 15 to 20 percent inflation rate during the next year or two.

Yet, since last summer, the rate of inflation has been falling and over the past six months, calculated on an annualised basis, the rate has been within single figures.

When the predictions from the quantity theory are compared with what is actually happening to prices then, if one accepts the quantity theory, it has to be concluded that the reduction in the inflation rate, last year and during this coming year, must be the result of the slump and the strength of the petro-pound rather than the outcome of an effective monetary policy. Sir Geoffrey may have tried to implement monetarist policies, he may have tried to restrict the quantity of money, but so far he has failed. Indeed he cannot be said to have even begun to follow the medium term strategy of squeezing out inflation by restricting the money supply.

As Sir Keith Joseph has admitted, perhaps too honestly for a Cabinet Minister, the government lost their first year. But if we go along with Sir Keith, and to do so is no more than accepting the published evidence, what went wrong? Why did the government lose their first year?

Some members of the government would stress their failure to reduce the borrowing requirement. But those politicians who give top priority to reducing the borrowing requirement at this time cannot claim the unqualified support of the quantity theorists, for Professor Friedman asserts that fiscal policy does not matter for inflation providing any budget deficit is covered by what he calls true borrowing – that is, borrowing that removes purchasing power from the rest of the economy, and does not tend automatically to increase the quantity of money.

Although Professor Friedman's assertion is a misleading overstatement of the quantity theory case, nonetheless, the theory does imply that in the medium term the method by which a government borrows is more important than the size of the deficit. The only borrowing limit applicable to the medium term is that the deficit must not exceed a sum that can be covered by 'true borrowing'.

However, the medium term in this context is some four years, so there is ample scope for political judgement as to timing. No matter how well founded a policy may be in theory, it will be a bad policy if implemented at the wrong time. When this government assumed office the world economies were sliding into a recession; a modern government cannot cut its borrowing requirement on the downswing of the trade cycle, and there is nothing in the restated quantity theory of money that implies it must make the attempt.

It is true that a substantial borrowing requirement does make life very difficult for a Chancellor who is committed to squeezing inflation out of the system by restricting the quantity of money. As he must eschew 'printing money', he has to turn to the more expensive methods of covering a deficit. Should he attempt to raise substantial funds from the market at the same time as he restricts the quantity of money, then he is in danger of squeezing out, not inflation, but productive investment. He will be appropriating for government use the funds needed for production.

Yet these difficulties are compounded further when during the downswing of a trade cycle a Chancellor attempts to reduce his borrowing by either cutting public spending, or by raising taxes, or by some combination of those two. If he attempts to cut public spending, the public view of this Cabinet to date, then he reduces the aggregate demand at a time when it is already falling. The recession becomes a slump. If he attempts to raise taxes, the view of Mr. Healey in 1974, of Mr. Enoch Powell in 1980, and it is forecast this Cabinet's view in 1981, if the Chancellor attempts to raise taxation then he increases costs, squeezes profits, and causes more bankruptcies. The recession becomes a slump.

When the economies of the world are sliding into a recession any deliberate attempt to cut the general government borrowing requirement is sufficient to precipitate a national slump, and the greater the resulting contraction of activity the larger will be the eventual borrowing requirement.

When people are thrown out of jobs not only do they cease to contribute towards government expenses but they themselves become an additional government expense. Unemployment is a very expensive social disease for a Chancellor.

During their first eighteen months the government have failed to exercise good judgement in timing the implementation of those policies they considered necessary for achieving their medium term strategy. Had Sir Geoffrey at the outset given top priority, not to cutting the borrowing requirement, but to minimising the effects of a world recession on the British economy then, during this year, the amount that he needed to borrow would have tended to fall automatically, and he could have speeded up the process with advantage to everybody.

To sustain a prosperous economy without inflation it is necessary for government, taking one year with another, to pursue an overall balanced budget policy; reducing the deficit is only a beginning. But the process can begin only at the right time, and adherence to monetarism does not preclude the exercise of political judgement as to timing.

That the government lost their first year, and more, is due not so much to their monetarism as to their lack of understanding of the theory from which they claim to derive their policies.

From listening to government ministers one might well believe that they are committed to a money supply theory. In fact the restated quantity theory of money is not concerned directly with the money supply – it is a theory about the demand for money. Put very simply, the theory's central proposition implies that the demand for money and the general price level will tend to rise and fall together. If prices rise for any reason then the demand for money will increase. If prices fall then the demand for money will decrease.

The restated quantity theory states that for any economy there is a stable demand function for real balances. Academics may dispute the details within the brackets but in general the proposition accords with the facts of experience. If we have to pay higher prices, then we need more money in order to do so.

From the proposition that there is a stable demand function for real balances, quantity theorists argue that an increase in the quantity of money will cause the supply of money to exceed the demand for money. This excess money supply will tend to reduce interest rates and thus lead to an expansion in the demand for investment goods. The excess supply of money will be reflected also in an increase in nominal wealth and thus lead to an expansion in the demand for consumption goods. The expansion of demand in the goods markets will spill over and expand demand in the labour market. As aggregate demand expands, so the argument goes, wages and prices rise, and as wages and prices rise the demand for money increases until the equilibrium between money supply and demand is restored at some higher general price level, or when the rate of inflation becomes fully anticipated.

There may be some weak points in the chain of reasoning but in general it is a logical argument deduced more or less directly from the restated quantity theory of money which, as Professor Harry Johnson has stated, is essentially a generalisation of Keynes's theory of liquidity preference. Indeed up to this point the reasoning of contemporary quantity theorists is not substantially different from Keynes; in the 1930s, Keynes concluded that in conditions of less than full employment any increase in aggregate monetary demand would cause some expansion of output and employment and some increase in prices.

However, what we need to note well is that the contemporary monetarist argument is not a general case but a special case of monetary theory. The argument, its conclusions, and its policy implications, can be applied to the real world only in the case where the initial impulse is a monetary impulse, that is where the sole causative factor of an inflation is an increase in the supply of money.

In 1956 Professor Friedman failed to observe that his chain of reasoning applied only to a special case. He assumed the line of argument I have outlined to be the general case and from this he concluded that "inflation is always and everywhere a monetary phenomenon" – that always and everywhere, it is prior increases in the money supply that lead to rising prices and that for inflation only monetary policy matters. Given Professor Friedman's assumption that an inflation is always started by an excess money supply then it follows of necessity that once an inflation has started it can be halted only by restricting the money supply.

There is an element of truth in Professor Friedman's conclusions. The restated quantity theory of money does imply that the proximate cause of inflation is, always and everywhere, an excessive money supply. It predicts that if the rate of increase in the money supply does not persistently exceed the rate of growth of real output then there can be no inflation, although a stable general price level – Keynes's stable equilibrium – may still be associated with a low level of economic activity or even an intensive slump.

But, whilst it can be deduced from the restated quantity theory of money that the proximate cause of inflation is, always and everywhere, an excessive money supply, it cannot be deduced from that theory that the primary cause of inflation is of necessity an excessive money supply. The theory admits of other possible primary causes, and so, one has to distinguish between Professor Friedman's conclusions, derived from his own assumptions, and conclusions that are derived from the theory itself. Contemporary monetarists do not always make this necessary distinction.

We know, as a matter of recent experience, that when Sir Geoffrey nearly doubled the rate of VAT in 1979 there followed a sharp increase in prices – prices rose as a result of a fiscal impulse, not a monetary impulse. According to the conventional wisdom of demand management such a fiscal impulse causes only a once and for all rise in prices and of itself may be deflationary since, as it is said, it will mop up excess demand. This piece of economic nonsense is accepted by Sir Geoffrey as a basis for policy but it is drawn from the 'real income and expenditure' approach, not from monetary theory.

In this country we are now in the fifth decade of persistently rising prices. We know that as prices rise, for whatever reason, our real incomes are eroded. We know also, as a matter of repeated individual experience, that as real incomes are eroded then not only trade unionists but all income receivers demand higher money incomes. Landlords up their rents, shareholders demand more in dividends, those in retirement feel entitled to higher pensions, students want bigger grants, and everybody in employment asks for extra money in their pay packet. Further, the operation of fiscal drag results in a more than proportional rise in gross money incomes.

A fiscal impulse does not have a once and for all effect on prices; it sets off a chain reaction. It motivates a complex tax shifting process that tends to be self-generating. In another context Professor Friedman asserts that you cannot fool all the people all the time. I agree. But if one accepts that people are not subject to money illusion then one must accept that they will retaliate against tax inflated prices by demanding higher money incomes and the increased cost of meeting these demands will raise prices yet again, leading to further demands, and so on, and so on. As prices rise, predicts the quantity theory, the demand for money will increase also. Thus we must conclude that a fiscal impulse as well as a monetary impulse can cause a continuing rise in prices and a corresponding continuing increase in the demand for money.

Once it is noted that the restated quantity theory of money admits to fiscal policy as well as monetary policy being possible primary causes of rising prices, then the theory becomes useful for evaluating alternative monetary policies.

When government inflates prices by fiscal policy they can meet the tax inflated demand for money by an inflationary supply of money. If they choose this monetary policy then the primary fiscal impulse will be dissipated in rising prices with little or no effect on output and employment. By an inflationary fiscal policy allied to an inflationary monetary policy the government create persistent tax inflation – that is, persistently rising prices motivated by excessive taxation.

Alternatively, the government can refuse to meet the tax inflated demand for money with an inflationary supply of money and if they choose this policy then, the quantity theory predicts, the primary fiscal impulse will precipitate a slump. By an inflationary fiscal policy allied to a restrictive monetary policy the government create a condition of suppressed tax inflation – the inflation is suppressed by the slump – by the fear of unemployment.

Put another way, the quantity theory predicts that if government inflate the demand for money by their fiscal policy then their monetary policy will become an instrument for determining the trade-off between the rate of inflation, and the rate at which output and employment contracts.

The restated quantity theory of money leads to the conclusion that in this country we suffer from persistent tax inflation, not monetary inflation. A restrictive monetary policy can only suppress tax inflation and this suppression is achieved by precipitating a slump. Once the slump is over the tax inflation will re-appear.

Let us now consider the last eighteen months in the light of the quantity theory itself, rather than in the shadow of the various assumptions and assertions that have been added to that theory.

Starting with the June 1979 budget, we come immediately to another piece of economic nonsense; again not drawn from monetary theory, or in this instance any other theory, but based on a misleading use of statistics by the Central Statistical Office.

Every year the Central Statistical Office (C.S.O.) publishes an international league table which purports to compare the tax burden of a number of leading industrialised nations. This month the table for 1979 was published and, on the basis of expressing total tax revenue as a percentage of the Gross Domestic Product at market prices, the U.K. comes tenth out of eighteen nations. From this exercise the C.S.O. concludes that all E.E.C. countries, with the exceptions of Ireland and Italy, are more heavily taxed than the U.K. The Times published the report on 8th January under the headline ‘Confounding myth of heavily taxed Britain’.

Admittedly the most recent calculations are an improvement on earlier attempts but they remain misleading nonsense – the method used is not a valid basis for comparing international tax burdens. The amount of tax as a percentage of its GDP at market prices that any country can bear without deleterious side-effects is relative to that country’s economic potential – the higher the potential, the more able it is to pay taxes.

You will appreciate that a store in Kensington High Street, by reason of its geographical position, is able to pay more in taxation and still remain highly competitive than, say, a village general store. As within a country so it is between one country and another.

The Treaty of Rome, by creating a vast western European customs union, changed the relative economic potentials significantly. Its effect may be considered as having moved West Germany and the Benelux countries onto prime sites along Kensington High Street, and at the same time moving British manufacturers way down a side street.

If Britain is to prosper then the government at Westminster and the Commission in Brussels must recognise the situation that exists. This country's economic potentials now approximate to those of Italy; higher than Ireland, but lower than other E.E.C. nations. We cannot afford to have such a large slice of our national cake appropriated by taxation. We are over-burdened with taxation, and in particular home producers are over-burdened with taxation.

The evidence was first published in 1969, following research that was carried out at Oxford under the direction of Colin Clark. I re-evaluated that evidence in relation to fiscal policy in E.S.A. Paper No. 3 published in January 1973, but none of this has yet penetrated the bureaucracies responsible for public finance – they continue to ignore the evidence and accept the nonsense.

From misleading official statistics given the official accolade of the C.S.O. it is concluded that we are not over-taxed, but that it is our heavily progressive present system of income tax that acts as a disincentive to work and enterprise. This has become part of our politicians' basic mythology.

In June 1979 Sir Geoffrey acted upon this nonsense – he did not attempt to cut taxes but switched part of the burden from direct to indirect methods. This, he believed, would provide the incentive for carrying through the medium term strategy. Asinine? Possibly, yet in the House of Commons he was surrounded by over 600 Members of his own kind, and they were supported outside by the majority of so-called informed economic opinion.

Sir Geoffrey's first act was to raise the basic rate of VAT from 8 percent to 15 percent. The inevitable result was a sharp rise in prices. Given such a result the restated quantity theory predicts an increase in the demand for money that will make it more difficult to control the quantity of money. Further, if the money supply is not increased to meet the tax inflated demand for money, then the theory predicts a trade-off between rising prices and a contraction of output and employment – the degree of trade-off being determined by the elasticity of the money supply.

So far the sequence of events has been fully consistent with the predictions from theory. By his very first act as Chancellor, Sir Geoffrey dealt a severe blow to his medium term strategy and to the British economy – not by pursuing monetarist policies, but by acting on a myth cultivated by misleading statistics published by the Central Statistical Office.

Oh for Sir Alec, and his matchsticks![17]

The corresponding part of this first budget was the announcement of a cut in income tax to take effect later in that year. A cut in income tax does not immediately affect an employer's labour costs; what it does is to leave more money in the pay packet. The supposed incentive of the two measures meant only that people were left with a little more money in their pockets to pay the tax-inflated prices. It was just another twist to the screw.

The other important tax measures have been the increase in social security taxes last April, and the announcement of further increases in the Autumn Statement of last November.

On the employees' side, an increase in so-called National Insurance cuts take-home pay and claws back any benefit from the earlier cut in income tax. Overall, the tax-imposed cut in earned incomes means less money to pay the tax-inflated prices and this must intensify the depression. Worse, an increase in employees' contributions falls heaviest on the lower paid, those who gained least, or nothing at all, from the cut in income tax.

On the employers' side, the employer's contributions and the National Insurance surcharge increase labour costs directly. In times of economic depression when profit margins are often non-existent firms have no option but to react to additional tax inflation of their labour costs, by raising prices, by cutting back on output and employment, or both – once again the trade-off, once again a prediction from the restated quantity theory is confirmed.

17 A reference to Sir Alec Douglas-Home, Prime Minister from October 1963 to October 1964. In an interview with The Observer newspaper in 1962, he said that, when asked the question of whether he would ever become Prime Minister, he had once replied "No, because I do my sums with matchsticks."

Another policy instrument that Sir Geoffrey has used is the imposition of high nominal rates of interest. Now there are monetary theorists who argue that high interest rates tend to reduce the demand for money and thus make it easier for the government to restrict the supply of money. However, the restated quantity theory implies that the interest elasticity of the demand for money is small, and the majority of quantity theorists argue that a government can control either the quantity of money, or interest rates, but not both at the same time. They argue in favour of government controlling the quantity of money and of leaving interest rates to be determined by the open market. So although the fixing of interest rates has been an important part of Sir Geoffrey's policy there are many quantity theorists who would deny that such actions are an essential part of monetarism. Rather, they maintain that fixing interest rates is contrary to monetarist policy.

What then are we now to conclude about monetarism and Sir Geoffrey Howe from the evidence of his first eighteen months as Chancellor of the Exchequer?

First it has to be admitted that Professor Milton Friedman, and many of his followers, dangerously overstate the monetarist case in public. It would appear that the government have been misled by these overstatements from presumed authoritative sources. The assertion that fiscal policy does not matter for inflation is derived not from the theory, but from an assumption made by Professor Friedman. Relax the Professor's assumption, and the theory carries very different policy implications. Fiscal policy does matter.

Second, whilst it may be permissible to argue that Sir Geoffrey is a disaster, or a saviour, depending upon one's political stance, it is not permissible to argue that his success or failure is a result of his monetarist policies, in the sense of being the certain result of implementing policies derived from the restated quantity theory of money. He may have intended to implement monetarist policies, but so far he has failed to do so. This government may be publicly committed to monetarism but if they are to be judged by the

Chancellor's actions then they are not monetarists. Sir Geoffrey is far less of a monetarist in practice than was his predecessor, Mr. Healey.

Third, whilst agreeing with Professor Ball that eighteen months is too short a period to pass judgement on the government's medium term strategy, we can assess the performance of the restated quantity theory of money. Shed of its added obscurities, the theory stands up well – so far, it has shown itself capable of predicting with reasonable accuracy the inevitable results of ill-timed and misconceived policies.

Yet, criticism from a vantage point well removed from the activity and with the advantage of hindsight is all too easy. Such criticism has its place in political economy but it is not the end purpose. Macroeconomic science is sterile unless it gives to any government practical advice, appropriate to time and circumstance, on matters economic.

The advice that Sir Geoffrey is receiving now falls into three broad categories. There are those who are advising Sir Geoffrey to expand his horizons and not place too much reliance on quantity theorists and monetary policy. I trust I have said enough tonight to demonstrate that most of Sir Geoffrey's difficulties and ours arise from his ignoring the implications of quantity theory and from his pursuing policies based on other theories and the widely accepted economic mythologies.

Others, like Professor Ball, advise pressing on regardless of immediate difficulties. They argue that some short-run costs are inevitable and that eighteen months is too short a time to assess the medium term strategy. But how can the government press on with something they have not even started? A prerequisite of their medium term strategy is the control over the quantity of money, not the suppression of tax inflation by turning a recession into a slump.

Yet others advise a U-turn, either because they consider the short-run costs are proving too high, or because they reject outright the basis of the medium term strategy. As an alternative this group advise an extension of government controls: import controls, dividend controls, wage controls, price controls, trade union controls, and so on.

Tonight, Mr. Aubrey Jones, boss of the old Prices and Incomes Board, is attempting to influence a Liberal Party economics group. What do such men of yesteryear offer? Like the new Cambridge group, these middle-ground men also are proposing a shift towards a bureaucratic state with a fully controlled economy. Their proposals have been tried and have failed. The electorate have rejected them not once but many times since the war.

Of what assistance is this conflicting and mostly politically unacceptable advice?

Sir Geoffrey, for better or worse, is a member of a government publicly committed to a definite medium term strategy. His Prime Minister, the First Lord of the Treasury, frequently re-affirms her adherence to that strategy, come what may in the short run.

What can the Chancellor do now and remain a member of the present Cabinet? The British economy is failing, the British people are suffering. Although we alone amongst the E.E.C. countries are self-sufficient in energy supplies, the present world recession appears to be affecting Britain more than the other industrialised nations. Are our choices limited to either accepting rising unemployment in the hope that it will reduce the rate of inflation, or making a U-turn, accepting state bureaucracy and accelerating inflation, in the hope of reducing unemployment?

Sir Geoffrey may be likened to a man who one cold morning is given the keys to a car he has for long coveted. In his exuberance he does not notice the car is parked on a hill, he jumps in, and takes off the brake before starting the engine. The car careers backwards downhill at an accelerating rate. In the circumstances, however foreseeable they may have been, to carry on, or to do a U-turn, is likely to prove equally disastrous. The car will be a write-off whether it hits the wall at the bottom boot first, or bonnet first.

The drill in such an emergency is to stop, and then start the engine. When the engine is warmed up, the driver can simultaneously take off the brake and let in the clutch. With this the car may be driven speedily and safely in the desired direction. A British driver has the advantage of a full North Sea tank.

Translated into terms of economic policy, Sir Geoffrey must stop attempting to cut the borrowing requirement, he must stop attempting to cut public spending, he must stop attempting to raise tax revenues. He cannot achieve these objectives as the economy slides into an ever deeper slump, and his adherence to monetarism does not require him to attempt the impossible.

Having stopped attempting the impossible he can make a start. He can begin by relieving producers in this country of their crippling employment tax burdens so that efficient firms can expand employment and sell their production at a profit in the competitive markets of the world. He can begin by reducing the tax inflated demand for money. With the economy running again, he will find, as it warms up, that government do not need to spend as much. He will find his tax yields recovering. He will find the general government borrowing requirement tending to fall automatically.

With all this happening, he will then be able to control the quantity of money, and proceed towards a prosperous economy with a balanced budget and a zero rate of inflation. As I understand it, that is the purpose of the medium term strategy.

3

The Future after the Budget

30th April 1981

In the heat of the immediate debate following the Chancellor's Budget proposals one might have felt justified in rephrasing the title of this talk and asking the question "Is there a future after the Budget?".

But now, as the 1981 Finance Bill starts to proceed through the Committee stage, it becomes possible to take a more objective, scientific view. The standpoint is important. To many, the future after the 1981 Budget proposals appears depressing, and macroeconomics can be used to confirm the reality of this appearance; yet, the macroeconomic view can show us also that the price we are being forced to pay in terms of a continuing slump is the price of ignoring the implications of monetary theory for short-run fiscal policy.

An excessive money supply causes, eventually, monetary inflation but additional excessive taxation inflates costs and prices almost immediately. When a tax-inflationary fiscal policy is allied to counter-inflationary monetary policy then the immediate result is a slump, and any downward pressure on prices comes only through the continuation and intensification of the slump.

Monetary theory does not support the conclusion that a slump is a necessary price for an effective counter-inflation policy.

I shall be arguing that the government's short run fiscal policy is incompatible with their longer-run monetary policy and that this is a result of a failure within the sphere of macroeconomics rather than politics.

Today, this country has unique natural advantages. We cannot afford to accept advice which leads to a dissipation of the benefits.

A new macroeconomic approach to current affairs shows us that the outlook can be changed, that we may begin to enjoy the benefits of our present advantages, not in some distant future but this year and next. This is a time of great opportunity for the British people. Let us begin by taking a brief glance back to remind ourselves how these opportunities came about.

The first 25 years after the end of the Second World War were good years for all western developed nations; some countries did better than others, but none fared badly. In this country we worried over our balance of payments and the weakness of sterling, yet our output doubled, our standard of living doubled, and everybody who wanted a job had no great difficulty in finding one.

Internationally, however, there was an ever-present threatening cloud of persistent inflation. Persistent inflation affected all countries, but some suffered more than others. Since successive British governments stoked the fires of inflation more assiduously than most, we suffered more than most western manufacturing countries.

Then, in the early 70s, the oil producing and exporting countries decided to retaliate against rising prices elsewhere. For years the Organisation of Petroleum Exporting Countries (OPEC) provided developed nations with a plentiful supply of cheap oil and received less and less goods in return, as a result of inflation in the oil importing countries. The price of oil was increased sharply and OPEC supported the higher prices by restricting production for export.

In the west, a long threatening storm broke. Years of soft living off cheap energy ended abruptly. There was an energy shortage – an energy crisis – and the steeply rising price of energy boosted inflation. The balance of world trade was suddenly and sharply shifted.

All this, and worse; in 1974 it became apparent that the western world was sliding into one of its periodic recessions. Britain entered this storm ill prepared. Our rate of inflation was higher than most, our currency was weak, our balance of payments problems endemic. We relied on buoyant world trading conditions more than most. Not surprisingly, we were battered by the storm.

Fortunately, in our hour of need, there came many hands to man the pumps; our trading partners, our overseas friends, international organisations such as the I.M.F. and, not least, the trade union movement with its voluntary restraint which continued until its members were exasperated by the then Labour government of Westminster. With this assistance we rode out the worst of the storm – a bit sluggish perhaps, but we survived.

Now for the good news. Contrived shortages and high prices for energy stimulated exploration and, in place of vanishing herring, the North Sea yielded up both gas and oil – expensive, admittedly, but it was flowing into an energy-hungry, expensive world. Even a new coal field was found with cheap easily mined supplies, sufficient perhaps for a hundred years or more.

Today, in 1981, Britain alone amongst major western developed nations is self sufficient in energy supplies. Sterling is a petro-strong currency. Rather than deficits, we are concerned with the size of our trading surpluses. More, our world trade is showing signs of improvement – a little halting at the moment, but on past experience we can expect it to become stronger as the year proceeds.

What a turnaround in our fortunes – what an opportunity for a manufacturing and trading nation. What matters, then, one Budget, pleasant or unpleasant, necessary or unnecessary? What indeed? But the opportunity is one thing; it is there. The ability to take advantage of that opportunity is something else, and it is also something that can be taken away by monetary and fiscal policy.

The importance of Sir Geoffrey's Budget proposals lies in how they will affect, if enacted, the ability of the British economy to take advantage of the opportunities that exist now, and may be expected to exist for the next 18 months to two years. We must not forget, however weak may be the current upturn – it may even be still-born – nonetheless, on the basis of past experience we can confidently expect a further downturn in world trading conditions to be in evidence by the end of 1983. The opportunities that exist for this country now will not remain in storage to await the outcome of the Chancellor's medium term financial strategy.

From the macroeconomic point of view, the current debate about public economic policy is essentially between those popularly labelled monetarist, who tend to concentrate on longer-run objectives to the disparagement of current affairs. They argue that the short-run effects of their policies are a necessary price to be paid for past excesses, and for the enjoyment of some future golden age.

On the other side, are those popularly labelled Keynesians, who direct their economic analysis to managing the economy in the short run, and favour the mitigation of deleterious longer-run effects by the imposition of controls. They tend to concentrate on current affairs and claim to be keeping alive the spirit of Keynes who wrote, in the year I was born,[18] "In the long run we are all dead".

Contemporary Keynesians do not deny that an excess supply of money will tend eventually to increase prices but, they argue, so long as an economy is operating at less than full employment then an increase in the money supply will cause some expansion of output and employment. In present conditions they favour reflating the British economy; an attractive proposition in a slump.

To restrain the inflation that would follow inevitably upon a monetary-induced expansion, they advocate a permanent shift towards some form of controlled economy.

As a long run solution some so-called Keynesians advocate socialism – that is, the exercise of control through taking into public ownership all the means of production.

Others prefer bureaucracy – the creation of local, national and super-national bureaucracies to implement the plans and controls they consider necessary for the good of the economy as a whole,

18 Quoted from the *Tract on Monetary Reform*, published by Keynes in 1923.

such as a permanent detailed prices and incomes policy. Currently in this country, there is a revival of interest in the bureaucratic solution but in politics this is mid-term. Is the revival of interest just another mid-term aberration – one time in Orpington, this time a new party?[19]

In the past, the British electorate have rejected the bureaucratic solution. Will they do so again when the time comes? I have not the gift of prophecy, so we must wait and see, but in the sphere of public economic policy the opportunities that exist now will not await the two or three years it will take to find out.

Today the government in power seeks advice from those macro-economists who reject bureaucracy and discretionary short-run policies in favour of longer-run objectives. Before the General Election of 1979, the Conservative Party made it very clear that if it returned to office their first objective would be to permanently reduce the rate of inflation and work towards the eradication of that particular social disease. They made it abundantly clear that they accepted the policy implications of the restated quantity theory of money. They publicly admitted that these monetary policies would cause some temporary rise in unemployment but, it was argued, this was an unavoidable price for an effective counter-inflation policy.

Accepting the conclusions drawn from theories developed by Professors Friedman, Laidlaw, Parkin, Ball, and Walters, to name but a few, Conservative politicians confidentially asserted that within two to four years unemployment would fall to a so-called 'natural rate' – that is, a rate of unemployment that cannot be permanently reduced by reflating the economy, or is consistent with any fully anticipated rate of inflation.

Following the election, the policy implications of the restated

19 A reference to the Orpington mid-term by-election of 15th March 1962, at which there was an unexpected swing of 22% in favour of the Liberal Party. This is contrasted with the formation of the SDP (Social Democratic Party) under Roy Jenkins on 26th March 1981. This talk was given on 30th April 1981, with a further General Election expected two years later, in 1983.

quantity theory of money became the medium term financial strategy. The new government were assured by their economic advisors, and a galaxy of monetary academics, that providing they held to that strategy then, within the life of the present Parliament, there would be a permanent reduction in the rate of inflation with little or no contraction in the volume of output and employment.

This year is the half-way mark. The rate of inflation continues in double figures and official indices published over recent months suggest the possibility of a re-establishment of a rising trend, and we have now the promised hump in unemployment. It is officially estimated that this hump will continue to grow for some time to come. Some forecast that the numbers registered as wholly unemployed will exceed anything recorded during the inter-war years of depression.

When may we expect a reversal of the trend – evidence of some steady progress towards this so called natural rate? Unfortunately for government, and more so for the rest of us, estimates of a natural rate seem to move in step with the actual recorded growth of unemployment. In the early 1970s when unemployment was still under a million, Professors Laidlaw and Parkin, both then at the University of Manchester, had estimated the natural rate of unemployment for the U.K. to be a little less than 2 percent. Since that time recorded unemployment has multiplied three times, and so have the estimates of the natural rate. Latest estimates suggest the natural rate of unemployment for the U.K. to be not less than 5 percent and rising.

Is, then, the medium term financial strategy a gigantic hoax perpetrated by some rather plausible academics? Recently, 364 academics asserted that there is "no basis in economic theory or supporting evidence"[20] for the government belief that by deflating demand they will bring inflation permanently under control and thereby induce an automatic recovery in output and employment.

To get an agreement for even a wholly negative statement such

20 Quoted from a letter to The Times, signed by notable economists of the day.

as this requires subtle wording. Do the government believe they are deflating demand? Is this the basis of the advice they are accepting? But it really is no matter; we can accept the academic monetarists' assertion – Professors Ball and Minford, for example – that it is still too early to pass judgement on the medium term financial strategy. We can accept also the government's view that the 1981 Budget proposals are the minimum necessary for holding to that strategy.

Accepting all this, the question for macroeconomists remains – are there alternative routes to a prosperous economy with a zero rate of inflation? It is no answer to assert, as did 364 academics, that the medium term financial strategy is a nonsense and that there are alternatives. Macroeconomists must be prepared to spell out the alternatives and the alternative routes must be signposted now whilst the opportunities for a recovery exist.

To pursue this macroeconomic question, let us now remind ourselves of the monetary theory upon which the medium term financial strategy is based. According to the restated quantity theory of money, there is in any economy a demand for a certain quantity of money. This demand for money is determined largely by the general price level, by the level of economic activity, and by the attractiveness of other realisable assets that are considered as alternatives to money holding, such as bonds, equities, houses, rare stamps, old masters, and so on.[21]

On the other side the quantity of money an economy is required to hold at any time is determined quite independently by the quantity actually supplied by the monetary authorities – in the U.K. this is effectively the government. It follows, if the quantity of money supplied by the monetary authorities is in excess of the quantity demanded in the given conditions, then the economy as a whole will find itself holding money balances in excess of actual requirements.

21 A reference to the established concept of 'liquidity preference' – whether the owners of assets choose to hold money balances, or longer term investments.

Professor Friedman and the majority of quantity theorists argue that the distribution of these money balances throughout the economy, and when and on what they will be spent, is largely indeterminate. All they are prepared to state with reasonable certainty is that from the past experience of many countries, these excess money balances will be spent and that their spending will cause a rising general price level. In turn, a rising general price level causes a demand for money to increase and equate with the supply. In other words, excess money balances are absorbed eventually in an increased demand for money, resulting from a higher general price level.

Upon this Professor Friedman and others conclude a persistent excess supply of money causes, sooner or later, persistent inflation.

As a corollary from this conclusion, it is asserted that once an inflation has been started then it can be halted only by the monetary authorities restricting the quantity of money supplied, so that in the economy as a whole excess money balances cease to be created. These conclusions can be fully supported by evidence from many countries, this century and earlier.

The difficulty with the monetary policy prescription is that it works only in the longer run. What happens in the shorter run is admitted at the outset to be indeterminate, yet the question that matters to governments and to those who live and work in an economy is how to cope with the present so as to be able to enjoy eventually the calm seas of stable prices. Always, the immediate problem is a safe passage through the present storm. On this issue contemporary monetarism has nothing useful to contribute, beyond stating that it is a necessary price to be paid and all will come right in the end.

Recently in a letter to The Times, Roger Opie[22] of New College, Oxford accused the academic establishment of a grave sin of omission. He wrote: “How, and why, did we fail to strangle this

22 Roger Opie (1928–1998). Fellow, Emeritus Fellow, and Tutor in Economics at New College, Oxford.

theory at birth? Indeed, why did so few of us even try?"

The answer may be stated briefly in two parts.

1) The quantity theory of money has been around the English universities for a very long time, at least 400 years. Strangulation at birth was not an opportunity that was presented to the academic establishment of today.

2) The overwhelming majority of academics of whatever persuasion recognise that the quantity theory of money accords with the facts of experience. The dispute is not so much in the sphere of monetary theory as in the sphere of public policy.

Roger Opie writes of this "treason of the academics", where he seems to use such language only to obscure any possible alternatives to his own solution. He plied his solution with yet another question: "How can we escape from this trap, except by a planned, phased and sustained growth of spending on investment and retraining starting now, and continuing for many years?" In other words, Roger Opie advocates a bureaucratic, if not the socialist solution.

Shed of its rhetorical questions and other obscurities, contemporary academic macroeconomics offers to the general public only two choices. If they wish to reach the haven of a prosperous economy with a stable general price level then either they must jettison a large number of their companions and leave them to wallow in the seas of unemployment and depression so the rest can have a safe passage, or they must all accept the chains of the galley slaves and work to the beat of some bureaucrat's drum, with or without the whip.

That these are the only two choices offered is indicative of a failure, not of politics, but of macroeconomics. A new choice will not arise from the election of a new government or through the formation of a new party, no matter how well intentioned the members of that new government or new party may be.

Those who have the power to decide, whether it be ministers between elections or the electorate at a General Election, those who have the power to decide at any particular time can exercise that power only as between the choices offered to them at that time. Changes in the level of politics within a parliamentary democracy will not effect a change in the permanent advisor staff. It will not effect a change in the academic establishment. The same economic advisors, the same academics will continue to offer the same two choices to the new as they do to the present, and as they did to the previous government. A new choice requires a new approach to macroeconomics.

Let us take another look at the quantity theory of money. It has, after all, stood the test of time. We may begin by admitting to its major conclusion, which fully accords to the facts of experience – if inflation is to be avoided in the absence of a fully controlled economy, then the monetary authorities, the government, must adjust the quantity of money they supply to the quantity of money demanded so as not to create persistent excess money balances in the economy as a whole.

But this monetary policy is a matter of the longer run – how long cannot be stated with any precision, as it depends upon how slowly, or how quickly, all the necessary adjustments take to link the initial monetary impulse with a change in the general price level. Again, what will happen in the economy whilst these adjustments take place is from the aspect of monetary policy also indeterminate.

However, although those who live in the economy may be concerned about the longer run they are concerned also with today, tomorrow, next month, the rest of this year. They are concerned about what will happen whilst the adjustments take place; they are concerned about what will be the state of the economy when the adjustments have taken place. All these things are matters for concern, but always to those involved, the shorter run is a matter of more immediate concern.

What help then is the quantity theory of money? I argue that the price we are being forced to pay in terms of the present slump is the price of ignoring the short-run policy implications of monetary theory. It is not a necessary price for past excesses or a necessary price for the eradication of inflation.

We all know, as a fact of repeated experience, that when a government increases taxes which directly affect costs, say by increasing excise duty, then within a few hours, or a few days and at most a few weeks, prices rise.

We know also, as a fact of repeated experience, that when a government increases income taxes then employees retaliate; this retaliation increases employers' labour costs, and in turn, these cost increases are reflected in higher prices. The tax inflation of prices is a little delayed when taxes on income are increased but it still happens in the shorter rather than in the longer run.

Now if tax increases cause tax inflation of prices in the short run, then, in the same short run, the demand for money must be increased. The process of tax inflation happens in the short run, just as surely as monetary inflation in the longer run.

Thus, from the quantity theory of money, we must conclude that whilst monetary policy is important for avoiding monetary inflation, and for ensuring the well-being of the economy in the longer run (or, to use the 'in' phrase, the medium term), equally fiscal policy is important for avoiding tax inflation and for ensuring the well-being of the economy in the shorter run.

From a restatement of the quantity theory some 25 years ago, the Chicago School concluded rightly that monetary policy is important for inflation. It then fell foul of its own formatory thinking,[23] and asserted that fiscal policy is not important for inflation. The latter does not follow from the former. By failing to recognise its initial mistake, academic macroeconomics of today continues in error.

The British government is a victim of this error of macroeconomics and we all suffer. The government's stated objective is a permanent reduction of the rate of inflation within the lifetime of

23 The habit of weighing up propositions only in terms of pairs of opposites.

the present parliament, without any permanent contraction of output and employment or loss of personal liberty. To this end, the medium term financial strategy was devised. So far, so good.

Where macroeconomics has failed both the government and the British people is in the sphere of the annual fiscal policies needed to compliment the medium term monetary policy. Over the past two years the government have been misled into concentrating on attempts to reduce their borrowing requirement by cutting public spending and raising taxes. Given their monetary policy, given the world recession, then such a fiscal policy can have but one result: to precipitate a slump. As the slump intensifies, public spending inevitably increases and tax revenue inevitably falls. A certain result is that the government borrowing requirement grows at a pace which defeats all efforts to control the quantity of money being injected into the economy, and a slump is added to inflation.

The 1981 Budget proposals are intended to hold the economy to the medium term financial strategy. Again, the Chancellor is being ill served by his advisors and by those academics who claim to be monetarists. He is being ill served also by those academics not of the monetarist persuasion. They tell him only that he is wrong; they do not spell out an alternative fiscal policy, compatible with the government's longer-run objective.

As a result of misguided fiscal policy in the past, the Chancellor faced an estimated borrowing requirement for this financial year more than double that proposed in the medium term financial strategy. Understandably, this was considered too much. In November of last year the Chancellor announced tax increases to be effective from April of this year, estimated to add £1.0 billion to employers' labour costs directly, and to reduce take-home pay by £1.5 billion. In the Budget this April, he then proposed further additional taxation that would directly increase these costs by an estimated £3.8 billion and reduce incomes by a further £2.5 billion.

Thus, it is proposed in the midst of a depression to attempt to raise nearly £9,000 million in additional tax revenue this year.

Some £4,000 million will directly reduce disposable incomes and must be expected to intensify the slump by cutting back private sector demand.

In due course, as these income-effect taxes motivate a tax shifting process, there will be the added effect of the tax inflation of costs and prices. The balance of these additional taxes will inflate costs directly.

Additional cost-effect taxes cause the tax inflation of prices almost immediately upon their imposition and this has happened already to an immeasurable extent. With a tax induced rise in costs the competitive position of British producers is eroded and the slump is again intensified. On the other side of the account the Chancellor is proposing to dispose of, or perhaps fritter away is a better term, some one-third of this additional tax revenue by reliefs and cash benefits to particular sections of the community, but such actions are more exercises in political cosmetics than political economy. They will have no measurable effect on the level of economic activity, taken as a whole. Much publicity is being given to assisting small businesses, when I would argue that most small businessmen would be better off left to take their chance in an expanding economy rather than being offered, at the taxpayer's expense, a privileged position in a contracting economy.

The fiscal proposals for 1981/82 have been justified on the grounds that it is necessary to reduce government borrowing so that interest rates may be allowed to fall. This argument is no more than a variation on the theme of one hand ignoring what the other hand is doing. Admittedly, real interest rates for the private sector are excessive,[24] and excessive government borrowing does tend to keep interest rates high, but it requires 'cloud cuckoo land' macro-economic analysis to conclude that boosting the demand for money by £9.0 billion of tax inflation in order to reduce estimated government borrowing by £3.0 billion is, as a policy, conducive to

24 Interest rates in the UK had reached a peak of 17% in September 1980, and remained above 8% for several years thereafter.

a fall in interest rates. Indeed, if the authorities attempt at the same time to restrict the quantity of money supplied then there must be a further contraction of output and employment. True enough, as the slump continues and intensifies the slump will tend to reduce interest rates. Yet so far my analysis does little more than confirm the opinion of the 364 academics. The question remains, is there an alternative route?

Let us consider an alternative fiscal policy which could be introduced immediately and would complement the medium term financial strategy. This year it is proposed to collect over £12.5 billion from employment taxes imposed directly on employers – our administrators call these taxes employers' contributions, and surcharge. This astronomical figure for tax inflation of labour costs is proposed during a financial year when the Manpower Services Commission estimate unemployment may exceed three million. It is a nonsense at this time to persist with a policy which increases unemployment and is bound to be very expensive to government in terms of revenue lost and in terms of redundancy pay and unemployment benefits, etc. paid out.

As a first step towards a recovery, then, why not call a halt to this expensive and restrictive piece of tax inflation? If, say, it was abolished at the end of May, then the borrowing requirement this financial year is unlikely to be increased by more than £4.0 billion, at the very worst by not more than £6.5 billion. In the next financial year of 1982/83 such a measure, introduced now, would reduce the estimated government deficit. Immediately and automatically the tax deflation of labour costs would make British producers more competitive as against foreign producers, not only in overseas markets but also in the home market. British-based firms would be better able to take advantage of opportunities that exist for this country now and as output and employment expanded profitably much of our current public spending would be rendered unnecessary.

On the revenue side, tax receipts would rise with the generation of more income, so by a double concerted action the tax deflation of labour costs would work automatically to cut the Chancellor's estimated deficit. In addition, the tax deflation of labour costs would significantly reduce the rate of inflation and would be quick acting. Instead of raising prices by fiscal policy, the Chancellor would effectively cut prices. Instead of the rate of inflation continuing to hover around double figures, it would probably be halved by the end of the year, equal to the lowest E.E.C. rates.

The opportunities exist now, and to take advantage of these opportunities we need bold action on the part of government. The choice is not between the present restrictive fiscal policies or re-inflation. There is an alternative – expansionary policies can be pursued by way of tax deflation.

Those that would argue that the Chancellor cannot risk any increase in the borrowing requirement, even in the shortest run, are just ignoring the evidence. In the last financial year of pursuing misguided restrictive fiscal policies the actual borrowing requirement exceeded the Budget estimate by some 60 percent, or £5.0 billion. This financial year with even more restrictive policies the margin of error in the official estimate gives scope for a sweep-stake. One could almost guarantee that in the final out-turn the deficit would be less, given an expansionary fiscal policy by way of tax deflation of labour costs, than if the restrictive measures of tax inflation which are at present in the Finance Bill are enacted.

The alternative fiscal policy I have just outlined does not require the government to abandon their medium term financial strategy. It is fully consistent with that strategy, and with the longer run objective of a prosperous economy with a zero percent rate of inflation. It is the fiscal policies which the government have been advised to pursue over the past two years, and which they propose to pursue with even greater severity this year, that are making it impossible for them to keep to their financial strategy and move towards their stated economic objectives.

If a government persists in tax inflating costs and prices then they will persistently increase their demand for money relative to any given volume of output and employment. If at the same time they attempt to restrict the quantity of money supplied relative to the tax inflated quantity demanded, then only one thing can happen: output and employment must contract. This is what the quantity theory predicts. This is what is happening and this is what must continue to happen for just so long as the government are misled by their advisors into pursuing fiscal policies directly opposed to their financial strategy.

Established macroeconomics has demonstrated conclusively that it is not capable of doing the job that the government requires to be done. What is needed now is a new approach to macroeconomics. In making this new approach one does not have to reject Keynes if one accepts Friedman; one does not have to reject Friedman if one accepts Keynes. Friedman's restated quantity theory of money is essentially a generalisation of Keynes's theory of liquidity preference. The policy implications to be drawn from the work of these two macroeconomists are not incompatible, but complementary. Short run fiscal policies based on the analysis of Keynes compliment the longer run monetary policy advocated by Professor Friedman and his followers.

Earlier this month, Professor Stapleton, a monetarist at Manchester University, asserted that there are material differences between the recession of the 1980s and the depression of the 1930s. He is right – the present slump is more like the 1920s. A comparison with the thirties remains a prospect for future years.

However, as a contemporary monetarist, the Professor then felt bound to proceed and to argue that since there are these material differences then the analysis of Keynes is irrelevant at the present time. This is a nonsense. Previous to the *General Theory*, Keynes published two important works on monetary theory. Earlier I repeated a frequently quoted remark that Keynes slipped into one of his publications on monetary theory: "In the long run we are all dead". Taken out of context the quotation is often misinterpreted.

Today, in its context it is apposite.

During the 1920s there was, as now, an important public debate on monetary policy. Keynes contributed to that debate and whilst not denying the importance of the longer run, he deemed it necessary in the conditions then prevailing to emphasise the importance of current affairs. At the time, Keynes was a minority of one. His advice was rejected and that of the established majority accepted. As a result, the British economy was unable to take advantage of the recovery in world trade during the latter part of the 1920s and was totally unprepared to cope with the cold blast of the thirties.

Changing governments did not help. In quick succession we elected a Conservative Government, a Labour Government, and a National Government, but all through these changes the Treasury view continued to dominate public policy. This may sound all too familiar. Once again, established academics debate the pros and cons of monetary theory and its implications for public policy. Once again, Keynes is rejected as irrelevant and meanwhile the British people are being prevented from taking advantage of current opportunities. Are we to enter the next storm in as low an economic state as 50 years ago?

Within a few years it may be appropriate to draw a comparison with the 1930s, but now is a time of great opportunity. The British economy is at an advantageous position, and there is still time to change the economic outlook, for the immediate issue is not long-run monetary policy, it is short-run fiscal policy. So I will close tonight by quoting from the John Maynard Keynes of the 1920s, from his *Tract on Monetary Reform* published in 1923. "But this long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past, the ocean is flat again."

4

Unemployment and the Tax Wedge

8th September 1981

"Unemployment... is the specific social disease of western civilisation in our time."[25] – from *The Times* of 23rd January 1943.

The social disease of prolonged mass unemployment has re-established itself in this country after an absence of forty years.

How did this come about?

Some highly distinguished macroeconomists, and their number includes advisors to former governments, place the blame firmly on the present government. They call for an immediate scrapping of the medium term financial strategy which, they assert, is based on an "over-simplified view of how the economy works."

They propose an alternative policy of reflation – that is to say, they propose that the government should spend its way out of the present difficulties.

Others, only marginally less distinguished, reject the arguments for reflation and the theories from which they stem. The academic supporters of the medium term financial strategy contend that monetary policy is working successfully to reduce the rate of inflation and, in the words of Professor Rose of the London Business School, argue that: "the main direct cause of the rise in unemployment... was the 22% increase in wages in the 1979/80 pay round."

To this is added: "Britain's history of indifferent management, union restrictive practices, and structural decline, culminating in a reduction of excess manning that was long overdue."

The academic trench warfare in this particular sector has rumbled on for a number of years. Both sets of arguments include

25 Quoted from the articles on *Planning Full Employment*, of January 1943.

some of the truth, but although there has been changing of sides amongst the rank and file there is as yet no sign of any movement towards agreed conclusions. I reviewed the issues and implications of this particular academic dispute in three earlier talks, and they are now available in recorded form, so I do not intend to trudge through the same smoke again – tonight, I shall be presenting evidence rather than reviewing conflicting theories. In doing this I shall be following the established procedure of the scientific method which begins with observation.

As a starting point, it is observable that British experience of unemployment over recent decades differs in at least one fundamental from the experience of most other western developed nations – in this country unemployment has been showing a rising trend for the past twenty-five years.

As an example, the chart in Figure 1 shows unemployment rates over the past 25 years as officially recorded in the United States, and also in this country, the United Kingdom. The solid green line shows registered unemployment from 1956 through to 1974, and the solid red line shows registered unemployment from the year 1975 to 1980, with the 20-year trend lines in black.

Both countries suffered an upsurge of unemployment following 1974, and this is continuing. Some possible explanations for this are the world energy difficulties and the deep recession in world trade. Those who wish to add politics must remember that for most of the time in the U.S.A. there was a Democratic Administration and a Labour Administration in this country.

More important are the black trend lines based on experience in the respective countries over the twenty years prior to the present world recession. In the U.S.A. the line is near horizontal. There have been good years and bad years but on average unemployment has tended, if anything, to decline. In this country the line slopes definitely upwards. As the years go by, the good years are not so good, and the bad years become progressively worse. On average, unemployment in this country is definitely rising.

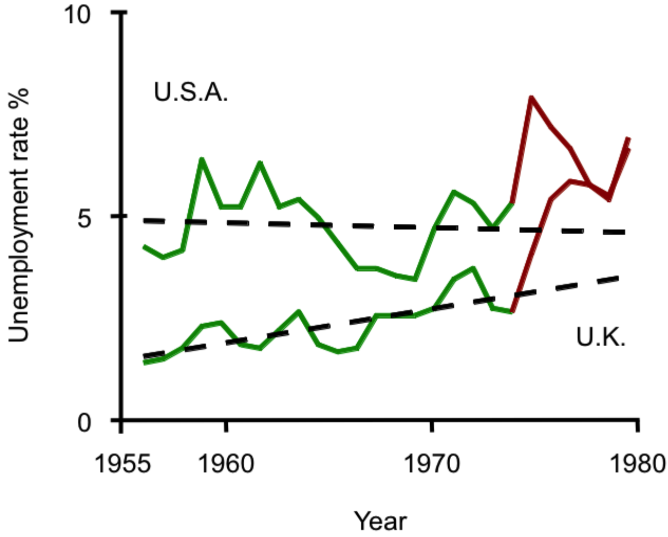

Figure 1: Unemployment rates, 1956 to 1980

Now the implication of the evidence shown on this chart is that whilst in the United States, as in most other western countries, it is reasonable to expect that in due course there will be a recovery, which will lead to unemployment returning to levels no worse than those of the sixties, in this country it would be foolish on the basis of past experience to hold such hopes. We have been proceeding along the road to mass unemployment for the past quarter of a century. Present experience is no passing phase; official estimates show a measurable rising trend of significant proportions, a trend well established before our immediate difficulties arose.

Ignoring the energy crisis, the deep world recession, Mr. Healey's imposed monetary policy,[26] this government's medium term financial strategy – ignoring all of this – the trend established in the twenty years prior to 1975 produces an unemployment rate

26 In 1976 the UK government requested a loan of £2.3 billion from the IMF. The terms of the loan required the Chancellor of the Exchequer, Mr Denis Healey, to impose reductions in public expenditure, and monetary controls.

for 1981 four times that of 1956. On the basis of past experience we can expect that any boom which might occur in the mid-eighties will still leave unemployment well in excess of 1 million.

How did we get to this road leading to prolonged mass unemployment? What is keeping us to this particular direction? That it is not a common experience implies that the forces are home-produced. That our experience is not shared by the United States implies that technological advance – such as the micro-chip revolution – is not a significant causative factor. Why should the technological revolution be a cause of rising unemployment in this country and not in the United States, which is in the van of the advance? Let us consider first the basic conditions common to all western developed countries.

A characteristic of all industrialised economies is the employer-employee relationship. The overwhelming majority of the working population are employees who, in order to earn their living, must reach an agreement with an employer. For the most part the employers are firms who can offer employment providing only that it is profitable for them to do so at the current cost of labour. Thus as a first hypothesis we may state that if mass unemployment persists then it is because it is unprofitable for firms to offer a greater volume of employment at the current cost of labour.

Profit in this context is the firm's disposable net income and the profit margin is the percentage slice of the 'national cake' that accrues to firms in any given time period. Whether this profit arises as a result of 'the exploitation of the working classes by the capitalist classes' or from some other cause is not an issue of immediate importance to this enquiry. We happen to live, for better or worse, in a country where private sector firms cannot for long continue to offer employment unless it is profitable for them to do so, and where even public corporations are not wholly exempt from this discipline.

In the contemporary British economy profit is the major source of investment funds. If a British firm is to keep abreast of the technological revolution and remain competitive then it must achieve a profit margin sufficient to finance the necessary new investments. For the economy as a whole, if the profit margin is insufficient to finance new investment on the required scale then firms will lose their competitive edge, profits will decline further and a contractionary spiral will become established.

Thus, given the contemporary British conditions it is reasonable to expect that there will be a close association between the after-tax profit margin and the unemployment rate; and this is confirmed by the evidence shown on this second chart, in Figure 2.

Before proceeding further, however, let me just explain a few of the techniques used when comparing economic time series.

First, one assumes one series to be the dependent variable. In this and the following charts I have assumed the unemployment rate to be the dependent variable, and in all cases it is shown by a continuous black line.

The measurements relating to unemployment are also shown in black. Along the bottom horizontal axis are measured the years and along the right-hand vertical axis, the percentage unemployment rate. The unemployment rate is a twelve-month average, in this case covering a period beginning in March of one year through to February of the following year.

Second, one assumes the other series to be the independent variable – that implies that it may be the causative factor carrying the active force. In this and the following charts the independent variable is shown by a continuous red line. The measurements relating to the independent variable are also shown in red. Along the top horizontal axis are the calendar years, with the percentage slice of the national cake along the left-hand vertical axis.

Third, between all the variables I shall be showing there is a time lag. For example, when the shunting engine pushes the truck next to it there is a ‘bang bang bang’ down the line, until the last truck rolls off into the siding. There is a time lag between the initial force and the result.

Again, when you are stuck at the end of a queue at traffic lights it is reasonable to assume that cars move forward when the lights are red; a dangerous assumption to continue to hold when you get to the top of the queue, and an example of a varying time lag.

In order to better show the relationship, the measurements are adjusted along the horizontal axes for the time lag, and in this case the profit margin for 1960 is related to the unemployment rate for March 1961 to February 1962 – a time lag of a little over a year. The chart shows the relationship between the private sector profit margin and the unemployment rate for the 20 years from 1960 to 1979. Prior to 1960 the profit figures are not strictly comparable. The relationship is negative – that is, a declining profit margin is associated with a rising rate of unemployment. To show this better, the right-hand scale is reversed.

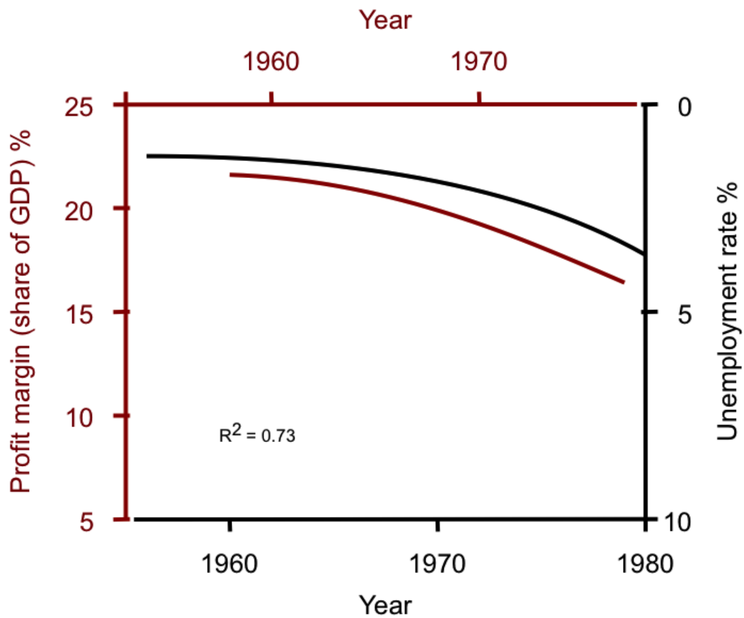

Figure 2: Profit margin and unemployment, 1960 to 1979

Clearly there is a significant negative relationship and for the mathematically minded the coefficient of determination works out at 0.73.[27]

Further, since a change in the profit margin precedes a change in the rate of unemployment by more than a year, this suggests a direction of causation from profits to unemployment. In other words the statistical evidence illustrated on this chart suggests that the rate of unemployment in any year is to a large extent determined by the private sector profit margin of the previous year.

In isolation this kind of statistical evidence is open to many interpretations. For example it could be interpreted as a reflection of indifferent management over the years and thus used to support Professor Rose's contention. Such interpretations enjoy a certain amount of credence since whilst indifferent management may be shown to apply in particular cases it cannot be quantified in general. It appears to the general public, untrained in the scientific method, that attributing the cause to indifferent management is consistent with indisputable evidence. It has to be admitted that there are indeed cases, perhaps too many cases, of indifferent management in British industry. However, the figures I have presented are drawn from the national account estimates and in the national accounts the private sector profit margin is in the nature of a residual item determined largely by the slice of the national cake appropriated by general government tax revenue.

It follows, as there is a significant negative relationship between profit margin and unemployment, and a significant negative relationship between the tax slice and profit margin – that is in both cases as one expands the other contracts – then also there will be a significant positive relationship between the tax slice and the unemployment rate – they will both tend to rise and fall together.

27 The coefficient of determination is a measure of how well the relationship fits the recorded data. A value of 0.5 would indicate that only half of the data points are explained by the proposed relationship, whereas a value of 1.0 would imply that all the data points are explained and that the relationship can be used to forecast future outcomes with a high degree of confidence.

The next chart, in Figure 3, illustrates the positive relationship between the percentage slice of the national cake appropriated by tax revenue, from 1955 to 1979, and the rate of unemployment, lagged by eleven months.

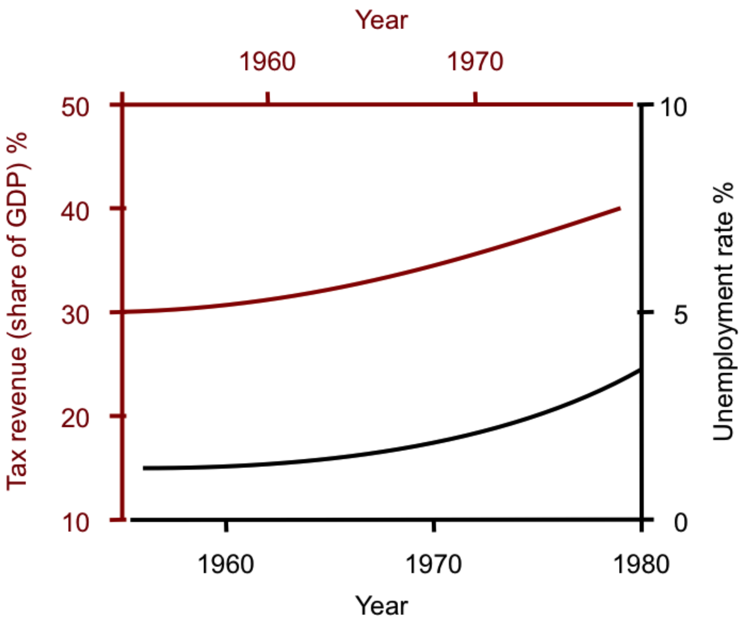

Figure 3: Tax revenue and unemployment, 1955 to 1979

From the evidence plotted on this chart it is possible, by regression analysis, to 'explain' over two-thirds of the increase in unemployment since 1956 in terms of the increased slice of the national cake appropriated by general government tax revenues.

Further, since the change in tax revenues precedes the change in unemployment by 11 months, the implication is that the direction of causation is from tax to unemployment. The change in taxes enacted by Parliament one year is a significant factor determining the level of unemployment in the following year.

Admittedly there are many causative factors which contribute to unemployment at any given time, such as indifferent management, but the evidence shown on this chart suggests that taking one year with another some two thirds of unemployment is attributable to taxation, and taxation, unlike most other factors, is wholly within the control of government. Do we appreciate the evidence shown on this chart as providing a general explanation, applying to the British economy as a whole over the past quarter of a century?

So far I have only developed one of the two possible lines of enquiry stemming from the original hypothesis that "If mass unemployment persists then it is because it is unprofitable for firms to offer a greater volume of employment at the current cost of labour." An investigation of the profit element has indicated the possibility that general tax revenue may be a significant factor determining unemployment in this country – but what of the cost of labour?

The cost of labour to an employer is the sum he has to pay out as a direct result of entering into a contract of employment with an employee. In this country today just about all contracts of employment, outside of the black economy, attract taxation and this tax drives a wedge between what the employee receives – his take-home pay – and what the employer pays out – his labour cost.

The difference between take-home pay and the employer's labour cost is the pay bargain tax wedge, which at present consists of Pay As You Earn (PAYE), the employees' social security tax, the employers' social security tax, and the current National Insurance surcharge.

The existence of the pay bargain tax wedge is a source of considerable confusion as to what is meant by the term wages. Does it refer to what the employee receives? Does it refer to what the employer pays out? Does it refer to some notional sum lying between these two that the Inland Revenue use as a basis for assessing income tax? To avoid these confusions I will avoid using the term wages. What the employee receives I will call take-home pay. What the government appropriates I will call the pay bargain tax wedge. What the employer then pays out – which includes both take-home pay and the pay bargain tax wedge – I will call the employers' labour cost.

Although the nominal sum paid out as labour cost is of importance to firms, of greater importance when deciding on the volume of employment they can profitably offer is the labour cost as a proportion of the proceeds they can expect as a direct result of offering a certain volume of employment. A measure of this for the economy as a whole is the percentage slice of the national cake represented by total labour cost. If our hypothesis is valid it is the labour cost slice that will be a factor in determining the rate of unemployment in the economy as a whole.

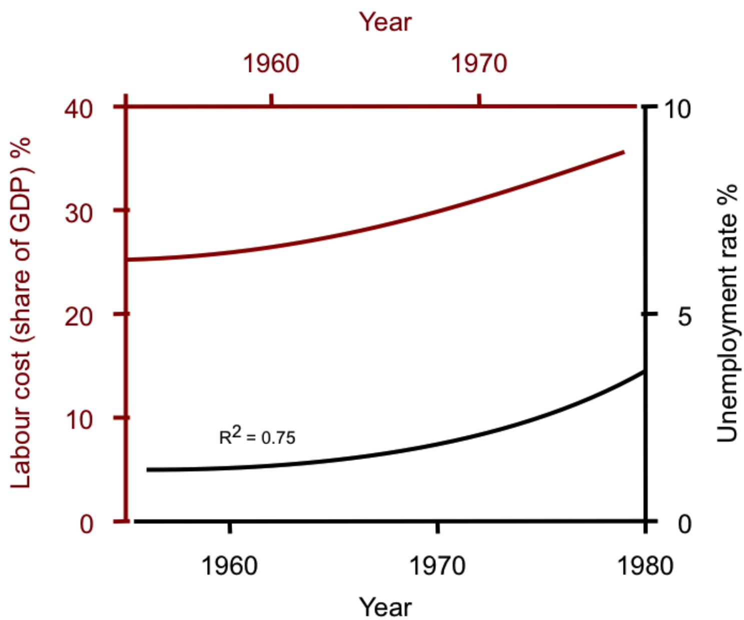

Figure 4: Labour cost and unemployment, 1955 to 1979

As shown in Figure 4, there is a close positive relationship between labour cost as a slice of the national cake – the red line –

and the rate of unemployment. Further, since labour cost precedes unemployment by much more than a year, this suggests a direction of causation from labour cost to unemployment rate. For the mathematically minded, the coefficient of determination is 0.75.

This means that over the past 25 years some three quarters of British unemployment can be 'explained' in terms of an expanding labour cost slice of the national cake. For policy makers this chart gives rise to a very important question – does the pay bargain tax wedge tend to reduce take-home pay, or to inflate the employers' labour cost?

Employees know as a matter of experience that an increase in either income tax, or their national insurance contributions, has an immediate impact on their pay packet.

Employers know that a change in their contributions or in the National Insurance surcharge will have an immediate impact on their labour costs. But what happens eventually? What happens at the next wage round?

Adam Smith concluded that all taxes assessed on employees' income are shifted by the employees onto their employers. In a paper published in January 1973 – *Fanfare to Action*[28] – I showed this two hundred year old conclusion to be confirmed by post-war British experience. Since 1973 the evidence has been accumulating from a number of countries beginning with research results from Canada in the Economic Journal of 1975.

In 1978 the OECD admitted "that labour unions do attempt to shift income tax increases forward onto higher money wages, and net of tax wage bargaining seems to be a rather common phenomenon in all OECD countries, except France." The reason why France is the exception is that the French national accounts do not give the required detailed information. So we see that the current experience of most western developed nations is consistent with a theory established in the eighteenth century by Adam Smith.

28 Fanfare to Action: Income Distribution as a Cause of Inflation, published by the Economic Study Association in 1973.

Employees shift all taxes imposed upon their income onto their employers, and this must mean that for the economy as a whole a change in the pay bargain tax wedge will be reflected in a change in labour costs rather than by a permanent change in take-home pay. Adam Smith took his analysis a stage further and argued that taxes imposed upon or shifted onto employers would be shifted forward, yet again, onto prices. This leads to the conclusion that in the final analysis an increase in the pay bargain tax wedge will be a cause of rising prices rather than unemployment.

However, in this matter it would seem that the twentieth century employee is not so easily fooled. It would seem that the possibility of employers raising prices to counter rising labour costs is fully anticipated in modern pay bargaining and as a result increases in the pay bargain tax wedge are associated with both rising prices and more unemployment – this tax shifting process is at the root of the phenomenon known as ‘the wage-price spiral’.

So by deduction from Adam Smith’s analysis and twentieth century evidence, we are led to expect a positive relationship between unemployment and the pay bargain tax wedge.

This final chart, Figure 5, shows in a simple way the direct relationship between unemployment and changes in the pay bargain tax wedge. They rise and fall together given a time lag of 12 to 18 months. Over the whole twenty-five year period over 80 percent of British unemployment can be ‘explained’ in terms of the pay bargain tax wedge. Over the most recent fifteen years the percentage rises to over 90 percent. For the mathematically minded the coefficient of determination has a value of 0.94.

As I said at the beginning of my talk my concern tonight is the presentation of evidence. My reason is that if one is to pursue macroeconomics as a science, then one must adhere to the scientific method, and this method begins with observation. These observations may then be generalised into a theory which must be re-checked against further observations before valid policy implications can be drawn.

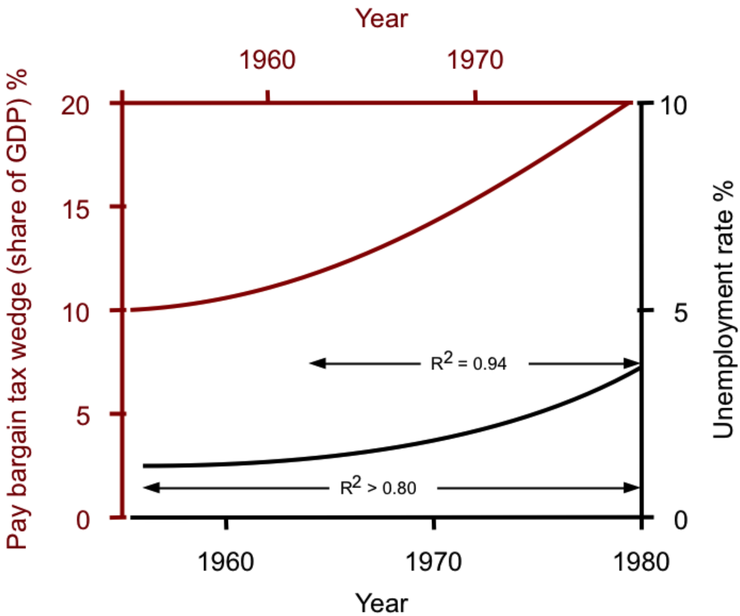

Figure 5: Pay bargain tax wedge and unemployment rate

The evidence shows that the return of mass unemployment to this country is not a temporary phase resulting from some chance coming together of international forces largely beyond our control.

This may be so for many other countries but it is not so for this country. The evidence shows that we have been proceeding along the road towards mass unemployment for twenty-five years. Monetary policy and recent international events may have been instrumental in our arriving sooner rather than later, but what matters now is that we have arrived – mass unemployment is today a 'fact of experience'.

Any explanation of unemployment in Britain today must take into account that we have been travelling towards this position for a very long time. The evidence I have presented to you tonight is largely ignored by British macroeconomists of all factions, by politicians of all parties, and it has been ignored by successive governments and their advisory staffs.

The evidence shows, however, that the rising trend of British unemployment over the past 25 years is closely associated with the slice of the national cake appropriated by the government as tax revenue. Since 1955 this slice has been increased from around 30 percent to the present 40 percent.

More, the evidence shows the level of unemployment to be very closely associated with the methods used to increase the tax slice. Since 1955 the pay bargain tax wedge has been doubled and the increase accounts for the whole of the increase in general taxation.

That mass unemployment has returned to this country should not be a matter for surprise, for successive British governments have piled all tax increases onto employment. Employees, it would appear, have not priced themselves out of jobs by excessive pay claims but they have been taxed out of jobs by irresponsible politicians and their advisors. In most cases these irresponsible tax policies have been put over to the accompaniment of cant about spending to maintain full employment.

If we are to move away from mass unemployment towards a "high and stable volume of employment" then the evidence suggests that we must first change the tax policies that have been pursued by former governments and continued by this government. In particular, we must reform the methods by which tax revenue is raised.

During the past twenty-five years over 80 percent of the rise in British unemployment can be explained in terms of an expanding pay bargain tax wedge. Over the past ten to fifteen years over 90 percent of unemployment can be explained in these terms.

The evidence suggests that by appropriate tax policies government could within a very few years create conditions in which more than two million of the present three million unemployed would have jobs. Having reached such a position it may then become possible to carry through the reforms necessary for tackling the balance of the problem.

Finally there are those macroeconomists who would reject the evidence that I have presented tonight on the grounds that it is “measurement without theory.” To this I reply that according to the established procedure of the scientific method observation comes first.

Tonight I have attempted no more than this first stage. However the evidence I have presented tonight is not in fact “measurement without theory”. For those of you who wish to know the theory and the policy implications to be drawn from that theory the E.S.A. have arranged a seminar series beginning on Tuesday 29th September.

Prolonged mass unemployment is for Britain in the 1980s a self-inflicted social disease. We are suffering from ‘statutory unemployment’. Statutory in the sense that it is largely the direct result of enactments by successive Parliaments at Westminster; statutory in the sense that the trend can be reversed just as easily and with greater speed than it was first established.

It is this fact that offers all of us in this country a golden opportunity for a prosperous future.

5

Unemployment – Who is Being Fooled?

7th January 1982

"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".[29]

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 Restatement*." This was essentially a generalisation of Keynes's 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.

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29 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 the Keynesians to react with some aggressive noises, and last year 364 varieties of academic Keynesians signed a paper 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 to that paper, 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 the 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, called *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. Along the horizontal axis he measured, according to convention, the assumed independent variable – the rate of unemployment. On 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 sets of observations described a curve, similar to the example in Figure 1.

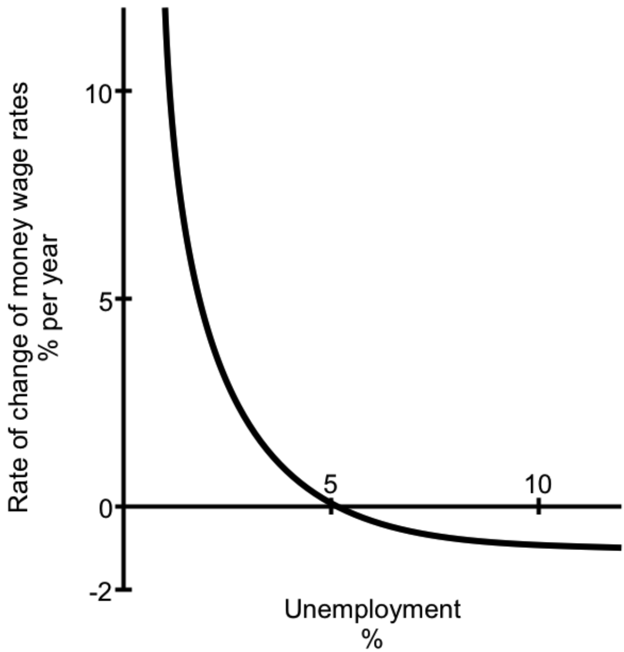

Figure 1: Wages and unemployment, 1861 to 1957

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.

Macroeconomists 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.

It seemed, then, that 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's 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's 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 he 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, two percent 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 two percent 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's 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 *Eo*, but also that this particular long-run 'natural' rate of unemployment is uniquely related to a stable rate of real wages. This is 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.

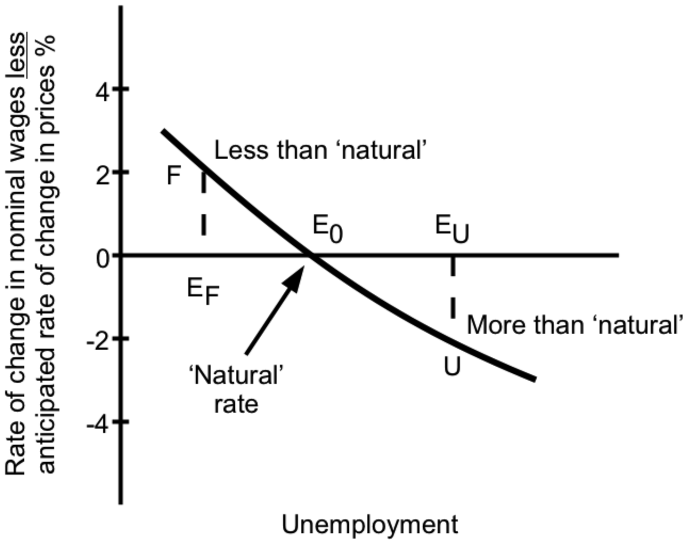

Figure 2: Wages and unemployment

Figure 3A is, I consider, a rather 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 coincide with the horizontal line corresponding to zero measured along the vertical axis of Figure 3A.

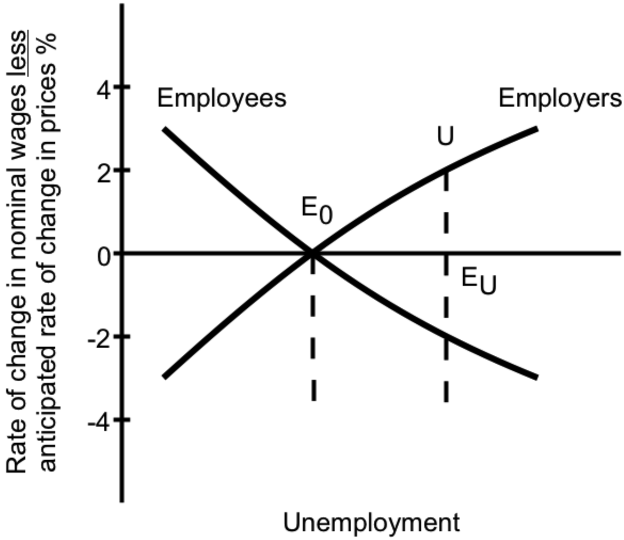

Figure 3A: Wages and unemployment

However, more of this anon; in London these important issues were not raised, and so Professor Friedman's story then 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 now moved ahead, 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 two percent 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 *Eo* to full or over-full employment corresponding to *Ef*, as there is a movement up the short-run curve to a new point of intersection, *F*.

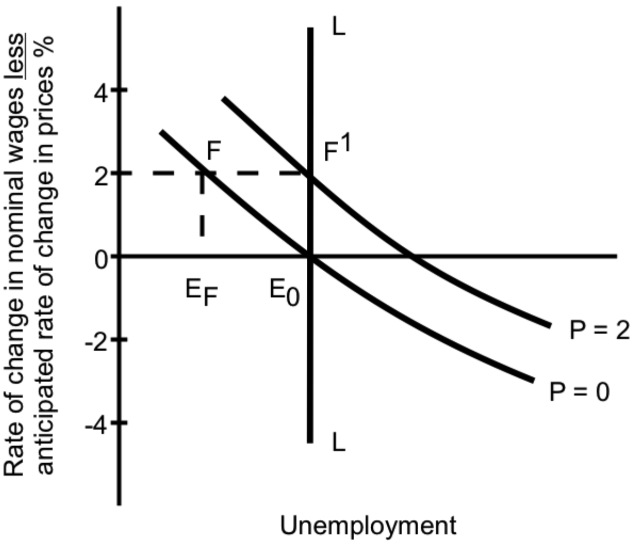

Figure 4: Wages and unemployment

As time passes people adjust their inflationary expectations to their continuing experience, that is, they begin to expect an inflation rate of two percent per year. This change in inflationary expectations Professor Friedman illustrated by drawing another short-run curve, now incorporating inflationary expectations of 2 percent. As the annual 2 percent rise in nominal wages and prices becomes fully anticipated unemployment rises from the low of *Ef* back to the level where it started before the inflation, the natural rate of unemployment *Eo*. This new point of intersection is given by the new short-run curve incorporating inflationary expectations of 2 percent shown on Figure 4 by the second 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 well be reasonable to expect that unanticipated inflation will tend to 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 restated quantity theory of money, and made his proposals for halting inflation by a restrictive monetary policy politically acceptable – in the longer run, he had said, 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 percent.

Thus, 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 half a 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 half a million, it can be argued, are the result of an intensive worldwide depression. So the policy dispute turns on about half a million new jobs.

The Keynesians argue that these half a 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 ½ 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 2½ 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 macroeconomists 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 rate of unemployment' 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 indeed such a 'natural' rate of unemployment – not a method of reasoning which inspires much confidence.

But of greater importance to us in the United Kingdom today is not the question of validity, but 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, in fact, be applied to a contemporary industrialised economy such as the United Kingdom? 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 percent of all government tax revenue. It is the equivalent to a VAT rate of 40 percent on take-home pay – for every £1 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 percent. 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 as employers’ labour cost. Given Professor Friedman’s definitions, then for an economy such as the United Kingdom, 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 *Eo* 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.

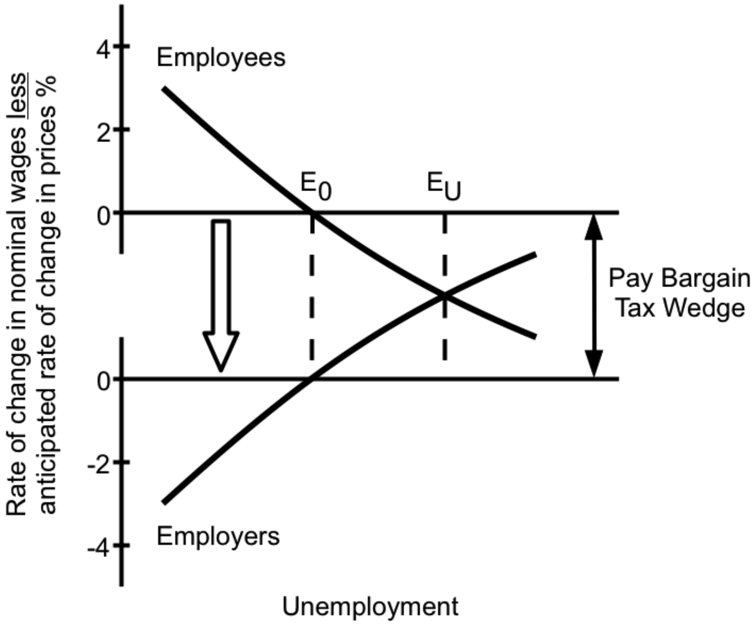

Figure 3B: Wages and unemployment

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's *General Theory*, published some 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 experience, provides the supporting evidence for this conclusion from theory. The rate of unemployment, lagged 15 months, is a function of the pay bargain tax wedge.

Figure 5 shows the evidence for the U.K. over the past 25 years plotted on a scatter diagram, similar to those used by Professor Phillips and Professor Friedman. This figure, however, shows a very different picture.

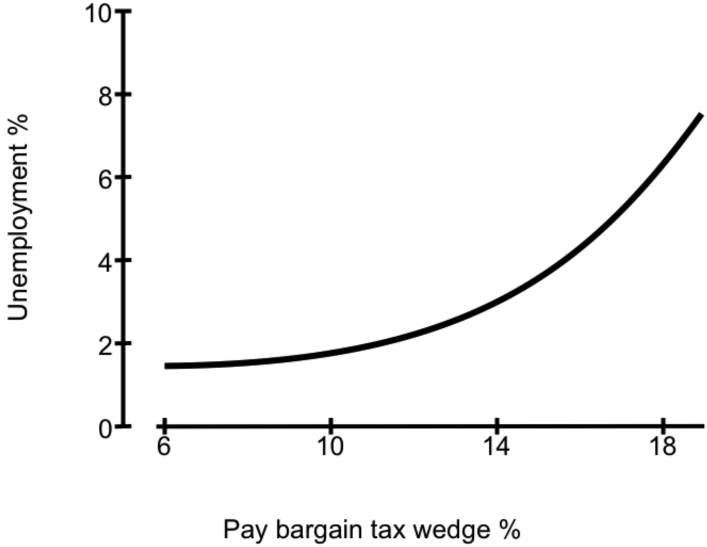

Figure 5: Pay bargain tax wedge and unemployment

The unemployment rate, lagged by fifteen 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 this case, as a percentage share of the product.

The dots show the observed data, and the curve represents the calculated line of the average relationship between the plots. By inspection, the U.K. experience is shown to be consistent with the 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 two to four 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 Keynesian economists of today, 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*. Macroeconomics can go back and start again by developing Keynes's 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 parties,[30] or changing governments; not even through the changing of 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 a 'natural' rate of inflation. Both theory and the facts of experience combine to tell us, however, 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.

30 A reference to the formation of the SDP as a new political party in March 1981. This talk was given almost a year later, in January 1982.

6

The Basis for Expanding Employment

15th April 1982

"How can we cure unemployment without causing a new surge of inflation?" According to a leader in The Times just before Easter, that is the key question of economics today.

Forty years earlier, a leader in the same paper had stated: "Unemployment has been the most widespread, most insidious, and most corroding malady of our generation. It is the specific social disease of western civilisation in our time."

Yet, in Fleet Street, or at least among the pubs in Fleet Street, while it continues to be asserted that news is the most perishable of all commodities – well, I bow to the journalist's expert opinion – news or not news, unemployment still is the specific social disease of western civilisation in our time.

Tonight, I wish to consider this recurring political issue in a stronger form, more appropriate to the advice that contemporary macroeconomics must needs be able to give to a government of Westminster in the 1980s. How can a government of Westminster pursue a policy of expansion without reflation, starting from where we are now, and for it to be effective within the lifespan of a single parliament?

Now, the scientific method by which macroeconomics should proceed was laid down by Aristotle over 2,000 years ago. It begins with observation and proceeds through theory to conclusions to be checked against further observation.

Observation shows us that first, a distinguishing characteristic of our economy is the employer-employee relationship. In this country today almost the entire working population are employees, employed by or seeking employment from firms – organisations that offer employment.

Second, we may observe that the demand for employees' labour is a derived demand. It is derived from the aggregate demand for the output produced by labour employed by a firm. So, aggregate demand is one of the fundamental factors determining the amount of employment firms are able to offer.

Keynes, in his *General Theory of Employment*, explicitly rejected the statement that supply creates its own demand – a statement derived from Say's law, formulated at the turn of the 18th and 19th centuries, and which continued to underlie all orthodox economic theory of 50 years ago, at the time that Keynes wrote his *General Theory*.

But Keynes did not fall into formatory thinking.[31] In rejecting the proposition that supply creates its own demand, he did not embrace the opposite proposition: demand creates its own supply. Having rejected Say's law, Keynes went on to write: "If, however, this is not the true law relating the aggregate demand and supply function, there is a vitally important chapter of economic theory which remains to be written, and without which, all discussions concerning the volume of aggregate employment are futile."

To appreciate Keynes's argument as it applies to the economy of the U.K. today, one needs to make yet a third observation. A further distinguishing characteristic of a modern industrialised economy in the western world is that firms can offer employment only to the extent that it is profitable for them to do so, given their current demand cost of labour.

Now, some may hold that this is to describe a condition in which the working classes are being exploited by the capitalist classes – a condition to be changed immediately, and by direct action if necessary. Others, more touchy than active, may have an antipathy to profits and prefer a term which implies a value judgement, say unearned income. There are yet others again who may object to the term demand cost of labour and assert that it

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31 The error of thinking in a formulaic fashion, in terms of opposites; a semi-automatic form of logic. The term is found in the works of P. D. Ouspensky.

does imply a value judgement since the return to labour – wages – is not a cost.

Well, in reply to these and similar questions or criticisms, I'm fortunately able to remain true to my traditions and proffer the Irishman's advice. If you wish to expand without reflation, you would be better starting not from here but from somewhere else.

However, having had some experience as a navigator, I know as a fact of experience that a prerequisite to moving towards a certain objective is to know precisely where one is, for one can start only from where one happens to be.

The observation that firms can offer employment only to the extent that it is profitable to do so given the current demand cost of labour is a supply side view which in conjunction with the demand side view of the second observation will enable us to open that chapter of economic theory without which, as Keynes wrote, "all discussions concerning the volume of employment are futile."

Now, Keynes's *General Theory of Employment* is, like all great ideas, essentially simple. It states briefly that the volume of output and employment towards which any economy tends automatically is determined by the point of intersection between the aggregate demand function and the aggregate supply function.

The aggregate demand price of the output of a given volume of employment is the money receipts that firms, as a whole, expect to receive from the sale of that output.

Keynes wrote the aggregate demand function in the form shown on the top line of the diagram, shown in Figure 1, thus: $D = f(N)$.

Thus the money sum firms expect to receive from the output of any given volume of employment, the aggregate demand price, D, is a function of output and employment, N.

Now, on the other side, the aggregate supply price of the output of a given volume of employment is the money receipts firms, as a whole, expect to be just sufficient to make it worth their while to produce that output. Keynes wrote the aggregate supply function in the form shown on the second line, as $Z = \Phi(N)$.

The money sum firms expect will just make it worth their while to produce the output of any given volume of employment, the aggregate supply price, Z, is a function of the volume of output and employment, N.

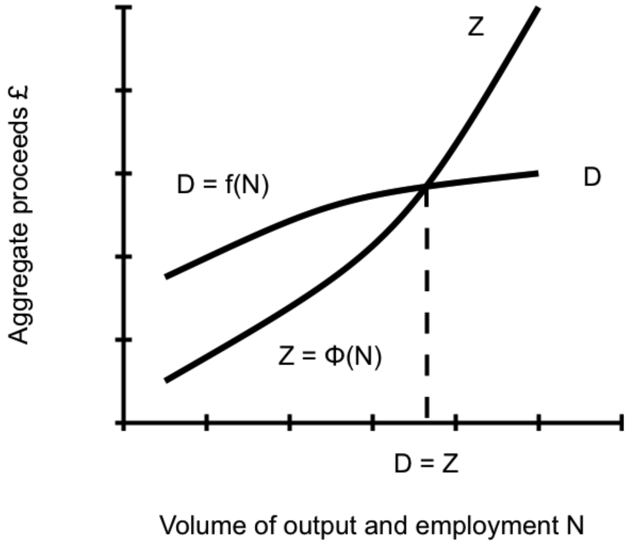

Figure 1: Aggregate supply and demand functions

The aggregate demand function relates to the money sum firms expect to receive from the sale of the output of a given volume of employment. The aggregate supply function relates to the money sum that will just make it worth their while to produce that output for sale. The one is what they expect – D, the demand function; the other is the minimum that will induce them to produce it – Z, the supply function.

And note carefully, according to Keynes, both the aggregate demand function and the aggregate supply function are of equal importance in determining the level of activity in any economy. They are the determining factors in combination: the money sum which firms expect to receive from the output of a given volume of employment – the aggregate demand price of that output; and the money sum which firms expect will just make it worth their while to produce that output – the aggregate supply price of that output.

Now it follows from this, when the money sum firms expect will just make it worth their while to sustain any given level of economic activity is greater than the money sum they expect to receive from that level of activity, then they will tend to contract their activity in an effort to minimise expected losses.

In terms of the chart, in terms of Keynes, when the value of Z exceeds the value of D the economy as a whole will tend to contract and unemployment will increase.

Alternatively, when the money sum firms expect to receive from their current level of activity is greater than the money sum which is just sufficient to make it worth their while to sustain that activity then they will tend to expand activity.

This will happen if they expect good profits and they will expand either to maximise their profit or in the fear of competition from other firms who, attracted by the good profits, may become established. In a modern industrialised economy such as ours, the competitive struggle as between firms, both nationally and internationally, is usually the more compelling motive. Firms are driven more by the stick, the fear of competition, than by the carrot of making a fast buck.

In the notation of the *General Theory*, when the value of D exceeds the value of Z the economy as a whole will tend to expand and unemployment will fall.

Thus, the *General Theory of Employment*, as formulated by Keynes, leads inevitably to the conclusion that any economy will tend automatically towards a point of equilibrium determined by the intersection of the aggregate demand function and the aggregate supply function; to a point where the money sum firms expect to receive from the output of a given volume of employment equals the money sum they expect to be just sufficient to make it worth their while to produce that output of a given volume of employment; to a point, as stated on the bottom of that chart, where the value of D equals the value of Z – where they equate.

Now in the 1930s, Keynes, for the first time in macroeconomic theory, emphasised that the equilibrium point to which any economy tends automatically might just as easily coincide with prolonged mass unemployment as with a zero rate of unemployment, or with any rate of unemployment between those two. Before that it had been assumed by most macroeconomists that in the nature of things, an economy tended automatically towards full employment or a zero rate of unemployment.

Keynes argued differently, and he said that the actual rate of unemployment consistent with equilibrium depends on the relative value of both the aggregate demand function and the aggregate supply function. These are the two things which will determine the point of intersection, and the point at which they intersect will determine the level of activity towards which that economy will tend automatically. So much for the theory of Keynes.

We are now 50 years on. After decades of so-called Keynesian policy, we have to consider: is the theory wrong, or has the theory been misinterpreted?

I argue that the *General Theory of Employment* as formulated by Keynes has been and continues to be misinterpreted.

Those who followed Keynes, the contemporary Keynesians, are stopped short, it would seem, by the second observation, that the demand for labour is derived from the aggregate demand for output produced by labour employed by firms.

Blinded by the revelation of the importance of aggregate demand, they proceed to the conclusion that by increasing the amount of government spending, then the nominal aggregate demand can be increased sufficient to sustain a zero or a near zero rate of unemployment. They appear to ignore the existence of the aggregate supply function, as shown on the second line of that chart.

But in fact, they fall for formatory thinking. Like Keynes, they reject the notion that supply creates its own demand. But unlike Keynes, they proceed to embrace the opposite; demand creates its own supply.

The notion that demand creates its own supply underlies all those policy proposals which in the U.K. conditions of the 1980s call for increased government spending in order to reduce the present level of unemployment. Such policy proposals are derived not from the theory of Keynes but from the opposite of Say's law. These so-called Keynesian policy proposals ignore that "chapter of economic theory without which all discussions concerning the volume of employment are futile."

That full employment policies based on Keynesian demand management techniques must fail is implicit in the theory of Keynes. When government spending is increased, sufficient to increase nominal aggregate demand so as to sustain a point of intersection between the aggregate demand and supply function consistent with a near zero rate of unemployment, then, one way or another, that additional government spending has to be financed.

As Keynes argued in his *Tract on Monetary Reform* published in 1923, there could be no such thing as an uncovered government deficit. In the United Kingdom where the government are also the monetary authority – not the same, remember, in the United States – but in the United Kingdom, where the government are also the monetary authority, the required additional government spending can be financed in any one, or in any combination, of three ways.

One of the ways by which a Westminster government can cover additional public spending is by the method Professor Friedman describes as 'printing money'. They can cover their spending from the proceeds of producing more legal tender – and they have a monopoly in the business – or their more usual method, from the proceeds of the sale of government short-dated paper.

But either way, the reserve assets of the banking system are expanded, and the quantity of money in circulation is increased by a multiple of this expansion automatically.

Currently, the British banking system operates on a prudential ratio of reserve assets and liabilities and this would seem to be settling somewhere around 12 to 1, something of that order.

Now what that means is, that for every £1 million pounds the government expand the reserve assets of the banking system, in order to finance public spending, then the quantity of money in circulation is increased by £12 million, a 12 to 1 ratio.

The effect of increasing aggregate monetary demand financed by printing money may be, in its impact, expansionary, but very quickly, as a majority of macroeconomists agree, on the basis of both theory and conclusive and extensive evidence, very quickly, any expansionary impact is dissipated in a rising general price level, and the inflation in due course is most likely to set in motion contractionary forces. Keynesian full employment policy cannot be pursued by the method of printing money to finance a required level of government spending.

Another method of financing additional government spending is by government borrowing from the non-bank private sector; that is, from you and me – if they can. This is what Professor Friedman describes as ‘true borrowing’.

Now in certain conditions, additional government spending financed by true borrowing can be advantageous to the economy as a whole, and through the operation of the multiplier, lead to a higher level of economic activity than would otherwise prevail.

In the early thirties, Keynes and the majority of other influential economists proposed additional government spending on public works to be financed by true borrowing as a means of jerking the economy out of that particular depression. In the United States, President Roosevelt introduced his New Deal policy, which had a similar basis.

True borrowing also has a place within a system of contra-cyclical public finance with deficits over a period of three or four years being followed by surpluses over a similar period – the object being to achieve greater stability over the full period of the international trade cycle.

But of course all that is very different to a government resorting to true borrowing persistently in order to finance the continuing additional spending required to pursue their so-called Keynesian full employment policy.

In all probability, persistent true borrowing will, in any event, lead to an increase in the quantity of money in circulation in excess of the rate of growth of real output and thus cause the intended expansionary effect to be dissipated by inflation.

One thing is certain. When governments borrow persistently then they are faced also with the persistent rise in their annual debt service charge. Eventually, they must find themselves in the position of having to borrow, not to finance a current full employment programme but to meet the current charges arising from previous borrowing.

A Keynesian full employment policy may be financed for a time, a considerable number of years possibly, by true borrowing but such policies cannot be sustained for very long in that way. Sooner or later, it ceases; it stops working.

Now, the only remaining way for a Westminster government to finance additional spending is by imposing additional taxation.

The difficulty with this method of financing additional spending needed to sustain a full employment policy is that all taxation, however assessed, tends eventually to squeeze profits. As profits are squeezed, firms have no option – say to finance a new investment necessary to maintain their competitive edge – firms have no option but to raise prices.

Now, in the condition of a full employment policy, they are able in general to take such action since aggregate demand is being kept up by government spending. But you see, it comes down to the fact that this method of financing Keynesian full employment policies also generates inflation.

Should the government be tempted to restrain the inflation by a restrictive monetary policy then, according to the theory of Keynes, this must set in motion contractionary forces and rising unemployment. This must be so, since underlying the appearance of inflation is the fact that the increasing taxation is causing the value of Z, the aggregate supply price, to increase for all values of N, the volume of output and employment.

Thus, the theory of Keynes predicts that Keynesian full employment policies must lead inevitably, first to a rising general price level and then depending on monetary policy, to a trade-off between the rate of inflation and the rate of unemployment. This prediction is, I suggest, consistent with post-war British experience and supports the conclusion that it is Keynesian policies that are wrong rather than the theory of Keynes.

Let us now turn to the United Kingdom evidence. The period of domination by Keynesian full employment policies may be said to have begun in 1945; with the end of the second war; with Full Employment in a Free Society, Beveridge, and all that. By the second half of the fifties, mass unemployment it seemed had been banished to the history books.

I will take as the base year 1960, the age of Super Mac (Prime Minister Harold MacMillan). In that year, the slice of the national cake appropriated by taxation was the lowest of any post-war year. The rate of unemployment fluctuated around 1% of the employed population. The general price level rose by fractionally over 1%, although within that overall figure, consumer prices, which are the popular measure for inflation, rose by less than 1% over the year.

Looking back, we can perhaps better appreciate the basis for his claim – ‘You’ve never had it so good’.

But let us look first at what has happened to taxation and profitability since 1960, which is shown on the chart in Figure 2.

Now, the graph at the top shows the slice of the national cake appropriated by general government tax revenue. In the 1960s, the tax revenue share was less than 30%, that’s fractionally under 30%, twenty-nine point something. By 1980, it was over 40%. In twenty-one years, that is an increase of more than a third. For those of you that wish for precision 36.5%. Now, as the red line shows of course the increase proceeded somewhat irregularly, but the black line shows the rising trend, over the full period, and the trend is definitely rising.

Now the lower graph is a measure of the profitability of private companies and of public corporations after allowing for their stock appreciation, capital consumption, and total tax payments.

It represents the overall slice of the national cake accruing as disposable net profits to companies, and to public corporations. Again, the black line indicates the trend, only this time, it is a declining trend.

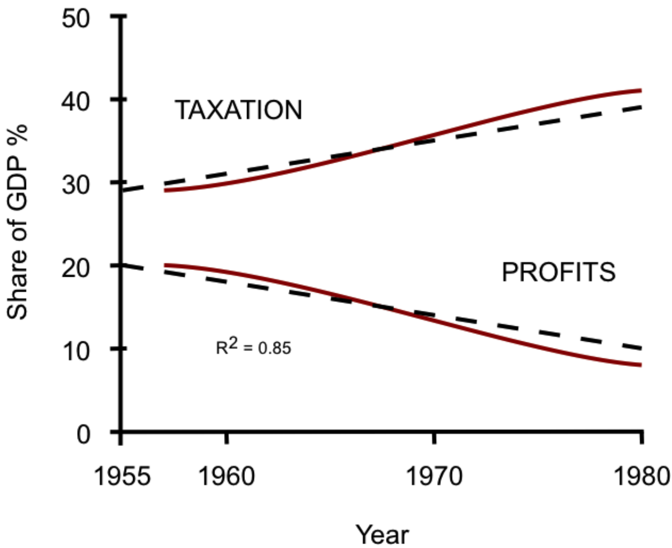

Figure 2: Taxation and profits, 1955 to 1980

It is quite clear from inspection, that as the share appropriated by taxation rises, the share accruing as disposable net profits declines. If one goes up, the other goes down. They move around the line a little, but they keep on the same trend: one up, one down.

For the more statistically minded, the coefficient of correlation between these two time series is a very significant 0.85. Or if you prefer, 72% of the decline in the profit share can be explained in terms of the larger share appropriated by taxation, which again is statistically very significant.

Of course, although all taxes squeeze profits as the chart shows and as a result, cause the aggregate supply price to increase for all volumes of output and employment, like the line on the previous chart, more important for employment – as opposed to the general level of activity in the economy – more important for employment is the broad method by which this additional tax revenue is raised.

How did the government increase their share of the national cake over a period of 21 years by 36.5%? This is more important for employment.

Now, pay bargain taxes – that is P.A.Y.E. (Pay As You Earn), social security taxes, and the National Insurance surcharge – these pay bargain taxes act to increase the demand cost of labour, either immediately, or after a short time lag – in this country, after no longer than about a year.

Thus quite apart from any longer term effect on profits, the method of raising taxation by pay bargain taxes raises the demand cost of labour and of necessity at the same time increases directly the aggregate supply price for all volumes of employment.

Firms can only offer employment so long as it is profitable or to the extent that it is profitable for them to do so, at the current demand cost of labour.

Now, all taxes make offering employment less profitable; but particular taxes, pay bargain taxes as I describe it, not only in the longer run do they make it less profitable but also they make it more costly. They act both ways; and they do so – they make it more costly anyhow – within a time lag of only about a year in the United Kingdom. Other countries have different time lags; the time lag is longer for example in the United States.

Let us move on to the next chart.

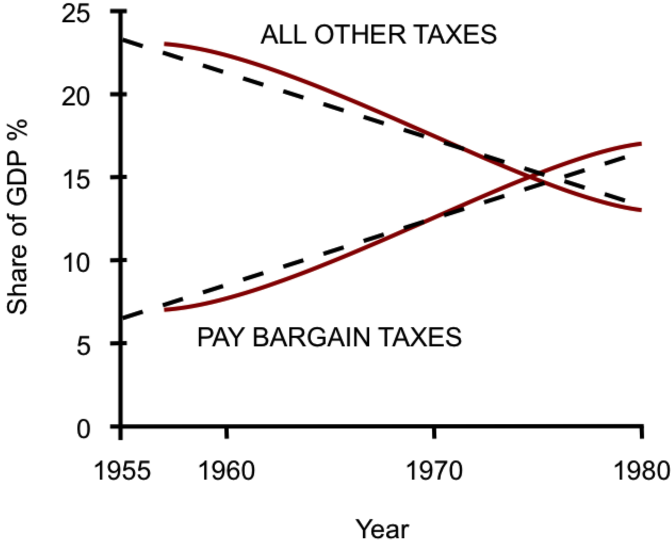

Figure 3: Pay bargain and other taxes, 1955 to 1980

Now, in this chart, Figure 3, the lower graph shows the slice of the national cake appropriated by pay bargain taxes; and the top graph, the slice of the national cake appropriated by all other taxes.

By simple inspection, you can see very clearly, that since 1960 the whole of the increase of the tax share has been achieved by means of these pay bargain taxes; and more, since the share of the other taxes has in fact been on a declining trend. So since taxation as a whole has increased, if all these other taxes have declined, then pay bargain taxes for 21 years must not only account for the whole of the increase, but also, the decline in the rest of the taxes.

What this amounts to in relation to the theory of Keynes, is that successive British governments have been pursuing since 1960, not full employment policies that have failed, but unemployment policies that have succeeded – and they blame it all on Keynes.

Now in my last public talk in January of this year I showed, when dealing with Professor Friedman's theory of employment, that over 80 percent of the present three million unemployed could be attributed to the effects of the pay bargain tax wedge.

I won't go through that argument again tonight. The talk is available now as a recording, and by avoiding or missing out that argument (which you can listen to at your leisure provided you pay the money first), this will enable me to divert from tonight's main theme to consider an alternative to Professor Friedman's exclusive monetary explanation of inflation. This may be relevant, perhaps a diversion, but the other is on the recording, so you can listen to it.

In 1943, Nicholas Kaldor of Cambridge University published in the Economic Journal a post-war full employment budget for the United Kingdom – what had to be done, what the government has to spend, and so on and so forth, in order to ensure that when the war finished, we could enjoy full employment.

It required government to appropriate by way of taxation plus borrowing 35% of the national cake. This was the article published in the Economic Journal of 1943.

Now, in an article published in the same journal in December 1945 Colin Clark, then the economic advisor of the Government of Queensland, concluded from extensive evidence that whenever a government appropriated more than about a 25% share of the cake, then economic forces were set in motion leading to rising costs and prices, and some contraction of output and employment.

On that basis, Colin Clark argued, Kaldor's proposals were unworkable; and Keynes agreed with Clark, in 1945. In the event, Kaldor's proposals proved more acceptable to a post-war British government and their electorate. Nicholas Kaldor is now Lord Kaldor and the British economy has a double figure inflation rate and a double figure unemployment rate. So be it; let us proceed.

On the next chart, Figure 4, the top graph shows the pay bargain tax share as the black line, and this, plus the general government borrowing requirement – the two combined – is the upper red line. On the lower graph is plotted the annual rate of inflation, again in red. What is important is the relationship between these two red lines – the pay bargain tax wedge plus government borrowing as a slice of the national cake, and on the other hand, the annual rate of inflation as measured by the GDP deflator.

Now, from Clark's 1945 study, we would expect a close and significant statistical association between these two sets of figures. There is. The coefficient of correlation is 0.92.

By regression analysis, one can explain some 84% of the annual rate of inflation in terms of the changes in that red line at the top – in terms of pay bargain taxes plus government borrowing.

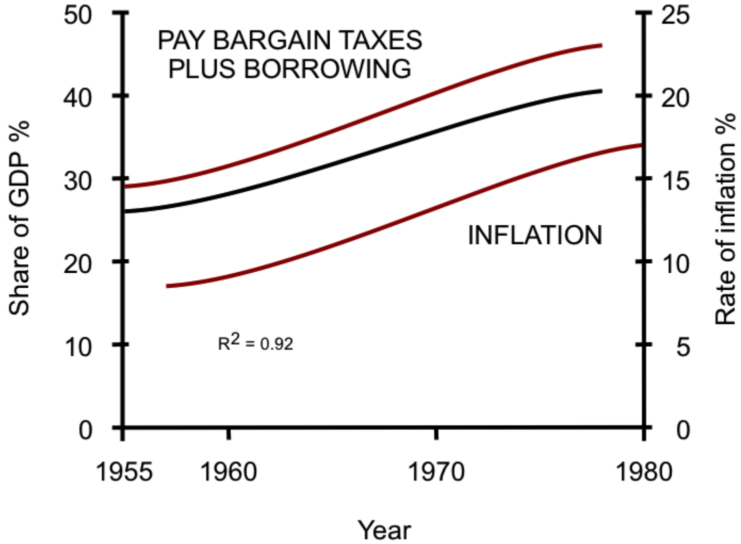

Figure 4: Pay bargain taxes and inflation, 1955 to 1980

Tonight, I don't wish to emphasise any direction of causation, but the evidence certainly supports the 1945 position of both Colin Clark and Keynes, and certainly goes against the position, which was put into practice, of Lord Kaldor and his Cambridge friends.

But of course this is in the past, this has happened, and as a result, now in 1982, the United Kingdom is in no position to set out along the road to 'full employment in a free society' – the road along which we intended to proceed 37 years ago. Now, we have first to retrace our steps, out of the mire of the social evil which Keynesian demand management policy with the assistance of an over-emphasis on monetary policy have led us.

We can however have confidence in the theory of Keynes, for the evidence fully supports the prediction from that theory. We are in the mess that the theory of Keynes predicts we should be in, arising from having pursued foolish fiscal and monetary policies throughout the post-war decades.

So what then are the policy implications to be deduced from the theory of Keynes applicable to the position in which we now find ourselves in the spring of 1982? What is a basis for a public policy that in the medium term may be expected to expand employment without causing a new surge of inflation?

There can be no way out by increasing government spending, in the hope of increasing aggregate demand – that was a solution applicable to the position we were in 50 years ago, in the thirties. Today such a policy must lead, first to accelerating inflation and then as the additional spending is reflected in higher taxes to yet a further contraction of output and a corresponding further rise in unemployment.

Today, the theory of Keynes calls attention to a tax inflated aggregate supply price. This tax inflation is attributable wholly to the consistent and continuing increase in the pay bargain tax wedge; in terms of current taxes, the National Insurance surcharge, employers' and employees' social security taxes, and Pay As You Earn.

As many of you have already noticed, the tax reduction that was promised to you in the last Budget, in the amount of Pay As You Earn, has in fact turned out to be a pay cut, due to the fact that the Chancellor has more than increased (unless you are receiving a very good salary indeed) the charges for social security taxes. There is a continuing increase. It doesn't matter which one he puts them on – that only affects the time lag just a little.

The fact is that the slice of the national cake appropriated in the form of pay bargain taxes has been increased two-and-a-quarter times since 1960. We have to reverse this trend, or go down.

Demand will not create its own supply, any more than supply creates its own demand. The action required from the British government today in the economic sphere is to free supply from its excessive tax burden so that it may expand, to meet an already existing aggregate demand.

This is the basis of expanding employment without a new surge of inflation. It is a policy implication to be drawn from Keynes's *General Theory of Employment*, applicable not to unemployment under the deflationary conditions of 1932, but to unemployment and the inflationary conditions of 1982.

7

Local Taxation – an Alternative

9th September 1982

Parliamentarians tell the story that local government is boring and local government finance is boring absolutely. For those in Whitehall and at the Palace of Westminster the story is useful – it serves as a smokescreen to obscure their actions or lack of action and to choke off or misdirect objections arising from the localities.

Earlier this year, for example, the Courts did their job of interpreting an Act of Parliament as it affected the issue of London Transport fares. The decision went against the Greater London Council. Yet, those who supported the GLC scheme presented the Master of the Rolls as some kind of Hampshire villain thwarting the will of Londoners. But clear away the smokescreen and it becomes apparent, if the Court's decision requires a villain, then it can be only Parliament, who passed the Act.

By the Road Traffic Act of 1930 Parliament took away from local authorities the licensing of passenger road services. In 1947 Parliament went further; under the Transport Act of that year all local authority owned passenger services became liable for transfer to new managements, to be nominated and controlled by central government.

More recently, London appeared to have re-established control over local passenger services; yet, as the Court determined, the powers passed back by Parliament to London's County Hall were circumscribed.

In this saga the fundamental issue is not the GLC's fare scheme. It is not even 'you pay your money and take your choice' – as taxpayers you will pay, with or without local choice. Rather, the issue is whether each and every one of us must accept: those in Parliament and Whitehall know best. Should Londoners, through their elected local representatives, decide a local London transport issue or should it be decided over their heads by a vote in a central Parliament whose members claim to represent the whole electorate from the Shetlands to the Scillies?

The history of this issue is longer even than Lord Denning's tenure as Master of the Rolls.[32] Some seventy years ago Professor Cannan wrote in the preface to his History of Local Rates in England, "A few months ago a distinguished continental Professor, who had been commissioned by his government to enquire into local taxation abroad assured me that he, like others, had been brought up in the belief that England was the home of local self-government, but he had found we enjoyed less of it than any other country he knew." Twenty-seven years ago reports prepared for a Congress of the International Union of Local Authorities similarly concluded that local authorities in this country had a far greater financial dependence upon central government and enjoyed far less freedom and autonomy than did local authorities in other comparable countries.

Lord Denning's decision marks but a stage in the history of a power struggle between Parliament and Whitehall on the one side and the Counties, Boroughs and Districts on the other, and it is entering now a critical phase. The struggle has political overtones, and some would assert that it is essentially a party political issue; nonetheless, the factor that will determine the outcome is finance. Political subjugation follows upon financial dependence. There are many current examples around the world and it is happening here. Indeed this country has drifted already into a position where the balance of administrative advantage lies with replacing the present rating system with national taxes. Such a proposal is thought likely to attract votes at a general election. These are powerful political party reasons for advocating the proposed measure, even though its enactment must then set up the United Kingdom as a centrally controlled state, with only the political hue to be decided.

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32 Lord Denning (1899-1999) was Master of the Rolls from 1962 until 1982.

At the last General Election the Conservative Party did commit itself to the abolition of the system of domestic rates. Such today is the dominance of central government money in local authority budgets that this limited measure raises no great tax difficulties. A general increase of say 5 percent on the standard rate of VAT would yield more than sufficient to finance the abolition of domestic rates by way of an assigned revenue or by an increase in central government grants. Moreover, in the recent Green Paper it was stated that some system of assigned revenues has a claim to serious consideration. But to proceed along this road raises further questions. Why hand over even more of the national taxpayer's money to be spent by local councillors? Why stop at the abolition of domestic rates?

If the central government took over, say, education, then the whole local rating system could be abolished without the need for the Exchequer to contribute more to local authorities by additional grants or by introducing assigned revenues.

Such an Act of Parliament would be no more than another small step in the direction we have been moving for decades. At one time the former London County Council was the largest hospital authority in the world and then, by Act of Parliament, it ceased almost overnight to be a hospital authority at all. Let us therefore do for schools this year what was done for hospitals in 1946. A reasonable enough proposal, on appearance.

The other side to the proposal is that local authorities can exist as free political institutions only to the extent that they have a measure of local financial independence for which they are fully accountable to their local electorate. Abolish local government's rate revenue and one abolishes local financial responsibility and with it local independence.

Thus, the outcome of the present debate will determine whether or not local councils are to be no more than local agents of an all-powerful central government in London. We are back again to the fundamental issue. Are we to have a local choice backed by local financial muscle in respect of our local affairs, or must we all conform to a central plan and accept that Parliament and Whitehall know best?

The recent Green Paper, Alternatives to Domestic Rates, ruled out as not meriting further serious consideration a whole range of suggested new local taxes including: local duties on petrol, alcohol and tobacco; a local vehicle excise duty; charges for licences for the sale of alcohol and petrol; a local payroll tax. Of the remaining suggestions it concluded, "Probably none of the new sources of local revenue discussed in this Green Paper – local sales tax, local income tax, or poll tax – could be used on its own as a complete replacement for domestic rates."

As this is so for domestic rates, which account for only some 44 percent of the total rate revenue, then it follows inevitably, to avoid local issues coming completely under the thumb of the central government, the rating system must be kept in some form. From the sentiments and admissions published by the government in their Green Paper it is to be concluded that the present public debate on local authority finance should be concerned primarily not with the abolition and replacement of the rating system but with the reform of the rating system. Indeed, some Conservative Cabinet Ministers, although committed by their party to the abolition of domestic rates, talk now of reforming the rating system as a whole.

That a British government is forced to admit to the need for a local revenue from local rates is no cause for surprise. A notional income from land or buildings is used widely by industrialised countries as a basis for raising local revenue. The United States, for example, have their property taxes which account for about 90 percent of local tax revenue and form a higher proportion of total general government tax revenue – Federal, State and local – than does the revenue from rates in this country. The great advantage of using the notional income from fixed property is that the basis is essentially local. Land cannot be removed from one locality to another in search of the lowest poundage rate. However, like all systems it can be abused and when persistently abused the rating system does become a cause of decay in certain areas, or even a cause of widespread distress.

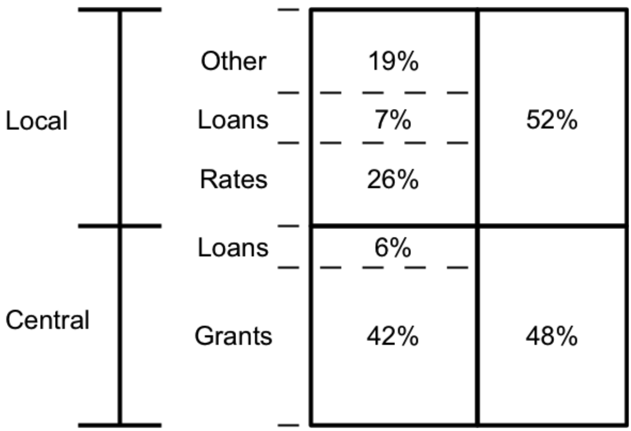

Figure 1: Sources of local government funding

Figure 1 shows the main types of local and central funding for local government in the United Kingdom averaged over ten years. Although the local rate revenue in this country is proportionately smaller than local revenues in any comparable countries, our local authorities spend, largely as required by Acts of Parliament, one pound for every three spent by central government. Many British local authorities have annual budgets substantially larger than the annual budgets of many independent countries who are members of the United Nations. On the other side of the books, local rates raise only one pound for every nine raised by national taxes.

This imbalance between local spending and local revenue is the crux of the issue, and is the source of Whitehall power and of local weakness. It is largely Parliament that requires local authorities to spend 25 percent of total tax revenue whilst allowing them to raise only 10 percent.

The revenue from local rates is small not only relative to local spending but also relative to the yield of some national taxes. For example, VAT raises 50 percent more revenue than rates; national insurance and the surcharge raise twice as much; income tax raises nearly four times as much. Yet it is local rates that appear to be the final straw that breaks the back of many businesses, especially small businesses. That this should appear to be so is due not so much to the inherent weakness of the present rating system as to the cumulative effects of acts and omissions by successive central governments, in particular the persistent erosion of rateable values, the basis of rate revenue, by Acts of Parliament.

One way by which Acts of Parliament cause the erosion of rateable values is when they create privileged classes who are exempted from rates, or at least not liable for the full rate. Way back in 1875 Parliament enacted that the general district rate was to be assessed on one fourth part only of certain classes of property, mainly farming, canals and railways. After changes and much parliamentary pressure agricultural users gained a complete exemption in 1929.

During the past twenty years a Royal Commission on Local Government, a government White Paper on the Future Shape of Local Government Finance, and the Layfield Committee of 1976, have all reported it to be reasonable to re-rate the farming industry, yet Parliament has taken no action and the industry continues to enjoy its privileged position.

I am not concerned in this talk with the rights or wrongs of any particular case for exemption. What I do wish to bring to your attention is that when Parliament create privileged classes who are exempt from local rates they reduce total rateable values and local councils, as a result, have little option but to increase the poundage on the rest. If some are exempted then the rest must pay more. Raising the poundage causes further distortions and in turn these distortions are a cause of hardship and distress among those who continue to have to pay local rates.

Again, since 1915 Parliament has continuously interfered in the private market for rented dwellings. The 1915 Increase of Rent and Mortgage Interest (War Restriction) Act froze at their August 1914 level all rents on dwellings with a rateable value below £26, or £35 in London. A necessary war emergency measure, maybe, but after the war the restrictions were extended. It has been estimated that in 1939 one in three of all rented flats and houses were controlled at rents not exceeding 40 percent of the rent charged in August 1914. With another war, another necessary emergency measure, which froze rents at their September 1939 level on all dwellings with a rateable value below £75 (£100 in London). The Act was estimated to bring two-thirds of all dwellings within the freeze.

As after 1918, so after 1945 – the restrictions were continued. Between 1939 and 1954 the general price level more than doubled yet the Housing and Repairs Act of 1954 was intended to keep 'net' rents at their 1939 level. Since then, Acts of Parliament have changed the position from time to time, some one way and some another; nonetheless the parliamentary restrictions and interference continue what began in 1915 as a wartime emergency measure.

When Parliament restricts rents to less than the current market level, then automatically they also restrict rateable values. Rate poundages are then increased and the system is distorted. Those occupying the controlled dwellings may gain a little at everybody else's expense, but the cumulative effect of all this legislation has been disastrous for the rating system and local authority finances.

Further, the owners of controlled dwellings are then prevented by law from obtaining the current market rate of return on their investment. When the condition persists the private sector supply of dwellings for letting at reasonable rents begins to dry up and eventually ceases altogether. This hits local authority finances in two ways.

First, Parliament has imposed on local authorities a statutory duty to provide dwellings for letting at reasonable rents. As the private sector supply dwindles, local authority spending has to increase in an attempt to make good the deficiency. Second, rateable values are required, by Act of Parliament, to be assessed on the basis of rental evidence from the private sector market. As this market contracts to near extinction, so does the evidence for making valuations for rating purposes. I will return to this later. For the moment we may note that the series of Acts of Parliament affecting housing and rents have not only eroded rateable values and increased local expenditure, but have also destroyed the very basis of the present rating system in an important area.

All this may seem bad enough yet it fades into insignificance in comparison with what followed from the Local Government Act of 1948. From time immemorial valuations for rating purposes had been carried out by local authorities. Then, in 1948, Parliament transferred the responsibility to a central government department – the Inland Revenue. What was the result? There was no full post-war revaluation until 1963. The fifteen years that it took the Inland Revenue to produce their first full up-to-date list meant a break of a quarter of a century during which prices had trebled, quite apart from all the upheavals and destruction of property as a result of the war. It took the Inland Revenue another ten years, until 1973, to produce their next and last full revaluation list. Now the job of revaluing for domestic rates has become impossible.

If it were not a fact of recent experience it would be incredible that an educated electorate, claimed to be the most experienced free electorate in the world, would stand by and allow successive central governments to bring the system of collecting local revenue into disrepute and to a near breakdown by completely ignoring a statutory duty. Worse, Ministers of the Crown now accuse local councils of financial irresponsibility, of failing to do their duty to their localities and to the country as a whole. There have been no searching questions from the media, from backbench MPs, or from Her Majesty's Opposition. It would seem to be the cover up to beat all cover ups.

Let us just suppose that the Inland Revenue had managed only to re-assess personal incomes for the purpose of income tax twice since the war and that the last time was in 1973 – that for each and every one of us our liability for income tax this year was to be assessed on our 1973 taxable income. Distortions and injustices apart the standard rate of income tax would be not 30 percent but well in excess of 100 percent. Could any Chancellor even begin to attempt the management of government finances on such a basis?

What an outcry would arise in the country, stirred up by the combined efforts of the media, backbench MPs and Her Majesty's Opposition. My supposition may seem beyond credibility, yet it is analogous to what has been foisted upon local authorities without so much as a murmur from self-styled guardians of our liberties.

What is frequently asserted today is that the rating system, although it served well enough in the past, is an ancient system totally unsuited to modern inflationary times. It is unfair, a cause of hardship, a source of injustice, incapable of raising sufficient revenue for modern expanded local government. All this is safe ground for it is so – but when one considers how the system has been abused over the past 150 years of reformed Parliaments, how central government have kept rateable values in deep freeze, then the present defects are less than might be expected. However, all this abuse has happened, and it has brought the country to a critical point where the rating system, which is the only sufficient source of independent local revenue, must be either replaced or reformed, and quickly.

The key issue for a decision to replace or reform local rates is whether updated rateable values may be expected to be sufficient and to move in step with the income requirements of modern local government, for aggregate rateable values limit the revenue yield.

Little purpose is to be served by reforming the rating system so that it ceases to be unfair, ceases to cause distress, if at the end of that process of reform the system is incapable of yielding sufficient local revenue. Figure 1 shows that the system at present does not raise sufficient revenue but, as has been argued, this is largely the result of parliamentary abuse; in particular the failure of successive central governments to carry out their statutory duty of full, regular revaluations. The general picture is shown in Figure 2.

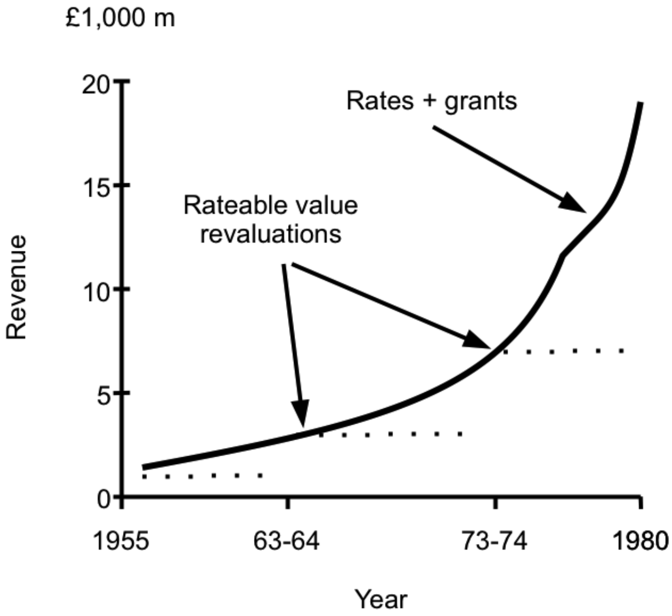

Figure 2: Local government revenue, 1955 to 1980

Until 1939 local authorities carried out revaluations at regular intervals and aggregate rateable values moved in step with local revenue needs. During the following 25 years there was only a partial revaluation in the mid-fifties and aggregate rateable values did not move in step with local revenue needs.

Nonetheless when the full revaluation was carried out in 1963, the pre-war relationship was found to hold. On the 1963 returns rate revenue represented an average rate of 45 pence in the pound whilst an average rate of 97 pence in the pound would have yielded sufficient to cover total rate revenue and total income from grants by central government.

When the full revaluation was carried out in 1973 the pre-war relationship was again re-established. Rate revenue represented only an average rate of 37 pence in the pound, whilst an average rate of about 97 pence would have been sufficient to cover both spending out of rate revenue and income from central government grants.

It is only when central government fail to carry out their statutory obligations that local income needs rapidly outpace the growth of rateable values – inevitable, over years of double-digit inflation. Today we are in a position again where an average rate of £3 on every £1 of rateable value would not be sufficient to cover rate revenue plus the grant contribution from the national taxpayer.

The evidence shows that the present rating system, given full revaluations, is as capable today of yielding a revenue that is uniquely local and sufficient to meet the needs of modern local government as it ever was in the past. This is so in spite of the erosion of rateable values and all the other abuses I touched upon earlier. Thus the present rating system warrants reform rather than replacement. To argue otherwise is to ignore the evidence to hand, particularly the most recent evidence of the two Inland Revenue valuations of 1963 and 1973.

The first step in the reforming process must be to get a full revaluation without exemptions and an assurance that the list will be kept up-to-date. It is only on this basis that firm decisions can be made on issues such as rate exemptions, equalisation schemes or contributions from the national taxpayer. On the information from the form book, it would seem reasonable to transfer responsibility for valuations back to the local authorities. Central government have no immediate direct interest and for the past 34 years have dragged their feet. Local authorities have an immediate and direct interest and did perform their task regularly for 340 years.

Unfortunately past form and a willingness to complete the job with alacrity is now not sufficient to produce an up-to-date list of rateable values. As I stated earlier, Acts of Parliament have worked to destroy the necessary evidence. Following the 1973 revaluation the Deputy Chief Valuer of the Inland Revenue stated: "although some 17 percent of privately owned dwellings were rented, less than two percent of those dwellings were let at rents that could be reconciled with the definition of gross value." In other words, ten years ago the Inland Revenue had to infer from just two percent of domestic dwellings rateable values for the other 98 percent. Since 1973 the private market for rented dwellings has contracted further so that it has become an impossible task to complete a revaluation, given the definitions currently laid down by Act of Parliament.

As a solution to the difficulty of a lack of current market rental evidence it has been proposed that the basis of valuation be changed from a rental basis to a capital value basis.[33] Throughout the country there is abundant evidence of current market capital values for all types of property. The snag with this proposal is the Inland Revenue estimate that to start from scratch on a full capital revaluation of land and buildings might take until the end of the century to complete. Maybe their estimate is exaggerated and local authorities having a direct interest would work faster, but even assuming a 100 percent exaggeration a capital valuation of land and buildings is unlikely to be ready until well into the 1990s. The capital valuation of land and buildings for rating purposes is not, it seems, an immediate solution to the present issue.

An alternative proposal has been put forward by the Land Institute – an independent body formed by those professionally concerned with rating matters. The Land Institute has proposed simplifying the process of valuation by excluding from rateable values all buildings and improvements. Their proposal is based on practical experience in the field. Members of the Land Institute have been associated already with two pilot schemes, which covered the former Urban District of Whitstable, and were timed to coincide with the Inland Revenue revaluations of 1963 and

33 The change to capital values as a basis for valuation in a series of bands was implemented with the introduction of Council Tax in 1993.

1973. The pilot schemes showed that aggregate rateable values, excluding buildings and improvement but allowing for no other exemptions, were of the same order of magnitude as aggregate rateable values yielded by the Inland Revenue list.

As the aggregate rateable values are approximately the same, then it is reasonable to assume that both assessments are capable of yielding a similar rate revenue. This means that, with up-to-date information, an average poundage of less than 100 pence may be expected to yield, in aggregate, a revenue equal to current rate revenues plus total government grants to local authorities.

It is reasonable to conclude that a rating system based on the Land Institute’s method of valuation, for which current market evidence is available, is capable of yielding a local rate revenue not less than that yielded by the present system, which in any event is impossible to continue due to a lack of current market evidence as required by Act of Parliament.

More important to the resolution of the immediate issue is the speed at which the simplified task of evaluation can be carried through to a final published list of individual valuations. In 1963 work on the pilot scheme began in April and was completed by Christmas. The full valuation list with the surveyor’s report was published by the Rating and Valuation Association in February 1964 – eleven months from start to finish. The 1973 pilot scheme was carried through on a similar time scale.

Thus, by accepting the Land Institute's method of simplified valuation and making a start when Parliament returns in October, the government could introduce an up-to-date and reformed rating system in April 1984, having allowed ample time for the hearing of objections, as well as Parliamentary time for deciding issues of exemptions, equalisation schemes, central grants and so on.

This government may like to note that private enterprise, albeit charitable, has twice demonstrated that the job can be done. All that is needed is a little of the political will and determination to be applied to a local issue as was recently applied to the settlement of an issue 8,000 miles away in the South Atlantic.[34]

At a time of slump with youth unemployment a major problem, prompt action by government on revaluations could offer a bonus. The pilot scheme at Whitstable was completed in eleven months under the direction of Mr. Wilks as the only fully qualified and experienced rating surveyor. He was assisted by an experienced office manager and five office staff, plus a host of inexperienced and unqualified field workers. What an opportunity this offers for resolving youth unemployment - by combining with the existing Youth Opportunity Programme and job creation schemes, every unemployed school leaver could be offered fieldwork in their own locality. The country could have a reformed rating system by April 1984 at a relative small additional cost over the sums that will be paid out through social security and employment subsidies.

However, although the Land Institute's proposal does offer a practical solution to more than one immediate issue it does contain also a detail which I must dispute. It arises from economic theory but is of importance in the context of contemporary politics. The Institute proposes that freeholders rather than occupiers should be made liable for the payment of domestic rates on the grounds that it is logical for property owners to be liable for 'the payment of a property tax'. It seems that this proposal is made without giving due consideration to current theory and contemporary politics.

When buildings and improvements are excluded from rateable values, then what is being assessed is the current market price for the occupation of a particular location or site – what Professor Alfred Marshall described in his *Principles of Economics* as the public value.

In a modern industrialised country such as the United Kingdom, this market price, be it expressed on a rental or capital basis, is determined to a great extent by the quality and quantity of public goods and services being made available to the occupier of that particular location or site.

34 A reference to the Falklands conflict of six months earlier, in April 1982.

The Rating and Valuation Association admitted to this in 1964 and gave it as the reason for omitting public utility services from the valuation list. Their Surveyor stated in his report: “The values in the urban areas are the result of the installation of public utility services” and, he concluded, “there will be double valuation if one values them as well.”

It follows that when buildings and improvements are excluded from rateable values then the rate payment which any particular site attracts will be in the nature of a current market price for the public goods and services being made available to the occupier of that site. This is to say there would exist a direct ‘quid pro quo’.

Although one distinguished academic[35] told an earlier Royal Commission on Local Taxation that “The state revenues which are always called taxes do not appear to us to be divided by any sharp line from those which are never called taxes”, nonetheless, today it is generally admitted by economic theorists that the distinguishing characteristic of a tax payment is the absence of a direct ‘quid pro quo’ between the payment made and the public goods and services received by the individual taxpayer.

Hugh Dalton, who not only was a distinguished academic in the sphere of public finance but also had practical experience as Chancellor of the Exchequer, wrote in his work *Principles of Public Finance*, “a tax is a compulsory contribution imposed by a public authority, irrespective of the exact amount of service rendered to the taxpayer in return, and not imposed as a penalty for any legal offence.” Thus, economic theory leads to the conclusion that when buildings and improvements are excluded from rateable values, then, if the annual rate is charged to the occupier, it cannot be properly be described as a property tax, for it is not a tax. It is misleading to describe it as a tax since the rate payment is directly related to the current market price of the public goods and services being made available to the occupier – the rate payer.

All this is not just an exercise in semantics for it has immediate

35 Edwin Cannan, 1899. Evidence to the Royal Commission on Local Taxation.

important implications in contemporary politics well beyond the question as to who should be made liable for rate payments. This government fully appreciates that the provision of public services conveys benefits which are measured by the market in terms of rents, or capital values, in the localities affected.

In the summer of 1982 the central government was considering ways of obtaining £65 million of private finance for building a light railway connecting the London Docklands development area to the City. What they wished to tap was the expected increase in site-only capital values – that is valuations excluding buildings and improvements – from the then current level of £100,000 per acre to an estimated £l million per acre given a rapid transit system.

Once it is seen that the Land Institute's proposal is not some new and ingenious method of property taxation, but a method of collecting the current market price for public goods and services being made available, then the proposal may be seen also to offer the government a solution to yet another immediate difficulty.

Given the reformed rating system the GLC would collect automatically the current market price of the benefits generated by a rapid transport system. If, as the Labour Party currently argue, the government estimate for the increase in local value is based on "dubious assumptions", and the estimated increase in rate revenue insufficient to service the capital cost, then the proposed transport system is not an economically viable proposition. In this case it remains with the central government to decide whether on social grounds additional finance should be provided by the national taxpayer. One has, as it were, a built in cost-benefit analysis.

But let us not get too involved now with the possibilities arising from a reformed rating system based on simplifying the method of valuation by excluding buildings and improvements from rateable values. It has been demonstrated to be a practical method capable of yielding sufficient local revenue and when presented with due regard for current economic theory it may be seen to accord with this Conservative government's oft-stated market philosophy.

What I wish to stress is that underlying the present public debate about the future of local finance is the power struggle between central government and the localities.

This struggle has entered a critical phase, and it is the method of financing local authorities that will determine the outcome – whether, in the future, the United Kingdom is to be a centrally controlled state in which every locality conforms to a central plan drawn up by Whitehall experts and imposed by central government power irrespective of local needs, or a country in which the wide variety of local needs can be met by independent local government fully responsible to their local electorate.

I do not suggest that the Land Institute's proposal is the final solution to the fundamental issue but it does offer the possibility of a speedy solution to immediate issues in a way pointing towards a just and lasting solution of the fundamental issue. As a first step it is worthy of more than "serious consideration" – it demands from individual electors and from Parliament immediate action.

8

Economic Myths and Party Manifestos

January 1983

Senior members of the present administration are, as it was said at the last General Election and since, slaves to the ideas of Milton Friedman. Their attempt to put his ideas into practice is held by many to be a major cause of this economic depression. Certainly the advent of the medium term financial strategy was associated with an intensification of the depression. Be all this as it may, now, many economic commentators, such as Mr. David Lomax of the National Westminster Bank, are arguing that the government have abandoned as a matter of practical policy the full rigours of so-called monetarism.

But if the government are in practice relaxing their attempts to squeeze inflation out of the system by controlling the money supply, if they are turning away from the belief that the economy will tend automatically towards a 'natural' rate of unemployment irrespective of the monetary and fiscal policy pursued, and if the commentators mean that the ideas of Milton Friedman are on the way out, then what ideas are on the way in?

As another General Election approaches[36] the issue of economic ideas is a matter for concern not only to the party of government but also to the parties of opposition. At a General Election all the parliamentary parties are subject to the same test, and at the next General Election – as at the last – the outcome is most likely to be determined by economic ideas and economic policies.

In an article published recently in the Times, this political issue of economic ideas was summed up by Gordon Tether in a jingle.

36 A General Election was anticipated within the next few months, and took place on 9th June 1983.

"Hayek and Friedman have had their day. Now we're all backing JMK." A light journalistic touch for which some authority may be claimed. As John Maynard Keynes wrote in 1936: "Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler a few years back."

But, with Gordon Tether's light journalistic touch, come some very misleading implications. By implication the jingle equates the ideas of Friedrich Hayek with those of Milton Friedman and places both in opposition to the ideas of Maynard Keynes. It implies also that the economic ideas and theories on the way in are those of Maynard Keynes. Now maybe this is what the commentators and some politicians actually believe; maybe it is what parliamentary parties would have the electorate believe; maybe it is what the electorate would like to believe; nonetheless, the implications of the jingle are misleading. They serve only to thicken up the smokescreen behind which parliamentary parties have for too long obscured their party policies and objectives. In the sphere of party politics it has become customary over recent decades to link the names of Hayek, Friedman and Keynes not with their economic theories and ideas but with economic myths. It is these economic myths that place Hayek and Friedman on the one side, and Keynes on the other opposing side, so as to make plausible opposing party manifestos.

That Hayek was one of Keynes's severest critics during the thirties is well documented and Keynes, for his part, packed a stinging counter-punch. On the occasion of Hayek's critical review of his *Treatise on Money*, Keynes in his reply turned on Hayek's then recent book *Prices and Production*.

Maynard Keynes wrote: "It is an extraordinary example of how, starting with a mistake, a remorseless logician can end up in Bedlam." (JMK XIII p. 252 and Moggridge p. 36)[37] But these were disputes on theoretical issues – that they were hard fought does not

37 The references are to the *Collected Writings of John Maynard Keynes*, and to D. E. Moggridge's widely respected 1976 biography of Keynes.

imply an implacable opposition of fundamental ideas and views as between the disputants.

In 1939 Maynard Keynes summed up his political creed in The New Statesman as "a system where we can act as an organised community for common purposes and to promote social and economic justice, whilst respecting and protecting the individual – his freedom of choice, his faith, his mind and its expression, his enterprise and his property." (see Moggridge, p. 47). More here for Hayek and for Friedman than for those party politicians who, claiming to be the inheritors of Keynes's mantle, advocate long lists of restrictive measures – the closed shop, a statutory prices and incomes policy, and so on.

Bearing in mind Keynes's statement of 1939 it is no matter for surprise that, on having read *The Road to Serfdom*, Keynes wrote to Hayek and although accusing him of "perhaps confusing a little bit the moral and material issues", nonetheless, he agreed on the need for "a community in which as many people as possible, both leaders and followers, wholly share your own liberal moral position." (JMK XXVII pp. 387-8, and Moggridge p. 46)

But of course moral issues are one thing, but when it comes to money issues then, as everybody knows, there is a direct opposition between Keynes, who held that money does not matter, and Hayek and Friedman, who hold that money does matter.

That this piece of economic mythology is now generally accepted can be ascribed only to widespread economic illiteracy. Maynard Keynes's three major economic works were *A Tract on Monetary Reform*, published in 1923; the *Treatise on Money*, published in 1930; and *The General Theory of Employment, Interest and Money*, published in 1936. The last years of his life were spent in setting up an international monetary system which provided the monetary foundation for 25 years of unparalleled worldwide economic growth and prosperity.

What Maynard Keynes attacked throughout his life were the rigid and out-dated ideas and practices of the Treasury and of the banking establishment – ideas and practices which may have served well enough in the nineteenth century but were a cause of recurrent disasters when carried through to the changed conditions of the twentieth century. For example, the Bank of England had opposed Keynes's proposals for what has now become known as the International Monetary Fund.

In February 1944 Keynes wrote to the Chancellor of the Exchequer: "The Bank are not facing any of the realities. They do not allow for the fact that our post-war domestic policies are impossible without further American assistance. They do not allow for the fact that the Americans are strong enough to offer inducements to many or most of our friends to walk out on us, if we ostentatiously set out to start up an independent shop. They do not allow for the fact that vast debts and exiguous[38] reserves are not, by themselves, the best qualifications for renewing old-time international banking.

"Great misfortunes are not always avoided, even when there is no difficulty in foreseeing them, as we have learnt through bitter experience. I feel great anxiety that, unless a decisive decision is taken to the contrary and we move with no uncertain steps along the other path, the Bank will contrive to lead us, in new disguises, along much the same path as that which ended in 1931. That is to say, reckless gambling in the shape of assuming banking undertakings beyond what we have the means to support as soon as anything goes wrong, coupled with a policy, conceived in the interests of the old financial traditions, which pays no regard to the inescapable requirements of domestic policies. Ministers should realise that these things . . . are what the trouble is all about." (JMK XXV pp. 412-3, and Moggridge p. 39)

In 1983 this extract may seem a little too prophetic for comfort but it could have been written, I suggest, only by a man to whom a stable monetary system is the necessary foundation for a stable and prosperous economy.

38 Small, or extremely limited.

That money matters very much with regard to the "inescapable requirements of domestic policies" is something Lord Keynes saw most clearly, but it is something which has been obscured by post-war economic myths woven for party purposes "by politicians and their obsequious back-room academics".

Milton Friedman's major contribution to the development of economic thought is contained in his essay *The Quantity Theory of Money – a Restatement*. It was first published in 1956, ten years after the death of Lord Keynes. This "restatement" is essentially a generalisation of the theory of liquidity preference as formulated and published by Keynes in the *General Theory of Employment* in 1936. It is most usefully understood as a development from the economics of Keynes, with important additions, rather than as a statement contrary to the theory of Keynes.

Friedman's contribution is of particular importance for not only has it opened the way to major advances in monetary theory but also it re-emphasised the importance of monetary policy in 'a monetary economy' – something which in the years following the death of Lord Keynes had largely been ignored by governments and their economic advisors.

That the new developments in monetary theory have come to be widely accepted as an alternative to the economics of Keynes stems from the fact that they follow from an attack by Milton Friedman on the 'real income and expenditure approach' recently developed by the so-called Keynesians. This distinction between the economics of Keynes and Keynesian economics is of some importance, for in the final years of his life Lord Keynes was prepared to admit to being a non-Keynesian. In this age of media-men it is as well to be wary of labels – the contemporary so-called Keynesians are more in the tradition of Ricardo, Marx and Kalecki than heirs to the ideas of John Maynard Keynes.

However, whilst it can be argued that on moral issues the ideas of Friedrich Hayek and the ideas of Maynard Keynes share much common ground, and that the new monetary theories pioneered by

Milton Friedman are most usefully considered as developments from the economics of Keynes, an immediate issue is employment theory and employment policy. In this, the 'natural unemployment rate hypothesis' formulated by Friedman in the late 1960s is a throw-back to 19th-century ideas prior to the *General Theory*. In the sphere of employment theory and policy the deep divide between Friedman and Keynes is a reality not a myth. I considered Friedman's employment theory in detail last January. Sufficient for tonight to state briefly that Milton Friedman and his monetarist followers assume that any economy tends automatically towards a 'natural rate of unemployment' determined by institutional factors rather than by fiscal and monetary policies.

Against this, the *General Theory of Employment* as formulated by Maynard Keynes states the volume of employment in any economy to be determined by the point of intersection between the aggregate demand function and the aggregate supply function.

It follows, since the aggregate demand function is directly influenced by government spending policies and the aggregate supply function by government tax policies then in any economy the volume of employment – or if you prefer the rate of unemployment – is determined largely by fiscal policy. When one brushes aside the post-war myths and incorporates the latest developments in monetary theory, then unemployment is determined by fiscal and monetary policy combined.

Thus, it might seem reasonable to conclude that on the employment issue there is on the one side Milton Friedman and the monetarists who believe fiscal policy to be relatively unimportant and on the other side Maynard Keynes and the Keynesians who believe fiscal policy to be all important.

Yet this conclusion also perpetuates a myth. Although on matters of employment theory and policy there is a deep divide between the monetarists and the ideas of Maynard Keynes, there is just as deep a divide, although different, between the contemporary Keynesians and the ideas of Maynard Keynes.

Forty years on we tend to forget that *Full Employment in a Free Society* was written by William Beveridge, and not by Maynard Keynes. Keynes did not relate his concept of full employment to any particular rate of unemployment; for Keynes, full employment was a theoretical benchmark that coincided with a point of true inflation where any further increase in aggregate monetary demand could not expand output and employment, but only raise prices.

It was William Beveridge who defined full employment as a condition in which the number of registered unemployed is not greater than the number of registered vacancies. It was William Beveridge who transformed the concept of full employment from the theoretical benchmark used by Keynes into a post-war party political slogan implying a near zero rate of unemployment.

According to the records, Keynes had considerable doubts as to the feasibility of the original Beveridge Plan and, in particular, doubts as to Beveridge's quantification of full employment and its use as a policy target.

Again, a post-war full employment Budget was the idea, not of Maynard Keynes, but of Nicholas Kaldor[39] and first published in the Economic Journal of April l943.

A couple of years later, in the Economic Journal of December 1945, Colin Clark published an article which on the basis of statistical evidence from many countries concluded that when general government tax revenue plus the borrowing requirement persistently exceeded 25 percent of the net national product at market prices then economic forces were set in motion leading to rising costs and prices with some restriction of output.

Clark concluded Kaldor's budget proposals to be unfeasible, as if implemented, they would necessitate a tax take the equivalent of

39 Nicholas Kaldor (1908–1986) advised the Labour government from 1964 onwards, and also produced some of the early concepts for the introduction of Value Added Tax (VAT). He is also regarded as one of the authors of the Selective Employment Tax (SET), which was introduced in 1966, and was subsequently replaced by VAT as part of Britain's entry into the EEC. He was Professor of Economics at Cambridge University from 1966 onwards.

35 percent of the estimated post-war U.K. net national product at market prices. Clark went on: “It may be contended that the tax payer will be more ready to meet the proposed payment into extra-budgetary funds because these provide him with health and other services which otherwise he would have had to pay for in any case. Even if this argument is accepted, the remaining burden, at 30% of the national income, is definitely excessive.”

Since 1945 here in the U.K. burden has always exceeded 30% and we have suffered also persistent inflation. In 1975 the burden peaked at 51% and was associated with a 27% rate of inflation.The rate of unemployment has also been on a rising trend since 1955 and the present level is comparable to that experienced in the early thirties. Similarly the U.K. rate of growth has been on a declining trend since 1955, and over recent years it has been all but non-existent.

It was as early as 1923 that Maynard Keynes wrote with reference to France: “The level of the franc is going to be settled in the long run, not by speculation or the balance of trade, or even the outcome of the Ruhr adventure, but by the proportion of his earned income which the French taxpayer will permit to be taken from him to pay the claims of the French ‘rentier’.”

On the issues of post-war U.K. government taxing and spending Keynes came down firmly on the side of Colin Clark rather than on the side of the full employment Budget of Nicholas Kaldor – today, the influential so-called Keynesian. In a private letter to Colin Clark dated 1st May 1944 Maynard Keynes wrote: “In Great Britain after the war I should guess your figure of 25% as the maximum tolerable proportion of taxation may be exceedingly near to the truth. I should not be at all surprised if we did not find a further confirmation in our post-war experience of your empirical law.”[40]

Perhaps, as the economic depression continues to deepen, of more immediate importance is the fact that the contemporary

40 As quoted, for example, in IEA Hobart Paper No. 26, *Taxmanship*, p. 21.

Keynesians have wrenched asunder the concepts of aggregate demand and aggregate supply which Keynes brought together into a coherent whole. Contemporary Keynesian policies are based, not on an idea of Maynard Keynes but on the reverse of an idea – 'Supply creates its own demand' – that dominated nineteenth century policy makers.

For contemporary Keynesians the dominating idea is 'Demand creates its own supply'. Having quantified full employment as a near zero rate of unemployment, contemporary Keynesians assume the existence of unemployment to be a proof of a deficiency of aggregate demand that can be made good only by additional government spending financed by more taxation and borrowing.

Thus the economics of Keynes differs fundamentally from 'Keynesian economics'. The latter does not take into account the aggregate supply function. It assumes the existence of unemployment to be proof of a deficiency of aggregate demand. It does not take into account that for any economy in given conditions there is a limit to the amount of general government spending that can be financed by general government tax revenue and borrowing. Further, the analysis of Keynes does not support the conclusion that the existence of unemployment is a proof of a deficiency of aggregate demand.

Thus, when we sweep away the misinterpretations and the myths, we find much common ground between Friedrich Hayek and Maynard Keynes on the important moral issues, whilst the differences between Milton Friedman and Maynard Keynes are in the sphere of employment theory and policy rather than in the sphere of monetary theory and policy. We find also that the differences between contemporary 'Keynesian economics' and the economics of Keynes are deeper and more extensive than any difference between the ideas of Maynard Keynes and the ideas of Friedrich Hayek and Milton Friedman.

Further having swept away the misinterpretations, the misconceptions, and the post-war economics myths, we discover that the assertion "Now we're all backing JMK" is a nonsense. So far as our parliamentary parties are concerned, it amounts to a wholly false accusation.

For example, a few weeks before Christmas the Labour Party announced their five-year plan to expand output and reduce unemployment to about one million: *Programme for Recovery*. It is based on contemporary Keynesian analysis. It diagnoses a deficiency of aggregate demand, and to remedy this deficiency it proposes to increase government spending up to £25 billion a year coupled with a 30% devaluation of sterling. It is admitted that these measures on their own would lead to double digit inflation and a balance of payments deficit of in the region of £18 billion a year. To constrain the balance of payments deficit to £1 billion a year with an inflation rate of 8% a year the programme proposes the extensive use of central government control – exchange controls, import controls, price controls, and so on. It proposes "to control earnings and incomes through an agreement with the Unions." Keynesian analysis and Keynesian remedies? Such a programme may be passed off today as Keynesian but neither the analysis nor the proposed measures are derived from the ideas of John Maynard Keynes. The Labour Party at least does not intend to "back JMK."

The other major opposition group, the Liberal SDP Alliance,[41] claims to be the true heir to the ideas of Maynard Keynes. In the 1920s Keynes often spoke in support of the Liberal cause and in 1929 he wrote in association with Hubert Henderson a political pamphlet called: *Can Lloyd George Do It?*

However, more relevant today is Keynes's reply to a questioner at a public meeting. The Manchester Guardian of 29th May 1929 reported him as replying: "The difference between me and some other people is that I oppose Mr. Lloyd George when he is wrong and support him when he is right." In this instance Mr. Lloyd

41 The Liberal SDP Alliance had been established to contest the forthcoming General Election of June 1983.

George was right, for Keynes had formulated the proposals included within the pamphlet (Harrod, p. 396).[42]

Published more than 63 years after *Can Lloyd George Do It?* the Alliance policy document *Back to Work* most certainly does not include proposals formulated by Keynes to remedy the present economic depression. As a matter of fact, *Back to Work* is based, not on the economics of Keynes, but on 'Keynesian economics'.

With one important exception it is indistinguishable from the Labour Party's Programme for Recovery. The exception is very important, for the Alliance does not propose to rely on agreement with the Unions for the control of earnings, but proposes to enact a statutory prices and incomes policy backed by severe penalties on those who ignore the centrally imposed norms.

This idea of a statutory prices and incomes policy did not enter the Liberal Party programme until some 30 years after the death of Lord Keynes. It was put forward by Mr. John Pardoe on the advice of Professor Peter Wiles of the L.S.E. Now, Professor Wiles set out his non-Keynesian Marxist approach most clearly in an article published in the Economic Journal of June 1973. He concluded the U.K. economy to be suffering from "cantering cost inflation" caused by excessive pay settlements.

Peter Wiles went on: "Our choice is either to let it rip forever or to sharply restrain it. We can do this either by massive unemployment or strong anti-union measures, up to and including the installation of a Communist government" (p. 377).

Although admitting that the political and legal risks of strong anti-union measures – such as a statutory prices and incomes policy – might be smaller than is often alleged, Peter Wiles then spelt out the political consequences of detailed intervention. He wrote: "It will often fail of its overt purpose – just as the monetarists assert of the less detailed Keynesian interventions. It brings new laws to evade, and so diminishes respect for all laws. It

42 The reference is to the standard biography of Keynes by Sir Roy Harrod: *The Life of John Maynard Keynes*, published in 1951.

makes possible political discrimination by economic means, and so threatens freedom. Above all any programme of detailed intervention, honestly designed to have a serious effect on inflation, involves a head-on clash with the trade unions, which probably means bloodshed."

To lay claim to the traditions of Maynard Keynes, and at the same time advocate a statutory prices and incomes policy, goes beyond – as the words of the originator of that policy make very clear – well beyond the creation of an economic myth for the purposes of putting over a party policy. Maynard Keynes was a man who when faced with the enactment of compulsory military service, for which he was not liable, and admitting to the possibility of "conceivable circumstances in which I should voluntarily offer myself for military service" felt bound to object to a Tribunal on the grounds "I am not prepared on such an issue as this to surrender my right to decision, as to what is or is not my duty, to another person, and I should think it morally wrong to do so." (See Moggridge pp. 20-21.)

"Now we're all backing JMK." When applied to the policies of the major parties of opposition it is more of a sick joke than an amusing journalistic jingle. So where does the party of government stand?

In an interview put out last week by LBC, the Chancellor of the Exchequer[43] informed us that with inflation reduced to the lowest levels for ten years and with further reductions in the pipeline there existed now for the British economy a firm base for the expansion of output and a reduction of unemployment. To take advantage of this opportunity all that is needed, he asserted, is a significant reduction in aggregate costs per unit of output so that firms could expand profitably to meet an aggregate demand existing already.

Here surely is the authentic voice of John Maynard Keynes echoing over the decades to call attention to the importance of the aggregate supply function in relation to aggregate demand.

43 At this time, prior to the General Election of June 1983, Sir Geoffrey Howe.

The analysis of Keynes treats these aggregate costs per unit of output as components of the aggregate supply price – namely, the take-home pay of employees, tax revenue, and a net disposable profit margin just sufficient to make it worth the while of firms to produce the output of a given amount of employment.

Government estimates show that over the past 25 years, since unemployment was around 1%, take-home pay has fallen in real terms, whilst aggregate net disposable profits have fallen from around 10% to around zero.

The only component that has increased, indeed multiplied, is tax revenue, and in particular that part of tax revenue which is included within the pay bargain tax wedge – PAYE and social security taxes imposed on employers and employees.

Pay bargain taxes

	1960	1981
Take-home pay of employees	100	91
Net disposable profit margin	100	31
General government taxation	100	148
Pay bargain tax wedge	100	233
All other tax costs	100	113

Table 1: Pay bargain taxes, 1960 to 1981

For this chart, I have taken as the base year 1960, for in that year we more or less attained the post-war political policy target of full employment with stable prices. Inflation was less than 1% and unemployment was 1½%. Money cost per unit of output increased by six times between 1960 and 1981, but very largely this was the result of inflation; whether or not it constitutes a disaster depends to a great extent on the rate of inflation of our competitors and the rate of exchange as between our countries.

Of importance for internal domestic policy is which of the cost components is exerting the most upward pressure and to show this one has to construct an index. The figures shown on the chart refer to 1981 – the last year for which detailed estimates are available.

Take-home pay of employees has an index figure of 91 for the year 1981. This indicates that this particular cost component fell by about 10% between 1960 and 1981. The next figure down refers to the net disposable profits of private sector companies. Here an index figure of 31 means that profits fell by more than two-thirds between 1960 and 1981. Reading down again the next figure refers to general government taxation. For 1981, this yields an index figure of 148; it means that tax costs in real terms per unit of output increased by nearly 50% between 1960 and 1981.

Of greater importance is precisely where this tax increase was concentrated and this is shown by the two lower index numbers on the chart. The real tax costs included within the pay bargain tax wedge – Pay As You Earn, Social Security Contributions, and now the National Insurance Surcharge – multiplied by two-and-a-third times between 1960 and 1981.

These taxes, by inflating the employers' labour costs directly, act to increase unemployment and reduce the competitiveness and profitability of British producers. On the other hand, all other real tax costs per unit of output together increased by only 14% and these include such items as local rates and VAT, about which there is so much complaint.

The only cost component that has increased is taxation; in particular, that part of tax revenue included within the pay bargain tax wedge, which has multiplied. To all but the blind and those that will not see the required action is obvious. If the Chancellor of the Exchequer believes his diagnosis to be right, then he must cut pay bargain taxes. This is an action wholly within his powers.

When the analysis of Keynes is applied to the government's diagnosis and their official estimates then a cut in pay bargain taxes is the necessary first step on the road out of the present depression. But the Chancellor of the Exchequer and the party of government, like all of the parties of opposition, are blinded by economic myths, some of which go back to Parliament's reaction to the economic consequences of the Black Death, which occurred in the 14th century. This first statutory prices and incomes policy led to Wat Tyler's rebellion in 1381.

In addition the present day Chancellor has his own particular myth shared with some of his Cabinet colleagues. He considers himself to be a monetarist and therefore the economic analysis of Keynes is an anathema. Do not be misled by the Chancellor's sound; Sir Geoffrey was echoing not the voice of Keynes but a ricochet off an economic myth.

The Chancellor of the Exchequer can see only one road out of the present depression. We must all work harder to produce more and then accept less take-home pay in return. He can see that our aggregate costs per unit of output are too high to meet an aggregate demand that exists already both at home and abroad. What he cannot see – and this blindness is common to both sides of the House and many outside – what he cannot see is that the high costs are the result not of the excessive pay demands of employees or their trade unions but of the excessive tax demands authorised each year by Members of Parliament.

The party of government it would seem are less influenced by the ideas of Friedrich Hayek and Milton Friedman, or even John Maynard Keynes than by the analysis of a non-Keynesian Marxist, Peter Wiles. The Alliance opposition in their document advocate a statutory prices and incomes policy and all the social evils that will entail. The party of government have chosen, albeit unknowingly, the alternative method suggested by Professor Wiles – massive unemployment and all the social evils that entails.

The ideas of economists and political philosophers are powerful and they can explain many of the international divisions and national internal dissensions that exist today, but the major British parliamentary parties accept the ideas of Hayek, Friedman and

Keynes only when they happen to coincide with long existing party objectives or would seem to offer some party advantage. Whether by intent or as the result of ignorance our parliamentary parties are prepared to perpetuate old economic myths around the names of great economists to fool the electorate into accepting economic proposals included within their party manifestos. As an irate Maynard Keynes noted to a Treasury colleague in 1940: "It is the bloody politicians whose bloody minds have not been sufficiently prepared for anything unfamiliar to their ancestors."

In this country a prerequisite for an economic recovery is for the electorate to penetrate the myths and look beyond the labels to the true nature of the party proposals, that is to say by the electorate preparing the minds of politicians so that they may see the facts of everyday experience and are forced to propose effective and just remedies.

Treat the politicians of today as Keynes treated Lloyd George: oppose them when they are wrong; give them support only when they are right.

9

Who Needs an Incomes Policy?

14th April 1983

When deciding, as private persons, how much we can afford to spend all of us have to take into account our expected income and any savings from income received already.

Government operates the other way round. It is now the accepted practice for government first to decide how much they intend to spend and then to fix taxation at a level expected to provide, more or less, sufficient revenue.

It was not always thus. In dim ages past English Kings were expected to provide for the expenses of State from their ordinary revenue and not to trouble their subjects. In the history of the English it is not until the late Anglo-Saxon times that we come across payments from subjects to the Crown that might be described as taxation. From the outset these tax payments were considered to be in the nature of a gift to the Crown to meet extraordinary expenditure and even today a clause to this effect is inserted in the Preamble to every annual Finance Act.

When is a tax not a tax? When it is a gift which can be collected as if it were a debt. So holds our constitutional fiction.

But fiction or not, being considered as a gift, taxation in this country of necessity requires consent – the consent of Parliament. This is a source of parliamentary power – no ruler can meet state expenses for long without calling a Parliament. In turn Parliament has used this power to gain control over the expenses that give rise to the need for its consent to additional revenue.

Thus, in 1340 Parliament demanded the production of Royal Accounts. In l406 the Commons were allowed to choose Auditors. By the time of William and Mary it had become normal practice to insert a clause in Money Bills forbidding the Lords of the Treasury to use the moneys for any other purpose than that for which it was appropriated. This century the House of Commons has succeeded in reserving to itself the power to spend public revenue and the power to determine and consent to taxation.

The story of how the present practice of public finance came to be is a story closely intertwined with the securing of our liberties: a cause in which over the centuries many bloody battles have been fought, and a cause in which many have died, suffered deprivation, torture and execution.

But nonetheless, in the long struggle to secure our liberties, the present practice of public finance has emerged not so much as an integral part of the Constitution essential to the continuance of our parliamentary democracy and our personal liberties but rather as a weapon – a weapon which ensures political power is concentrated in the hands of these who control that weapon. This political power struggle may be considered as a constitutional example of, as it were, Darwinian evolution – the survival of the fittest. The fittest has proved to be the First Lord of the Treasury who for the past two centuries has been acknowledged as the Prime Minister – although such a position was not recognised constitutionally until 1905.

With the continuing development of the Constitution we have drifted into circumstances where under the leadership of the Prime Minister the majority party for the time being in the House of Commons exercises far greater power over public spending and taxing today than did any absolute monarch of old.

The constitutional requirement to hold a General Election within every five years appears to be even less of a force for restraining the financial irresponsibility of modern governments than did the fear of insurrection in times past.

We have moved now beyond the time when the taxpayer could expect at least some temporary relief from the regular Election Budget. The fact that Sir Geoffrey Howe during his period of Office as Chancellor of the Exchequer managed to extract from the taxpayer an additional £7 billion in a time of slump, and did not produce an Election Budget, was claimed as a mark of political integrity.

Constitutional issues apart, in this final quarter of the twentieth century it is the very magnitude of public spending and taxing that raises a vital question for macroeconomics: To what extent is the appropriation by general government of nearly half the nation's income a cause of present social evils? A practical question demanding a practical answer.

If we then peruse the literature of contemporary established economics for an answer to this question we will end up rather disappointed. Professor Prest for example devotes a whole chapter of his book *Public Finance in Theory and Practice* to the issue of allocating resources as between government and the rest of the economy. He concludes: "But the very bareness of the economic principles set forth will make it clear that we are now on the borderland where economic and political considerations meet and mingle inextricably with one another. Recent years have in fact seen the publication of various ideas by economists on the appropriate principles of voting, on the grounds that one simply has to seek a political solution to these issues."[44]

Go back two hundred years to *The Wealth of Nations*, and the question remains unanswered. Although Adam Smith denounced profligate government with all the Scottish fervour known only to a Balliol man, nonetheless he concluded that when the needs of the State exceed the revenue from proper subjects of taxation then government must have recourse to improper ones.

Yet, whilst there may be little to glean from writers in English, during the forty years prior to the outbreak of the Great War there was a lively debate amongst Austrian, French, German, Italian and Swedish writers on public finance on both the ideal means of taxation and the optimum distribution of resources as between government and the rest of the economy.

44 Towards the end of Chapter 3, *The Allocation of Existing Resources*, p. 65.

To give you the flavour I will quote from just one of this number, a Frenchman, Paul Leroy-Beaulieu. He admitted: “the major part of the sums raised by taxation have been put to uses which are commendable neither from the economic nor the social point of view” but he also rejected the then popular view which considered all taxation as an evil.

In a passage that could be read with advantage by all those who today would advocate indiscriminate privatisation, Leroy-Beaulieu supported his view that some taxation is necessary, with a then topical example.

He wrote: “A new branch railway exerts a beneficial influence over a very wide sphere; it increases the receipts of neighbouring lines which it feeds, and augments the income not only of those who use the new line for the transport of their products, but also of those who do not send their products any distance away but simply bring them to the nearest market which is now less glutted. Thus the effect of the branch line is widespread, diverse and manifold; but the entrepreneurs cannot make all the beneficiaries contribute to the cost, since many of them derive no direct benefit from the new line nor even manifestly use it at all, simply stepping into the place of those who do use it. This is why many public works cannot be carried out for private account; they would ruin private entrepreneurs, while being highly remunerative for society as a whole.” [45]

I select Leroy-Beaulieu for particular mention as he formulated precisely the contemporary practical question.

45 A similar example of a public good is the construction of a lighthouse on rocks dangerous to shipping. No bargain can be struck between the ship’s captain, who may or may not observe the beam, and the lighthouse keeper; nor is the availability of its benefit to other captains diminished if he does observe it. Not least among its benefits is the saving of the lives of sailors, who would otherwise be at risk of drowning; whilst those merchants who do not venture overseas also benefit from the construction of a new lighthouse because of reduced competition in their home markets. It becomes apparent, therefore, that an equitable method is required by which the cost of building, operating and maintaining the lighthouse can be met.

"Is there a formula", he asked, "which could serve as a rule for the establishment of the proportion of people's income which can be exacted without damage for society as a whole?"

He attempted a practical answer and wrote: "We believe that it is possible to fix an empirical lower and upper limit to taxation. The limits are not inflexible; they are only approximate. We consider that taxation is very moderate when the sum of national, provincial and municipal taxes does not exceed five or six percent of private incomes. Such a proportion should be the normal rule in countries where the public debt is small and whose politics are not dominated by the spirit of conquest. Taxation is still bearable, though heavy, up to ten or twelve percent of the citizens' income. Beyond twelve or thirteen percent the rate of taxation is exorbitant. The country may be able to bear such a rate, but it is beyond doubt that it slows down the growth of public Wealth, threatens the liberty of industry and even of citizens, and hems them in by the vexation and inquisition necessarily entailed by the complexity and the height of the taxes."

This continental debate was largely ignored by English speaking economists. One possible reason was that not until the advent of Lloyd George as Chancellor of the Exchequer in 1908 did the tax take in this country regularly exceed a ten percent slice of the national cake. Until then, the attitude of the establishment was determined by the *golden maxim* of J. B. Say: "The best of all plans of public finance is to spend little, and the best of all taxes is that which is least in amount."

Even during the 1930s the dominant view had changed very little. The 'Treasury view', as it was then lampooned by Maynard Keynes, ensured that during that depression a Labour Government and its National Government successor both reacted to falling tax revenues by retrenchment. Through to the 1940s governments at Westminster were parsimonious rather than profligate.

During the course of the Second World War a change of attitude was forced upon those in authority, and at the same time economics became dominated by a new breed of so-called Keynesians. In addition to the plans for social security prepared by the then Sir William Beveridge, The Times published between November 1942 and April 1943 a series of ten articles under the general heading of ‘Full Employment’.

The Economic Journal of April 1943 published a ‘Post-war full employment Budget’ prepared by the then Nicholas Kaldor.

Thus, successive post-war governments found themselves committed to whatever volume of spending might be required to sustain a near zero rate of unemployment in a welfare state. The golden maxim and the worship of a balanced Budget were cast out to join the dodo. In pursuit of these all-party objectives, public spending was increased to record peace-time levels and, in accordance with accepted practice, taxation was raised to record peacetime levels also and topped up by persistent borrowing.

With this fundamental change in the establishment’s attitude to public spending and taxing there sounded at least one English speaking senior academic voice echoing from time to time views similar to those expressed by Leroy-Beaulieu and other participants in the earlier continental debate.

In an article published in the Economic Journal of December 1945 Colin Clark concluded from pre-war evidence gathered from many countries that when general government spending necessitated a tax revenue persistently in excess of 25 percent of net national product at market prices then economic forces were set in motion leading to rising costs and prices with some restriction of output. From this evidence Clark concluded Kaldor’s full employment Budget to be unfeasible, as it implied a tax take exceeding 30 percent of the net national product at market prices. Maynard Keynes agreed with Colin Clark.

Since 1945 Colin Clark has many times restated his case on the basis of the post-war evidence, but with little effect on established views, be they contemporary Keynesian or monetarist. In 1977 he returned to London from semi-retirement in Australia to publicly state his case yet again. At that conference his paper was criticised and rejected by an economist MP who is now a member of Mrs. Thatcher's administration, Mr. Nigel Lawson.[46]

Today there are indeed many economists, in this country and others, who argue for one reason or another in favour of significant cuts in general government spending and taxing. The British and United States governments have attempted to follow this kind of advice but without success – both countries have suffered a more intense slump than most and in both countries the general government share of the national cake has increased as a result.

Ranged against this view there is today also a large body of economists who assert that the road to recovery requires an increase in general government spending. The French government have attempted this road without success.

Unfortunately this contemporary academic divide has not given rise to an academic debate in which the case of each disputant is well founded in theory and all are seeking to eradicate error.

Rather, it has given rise to something resembling a war game, with each faction trying to obliterate the other whilst remaining ensconced in their particular ideological bunker. This economic war game is proving to be more destructive of livelihoods than anything as yet unleashed by the military men. To the best of my knowledge there has been, for example, no sustained scientific research at our universities designed to discover whether Colin Clark's conclusion from his empirical studies is a matter of statistical accident or whether it is to be predicted from theory.

To find a dominant school of thought with a truly scientific approach to public finance founded on a coherent theory one has to go back to eighteenth century France – to the Physiocratic school.

The Physiocrats were scientific in the sense of having a confident belief that all phenomena will yield to investigation and

46 Mr. Nigel Lawson became Chancellor of the Exchequer shortly afterwards, replacing Sir Geoffrey Howe after the General Election of 9th June 1983. On 7th July 1983 he announced some £500 million of public expenditure cuts.

will turn out to fit into a scheme of natural law. They are widely accepted as being the founders of modern economics as a distinct discipline and certainly the crude origins of many contemporary concepts may be traced to this group.

For example, they recognised that included within the material output of any undertaking there is a material input which must be deducted when aggregating the net contributions. This notion is, after all, the basis of modern value-added analysis, and it is also the basis of Colin Clark's aggregate – the net national product at market prices.

In the 1980s we need not bother overmuch with the details of the Physiocratic system, for we now live in a very different kind of society, and economics too has made some significant advances over the past two hundred years. It will be sufficient for us to note the scientific method by which the Physiocrats reached their conclusions in respect of public finance.

The Physiocrats adopted a macroeconomic approach. Their 'natural order' was divided into three classes: an agricultural class, a proprietary class, and an industrial or merchant class which included the rest. The industrial class were considered to be sterile in the sense that as a whole they made no net addition to the wealth of the economy – the material output of this class was reckoned to be no greater than their material input.

Only the agricultural class were considered to be productive in the sense that their material output was reckoned to be greater than their material input. The excess produced by the agricultural class – termed the net product – became the income of the proprietary class.

From this position the Physiocrats argued it to be wrong to tax the industrial class, for there was no net addition – there was nothing to tax. Any attempt to impose a tax on this class would take away what they needed to sustain themselves and their production and so lead to poverty.

Equally they reasoned it to be wrong to tax the agricultural class, for after passing the net product to the proprietary class, the agricultural class too were left with no more than was needed to maintain themselves and to sustain future production. Any tax on the agricultural class must of necessity restrict future production and so impoverish society as a whole.

It followed that the proprietary class must bear the full burden of taxation, for their income – the net product – was the only available source of taxation which could be used without damage to society. The Physiocrats concluded the natural and proper rate for taxation to be 30 percent of the net product.

To those who argued 30 percent of this net product to be insufficient to cover the expenses of government, Dupont – the same man who later went to America and founded the firm which today is the multinational bearing his name – Dupont replied: “If unfortunately it be true that three-tenths of the annual net product is not sufficient to cover ordinary expenditure, there is only one natural and reasonable conclusion to be drawn from this, namely, curtail the expenditure.”

Note well. For the Physiocrats, no woolly waffling about the need to cut or increase public spending by some unspecified amount. No moralising about the need for workers to restrain their demands, to work harder for less, in order to sustain a profligate government. No question of government enjoying a privileged position and having the right to adjust tax revenue to whatever amount they might decide, in their wisdom, to spend.

To each class there accrued an income, and each class was required to live within that income. The agricultural and industrial classes received an income sufficient to maintain themselves and to sustain production. The surplus, the ‘net product’, was divided proportionately between the proprietary class and government.

One might say that the idea of an incomes policy also originated with the Physiocrats but their incomes policy included government with everybody else. Their argument admits of no exceptions; in their approach to public finance there is, as Dupont put it, “only one natural and reasonable conclusion.”

Today we live, as I have said, in a very different kind of society to that of the Physiocrats. Whether the Physiocratic system would have been workable in 18th-century France is a matter for historians; it is not applicable directly to 20th-century Britain.

Yet, we can learn from their method – from their scientific approach to the matter of public finance. Conditions have changed, but the questions related to public finance which macroeconomics is required to answer today are not fundamentally different from the questions the Physiocrats attempted to answer over two hundred years ago.

The Economic Study Association (ESA) has spent twenty years researching into issues related to public finance, and the scientific approach pioneered by the Physiocrats has proved useful.

However, in the second half of the 20th century we did not start with the basic concepts and definitions of the Physiocrats but with something more appropriate to contemporary conditions – with the *General Theory of Employment*, as formulated by Keynes in 1936.

We have developed the supply-side of Keynes’s theory in a way that incorporates Milton Friedman’s restated *Quantity Theory of Money* – which is essentially a generalisation of Keynes’s theory of liquidity preference – as well as later developments in monetary theory, and also in a way that provides theoretical backing for Colin Clark’s empirical work on what he calls the “economic upper limit to taxation”.

As a matter of theory we can argue now that once a lower tax threshold is breached then all taxation motivates a tax shifting process. If government increases employees’ social security taxes by, say, a penny a week then nothing much may happen, but if they make the increase £1 a week, on average, then employees will retaliate. The tax-induced cut in take-home pay will be taken into the reckoning at the next pay round. As a result employers’ average labour cost will be higher than it would have been had the tax increase not been imposed.

Faced with higher labour costs employers will, in turn, depending on market conditions, either raise prices or cut back on employment, or some combination of these two.

In terms of the theory, the tax shifting process causes the aggregate demand function and the aggregate supply function to increase simultaneously by more or less the same amount so that the point of intersection rises vertically.

In practical terms, the tax shifting process causes a rising general price level which effectively disperses the tax effects throughout the economy until they are so thinly spread that they cease to motivate further retaliation.

In other words, the tax shifting process may be considered as a mechanism by which an economy absorbs a level of taxation, or additional taxation, by a movement from one stable general price level to another higher general price level. The converse holds for a tax cut.

This line of reasoning leads to the conclusion that in any economy it is possible for the amount of taxation to be such as to cause the tax shifting process to continue indefinitely. When this happens that economy will then be subject to what may be called persistent tax inflation.

Thus, as a matter of theory, it is to be predicted that for any economy in given conditions there is an "economic upper limit to taxation" – as Colin Clark concluded from his empirical studies.

When government spending necessitates the economic upper limit to taxation being persistently exceeded, then, the theory predicts, monetary policy will determine the trade-off between the rate of inflation and the restriction of output and employment. With a lax monetary policy there will be more inflation and less unemployment. With a tight monetary policy there will be less inflation and more unemployment.

This prediction from theory changes fundamentally the significance of the work pioneered by Colin Clark. The economic upper limit to taxation ceases to be a mere statistical inference from empirical studies, which may or may not hold at some other place or at some other time. The statistical investigations become tests of a prediction from theory – attempts to answer the question as to whether the conclusion from a generalisation is borne out in practice.

The scientific method begins and ends with observation. Let us look at the evidence. Until recently both the United States and this country pursued discretionary monetary policies – that is to say, "lax" policies – and in these circumstances the theory predicts a significant positive relationship between the annual rate of inflation and the proportion of the net national product at market prices (NNP) appropriated as general government tax revenue.

First the United States:

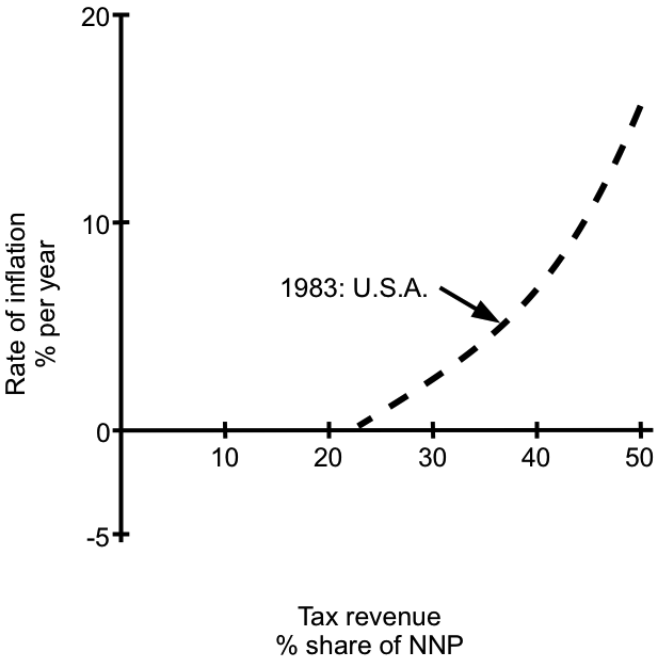

Figure 1: Tax revenue and inflation rate, U.S.A.

Now the United Kingdom:

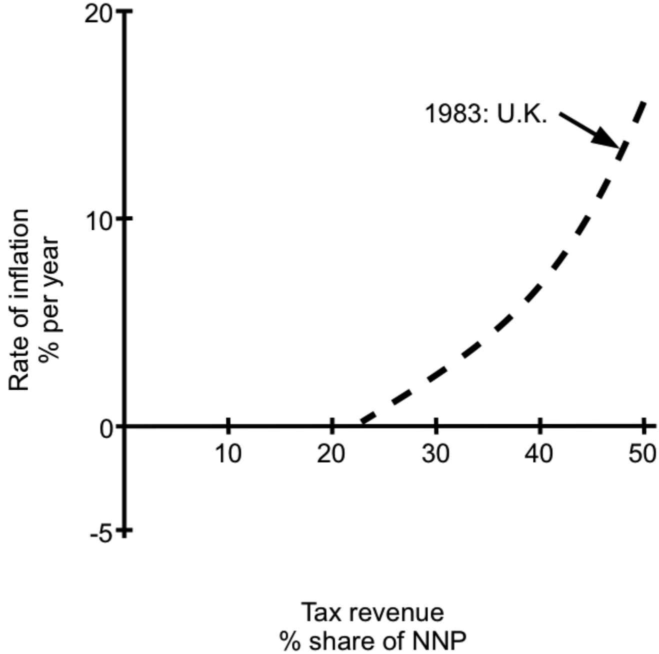

Figure 2: Tax revenue and inflation rate, U.K.

As may be seen from the charts the evidence is consistent with the theoretical prediction. In the United States the rate of inflation has moved up and down with the tax percentage of NNP at market prices. In the United Kingdom, where a borrowing requirement has been a persistent post-war characteristic, the rate of inflation has moved up and down with the total of tax revenue and borrowing requirement as a percentage of the NNP at market prices. With the further use of calculus it can be shown that in both countries the relationship is positive and significant.

Now the importance of these statistical investigations is that they show predictions from the theory to be consistent with the facts of experience. One can also carry out a number of statistical tests to show that the chances of these statistical results being a matter of accident are negligible. Thus, we have confidence in the theory, and may proceed to draw particular policy implications.

The implication for United States economic policy is that if the Federal Reserve Board pursues a monetary policy consistent with a zero rate of inflation, then, to avoid a slump, the United States government must pursue a fiscal policy requiring a tax take of no more than 23 percent of the net national product at market prices. Put the other way, if the United States government persist with their present fiscal policy then it is impossible for an economic recovery to be sustained without an upsurge in the rate of inflation.

For the United Kingdom our theory predicts that if government persist in combining present fiscal policy with the medium term financial strategy then inflation may be squeezed out of the system over time but only at the cost of keeping the economy permanently depressed.

Ministers of the Crown who stump the country claiming that inflation is now under control and that they foresee a sustained economic recovery without inflation either have fooled themselves or are attempting to fool the rest of us.

To what extent is the appropriation by general government of nearly 50 percent of the nation's income a cause of present social evils? A practical question to which now we can give a practical answer.

Theory predicts and the facts of experience confirm that the primal cause of the present social evil of inflation is a tax take persistently in excess of the economic upper limit to taxation. For just so long as government continue by the force of law to appropriate nearly half of the nation's income then, just so long as we continue to enjoy the freedom of choice, our choice will be limited to either hyper-inflation or mass unemployment.

The alternative to having a choice is to give up our liberties for the regimentation of a centrally controlled siege economy. There is always this alternative.

However, do not rush to the easy conclusion that both macro-economic theory and the facts of experience demand the indiscriminate slashing of general government spending. Some government spending could be cut with advantage to all for it is unnecessary and wasteful. It is as true today as when Leroy-Beaulieu was writing at the turn of the century: "The major part of the sums raised by taxation have been put to uses that are commendable neither from the economic nor the social point of view."

But the social evil of inflation is the result of successive governments persistently exceeding the economic upper limit to taxation and this limit is a ratio. Whether or not the limit is being exceeded is determined as much by the size of the nation's income as by the amount of taxation. Both theory and evidence support the conclusion that whilst the primal cause of the present social evils of inflation and unemployment is in part an excessive amount of taxation, a not insignificant part is the method of raising tax revenues – methods which constrain the nation's income. But this question of method is beyond the scope of this talk – perhaps we may consider it another time.

The title of this talk poses the question 'Who Needs an Incomes Policy?' The answer must be the government, not the rest of the economy. The non-government sector of the economy has shown such restraint during the post-war decades that its share of the nation's income is now smaller than ever before in our history. We are on average better off than pre-war for the simple reason that we have multiplied our output – in other words, 70 percent of ten oranges was not as many oranges as 50 percent of twenty is now.

Nonetheless it is our post-war governments that have lacked restraint; it is post-war governments who have made excessive income demands, and an unbridled government is inconsistent with general prosperity and social justice.

10

Methods of Taxation

15th September 1983

If the proposition 'all taxes are bad' were put to a vote of taxpayers, there can be little doubt that it would be passed by an overwhelming majority. Their motives may be varied, but the certain result is consistent with the conclusions to be drawn from an economic analysis. All taxes are bad; they are bad in that by their formal incidence, that is on impact, they distort relative prices and so distort the economy as a whole.

More than that, all taxes are bad in that sooner or later they all motivate a tax shifting process, and eventually this tax shifting process causes a rising general price level with some cutback of output, the social evil which is described in the jargon of today as 'slumpflation'. In this country we are suffering from what may be accurately described as statutory slumpflation – statutory, for it is largely the result of decisions taken in Cabinet and confirmed by Parliament.

The direct cause of our statutory slumpflation is an excessive tax burden, that is an excessive amount of taxation relative to the Net National Product (NNP) at current market prices, and we will be rid of the disease only when the cause is removed.

Do not be fooled into believing that this government's policies are removing the cause, even of inflation. The evidence is quite to the contrary. What is happening is that the social evil of mass unemployment is being pitted against the social evil of persistent tax inflation. As a result, the unemployment of both people and resources, and in particular the fear of unemployment – all this is slowing down the tax shifting process, and in turn, this is being manifested as a slowing down in the rate of inflation. The primal cause remains, and it has a greater power today than it had in 1979.

I dealt with this issue of an excessive tax burden in my talk last April (Who Needs an Incomes Policy? – 14th April 1983), and so tonight, what I wish to consider is the methods of taxation which have been pursued by successive British governments, and as I will hope to show you, methods guaranteed to ensure that any amount of taxation will prove to be an excessive burden.

That they are taxing too much may be so – but even if they weren't taxing enough the way they are doing it would make it excessive, because the fact is that whilst all taxes are bad, some taxes are worse than others, and some taxes are worse than others in that they have a greater power than other taxes to restrict the economy, and to create the social evils of mass unemployment and persistent inflation. Successive post war British governments have consistently relied more and more on revenue from those same very bad taxes, and less and less on the revenue from not-quite-so-bad taxes. By their fiscal policies, they have not only perpetrated sins of injustice, they have compounded them.

However, let us begin by looking at the evidence – the official estimates made and published by government departments. On the chart in Figure 1, it has been broken down into three broad classes: pay bargain taxes, other direct taxes, and other indirect taxes.

Pay bargain taxes are those taxes which drive a wedge between what employees receive as take-home pay for their labour, and the cost of that labour to their employers. At present, these pay bargain taxes consist of income taxes on wages and salaries, employees' and employers' social security contributions, and the National Insurance surcharge.

Other direct taxes include all income taxes other than taxes on wages and salaries – that is, including such things as corporation tax, petroleum revenue tax, and so on and so forth. Included also in this class are all taxes on capital – those are mainly death duties, and Capital Gains Tax.

Lastly, the other indirect taxes include all of the so-called taxes on expenditure (other than the National Insurance surcharge which is included as a pay bargain tax), so that other indirect taxes, as I have described them, include such things as the local rates, Value Added Tax (VAT), and all other classes of customs and excise revenues, stamp duties, motor vehicle duties – you name it, and they are included in it. That is other indirect taxes.

So, in Figure 1, there are pay bargain taxes – that is taxes which drive a wedge between what an employee receives and what it costs an employer; other direct taxes – that is all other kinds of income tax and capital taxes not already included; and the other indirect taxes – which includes all taxes on expenditure (only one of which is included in pay bargain taxes, the National Insurance surcharge). A little earlier, around the seventies, there was also the Selective Employment Tax (SET).

Now, in order to produce comparable statistics over some 37 inflationary years for the revenue from each of these taxes, or from each of these broad classes, I have expressed them as a percentage of the Net National Product (NNP) at current market prices for that year. By expressing it as a percentage, one can eliminate any inflationary elements – in other words, what it represents is a slice of the cake, when those taxes are taken, or as I would describe it, they are a burden.

Let us then start at the bottom, with other indirect taxes. As you can see, the proportion has remained fairly steady throughout the post-war years from 1946 through to 1981. (I apologise that it's so far out of date but the government are rather slow to produce the necessary information, and one can't get details for later than 1981 – the details are not yet published.) As you can see, it starts high just after the war, stops a little, and then climbs up towards the end here. That's the sharp increase in the VAT rate introduced by Sir Geoffrey Howe, and of course he was also rather keen on putting up excise and other duties – you had to pay more for your beer and wine and so on, since his tenure of office – and this shows itself in the sharp jump from 1979, but even so, the percentage has only just about returned to what it was in the late forties.

In any event, throughout the whole of those 37 years, the other indirect taxes have only gone up and down by about 3 percentage points – the range is very small.

Move up to the other direct taxes, and of course this shows a very steady and persistent decline over the years, and indeed, were it not for the North Sea and the new petroleum tax, as a share of the national product this would have already gone to join the dodo. The sharp turn up is entirely due to the petroleum revenue tax – North Sea taxes, which now account for over 30% of all other direct taxes. In fact, if we ignore the North Sea element in this, then these other direct taxes have fallen quite sharply over the past couple of years. They would be down at the bottom, and off this graph, but the fact is that there is North Sea oil, and we have got a petroleum revenue tax, which is included.

Taking these other direct taxes as a whole, that particular class is only about half as burdensome today as in the late 1940s, when they were a little over 14% percent. Today they are between 6% and 7%, so they are about half as burdensome as they were. Now one main reason for that decline is the squeezing of profits. If you squeeze profits, that will reduce dividends. This has happened as a result of increasing pay bargain taxes. Very simply, if you squeeze the base of a tax, then obviously the yield of it is going to fall. As I say it's quite a serious decline, but it does to an extent measure the decline in the profitability, or net profitability and competitiveness, of British producers.

Moving now to the top of Figure 1, there are the pay bargain taxes, and this has simply leapt; the burden of this class of tax has trebled during the post war decades. In 1947, pay bargain taxes took about a 6½ percent slice of the Net National Product; today they take a 20 percent slice.

From being a class of tax which yielded the smallest revenue – and before the Second War it was an insignificant revenue – from being, just post-war, the class of tax with the smallest revenue, it now yields the most revenue.

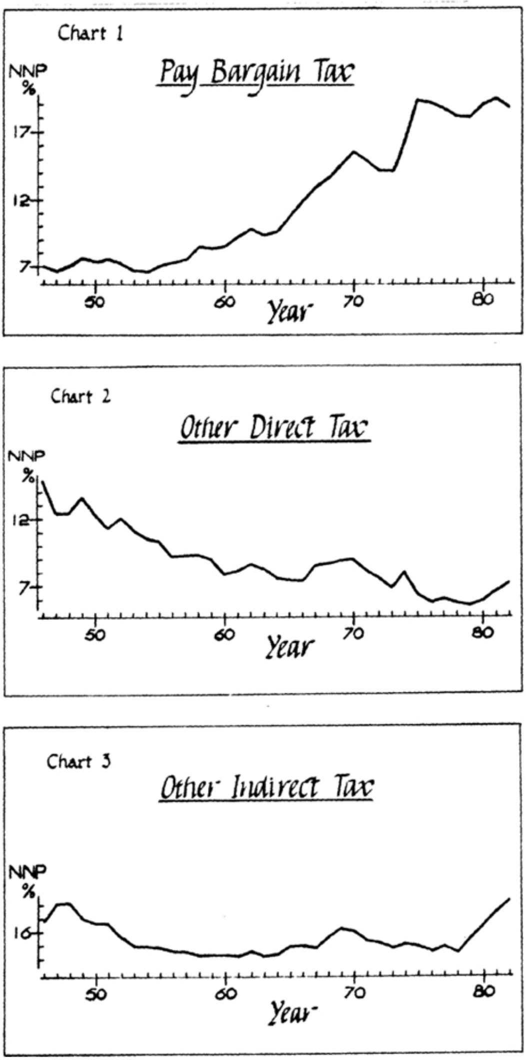

Figure 1: Classes of taxation, 1946 to 1981

Since 1959 the yield of pay bargain taxes has risen above other indirect taxes, and since 1973, it has risen ahead of the other direct taxes, from being the smallest class to become the largest class.

Since 1960 the burden of general government taxation has increased by about fifty percent; almost the whole of that increased burden has been imposed through increased pay bargain taxes.

We hear a great deal today about the burden of Non-Domestic Rates[47] – it's one of the 'in things' for the CBI (the Confederation of British Industry) to complain about – how they are knocking out otherwise thriving businesses. But that's no more than the last straw, and it's always the last straw that gets noticed. The burden of pay bargain taxes, happily being paid by business, is some eight times that of Non-Domestic Rates.

Today the Trades Unions march and protest about the increase in the standard rate of VAT to 15%. They claim it has caused a lot of their members to lose their jobs; well, if that is so, then what of pay bargain taxes – a direct tax on jobs with a burden three times that of VAT, even at its new rate of 15%?[48] If only people would look and consider, before they go out and cause civil commotions, and incidentally put up our domestic rates in so doing, that the last straw produces a noticeable effect only because a burden of many tons has been imposed previously.

This chart, Figure 1, shows how according to official estimates, the method of raising general government tax revenue has changed over the post-war years, and it is a very significant shift.

Gladstone talked about these two taxes – they didn't have that sort of tax in his day – as being the two sisters, the twin sisters that he courted, and that remained valid until the Second World War.

There were pay bargain taxes before the Second World War, but they were quite insignificant. They were very difficult to measure statistically because they were in the margin of error of aggregate national account figures.

But this new method of taxation has grown from being nearly non-existent to being the largest source of general government revenue, tax revenue, whilst what was previously used to provide

47 Now known as Uniform Business Rates; the same complaint is still raised.

48 The standard rate of VAT was increased from 8% to 15% in June 1979.

some 50% of general government tax revenue has now become the smallest of taxes.

This is a very significant change to have happened over a decade, but it's happened, so let us consider this significant shift, and disengage from our obsessions over the last straw that happens to hurt us, and consider the effects of this massive increase in pay bargain taxation – from next to nothing to close on 20% of the Net National Product (NNP).

Now in their formal incidence pay bargain taxes come in two varieties: those which have an impact effect on the take-home pay of employees – that is income tax on wages and salaries and the employee's social security contribution – and then there are those taxes having an impact effect on the employer's labour cost, that is the employer's social security contribution – the former Selective Employment Tax and the present National Insurance surcharge.

Now to take the first variety first, when taxes on the wages and salaries of employees are increased, what the Americans call rather descriptively, withholding taxes, when these withholding taxes are increased, then immediately and directly take-home pay is cut.

For example, when the employee's social security contribution was increased last April, then in the same month, the amount of money received as take-home pay was cut by precisely the same amount as the tax increase, because these are withholding taxes – you just don't get the amount that is withheld.

What you do get of course is an immediate distortion of relative prices. What happened was that for each of us as an employee, each of us who works for a living, the price each of us received in return for our own labour fell relative to all the other prices that we each had to pay out, or happened to receive. Similarly, when taxes imposed on an employer are increased, then of course labour costs are increased by the full amount of the tax. Again it's an immediate distortion of relative prices. The price an employer must pay for a given quantity and quality of labour increases, relative to all other prices that the employer pays out or receives.

Now, taking these two impact effects together, what happens is that a wedge is driven between the price paid out for labour by an employer and the price received in return for that labour by an employee – this is the pay bargain tax wedge. It has, inevitably, a disincentive effect on both the employee and employer, for as the taxman takes more, and the employee receives less, the employee becomes less and less willing to work, and that is matched by the employer becoming less willing to offer work, as the taxman takes more and labour costs more.

Further, the progressive nature of most of the pay bargain taxes intensifies the disincentive effect. The pay bargain tax wedge is, on average, the equivalent to a 40% payroll tax on take-home pay. In other words, if you take home £1, it costs your employer £1.40.

That's on average, and of course the average always tends to obscure what actually happens, and in particular, what tends to happen in the marginal cases; and in marginal cases, this difference comes close to being 100%. In marginal cases it means that if for some additional job an employee asks say £10, then the cost to the employer may be as high as £20. If the employer cannot afford £20 and the employee will not accept less than £10 pounds, then the job doesn't get done. But note, not only do the employer and the employee lose out, but we are all the poorer by a job not done.

Now of course, human nature is what it is, and fortunately for us on many occasions there is a will to find a way, and the only way is to evade the tax. Thus there is brought into being the black economy, so-called. Whoever wants some additional job done, and whoever is prepared to do that job, agree to a deal off the record, and split the tax saving. The person doing the job receives more, the person having the job done pays less; both gain, and only the government loses in tax revenue; but again more important, the job does get done, and to that extent we are all better off as a result of a job that has been done.

From time to time there is an exercise that civil servants in the Inland Revenue and the Treasury economists engage in – it's a nice little exercise, because they can occasionally get paid for it, and from time to time they can appear on radio as well as on television – from time to time, great claims are made as to the revenue to be gained from effective action against the black economy.

Just don't be misled – in most cases, if not all cases, there will be no gain in tax revenue, for if the tax wedge were enforced the job would not get done, and to the extent that jobs that are now being done in the black economy were not done, we should all be the poorer and the government no richer. Whatever the size of the black economy, what does it matter? They are earning a living, they are not on the dole, not drawing social security – well if they are that's up to the other people. As I say jobs are getting done but whatever may be the size of the black economy, if we wish to be rid of the black economy without all becoming poorer, then there is only one certain way – remove the cause, and abolish this pay bargain tax wedge.

It's very easy – if you don't like the result, don't do it. But note well, all that we have mentioned so far flows from just the formal incidence of pay bargain taxes – their impact effect, the way they hit – and serious though this effect may be, it really is as nothing when you start comparing it with the longer-run effect.

Two hundred years ago the granddaddy of all economists Adam Smith argued that any tax imposed upon the income of employees is shifted by them onto their immediate employers. Impose a tax of 20 percent on gross wages, and gross wages, he asserted, will rise by 25 percent.

By statistical investigation we can now confirm Adam Smith's conclusion from his tax analysis. The OECD (Organisation for Economic Co-operation and Development) admits that net of tax wage bargaining is common to all the industrialised countries. It is recognised as being so.

Thus, as predicted by classical theory and confirmed by modern statistical techniques, by tripling the burden of pay bargain taxes over the past 37 years, our successive British governments have caused British labour costs to be that much higher than they would have been otherwise and that much higher is now 20% of the Net National Product at market prices – 20 pence in every pound.

The British worker (and that probably includes most of us) has not priced himself out of the market – he's been taxed out of the market. We live, whether we like it or not – whether we accept it, or whether we are in the van of the reformers – we live in a society dominated by the employee and employer relationship, and the employers are, for the most part, firms and corporations who can offer employment only to the extent that it is profitable for them to do so, at the current cost of labour. When it is profitable for them to offer employment, they must do so in order to gain the profit. When it is not profitable for them to offer that employment, they cannot do so, and any of them that are foolish enough to attempt the impossible are eliminated. They go to the wall. They appear in the bankruptcy statistics.

Firms and corporations have no option; when it is profitable for them to offer employment they have got to do so, they've got to make the profit, and when it is not profitable for them to do so they can't, because if they attempt it they are finished, that is as it is.

It may not be a pleasant condition, but it is the contemporary condition, and from the existence of this condition it follows of necessity that as the current cost of labour is inflated by the imposition and shifting of pay bargain taxes, employers have no option but to either raise the prices of their products or to cut back on output or some combination of the two. Thus, we can predict that an ever increasing pay bargain tax wedge will lead, sooner or later, to a rising general price level and to rising unemployment.

Monetary policy will play an important part in determining the precise combination of these social evils. An easy monetary policy will allow for less unemployment but will cause more inflation. A restrictive monetary policy will allow less inflation but cause more unemployment. There is no amount of choice – you'll get both, it just turns on what the emphasis is going to be. But this isn't the only long run effect; the shifting of pay bargain taxes raises the current cost of labour relative to all other prices that an employer has to pay and of course in doing that, it encourages labour saving investment. First you get the distortion of relative prices, then research is distorted, then investment spending is distorted, and in the end many jobs are destroyed for all time.

It was no accident that the upsurge in self-service shops coincided with the imposition of Selective Employment Tax during the period when Mr Callaghan was Chancellor of the Exchequer;[49] that is just about there where this takes off. Irrespective of whether the customer desired the service or the shopkeeper wished to offer the service, neither could afford the service at the new tax inflated cost of labour. Once firms have incurred investment expenditure in a certain direction, its effects continue for a very long time and little can be done to induce any immediate change.

For example, the present heavy youth unemployment has not brought about a return of the delivery boy. Not only is he being taxed out of the market, but the pattern of recent investment in the distributive trades means that there is no place in that trade today for a return of that service. Until all the latest investment spending gets worn out and firms begin to consider replacing it, that's going to continue. Cutting youth unemployment benefits is not going to provide any solution; that only compounds the sins of injustice perpetrated by successive governments at Westminster.

Our recurring balance of payments difficulties, difficulties with the sterling exchange rate, our so called high propensity to import, have been made much worse by this post-war shift in the method of raising tax revenue. When the cost of British labour is inflated by taxation, the prices of all British products are inflated, be they intended for sale in the home market or the export market; but pay bargain taxes imposed in this country do not of course inflate the manufacturing costs of our overseas competitors. The result is that

49 Selective Employment Tax was introduced in August 1966, and withdrawn upon the introduction of VAT shortly after Britain joined the EEC in 1973.

our manufacturing base is eroded. Many markets are lost forever, and when markets are lost forever, output and employment is lost forever; each link in the chain, from cause to effect, is important when formulating public economic policy. Bright ideas and good intentions are not sufficient.

A public talk is not a place to go into the details of statistical investigations, and so I won't proceed to baffle many of you on regression calculus, but nonetheless, whilst the details of these investigations are best left to Economic Study Association (E.S.A.) seminars, the results of the complex investigations are informative.

On the basis of official estimates published by governments over the past 30 years, we can now explain more than 80% of the increase in the rate of unemployment by the increase in those pay bargain taxes. When the pay bargain tax burden is increased, then twelve to eighteen months later there follows an increase in the rate of unemployment, and on those rare occasions when the pay bargain tax burden was cut, which happened two or three times, then twelve to eighteen months later the rate of unemployment fell. This is quite predictable in accordance with a stable mathematical function.

A similar significant relationship exists between the size of the pay bargain tax wedge and the rate of growth of output, measured as Net National Product at constant market prices, but in this case the relationship between the rate of growth and the tax is a little shorter. Either a slowing down in the rate of growth follows six to nine months after the increase in pay bargain taxes, or an increase in the rate of growth follows six to nine months after those odd few occasions when they did actually cut the burden – about half the time that it took to show up in unemployment.

Again, our statistical investigation shows that a significant relationship exists between the size of the pay bargain tax wedge and the rate of inflation, but in this case the time lag is very short indeed – not more than a few months at the most. Of course this is to be expected, because producers are better able to calculate their costs and know whether or not they have to increase their prices, than they are able to predict demand, and further, in the absence of statutory controls, price changes can be quickly put into effect.

The result of that price change, however, in terms of output and employment, takes longer and comes later, so one would expect that difference in the time lag. First you get a change in this tax wedge that affects prices, then secondly, later on, it affects output, and then lastly, it affects employment; and all this in accordance with a stable mathematical function.

Taking it further, test statistics indicate that these relationships are not the result of any chance correlation, nor are they a matter of accident, and of course the time lags leave little room for reasonable doubt as to the direction of causation.

Thus, the combination of these two social evils of mass unemployment and persistent inflation, the two combined, is a post war phenomenon – and its cause is another post-war phenomenon, a significant pay bargain tax wedge. To eradicate slumpflation, governments must stop causing slumpflation; to stop causing slumpflation it is necessary for them to abolish pay bargain taxes. This is the inescapable policy implication to be drawn from the results of investigating the evidence produced by government.

Of course, from outside government it is very easy to propose the abolition of pay bargain taxes, and even more so when the available evidence fully supports the proposal, but for government there is an additional matter for consideration. Does the proposal amount to a feasible policy?

All the evidence may support the policy, the proposal may be both relevant and desirable, but the question for government is whether its implementation would be the act of a responsible government in the given conditions? Would it not be irresponsible for government to begin the process of abolishing a whole class of taxation, a class that yields 45% of total tax revenue, when every year government is forced to borrow large sums in order to cover their current spending?

It is an important question which government has to answer, so let us try answering it by again considering the available evidence. The first matter one has to consider, is that government today directly and indirectly is the largest single employer of labour in the country. It follows that a significant part of the revenue from pay bargain taxes is in effect paid by the government; what they receive in with one hand, they have to pay out with the other.

Now when you net out that rather large item, the net loss of revenue from abolishing pay bargain taxes is not 45% of current revenue but around 33%, or one third. If government spending is to be sustained at close to current levels and pay bargain taxes are to be abolished then the revenue from the two remaining classes of taxation must be increased by 50%. The last Chancellor did of course nearly double the rate of VAT, and his government was still re-elected, but even so we may doubt whether this government, the new government that was re-elected, or any other government could repeat that process without dire results. Fortunately, the evidence suggests that action along these lines, or along the lines of savage cuts in government spending, is not really necessary.

But again turning to official estimates, calculations show that current output measured as the Net National Product at constant market prices is less than two thirds of our potential, and, given the abolition of this class of tax – pay bargain taxes – then it is to be predicted, and predicted with some confidence, that output would expand by 50%. With the Net National Product expanded, then so would the revenue from these two remaining classes of taxation be expanded, without any need to raise the rates of tax.

Thus, over a period, the yield from these two classes of tax may be expected to grow to be equal to the current yield from all three classes, and so from that it is to be concluded, that the abolition of pay bargain taxes does not imply slashing government spending, nor does it imply the necessity of an upward shift in the rates of most other taxes, nor even does it imply a permanent increase in the annual borrowing requirement.

Whilst it may not imply all those things, there is still the present borrowing requirement, about which there has been much debate over recent years, and which Nigel Lawson is worried about. But, when one looks at the government accounts in relation to that, what does one find? Government accounts show that the present borrowing requirement is in the same order of magnitude as their present level of spending on unemployment benefit, social security supplementary allowances, and a whole variety of other grants and subsidies, that constitute necessary government expenditure only given the continuance of restricted output, mass unemployment and persistent inflation.

As output and employment expanded, as British firms became more competitive and profitable, then all this kind of government expenditure would in due course become unnecessary expenditure. The borrowing requirement as it stands at the moment would be allowed to fade away like an old soldier in his own good time, and would not be an excuse for cuts in public spending on what are truly necessary public goods and services.

All taxes are bad, and pay bargain taxes are worse than other taxes, but to abolish all pay bargain taxes is no more than a first step on the road to recovery. The proposal is not only relevant to our present predicament, but it also amounts to a feasible policy in present conditions. It was about one hundred years ago that a certain American economist wrote: "taking men in the aggregate, their condition is as they make it."[50] This comment is as valid in the 1980s as it was in the 1880s.

50 Henry George, *Progress and Poverty*, Part X: The Law of Human Progress. See Chapter 5, The Central Truth, Section 15: The Cross of a New Crusade.
"... when we see that social development is governed neither by a Special Providence nor by a merciless fate, but by law, at once unchangeable and beneficent; when we see that human will is the great factor, and that taking men in the aggregate, their condition is as they make it; when we see that economic law and moral law are essentially one, and that the truth which the intellect grasps after toilsome effort is but that which the moral sense reaches by a quick intuition, a flood of light breaks in upon the problem of individual life."

With all the advantages of a freely elected parliament we have allowed successive governments to pursue fiscal and monetary policies that could have no other result than a combination of the social evils we now suffer. We cannot expect to escape overnight from the consequences of past mistakes. It has taken many decades for us to plumb our present depths, and the cutting of the first shackle – the abolition of pay bargain taxes – will take some years.

But why not make a start? To reach any objective we have always to start from wherever we happen to be. That requirement has in fact a great advantage because it means we can always start now, from where we are now, for the simple reason we can't do anything else. Why then do governments persist in continuing with the mistakes of the past? The evidence is as readily available to government as to those outside. Why then do the freely elected opposition parties allow government to persist with such actions? Indeed, why do these oppositions expect to become government on the promise of continuing these mistakes?

A possible explanation – I won't go further than that – was given by Colin Clark some 20 years ago when he was Director of the Research Institute at Oxford, and this was at a time when we were all worried, because both rising unemployment and rising inflation were moving into the two or three percent region.

Colin Clark wrote: "Some moralists it is true would say that these actions are not blameworthy, because the politicians who perpetrate them are in such a state of profound and invincible ignorance about the consequences of their own actions and the standard of justice required of them, that no reasonable man can hope for them to act otherwise". He added: "Few politicians however would like to be excused on the grounds of such ignorance, even if the alternative were an accusation of injustice".

It is now no matter whether the politicians are to be accused of ignorance or injustice, for the consequences of their actions are now a fact of current everyday experience. In any event it is not the job of an economist to excuse or accuse; the job of the economist is to link causes with economic effects in a logical order.

The mass of evidence that is available today demands of an economist that he use advanced statistical techniques, and modern computer technology, and one result of that is that their economic arguments are mostly incomprehensible to both politicians and their electorate. This is a common characteristic of contemporary scientific advance, and a member of the general public who tries to understand a technical paper on say nuclear physics, indeed even a specialist in the subject, expects to find the reading of a technical paper hard going, but an economist in addition to exchanges with other economists is required to inform those politicians and the electorate. It is rather like an advocate at a Court of Law – he is required not only to be able to dispute the finer points of his case with other professionals but also to present a case in a way that can be understood by a jury, unlearned in the jargon and in the finer points.

A politician has to implement public economic policy and in a parliamentary democracy the electorate is from time to time called upon to accept or reject public economic policy. Now they can do this job only on the basis of information received, but there is another side to it. The electorate is required to make an effort, and act on the information received; for it is the electorate who have the power to cast out ignorant or unjust politicians and their professional advisors.

Well, I trust tonight it has been informative. The power to insist on right action by government lies in your hands – our condition is as we make it. Thank you.

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