Public Talks

Towards the Remedy

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Towards ‘The Remedy’

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This year 1986 marks, as many of you will know, the centenary of Henry George’s book *Protection or Free Trade*.

As a Vice-President of The Free Trade League this particular conference is then for me a special occasion, and I deem it an honour to all free traders to have been invited to read a paper.

After a hundred years *Protection or Free Trade* remains a must for all economists and others who are interested in the subject, for in it, Henry George carries the argument through to its logical conclusion – a mark of his genius.

“Free trade”, wrote George, “cannot logically stop with the abolition of customs-houses. It applies as well to domestic as to foreign trade, and in this sense requires the abolition of all internal taxes that fall on buying, selling, transporting or exchanging, on the making of any transaction or the carrying on of any business...”

He went on.

“Trade... is a mode of production, and the freeing of trade is beneficial because it is a freeing of production. For the same reason, therefore, that we ought not to tax anyone for adding to the wealth of a country by bringing valuable things into it, we ought not to tax anyone for adding to the wealth of a country by producing within that country valuable things. Thus the principle of free trade requires that we should not merely abolish all indirect taxes, but we should abolish as well all direct taxes on things that are the produce of labour; that we should, in short, give full play to the natural stimulus to production – the possession and enjoyment of things produced – by imposing no tax whatever upon production, accumulation, or possession of wealth, leaving everyone free to make, exchange, give, spend, or bequeath.”

At the time *Protection or Free Trade* was published, the British economy was no more than a step or so away from what George called ‘true free trade’. Protection had been abandoned, leaving only a few small revenue tariffs. The British people complained of the burden of taxation, as is the prerogative of taxpayers, but total tax revenue appropriated less than an eight per cent slice of the ‘national cake’. About all that was needed to bring about true free trade was the application of ‘The Remedy’ that Henry George had put forward in his earlier work, *Progress and Poverty.*

Today in Great Britain circumstances are very different. We are now fully protected as a member of a continental customs union – a bad arrangement for an off-shore island.

Internally, production and trade are also heavily taxed and extensively regulated. During the one hundred years since Henry George carried his message across the Atlantic, the British tax take has multiplied more than five times so that it appropriates now over 40 per cent of the ‘national cake’.

Even worse is the method used now by central government to raise half of this tax revenue. Henry George argued that all taxes on things produced by labour should be abolished; he did not argue explicitly that taxes on labour itself should be abolished. He did not envisage that a democratic government would be so foolish as even to attempt the imposition of such a tax and if they were so foolish no doubt he assumed that a free electorate would give them short shrift.

Yet in Great Britain the electorate have allowed circumstances to come about in which government raises half its tax revenue from taxes imposed directly on the employment of labour. It is this particular method of tax and its effects that I consider in this paper, for, from this British experience, the Georgists and Free Traders of today can learn an important lesson.

Great Britain, in common with the other western industrialised economies, is a trading economy. This is to say that an output is produced not primarily for the consumption of those directly

engaged in that production process, but for sale and eventual consumption by others.

One may distinguish between two kinds of trading economy. One kind conforms to the second principle of ‘true free trade’ which Henry George formulated as “That each man has an exclusive right to the use and enjoyment of what is produced by his own labour”. In other words, persons who supply the labour to a particular productive process enjoy title to the output of that process. This happens only very rarely in the British economy.

The general case in Great Britain is, as in most other western industrialised economies, that those persons who supply labour to a particular productive enterprise do not enjoy title to the output of that enterprise. It follows, when in a trading economy those persons who supply labour have no title to the output produced by their labour then they have nothing to sell, or trade, but their labour. On the other side, as labour is a necessary factor of production then those who will enjoy title to output must buy in, along with everything else, the labour necessary to produce the output to which they will enjoy title. Thus in this kind of trading economy there arises a labour market in addition to the markets for output. In a labour market those who have nothing to sell but their labour come together with those who must buy labour so that they may have something to sell; and then, these two parties, through the process of bargaining, determine what is, in effect, the market price for labour.

The process of bargaining is the basic mechanism in any market. Any particular exchange is the result of a bargain struck between two contracting parties. In a monetary trading economy the party offering a money sum in return for goods and services is called, by convention, the buyer. The party offering goods and services in return for a money sum is called the seller. The money sum which on an exchange is passed from the buyer to the seller is called the price. But bargaining is not a zero sum game. As Henry

George wrote, “If I did not want the thing I am to get more than the thing I am to give, I would not wish to make the trade”.

Thus as measured by the money sum the price at which any particular bargain may be struck is confined within certain limits. The top limit above which the price cannot rise is determined by the buyer. The buyer will have a certain money sum in mind above which he is not prepared to strike a bargain with a seller for the goods and services offered. The bottom limit below which the price cannot fall is determined by the seller. For the goods and services offered the seller will have in mind a certain money sum below which he is not prepared to strike a bargain with a buyer. It is important to note that for a bargain to be freely struck then the top limit for the price as set by the buyer must exceed the bottom limit for the price as set by the seller and between these limits the price at which the bargain is struck depends on the bargaining skills and bargaining powers of the two parties.

As for markets in general so for the labour market in particular. Employers are buyers of labour and, therefore, for any given amount of labour the cost of that labour cannot rise above the most employers can afford to pay. However, as employers are sellers of output, an employer’s demand for labour is derived from the demand for the output of that labour.

It follows, the most employers can afford to pay for any given amount of labour will be responsive, not to conditions in the labour market, but to conditions in the markets for output. Thus, it is to be expected, the most employers can afford to pay for any given amount of labour, which determines the top limit in the bargaining process, will tend to rise during good times and fall during bad times.

On the other side, once again quoting Henry George, “men who work for wages are not sellers of commodities; they are sellers of labour. They sell labour in order that they may buy commodities”. As sellers in the labour market employees determine the bottom limit in the process of pay bargaining which is the least they are

prepared to accept in return for supplying any given amount of their labour. But how is this least determined?

In the nineteenth century a widely held view was that wages tended towards a subsistence level just sufficient to maintain the so-called labouring classes. In the previous century Adam Smith had come to a different conclusion and one more in line with twentieth century experience. Adam Smith concluded one of the circumstances regulating the money price of labour to be “the price of the necessaries and conveniences of life” – the price of what twentieth century economists call ‘wage goods’; the kind of goods and services that employees purchase out of their take-home pay. Adam Smith observed that what are considered to be “the necessaries and conveniences of life” varied significantly from place to place and from time to time. This also is in line with present day experience. In contemporary western industrialised economies it is not the price of a subsistence allowance of bread or porridge that matters but the price of television sets, videos, cars, holidays abroad and the like.

What in any economy are considered “the necessaries and conveniences of life” seem to be related to the wealthiness of that economy, as Adam Smith acknowledged, or, as Milton Friedman expressed it when formulating his ‘natural unemployment rate hypothesis’, “after subtracting for growth”. Thus, the bottom limit in the process of pay bargaining, the least employees are prepared to accept in return for supplying their labour, takes into account changes in both productivity and prices with the result that it tends to fluctuate around some particular product share sustained by psychological and other barriers which respond only slowly, if at all, to labour market conditions.

Providing there exists a positive gap between the most employers can afford to pay for the amount of labour they demand and the least employees are prepared to accept in return for supplying that amount of labour then it is to be expected that actual pay settlements will be responsive within limits to changing

conditions in the labour market. In good times the most employers can afford to pay will tend to rise, their demand for labour will expand and cause unemployment to fall. All this will shift the balance of bargaining power in the labour market to favour employees and as a result actual pay settlements will tend to rise as unemployment falls. In bad times the most employers can afford to pay will tend to fall, their demand for labour will contract and cause unemployment to rise. All this will shift the balance of bargaining power in the labour market away from employees and as a result actual pay settlements will tend to fall as unemployment rises.

This conclusion is consistent with the conclusion reached by Professor A. W. Phillips in his paper *The Relation Between Unemployment and the Rate of change of Money Wage Rates in the United Kingdom, 1861-1957* which was published in 1958 and gave rise to the so-called Phillips curve hypothesis. Unfortunately for Phillips the stable statistical relationship which he had found to hold for nearly a hundred years previously was found not to hold in the conditions of the second-half of the twentieth century.

Over the years many economists and non-economists have joined the bandwagon slamming Phillips, but Professor Phillips was a competent experienced researcher and his paper was well researched. Admittedly he made some errors, but who does not make mistakes. It was a piece of statistical research and as it is said "a trend is a trend is a trend so long as it does not bend". In this instance the timing of the bend went against Phillips and the vast literature it spawned obscured a matter of importance. Why should a functional relationship which had held for nearly a hundred years suddenly become unstable? What had changed in the British economy?

One change was, as Milton Friedman pointed out, post-war persistent inflation. As prices in general rise then the most employers can afford to pay for any given amount of labour rises. As the price of wage goods rise then the least employees are

prepared to accept in return for supplying any given amount of their labour rises. Thus, not surprisingly, the actual level of nominal pay settlements rises irrespective of the prevailing conditions in the labour market and as this proceeds the precise statistical relationship calculated by Phillips on the basis of nominal pay must break down. But whilst persistent inflation was a factor it was not the only factor in the breakdown of what is called today 'the crude Phillips curve hypothesis'. This label is intended to distinguish the Phillips original from the 'expectations augmented Phillips curve hypothesis' formulated a few years back by Professor Laidler; in the free trade of economists, an export from Manchester University to the University of Western Ontario.

In Great Britain the most important factor causing the failure of the relationship hypothesised by Professor Phillips has been the erosion of the difference between the top and bottom limits in the pay bargaining process, the pay bargain gap, by the imposition of pay-roll and withholding taxes. A pay-roll tax does not affect directly the most employers can afford to pay for the amount of labour they demand but it does reduce directly by the full amount of the tax the most employers can afford to pay employees in return for supplying that amount of labour. On the other side a withholding tax does not affect directly the least an employee is prepared to accept in return for supplying any given amount of labour but in its formal incidence it does reduce directly by the full amount of the tax the sum actually received as take-home pay and this leads to retaliation.

In Great Britain the post-war evidence indicates that retaliation by employees demanding and getting higher gross pay has been successful in shifting withholding taxes on to employers. From a paper published in *The Economic Journal*, based on research done at the University of Calgary, I gather this holds true also for Canada. Recently the Organization for Economic Co-operation and Development admitted net of tax wage bargaining to be common in all OECD countries.

None of this need be a matter of surprise, for the ‘canny Scot’ argued to the same conclusion without statistics or a computer two hundred years ago.

Payroll and withholding taxes, which may be described more accurately as pay bargain taxes, appropriate, one way or another, some part of the pay bargain gap and so leave less room for manoeuvre in the process of pay bargaining. This leads inevitably to worsening industrial relations, more strikes and a loss of output.

Worse, by tending to increase the cost of labour to employers, pay bargain taxes place a premium on labour saving investment and this in turn distorts an economy and destroys jobs. Of course labour saving investment is not always labour saving from the point of view of an economy as a whole. More often than not the result is a transfer from paid labour to unpaid labour.

For example, the British ceased to be a nation of shopkeepers when a Labour government during the sixties imposed a pay-roll tax called the Selective Employment Tax which was intended to increase the cost of labour in the services sector. For once the intention of the administrators was fulfilled. The tax hit small family retailers hard and their trade was taken over by large groups with ample funds available for labour saving investment in self-service supermarkets. From the point of view of the retail trade it was labour saving and brought about measurable improvements in productivity. From the point of view of householders it was quite the reverse. Even after World War II it had been commonplace in Great Britain for a household to place its weekly order for groceries with a shopkeeper and for these then to be delivered to the doorstep by a roundsman or errand boy. Today a householder has to get out the car, drive to the supermarket, have the hassle of finding a parking space, wander round the supermarket and collect the groceries needed from the shelves, queue at the checkout point, load the car, drive back and then unload the car – all very time consuming hard labour. Has the enormous investment in response to the new tax saved labour? I wonder.

Certainly the new tax contracted the sphere open to profitable trade and in so doing destroyed paid jobs. The old success story of errand boy to boss is a possibility no longer, for taxation has knocked out the bottom rungs of the ladder.

All this is only a beginning. When government persist in increasing the amount of pay bargain taxes then eventually taxation appropriates the whole of the pay bargain gap. This appears to have happened in Great Britain already. After the last war pay bargain taxes amounted on average to less than a 10 per cent addition to take-home pay; now, these taxes verge on a 40 per cent addition. This means that for every £1 an employee receives as take-home pay the employer has to pay on average another 40 pence to the taxman. At the margin it is much worse for these pay bargain taxes are progressive. It can happen that for the last £1 an employee receives as take-home pay the employer has to hand over to the taxman more than 90 pence.

As pay bargain taxes begin to appropriate the whole of the pay bargain gap then a fundamental change takes place in the labour market. Once taxation has appropriated the whole of the difference between the most an employer can afford to pay out as labour cost and the least an employee is prepared to accept as take-home pay there is no room left for bargaining manoeuvres.

More, as take-home pay is unresponsive to market conditions when it has been forced down by tax to the least an employee is prepared to accept then, for the employer, the cost of any given amount of labour is fixed, more or less, by the amount of the pay bargain taxes.

With this the labour market ceases to operate as a place where buyers and sellers of labour are brought together to agree a price for labour and begins to operate as if it were a fixed price monopoly market.

The effective price, or cost, of labour to an employer is fixed exogenously; in the case of Great Britain it is fixed by a majority vote in the House of Commons.

When politicians create by means of taxation a fixed price monopoly labour market then both employees and employers find themselves in a take it or leave it position.

However, in a contemporary trading economy the employers can offer employment only when and to the extent it is profitable for them to do so given the current cost of labour. The result of this is that a kind of Phillips curve relationship continues to hold but the direction of causation is reversed. Instead of pay settlements responding to changing conditions in the labour market, as Professor Phillips hypothesised, it is the amount of pay bargain taxes that determines both labour costs and the conditions in the labour market. The post-war evidence from Great Britain shows conclusively that when pay bargain taxes are increased then 12 to 15 months later the rate of unemployment rises and on those rare occasions when pay bargain taxes have been cut then 12 to 15 months later the rate of unemployment falls.

What is the lesson in all this for Georgists and Free Traders in the closing decades of the twentieth century?

Labour is a necessary factor of production; it may not be sufficient but it is necessary, and from this it follows the condition in the labour market is a major factor determining conditions in the markets for outputs. When taxation causes the labour market to operate as if it were a fixed price monopoly market then free trade in the markets for outputs becomes an impossibility.

Today the first step on the road towards ‘true free trade’ is the freeing of the labour market. First things must be tackled first.

Again, when, as is the case in Great Britain, taxation appropriates around 40 per cent of the ‘national cake’ including the whole of the pay bargain gap, so causing millions of unemployed and widespread hardship, then no good purpose is served by proposing what to the general public will appear to be yet another new tax. They will refuse to know. In these circumstances the emphasis must be on the first part of Henry George’s remedy – the abolition of taxation. First things must be tackled first.

In Great Britain, and I can speak now only of that country, the Georgist movement including the Free Trade League is languishing in obscurity. A major reason for this state of affairs lies in a failure to recognise that conditions have changed since the tine Henry George wrote and published.

Nonetheless the works of Henry George continue to provide the clues, for he always followed his arguments through to their logical conclusion; but, his ‘remedy’ is not an immediate cure-all for every economic disease irrespective of the conditions in an economy. George's remedy is not so much a panacea as an objective. An economy may proceed towards an objective only from wherever it happens to be and the British economy is not where it was a hundred years ago.

First things must be tackled first. A man close to death from starvation cannot be saved by the offering of a thick juicy T-bone steak. He needs first some nourishing gruel to build up his strength. Having digested the gruel he will demand the steak.