Social Justice or Unbridled Government

By Ronald Burgess

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Foreword

The world should not underestimate the potential strength of the British economy, nor the power of a free people to resolve their difficulties. During the past year the free Trade Unions of Britain have shown what may be accomplished by co-operation. So called 'British Disease' is not a defect peculiarly inherent in the British people, for it is common to all nations to the extent that their governments lack economic discipline.

In Britain an 'economic miracle' can be achieved by simply realising our potential. The great financial and trading centre of the City of London is unique. Given the right policies at Westminster and now a Common Market hinterland, the expertise and vigour of 'The City' has unparalleled opportunities.

Again, unique among the developed nations of Western Europe, Britain can be self-supporting in its energy supplies. Coupled with the skill and enterprise of the British people, an exciting vista of a second industrial revolution, benefiting all, opens before us.

This paper concludes that our immediate economic difficulties are the result of a failure of Parliament to impose on both central and local government the minimum degree of fiscal and monetary disciplines necessary for the continued existence of a free and prosperous society.

If these disciplines are accepted in public affairs the British people will be free to use their skill and enterprise towards a revitalisation of the economy and a pride of position in the world.

Adam Smith wrote two hundred years ago:

> "It is the highest impertinence and presumption, therefore, in Kings and Ministers, to pretend to watch over the economy of private people, and to restrain their expense, either by sumptuary laws or by prohibiting the importation of foreign

luxuries. They are themselves always and without exception the greatest spendthrifts in the society. Let them look well after their own expense, and they may safely trust private people with theirs. If their own extravagance does not ruin the state, that of their subjects never will. Great nations are never impoverished by private though they sometimes are by public prodigality and misconduct."

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May 1976

Glossary

1. Components of Labour Cost as a percentage of National Income

   (a) Labour Cost – the aggregate of what employers have to pay out to employ someone. Effectively the total demand price of Labour.

   (b) Direct Employers' Taxes – employers' contributions to social security taxes. During the years 1966–1973, the Selective Employment Tax (SET) is included.

   (c) Wages and Salaries – the common-sense concept of employees' gross pay. Technically, it is defined by the Central Statistical Office in item 13a.

   (d) Direct Employees' Taxes – income taxes on wages and salaries plus employees' contributions to social security taxes.

   (e) Take Home Pay – again the common-sense concept serves. It is calculated as (c) less (d).

   (f) Indirect Taxes – the proportion of taxes on expenditure included in consumer expenditure, such as rates, customs and excise duties, and VAT.

   (g) Net Pay – represents the claim to a share of the product directly accruing to employees as a consequence of their employment. Effectively it is the supply price of Labour and is calculated as (e) less (f).

   (h) Employment Impact Taxes – includes all those taxes which directly inflate labour cost, and is the difference between the demand price of labour (Labour Cost) and the supply price (Net Pay). Changes in this form of taxation affect the volume of employment after a time lag of twelve to eighteen months. It is calculated as the sum of (b), (d) and (f).

(i) Employee Impact Taxes – all taxes which directly inflate wages and salaries. As pay agreements are usually made with reference to wages and salaries, changes in this form of taxation affect pay demands. Calculated as the sum of (d) and (f).

2. Economic Discipline – the minimum discipline a government must accept if a high level of employment without inflation is to be sustained in a free society.

   It may be considered in two parts:-

   (a) Fiscal Discipline – the necessity for Parliament to restrain public authority spending so that the total of tax revenue plus borrowing requirement does not exceed a certain fraction of the national income as defined by the economic upper limit to taxation.

   (b) Monetary Discipline – the necessity for government to keep the rate of increase in the money supply in line with the rate of growth of real output.

3. Economic Potential – a measure of the relative attractiveness of different locations to trade and industry.

4. Economic Upper Limit to Taxation – a certain fraction of the national income which, if persistently exceeded by tax revenue plus borrowing requirement, will result in a rise in costs and prices and a restriction of output.

5. Natural Unemployment Rate – the minimum sustainable rate compatible with the acceptance of full economic discipline in a free society.

6. Social Wage – the notional income of employees after tax and after adding an allowance for the provisions of state welfare.

7. Statutory Unemployment Rate – the natural rate plus the effects of non-acceptance of economic discipline by government. In the UK the rate of unemployment is largely determined by the level of taxation fixed by parliamentary statutes.

8. Tax Revenue plus Borrowing Requirement – total tax revenue plus borrowing requirement of the combined public authorities.

I

The Choice

"Full Employment in a Free Society". This was declared to be Britain's major peacetime aim as the British Army's first decisive victory ended the beginning of World War II. In 1943 a leader in *The Times* described unemployment as being, after war, "the most widespread, most insidious and most corroding malady of our generation" (1). Nowadays, this description applies to inflation.

At the same time, with over a million people out of work, the "corroding malady" of unemployment cannot be ignored; indeed, almost it seems both unemployment and inflation are endemic diseases. One must have lived in Britain for more than forty years to remember a year in which the general level of consumer prices failed to rise (Chart I), while unemployment has been on a rising trend for the past twenty years (Chart II).

In the thirties, Keynes, in the *Concluding Notes* to his *General Theory*, looked forward to a new system "more favourable to peace" (2, p.381), and in which full employment would be assured.

This new system would necessitate some changes; for example, "the euthanasia of the oppressive power of the capitalist to exploit the scarcity-value of capital" (2, p.376); but Keynes considered his proposals for "the enlargement of the function of government" as also providing "the conditions of the successful functioning of individual initiative" (2, p.380), rather than as making a case for State Socialism.

Forty years on, Keynes' optimism, it would now seem, was unfounded. The methods which, it is claimed, have been derived from his work have not merely failed to cure the disease of high unemployment: they have added a multitude of other diseases. But, as Keynes fully appreciated, ideas are powerful, and in politics they live on and on.

The policies which now masquerade under the name of Keynesianism have a history far longer than the *General Theory*. The first wage freeze in Britain, for instance, was proclaimed on the 18th of June 1349 and this 'King Canute' attitude of Parliament to rising wages and prices has changed little over the centuries. [1]

The proposals contained in Mr Healey's first Budget of 1976 follow directly in this long tradition. Possibly the Trades Union Congress had the 627th anniversary in mind when arranging for their recent Special Conference to endorse their agreement with the Government on wages.

This government, like so many of its predecessors, continues to rely on restricting wages, fixing prices and managing demand.

Admittedly, on the surface, there is now a new approach, but it is no more than a natural development from the former prime minister's much publicised 'pragmatism'. Essentially the methods of the British economic policy remain those which have invariably failed in the past. The April 1976 Budget proposals were attacked as being unconstitutional. Sir Geoffrey Howe was a little more to the point when he described them in the House as an "opening bid in negotiations yet to continue".

The question must therefore be asked: is full employment with stable prices incompatible with a free society?

Regimented communities, such as Russia and Germany, had solved the problem of mass unemployment within their controlled economies before the outbreak of the second world war. In the post-war world the ravages of domestic inflation are apparently being avoided by the fully controlled socialist economies. Have the British people spent years chasing a pipe-dream?

1 The Ordinance of Labourers (23 Edw. 3) was proclaimed by Edward III on 18th June 1349 and confirmed by Parliament as the Statute of Labourers in 1351 (25 Edw. 3 Stat 2 c1). Its provisions were repealed by the Statute Law Revision Act 1863 and the Statute Law (Ireland) Revision Act 1872.

II

Excessive Taxation

It is becoming increasingly popular to ascribe Britain's current economic difficulties to the government pursuing a policy of 'full employment at any price'. This is a misleading over-simplification.

The implication of the argument is that the 'full employment' objective must be abandoned, or at least modified to allow for a higher level of unemployment.

In truth, what must be abandoned is profligate public spending which the politicians have linked misleadingly to full employment. A big attraction to governments of the full employment objective has been that it could be used as an excuse for increases in public spending and an expansion of the public sector.

Thus, full employment and vast increases in public spending (payments for electoral success) were presented as complementary policies. Thus also, the 'full employment' objective was used to sanction the steady drift towards socialism and the concentration of economic power. Indeed, politicians have used full employment to such an extent that the electorate are now falsely indoctrinated to see any proposal either to restrict the public sector or to cut public spending as an attempt to increase unemployment and reduce the standard of living.

The limit

Over the past quarter of a century successive governments by redistributing income through taxation and public spending have significantly increased the *social wage*. In this way much suffering and hardship has been relieved and new opportunities have been created where previously they were denied by poverty, but there is a limit to this process in a free society.

When this limit is exceeded the results are a falling standard of living and rising unemployment, as well as many other social and economic ills. Those whom the redistribution was first intended to assist suffer most. They are least able to avoid the consequences of taxation and unemployment.

The economic limit to public authority spending was estimated by Colin Clark, in a paper published in the Economic Journal of December 1945, as about 25 per cent of the national income. Clark concluded, on the basis of pre-war evidence from many countries, that when tax revenue plus borrowing requirement exceeded about 25 per cent of national income for more than a few years together then, inevitably, *labour cost* would increase as a percentage of the national income; output would be restricted, and prices rise (3).

Keynes, who was then editor of the Economic Journal, agreed that post-war experience would probably confirm Clark's findings (4, p.21). The December 1945 hypothesis was confirmed by Clark with evidence from nineteen countries covering the years 1953 to 1963 (4, pp.21-23).

As is shown on Chart III, each year from 1948 onwards UK tax revenue plus borrowing requirement has far exceeded the 25 per cent limit which Clark defined as the economic upper limit to taxation. Chart I confirms a rising trend in prices, Chart IV the rise in labour cost, and if unemployment is accepted as an approximate reflection of output, then Chart II confirms Clark's prediction as to the effect on output.

III

Taxes Inflate Wages

The mechanics of Clark's empirical law in post-war Britain are provided by a more detailed analysis of the component parts of labour cost (see Chart IV). Historical evidence confirms *net pay* as having a stationary secular trend as a share of the national product with a cycle of about thirty years duration and an amplitude of approximately 6 percentage points (5).

Keynes, writing in March 1939, considered the constancy of labour's share of the product to be the best established of all economic statistics (6, p.48). The apparent declining trend of net pay shown on Chart IV is however produced by the cycle phase: a peak in 1956, and a trough in 1969.

This phasing is of considerable importance to economic policy. During the 1960s the effect of the downswing phase was to absorb inflationary tax effects, but an upswing must be expected to persist through the 1970s, and this will add to the effect of tax increases and subtract from tax cuts.

It necessarily follows that if the net pay has a stationary secular trend, then in the long run of a full cyclical period, a rising trend of total *labour cost* must be directly attributable to rising *employment impact taxes*. In the shorter run this relationship between labour cost and employment impact taxes will be modified or obscured by the phases of the net pay cycle.

When the economic upper limit to taxation is exceeded, it is inevitable for some part of any increase in the tax revenue to be derived from employment impact taxes and, as is confirmed by statistical analysis, this will result in a rise of labour cost.

In 1938, when UK tax revenue was just within the economic upper limit, employment impact taxes were the equivalent of 12 per cent of the national income. In 1974, with tax revenue at 44 per cent of the national income, employment impact taxes on the same basis had risen to 27 per cent. Expressed as a percentage of the national income, 75 per cent of the additional tax revenue raised between 1938 and 1974 was derived from employment impact taxes, thus directly inflating labour cost.

Gross pay re-evaluated

It is common practice to treat *wages and salaries* (see glossary) as synonymous with labour cost. This practice is sanctioned by long established concepts of economic theory. But, as is apparent from Chart IV, these two aggregates are no longer the same and the tendency is for them to diverge, with the ever increasing burden of employment taxes levied directly on employers.

Taxes that are popularly supposed to be paid by employees, such as social security contributions and PAYE, are in fact paid by their employers onto whom they are shifted as wage and salary increases. When formulating their employment or counter-inflation policies, governments must allow for projected changes in this form of taxation otherwise results will differ from expectations.

During the sixties some 75 per cent of the rise in labour cost is accounted for by increased social security contributions and SET (Selective Employment Tax). SET has been abolished but the relief to employers has been virtually wiped out by the increases in their contribution to social security.

From 1948 to 1974 changes of wages and salaries were of equal importance to changes in *employment impact taxes* (see glossary) in determining the level of labour cost, but the growing burden of employers' social security contributions has been reducing the relative importance of wages and salaries. This calls into question the efficacy of a government incomes policy which is not backed by an appropriate tax policy.

The measure of a 'successful' incomes policy is the extent to which labour cost is restricted by holding down wages and salaries so that employers can afford to employ. But holding down wages and salaries cannot have the desired effect on labour cost if at the same time extra taxes, such as social security contributions, are piled upon employers, as is persistently happening.

It follows inevitably that, if government policy requires the restriction of wages and salaries, the effective method to achieve this is by cutting taxes, namely, reducing employee social security contributions, PAYE, and indirect taxes on consumer expenditure.

In a roundabout way the TUC are wiser than the government in this matter. The TUC keep stressing the importance of retail prices to wage restraint: they recognise net pay as a determining factor for money wages.

For a short period it may be possible for an incomes policy to restrict wages and salaries and it is argued that the 1973 policy was 'successful' in this sense. Certainly, as is shown on Chart IV, net pay fell in 1973, contrary to the expected trend. An alternative hypothesis consistent with monetary theory is that this fall was the result of an unanticipated acceleration of the inflation rate.

However, irrespective of what may be argued for 1973, over the full term of the last Conservative government net pay rose whilst both labour cost and wages and salaries fell. This result must be attributed to cuts in employment impact taxes, and not to incomes policy. Statistical evidence leaves little room for reasonable doubt that taking two or three years together domestic forces generated by the net pay cycle and tax changes will prevail over any British incomes policy yet devised.

In his April Budget speech Mr Healey said it was important "to relate our tax policy in the coming year to the next policy for incomes." But this statement cannot be taken as an indication that the importance of employment impact taxes in determining gross incomes and costs is beginning to penetrate the fastnesses of the Treasury.

In return for TUC assent to limiting pay demands, Mr Healey offered to cut income taxes. As this offer was conditional it is clear the direct link between changes in wages and salaries and changes in taxation is not appreciated; neither is the direction of causation between the two properly understood.

The net pay 'catalyst'

The Chancellor of the Exchequer is wholly wrong on at least two counts. Firstly, he believes tax policy is dependent on incomes policy. It works the other way round. Secondly, he believes he can regulate net pay through changes in taxes that have an impact on wages and salaries. Experience does not support such a belief. He can only affect *take home pay* in this way. There is no significant covariance between changes in employment impact taxes and net pay but there is a significant covariance between changes in these taxes and wages and salaries (5, 7, 8).

At this time to restrict the rise in money wages and salaries by cutting income tax, as Mr Healey wishes to do, it is necessary to start by cutting tax sufficiently to offset the upswing of the net pay cycle (Chart IV) plus any other increases in employment impact taxes. Subsequent agreement on limiting pay demands will make the pay policy more effective and open discussion on this is to be welcomed.

But a freely elected government must seek the cooperation of the majority of the electorate, not merely minority pressure groups from both sides of industry.

IV

Taxes and Unemployment

When the economic upper limit to taxation is exceeded, increased employment impact taxes inflate labour cost, thus leading to more unemployment. Labour cost is the effective overall demand price for labour and, consistent with economic theory, a change in price must be expected to lead to a change in demand. This relationship is shown on Chart V. Since the change in the effective price of labour precedes the change in demand by five quarters, it follows that the level of taxes fixed by Parliament in one year determines next year's unemployment rate.

Employment impact taxes have a double action on the volume of employment: firstly by their direct impact upon labour cost, and secondly through the level of labour cost affecting the level of profit. Economic theory describes the demand for employees as a derived demand; that is, employers can only offer employment when they can afford to do so at the current price, and employment impact taxes increase the price. As to post-tax profits, these vary inversely with the total tax revenue, and not merely with profit or corporation tax (5, Ch. VII, pp.32-37).

Thus, a rise in taxation, including employment impact taxes, increases unemployment by raising the demand price of labour, and also by depressing profits. A cut in taxation, including a cut in employment impact taxes, will have the opposite effect.

The lesson of Chart VI

During the period from 1967 to 1973, contrary to much folklore on the subject of Mr Heath's 'U-turn', tax revenue plus borrowing requirement remained a fairly stable proportion of the national income, but there was an upsurge in unemployment.

On becoming Chancellor of the Exchequer during the late 1960s, Mr Jenkins increased overall taxation sufficient to cover the borrowing requirement and to produce a surplus. After a time lag unemployment rose. On taking office in July 1970, Mr Barber cut taxation and, after a time lag, unemployment fell. Apparently it is not possible to cover by taxation the current volume of public authority spending without causing substantial unemployment.

Equally, the experience of the last two years confirms that a massive borrowing requirement does not necessarily result in job security. The process is illustrated on Chart VI. It is an irony of politics that the unemployment peak resulting from the actions of Mr Jenkins occurred during Mr Barber's tenure as Chancellor, whilst Mr Barber's tax cuts provided Mr Healey with a relatively low unemployment figure during his first twelve months.

It appears that tax changes are now of far greater importance in determining the level of unemployment than total public authority spending as measured by tax revenue plus borrowing requirement.

The level of taxation is however determined by public authority spending. Borrowing can only put off the day of reckoning for a very limited period.

Those who now use unemployment as a basis of argument for increasing, or at least not reducing, public authority spending are in fact arguing for more unemployment. Those who truly wish to avoid a 'return to the thirties' should be campaigning for spending cuts combined with tax cuts.

A permanent expansion of the volume of employment will only follow a steady reduction of labour cost. A reduction in labour cost means tax cuts. The level of taxation can only be permanently reduced if public authority spending is cut.

V

Taxes and Output

That which affects employment also affects output, for to a very large extent one is a reflection of the other. If firms are to expand or even to maintain output, they must be competitive, and to keep their competitive edge they must also keep abreast of technological advance. For this they need profits. When tax depresses profits so that they are insufficient to finance the necessary new investment, firms lose their competitive edge, stagnate, then contract. Britain's position has already deteriorated far beyond this point.

Since the beginning of 1975 the aggregate net profits of private sector companies have barely been sufficient to cover their capital consumption. This means that many companies are suffering real losses, a condition which cannot persist for long. Even with the public sector the extent and time for which its losses can be borne by the rest of the economic community is very strictly limited.

Unequal burdens

A serious problem with most macro-economic analysis is that it treats economic forces as though they operated uniformly at every location. In the real world the intensity with which employment impact taxes act to inflate labour cost and to depress profit varies significantly from industry to industry and from place to place.

Generally, the incidence of employment impact taxes is greater on most service and basic industries as their labour cost tends to be relatively high in relation to net value-added. This is one of the factors underlying the persistent post-war difficulties of British Rail and the Post Office. It is also one of the factors which is now making it increasingly difficult for small independent retailers to compete against self-service multiples.

Customers may well be prepared to pay a reasonable price for service but with employment impact taxes equivalent to an average 60 per cent VAT applied to net pay, the price differential is out of all proportion to the service that can be offered.

The geographical dispersion of economic activity results in a tendency for labour cost as a proportion of net value-added to vary inversely with economic potential (5). That is, labour cost tends to be higher as a proportion of net value-added in the development areas than in the more prosperous parts of the country.

It follows that an increase in employment impact taxes hits the development areas harder than, say, the South East of England, exaggerating into a major problem what may perhaps be relatively small differences. Attempts to correct the imbalance by subsidies or grants tend to make matters worse (9).

More public spending must lead to higher taxation; higher tax levels will further exaggerate regional differences, thus creating an apparent need for yet more subsidies. In this way, the economy is planned firmly on a spiral to disaster.

Small firms squeezed

Small businesses are particularly vulnerable. Clearly, in any region of the country a small local retailer will be operating from a site of relatively low economic potential. Part of the service being offered is that it is local and not in the High Street. However, the financial resources of the public giants enable them to outbid the small firms for those sites which are the optimum for their trade and industry. Thus small businesses either from their nature or as a consequence of the concentration of economic and financial power tend to be located where employment impact taxes hit hardest.

When it comes to government handouts, again the small firm tends to be at the back of the queue or left out altogether. In many cases government orders impose a minimum limit to qualify for assistance, which they are unable to meet.

With a big firm many hundreds, or even thousands, of jobs will be at stake, and statistically it is a significant unit. In aggregate, there may be many more jobs at stake in small firms, but they are spread out, and not likely all to collapse simultaneously. In a slow trickle of failures they are not seen to be statistically significant.

Again, a large firm is better able to bring its case to prominence and it is much easier for the government to negotiate and supervise an agreement. When a multi-national is concerned, even Ministers of the Crown become involved in details of private business.

The squeezing out of small businesses is however of particular importance to the British economy at this time. If deceleration of the inflation rate is to continue without precipitating an economic depression, then British firms must be enterprising, vigorous, and above all else flexible. As inflation decelerates markets change and firms must react swiftly to these changes if they are to remain in profitable production.

The qualities now required in the economic community are precisely those natural to the small firm, and a multitude of small firms may provide more output and more employment than one large and inflexible multi-national.

A significant reduction of employment impact taxes, which may be partly offset by a reduction in the handouts mainly benefiting the big firms, would resuscitate the small firms; true entrepreneurs who thrive in competitive conditions presented by ever-changing markets.

Thus, not only does consistently exceeding the upper limit to taxation restrict output, but it does so in a particularly damaging and unequal way. The less prosperous regions suffer the greatest restriction and inevitably decline. In the more prosperous regions, the forces of macro-concentration eventually lead to congestion, slowing down of output, and reduced quality of life.

Smaller businesses and the financially weak tend to be the first and hardest hit; the concentration of economic power is cultivated at the expense of independence; and further consequences follow.

In turn our balance of international trade is upset. British export capacity has always depended upon the productive power and keen competitiveness of the regions, coupled with the flexibility, and the specialist qualities, of a multitude of relatively small units. When these decline, exports also decline.

In the end no one gains; for inequalities are exaggerated as the country as a whole becomes poorer.

VI

The Monetary Arguments

Clark's predictions, made before the sequence of post-war events, fit the British experience too well to be ignored. His concepts also shed considerable light on the implications for the British economy of the counter-revolution in monetary theory. Those who now lay claim to the Keynesian tradition should pay heed to Keynes' views on all these matters.

An important distinction

In the monetary debate much confusion results from a failure to distinguish between the proximate cause of inflation and its primal causes. Professor Friedman's conclusion that "inflation is always and everywhere a monetary phenomenon" relates to the proximate cause. Indeed in the same paragraph Friedman writes: "There are many possible reasons for monetary growth" (10, p.24), which is to admit that the primal causes of inflation are many, and may vary from economy to economy and from time to time. There may be occasions when monetary growth is both the primal and proximate cause of inflation but this is not the British case at the present time.

In this country the primal cause of inflation, and of many other social and economic ills, is that tax revenue plus the borrowing requirement has persistently exceeded the economic upper limit to taxation. It is this which has led the authorities to allow the rate of increase of the money supply to exceed the rate of growth of real economic output.

The distinction between primal and proximate causes makes it clear that 'British Disease' cannot be cured simply by restricting the money supply, or raising taxes further to cover the borrowing requirement.

Such policies, on their own, may well result in a deceleration of the inflation rate, but this deceleration will be achieved only by intensifying other evils and creating new ones. The last state would be worse than the first, which is an all-too-frequent outcome of British economic policies.

The argument that fiscal policy is not important for inflation (10, p.24) is only valid in a free society when the economic upper limit to taxation is not being exceeded. If government spending breaks that limit then the choices are a fully controlled economy, or a reduction of public authority spending in relation to output, or inflation, to which will be added other evils. Successive British governments have tried to compromise with a little inflation and a little more control, but the attempt has failed.

Where a government is dependent for its continuance in office upon a freely elected parliamentary majority, then fiscal policy is of vital importance for inflation. The first discipline imposed on governments is to keep their spending within the bounds set by the economic upper limit to taxation; monetary discipline is effective only to the extent fiscal discipline is accepted. When governments ignore discipline they do so at their peril, and worse, they endanger the very fabric of the free society they were elected to govern.

The accusers confuse

To advocate acceptance of economic discipline by government and society is often construed as wishing to perpetuate injustices, such as unemployment, poverty, lack of opportunity, privilege, and so on. Nothing could be farther from the truth, for injustices such as these are perpetuated by an unjust society, and acceptance of economic discipline is a necessary pre-condition for a just society.

It is a matter for everyday observation that the non-acceptance of economic discipline allows injustice to continue. As has been argued, the present unemployment rate in Britain, which Ministers of the Crown publicly proclaim to be 'totally unacceptable', has been created in a very large measure by the refusal of these same Ministers to be disciplined in respect of their government spending and tax policies.

In turn, those who, by ignoring fiscal discipline, have created unemployment now accuse those who advocate the acceptance of monetary discipline of being insensitive to unemployment. Thus, injustices are perpetuated by confusing the issues to an electorate who eventually have to bear the burden.

Unemployment by statute

The propositions of the counter-revolution in monetary theory do not exclude the possibility of full employment without inflation in a free society. What the monetarists do argue, however, is that full employment cannot be sustained in the long run by inflating demand.

They hypothesise that, consistent with stable prices, there is for any economy a minimum sustainable level of unemployment, the so-called 'natural' unemployment rate. Equating full employment with this 'natural' rate of unemployment is a matter of pursuing the right employment policy. Full employment without inflation can be achieved, argue the monetarists, by combining monetary policy with policies directed at reducing the 'natural' unemployment rate, chiefly by improvements in the structure of the labour market.

If monetarists are to be taken to task over unemployment then it should be on the grounds that their use of the term 'natural' is misleading; for they fail to distinguish between the supply price and the demand price of labour, and they fail to appreciate the tax effects on employment opportunities.

By defining the 'natural' unemployment rate as the minimum sustainable rate, excluding tax effects, which is compatible with stable prices, another unemployment rate may be distinguished which is the natural rate including tax effects. This rate may be descriptively termed the 'statutory' unemployment rate, since it is largely determined by the level of taxation agreed by Parliament.

In this country where, in aggregate, taxation now appropriates, after allowing for stock appreciation and for capital consumption, almost the entire home-produced income of private sector firms, and also inflates labour cost by some 60 per cent, it is the statutory rate which is of immediate practical importance to unemployment.

According to the natural unemployment rate hypothesis of the monetarists, unemployment will only fall below the ‘natural’ rate in response to either unanticipated inflation, or an unanticipated acceleration of the inflation rate. Conversely, unemployment will only rise above the ’natural’ rate in response to either unanticipated deflation or an unanticipated deceleration of the inflation rate (11).

Transitional unemployment

To apply this hypothesis to the British economy it is necessary to substitute the statutory unemployment rate for the monetarists’ natural rate. The hypothesis implies that, inevitably, a successful counter-inflationary policy will be accompanied by an immediate upsurge of unemployment; a transitional phenomenon while both jobs and resources are being re-allocated.

If, however, employment impact taxes are increased at the same time, then the statutory unemployment rate will be raised and what began as transitional unemployment will be turned into long-term unemployment.

On the other hand, if employment impact taxes are reduced in conjunction with a counter-inflation policy, then any transitional unemployment will be less and of shorter duration.

VII

The Policies Outlined

Has Britain been chasing a pipe-dream? The answer from the preceding argument is that "full employment in a free society" is attainable, but we have used the wrong methods. Bluntly, the cause of our present troubles is government attempts to avoid economic discipline by compromising, but justice will not be thwarted.

One way or another the price is exacted. It may be possible to have full employment without high inflation by accepting full state control. The price is our freedom.

Alternatively we can achieve full employment without inflation in a free society. The price is acceptance of economic discipline.

What is a pipe-dream, however, is the expectation that we can keep our freedom and enjoy full employment with stable prices in a welfare state which does not accept economic discipline. 'British Disease' is the price of chasing this illusion. It will be cured when we turn away from the chase.

Phase out employment taxes

A pre-condition for full employment (technically, the rate that is defined in this paper as the natural unemployment rate) without inflation in a free society is the full acceptance of both fiscal and monetary discipline. To satisfy this pre-condition, the government must work towards the abolition of all employment impact taxes and taxes having an effective incidence on profit.

It follows that the formal incidence of taxation must be wholly upon, and not exceed, aggregate rent, where aggregate rent is to be understood as aggregate situation rents, as defined (by the present writer) in *Local Government Finance* (9). Individual accruals of taxation must not exceed the particular situation rent on which the tax is assessed. This will provide a 'natural upper limit to taxation' determined by free market prices.

This concept of a 'natural upper limit' bears a relation to, but is distinct from, Clark's 'economic upper limit to taxation', which is a ratio of tax plus borrowing requirement to national income, and is the point at which any additional public authority spending has a statistically measurable effect on prices, labour cost and output.

This first condition is necessary for full employment without inflation since otherwise taxation may inflate labour cost, depress profit, restrict output and create a statutory level of unemployment higher than the natural rate.

Secondly, it is necessary, if the natural unemployment rate is to be sustained without inflation, for government to pursue a policy of balanced budgets, taking one year with another.

If governments do not accept this discipline they will be forced to increase taxation (which will increase unemployment), or to tax by means of inflation, or to borrow.

Should a government persistently resort to borrowing, however, then eventually the cost of servicing government debt will force it to increase taxes, or to tax by means of inflation.

Present the issues

To know our objective is vital, but we must start from where we are. Before effective policies can be implemented, it is necessary for those engaged in public life to stop confusing the issues.

Those who advocate no more than variations on the old themes must be shown to be chasing a will-o-the-wisp, a chase that ends in disaster. It must be seen that the end of the road for those who seek to solve every difficulty by extending the functions of government is a totalitarian state.

Those who advocate more controls, over imports, over prices, over incomes, and so on must come out from their covering labels and admit that their final solution requires giving up our freedom.

Equally, those who profess to be seeking a solution through a free society must admit to the vital necessity of accepting, as a minimum, economic discipline. They can only fulfil their promises to assist the under-privileged by reducing privilege. They must not attempt to cover the reality that the enjoyment of a right depends on the fulfilment of a duty.

In matters of free political choice the British electorate are the most experienced in the world. They may be relied upon to choose wisely provided, as a first step, the issues are presented fully and clearly. The second step is to give the electorate an opportunity to exercise their choice.

Practical policy is the third step along the road to recovery from the ‘British Disease’, but by definition practical policy cannot be decided upon hypothetically. The details must necessarily depend on where we are when making the second step. If, however, the case for a free society is to be put, then the limits within which policy details have to be decided must be made explicit, for they form part of the issues which the electorate have to decide.

The ‘British Miracle’

The magnitude of the task ahead must not be minimised. In the absence of economic growth, public authority spending must now be cut by between 55 to 60 per cent to come within the economic upper limit to taxation. Fortunately, there is plenty of room for growth, as the cumulative effects of economic mismanagement over many years have resulted in the British economy falling well below its output potential.

On the assumption of a 6 per cent annual growth rate and an annual 10 per cent cut in public authority spending, then output potential and the acceptance of both fiscal and monetary discipline would be attainable within the full life of a new Parliament.

The maximum growth rate and the necessary cuts in spending can only be achieved by carefully selected tax cuts. Lower target rates would needlessly extend the time period. Those who would argue on past experience the impossibility of sustaining such a rate of growth must be reminded that it is largely past mismanagement that now makes such a growth rate possible. This consequence of gradually accepting economic discipline only appears 'miraculous' in contrast to the results of the perverseness of post-war British governments.

Others may argue that such a rate of growth is undesirable, and this may be accepted provide it is also accepted that the lower the rate of growth, the greater must be the cuts in public authority spending. Economic growth can ease the process, but it cannot obviate the need for substantial real cuts in government spending.

The cuts in public authority spending will demand reductions in welfare spending and in transfer payments, including the gradual elimination of most subsidies and grants and particularly payments made directly to trade and industry. Some politicians may view these cuts as electoral suicide. Maybe they would be, but in a free society the case must be put to the electorate.

Net pay up by 35 per cent, and full employment?

Spending cuts which may appear to have an adverse effect on the *social wage* must be explained in relation to a 35 per cent increase in the value of *net pay*. In addition to full employment, this is what the achievement of output potential through economic discipline means to employees in a five year period.

To private industry, public economic discipline would mean competitive free markets in which it will be able to earn sufficient for efficiency and new investment without government handouts, which are invariably restrictive.

A further objection, based on past experience, is that economic recovery will have a disastrous effect on our balance of payments.

As output improves, a persistent British problem has been the tendency for imports to grow faster than exports. This is one of the arguments for import controls, but if the objective is a free society it is not to be achieved by bureaucratic licensing. The smallest part of this problem arises from the nature of things.

In Britain we must import raw materials before we can export goods. This is a matter of financing trade, and trade can finance itself provided that the British government are seen to be accepting both fiscal and monetary discipline.

The main difficulty hitherto has been that, as a direct result of government profligacy and interference, British industry has been severely handicapped. Foreign manufactures have been imported because they were more competitive than domestic products, and British exports failed to expand at the required rate because they were not competitive in world markets.

The gradual acceptance of economic discipline will go to the root of the problem by reducing cost and increasing profitability.

Under new conditions, economic expansion will emphasise the propensity to export rather than as now our propensity to import.

Of fundamental importance to a successful third step is the simultaneous reduction of total public authority spending whilst encouraging output. The detail of how this may be done can only be decided in the light of economic conditions at the time.

Certainly it must start with a cut in employment impact taxes sufficient to reduce labour cost and to improve profitability. This must be done at the outset, otherwise spending cuts will precipitate economic depression and resources made idle by those spending cuts will remain idle with British industry unable to compete either at home or abroad.

The tax reductions will have to be of such a nature as to give the maximum boost with the minimum net loss of revenue. The present size of the borrowing requirement leaves almost no margin for error. Any expected net loss of revenue will of necessity have to be offset by savings.

At the time of writing the most effective immediate measure would be to combine cuts in public authority spending with a cut in employers' social security contribution and pro-rata reductions for the self-employed. This would be effective if implemented now, but policy details change with changing conditions; this paper sets out an analysis which offers the possibility of a cure consistent with justice and an extension of freedom.

Ronald Burgess
Economic Study Association
1st May 1976

Postscript

The resolution to be put at the Special Trade Union Conference on June 16th accords with Government policy and is subject to the approval of Parliament. It is this which is of importance, not the precise percentage points limiting future pay demands. However, union leaders are paid to look after the interests of their members, and the government must not trade on party allegiance. Equally, government must not trade on employers' organisations continuing to co-operate with a policy which penalises their members.

This year, as last year, both sides of industry have accepted restrictions, but the time so given must be used to advantage. No good purpose is to be served by employees taking the initiative in accepting a lower standard of living, or by employers forgoing the profit they need for increasing employment and investment, if government indiscipline continues as before. As has been argued in this paper, 'British Disease' is a disease of government, not of the British people.

High unemployment, lack of competitiveness, the weakness of sterling, domestic inflation, all these ills and more, are the direct consequence of penal taxation and astronomic public borrowing necessitated by "public prodigality and misconduct". The country awaits some response from the Government to demonstrate its preparedness to accept economic discipline. The action, not words, is an immediate cut in public authority spending sufficient to allow a reduction in tax and borrowing requirement. Now the vital issue is whether the Government are prepared to play their part to win the confidence of our overseas trading partners and to deserve the support of the whole electorate.

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Charts

Tables

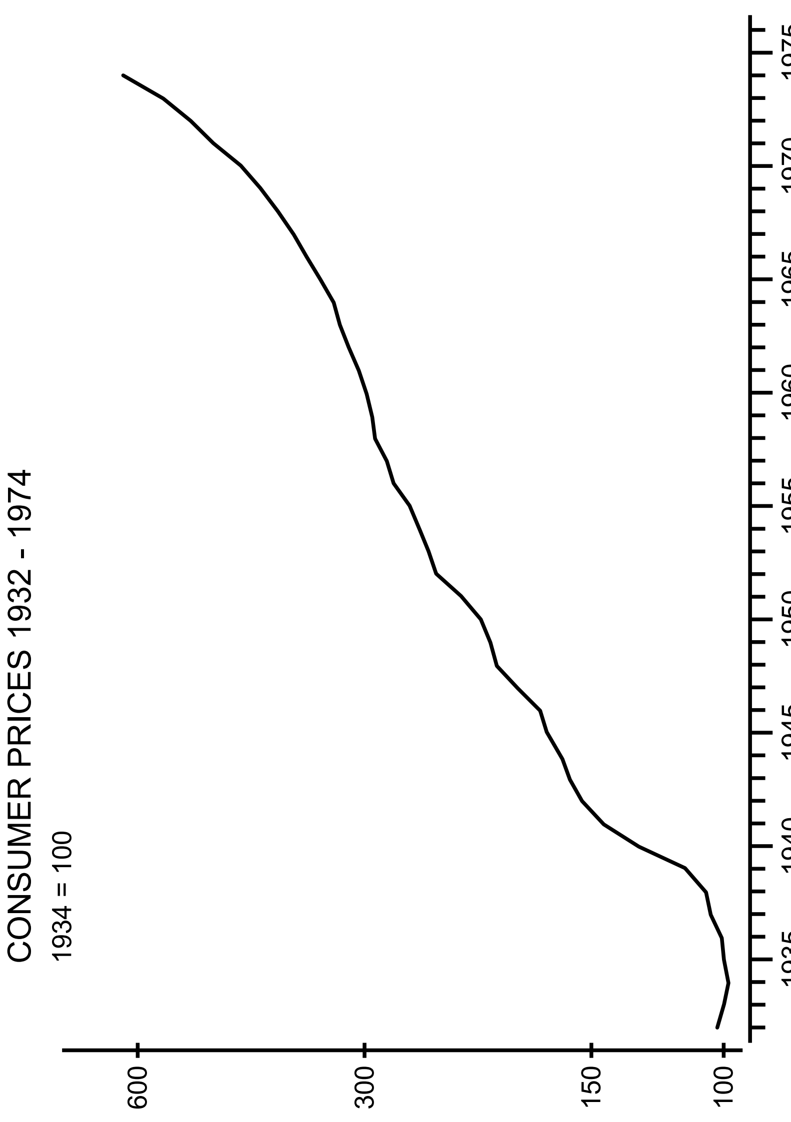
CONSUMER PRICES 1932 - 1974
1934 = 100
600
300
150
100
1935
1940
1945
1950
1955
1960
1965
1970
1975

Chart I

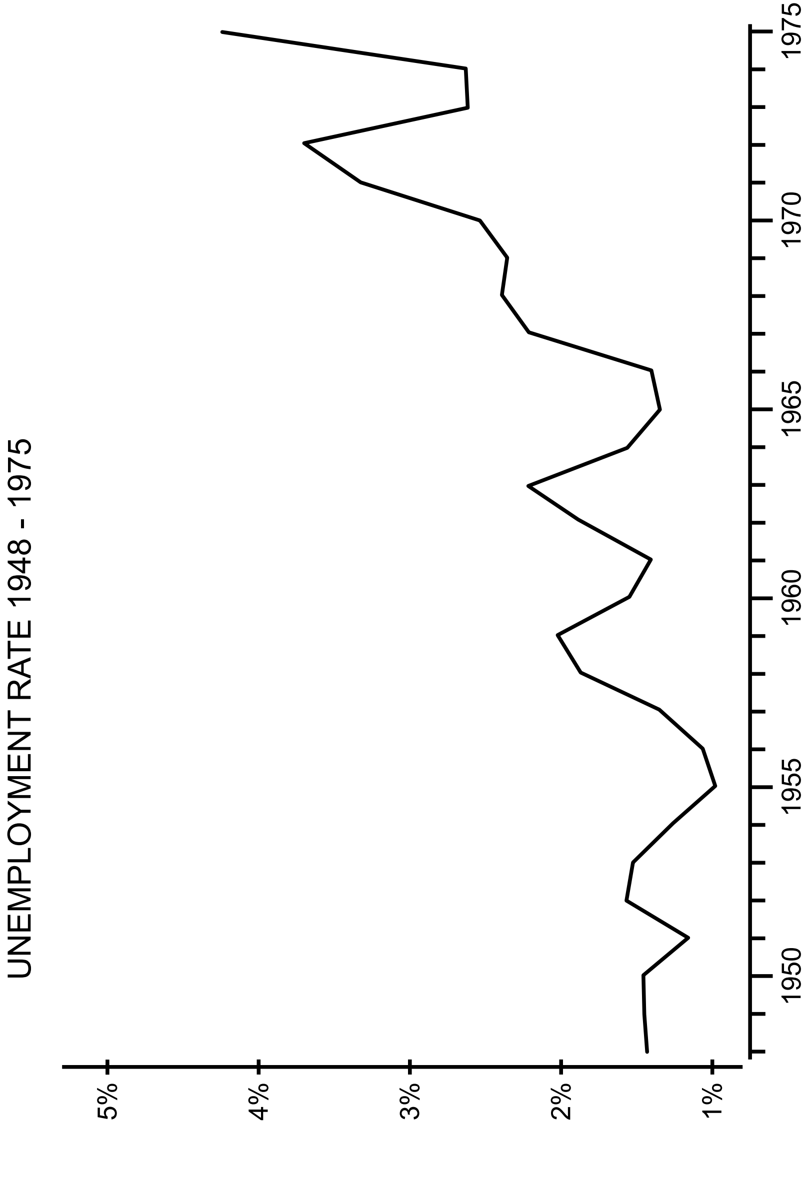
UNEMPLOYMENT RATE 1948 - 1975
5%
4%
3%
2%
1%
1950
1955
1960
1965
1970
1975

Chart II

TAX REVENUE PLUS BORROWING REQUIREMENT

As percentage of National Income, 1955 - 1974

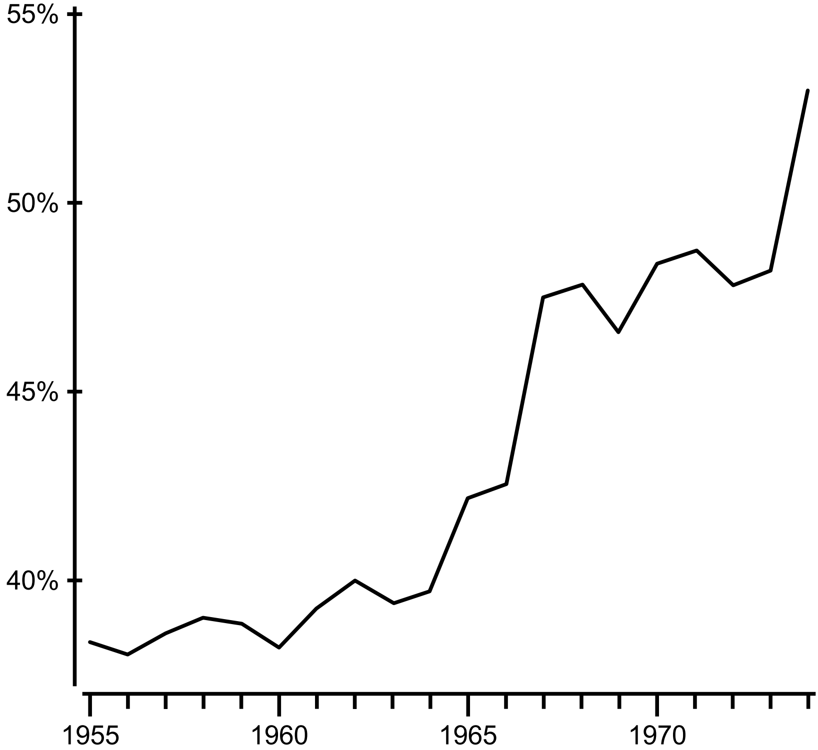

Chart III

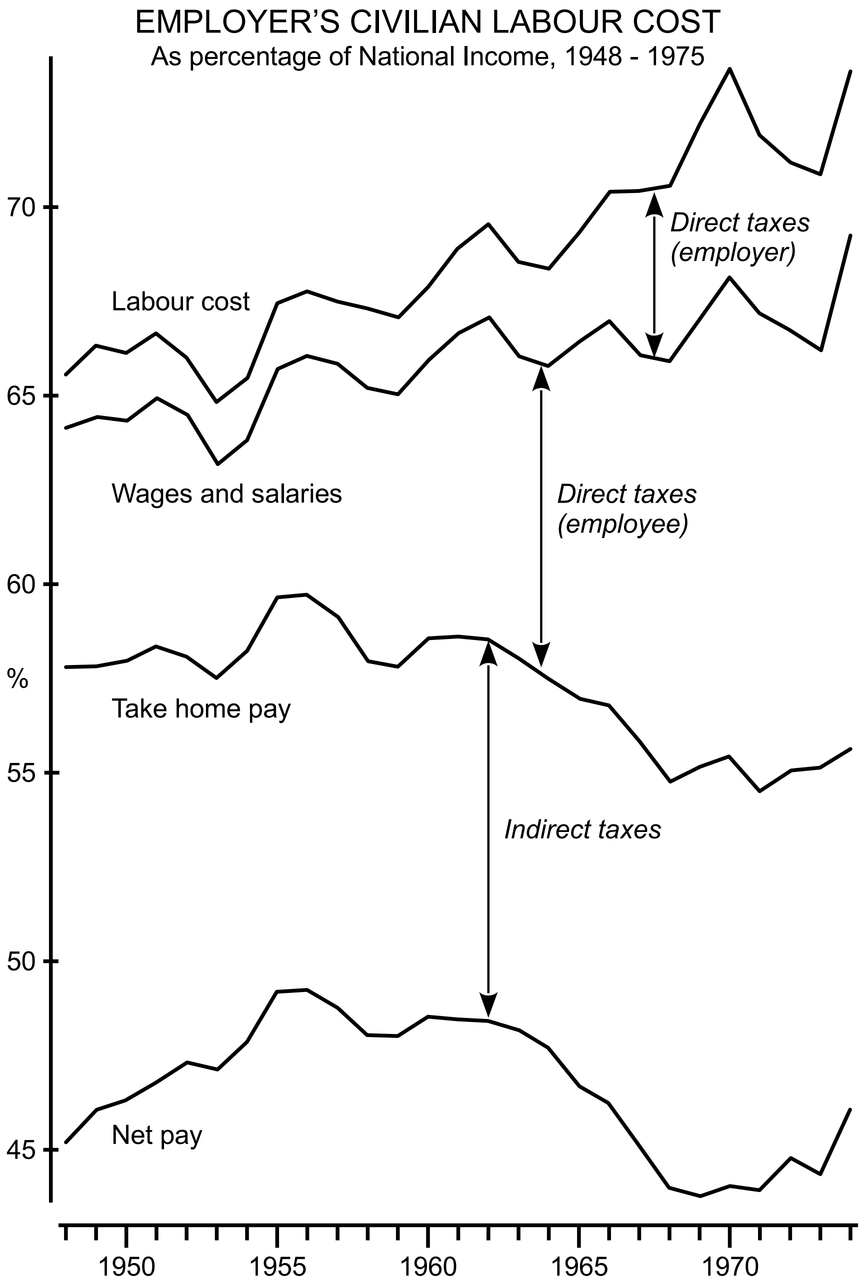
EMPLOYER'S CIVILIAN LABOUR COST
As percentage of National Income, 1948 - 1975
70
65
60
%
55
50
45
Labour cost
Wages and salaries
Take home pay
Net pay
Direct taxes
(employer)
Direct taxes
(employee)
Indirect taxes
1950
1955
1960
1965
1970

Chart IV

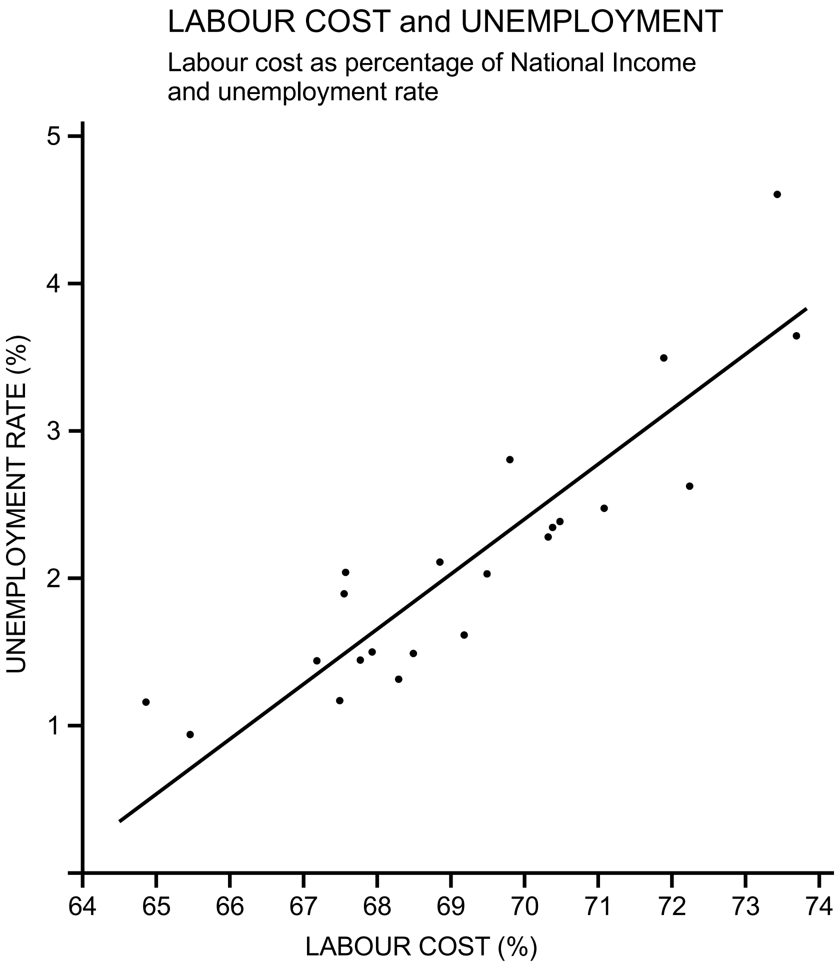
LABOUR COST and UNEMPLOYMENT
Labour cost as percentage of National Income
and unemployment rate
UNEMPLOYMENT RATE (%)
5
4
3
2
1
64
65
66
67
68
69
70
71
72
73
74
LABOUR COST (%)

Chart V

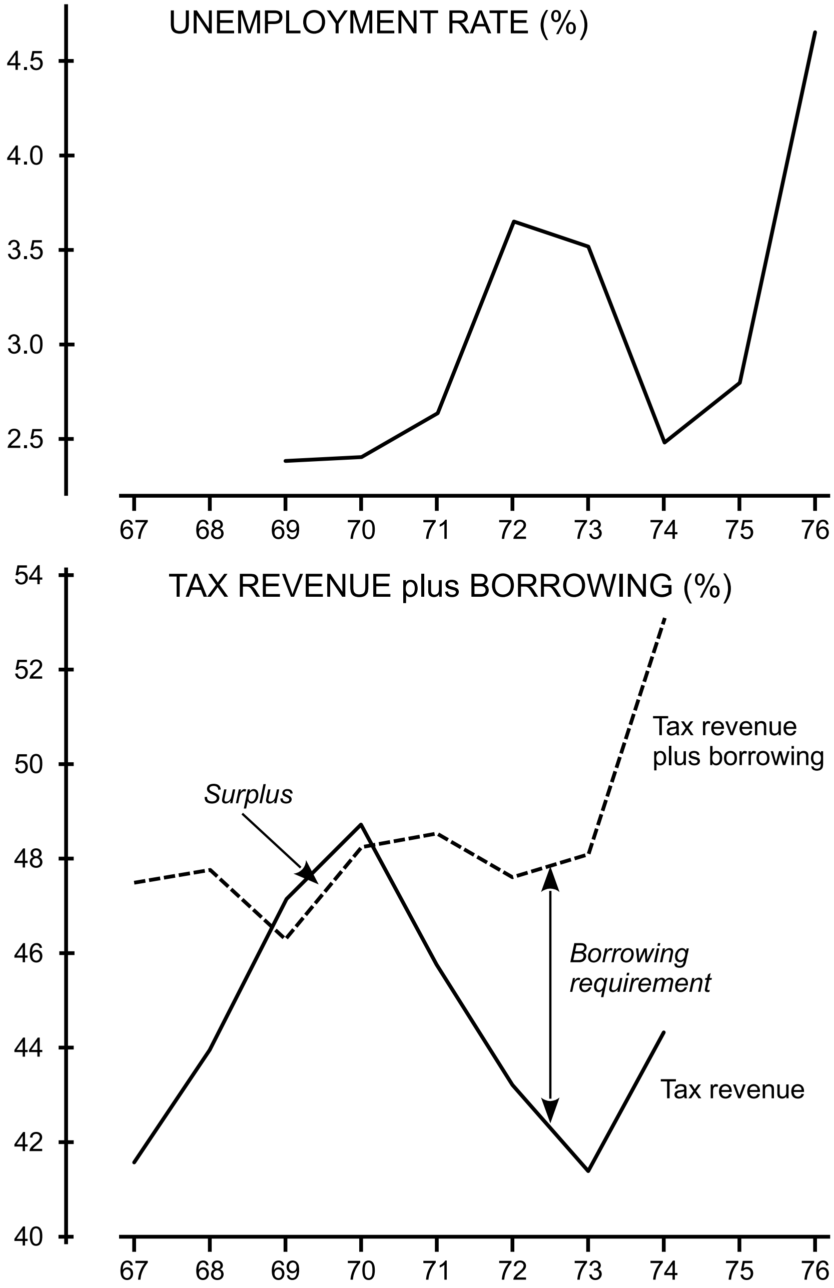
UNEMPLOYMENT RATE (%)
4.5
4.0
3.5
3.0
2.5
67 68 69 70 71 72 73 74 75 76
54
52
50
48
46
44
42
40
TAX REVENUE plus BORROWING (%)
Tax revenue plus borrowing
Surplus
Borrowing requirement
Tax revenue
67 68 69 70 71 72 73 74 75 76

Chart VI

Table 1: Tax revenue plus borrowing requirement (Chart 3).

All figures expressed as a percentage of national income.

Year	Tax revenue	Borrowing requirement	Tax revenue plus borrowing
1955	37.0	1.4	38.4
1956	35.6	2.5	38.1
1957	35.8	2.9	38.7
1958	36.5	2.6	39.1
1959	36.0	2.9	38.9
1960	34.8	3.5	38.3
1961	36.0	3.3	39.3
1962	37.8	2.3	40.1
1963	36.4	3.2	39.6
1964	36.0	3.7	39.7
1965	38.1	4.1	42.2
1966	39.4	3.2	42.6
1967	41.6	5.9	47.5
1968	44.0	3.8	47.8
1969	47.2	– 0.8	46.4
1970	48.7	– 0.4	48.3
1971	45.9	2.9	48.8
1972	43.5	4.3	47.8
1973	41.7	6.5	48.2
1974	44.7	8.6	53.3

Source: National Income and Expenditure ‘Blue Book’.

Table 2: Composition of employers' civilian labour cost (Chart 4).

Employment income expressed as a percentage of national income.

Year	Labour cost	Wages and salaries	Take home pay	Net pay
1948	65.6	64.1	57.8	45.2
1949	66.3	64.4	57.8	46.1
1950	66.1	64.3	57.9	46.4
1951	66.7	65.0	58.3	46.9
1952	66.1	64.5	58.1	47.4
1953	64.8	63.1	57.5	47.2
1954	65.4	63.8	58.1	47.8
1955	67.5	65.8	59.6	49.2
1956	67.8	66.1	59.7	49.3
1957	67.6	65.9	59.2	48.9
1958	67.3	65.2	57.9	48.1
1959	67.1	65.0	57.8	48.1
1960	67.9	66.0	58.5	48.7
1961	68.9	66.7	58.6	48.6
1962	69.5	67.1	58.5	48.5
1963	68.5	66.1	58.0	48.3
1964	68.3	65.8	57.5	47.8
1965	69.2	66.4	57.0	46.8
1966	70.4	67.0	56.8	46.3
1967	70.4	66.0	55.8	45.2
1968	70.5	65.8	54.8	44.1
1969	72.3	67.0	55.2	43.9
1970	73.7	68.1	55.4	44.1
1971	71.9	67.1	54.6	44.0
1972	71.1	66.8	55.0	44.9
1973	69.8	66.1	54.1	44.4
1974	73.5	69.3	55.5	46.1

Source: National Income and Expenditure 'Blue Book'.

Table 3: Composition of employers' civilian labour cost (Chart 4).

Taxation expressed as a percentage of national income.

Year	**Employment impact taxes**	**Direct tax** *Employer*	**Direct tax** *Employee*	**Indirect tax** *Employee*	**Total tax** *Employee*
1948	20.4	1.5	6.2	12.6	18.8
1949	20.2	1.8	6.6	11.7	18.3
1950	19.6	1.8	6.4	11.4	17.8
1951	19.8	1.7	6.8	11.4	18.1
1952	18.7	1.6	6.3	10.8	17.1
1953	17.6	1.7	5.7	10.3	15.9
1954	17.7	1.6	5.7	10.3	16.0
1955	18.3	1.7	6.2	10.4	16.5
1956	18.5	1.7	6.4	10.4	16.7
1957	18.7	1.7	6.7	10.3	17.0
1958	19.2	2.1	7.3	9.8	17.1
1959	19.0	2.1	7.2	9.7	16.9
1960	19.2	2.0	7.5	9.8	17.3
1961	20.3	2.2	8.1	10.0	18.1
1962	21.0	2.3	8.7	10.0	18.7
1963	20.2	2.4	8.1	9.7	17.8
1964	20.6	2.5	8.3	9.8	18.1
1965	22.4	2.8	9.4	10.2	19.6
1966	24.0	3.4	10.2	10.4	20.6
1967	25.2	4.4	10.2	10.6	20.7
1968	26.4	4.7	11.0	10.7	21.7
1969	28.4	5.3	11.8	11.4	23.1
1970	29.6	5.6	12.8	11.3	24.0
1971	27.8	4.8	12.5	10.6	23.1
1972	26.2	4.3	11.8	10.1	21.9
1973	25.5	3.8	12.0	9.7	21.7
1974	27.4	4.2	13.8	9.4	23.2

Source: National Income and Expenditure 'Blue Book'.

Table 4: Labour cost and unemployment (Chart 5).

Demand price of labour as a percentage of national income and 12-month average unemployment rate.

Year	(P) Demand price of labour	Financial year	(U) Unemployment rate (%)
1953	64.85	1954 – 55	1.18
1954	65.44	1955 – 56	0.96
1955	67.50	1956 – 57	1.17
1956	67.80	1957 – 58	1.40
1957	67.59	1958 – 59	2.04
1958	67.29	1959 – 60	1.89
1959	67.09	1960 – 61	1.44
1960	67.94	1961 – 62	1.49
1961	68.86	1962 – 63	2.13
1962	69.49	1963 – 64	2.04
1963	68.52	1964 – 65	1.50
1964	68.33	1965 – 66	1.32
1965	69.20	1966 – 67	1.63
1966	70.35	1967 – 68	2.30
1967	70.39	1968 – 69	2.36
1968	70.49	1969 – 70	2.39
1969	72.25	1970 – 71	2.63
1970	73.69	1981 – 72	3.66
1971	71.88	1992 – 73	3.52
1972	71.12	1903 – 74	2.48
1973	69.85	1974 – 75	2.80
1974	73.47	1975 – 76	4.64

Sources: National Income and Expenditure ‘Blue Book’ and Department of Employment.

The regression equation is:

$$U = -23.37 + 0.37P \quad (\text{where } r^2 = 0.89)$$

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