Public Talks

The Basis for Expanding Employment

Kensington Town Hall, London

15th April 1982

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"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.[1] 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

1 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.

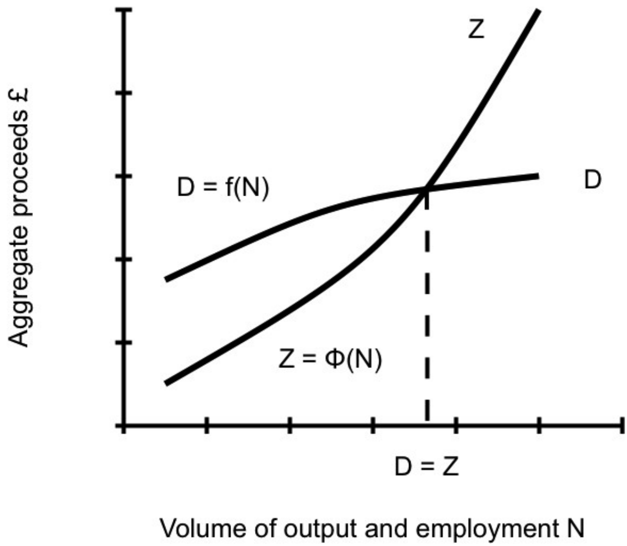

Figure 1: Aggregate supply and demand functions

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.

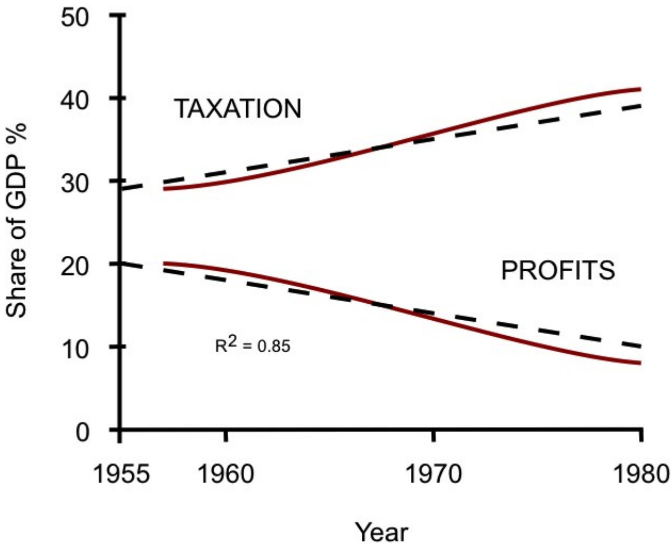

Figure 2: Taxation and profits, 1955 to 1980

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.

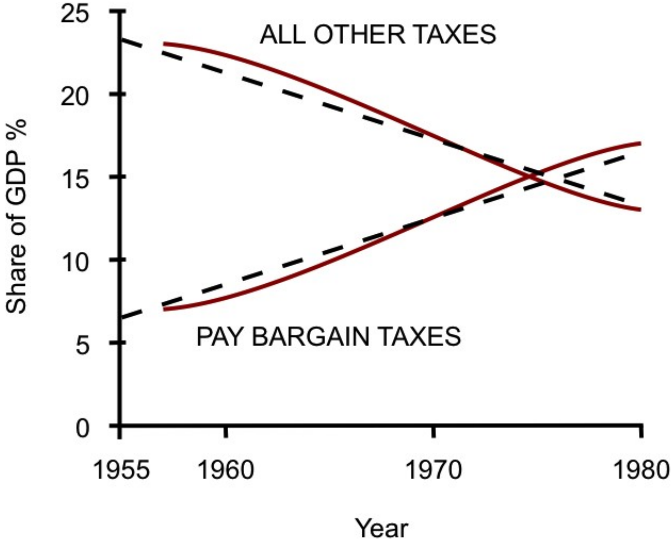

Figure 3: Pay bargain and other taxes, 1955 to 1980

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.

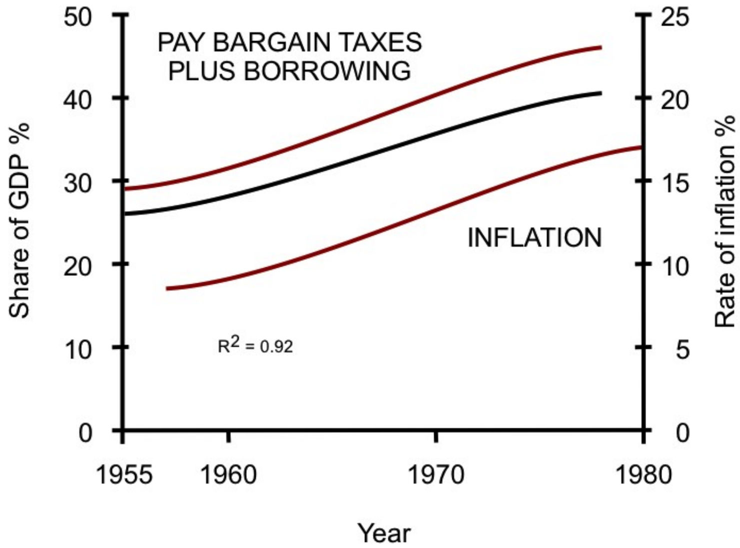

Figure 4: Pay bargain taxes and inflation, 1955 to 1980

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.