Inflation and stabilisation

Sound money, practical policy

Ronald Burgess

This is the fifth of a number of articles under the general title, Inflation and Stabilisation, each of which suggests a prognosis and cure for the nation's immediate financial ills. The contributors are drawn from leading economists representing the major schools of economic thought.

Observation shows us a Britain on the brink of economic disaster but as yet with the political parties still clinging to variations of a discredited prices and incomes policy. At one extreme the Liberal Party hold to a complete statutory policy; the official Conservative line takes the middle ground with stated preference for a voluntary policy without ruling out such statutory measures as they might deem necessary in particular circumstances; and on the left the Labour Party keep to their 'social contract' which is a voluntary incomes policy and a statutory prices policy. That such policies should remain dominant after years of complete failure is no mean recommendation for the expertise of the professional convincer; however, advocates of a sound money policy are making a strong challenge and have made important gains during recent months.

The monetarists have much on their side. Firstly since a sound money policy has never really been tried it is not a proven failure; secondly there is an abundance of evidence to support the view that when the rate of increase in the money supply is significantly in excess of the rate of growth of real output then there is inflation. Unfortunately in prevailing British circumstances the monetarists' point of view leads to a policy requiring both tax increases and reductions in public authorities' expenditure. It is admitted this policy would have the immediate effect of restricting trade and industry and of increasing unemployment whilst its expected effect on the rate of inflation may not become apparent until after a time lag of possibly two years. Fear of unemployment has determined British economic policy for over a quarter of a century and experience suggests this fear would translate the current emphasis on gradualism in pursuit of sound money into insignificant action.

To the extent that monetary theory may be subject to empirical tests the results are consistent with the theory, but it appears the theory is only partly right. In particular monetary theory does not take into account all the relevant factors and as a consequence the so-called sound money policy is wrong. In a paper published in 1945 Colin Clark concluded, on the basis of pre-second world war observations, that when tax revenue plus deficit (borrowing requirement) exceeded a certain proportion of the national product then inflation was inevitable. Privately Keynes agreed with Clark and suggested post-war experience would confirm the existence of this critical ratio. In post-war Britain tax revenue plus borrowing requirement has persistently exceeded the critical ratio and post-war experience is consistent with the existence of Clark's empirical law of inflation.

The conclusion to be drawn from observation is: when tax revenue plus borrowing requirement exceeds a certain proportion of the national product then the rate of increase in the money supply will be significantly in excess of the rate of growth of real output. The policy requirements to be deduced from this conclusion include a simultaneous commitment to a reduction in public authorities' expenditure, and an increase in the rate of economic growth. The important lesson to be learned from the empirical law of inflation is that it may not be necessary, irrespective of circumstances, to give absolute priority to reducing the borrowing requirement. Reducing the borrowing requirement by increased taxation will not reduce the aggregate of the borrowing requirement plus tax revenue; indeed, if such action restricted output, inflationary pressures would intensify.

Output depends upon profits and this is true even in an economy where the public sector is as dominant as it is in the United Kingdom today. If profit margins widen then output will rise; if profit margins are removed then output will fall. Today the aggregate post-tax trading profit, after allowing for depreciation and stock appreciation, of firms located in the United Kingdom is non-existent. In the circumstances it is not to be wondered at that output is stagnant if not declining. The easiest, quickest and most effective way to improve output is to restore profit margins, but if sound money is to be the final objective this must be done without increasing the public authorities' expenditure.

An effective sound money policy demands the methods of successive Chancellors – in particular the methods of Mr Barber and Mr Healey – be abandoned. Again observation offers a possible solution. It is to be observed that when tax is increased profit margins narrow and when tax is reduced profit margins widen, therefore reduction in taxation may be expected to increase aggregate net trading profit and from this an improvement in real output will follow. However, in a situation as serious as now exists in this country it is essential to obtain the greatest possible effect from the smallest possible reduction in tax. Further, since the aggregate net trading profit is nil there must be many efficient firms making losses and it is these firms who require the greatest benefit from any possible easing of the tax burden. For example, a reduction in corporation tax will be very welcome to firms currently making profits; such a reduction is of no more than academic interest to firms making actual losses. To be effective any tax reduction must benefit productive enterprises which now find themselves in financial difficulty through no fault of their own.

A political weakness of the sound money policy as advocated by the monetarists is its effect on employment opportunities. The mood of the British electorate appears to be such that any government wishing to remain in power during the second half of the 'seventies is required to keep unemployment down to an acceptable level. It may be argued that the unemployment statistic is a misleading indicator as to the state of the labour market, but even the strongest freely elected government is ultimately subject to the will of the electorate, and the will of the electorate is influenced by the monthly employment returns. Once more observation offers a possible solution without the necessity of straying from the road leading towards the achievement of sound money. Over at least the past twenty years a change in labour cost and net profit margins of employers has been followed over a year later by a change in the demand for employees, a rise in profit margins and a fall in labour costs being associated with an increased demand for employees. Therefore, if labour costs may be reduced without increasing government expenditure, as profit margins may be improved, so it becomes possible to reconcile a politically acceptable level of unemployment with a sound money objective.

The two components making up employers' labour costs are the take-home pay of employees and taxation. The tax component may be further sub-divided into direct income tax on wages and salaries and the employees' and employers' contributions to national health, et cetera. Although income tax is the largest aggregate the national health contributions are the most important since, being a poll tax, these contributions bear most heavily on the lowest paid and on firms located in the less prosperous areas. During the hundred years for which reasonably consistent estimates are available the take-home pay of employees is shown to represent a constant share of the national product. There are, of course, small random fluctuations, and there is some evidence suggesting the existence of a long-term cycle. It follows from this evidence that, taking one year with another, any variation in employer's labour cost must be the direct result of variations in the tax component, an increase in tax component resulting in an increase in labour cost and a decrease in tax component resulting in a decline of labour cost.

A practical view of the present economic situation leads to the conclusion that a reduction in the employers' contribution to a token amount will directly lower labour costs and improve profit margins. Such a measure provides the opportunity for resolving the twin problems of output and unemployment without increasing public authorities' expenditure; indeed it would provide immediate opportunities for some reductions. With an improvement in the rate of growth of real output and some reduction in public expenditure the critical ratio of tax revenue plus borrowing requirement to the national product would begin to fall sharply. In these new conditions the implementation of a sound money policy becomes possible without restricting trade and industry or increasing unemployment.

The net loss of revenue over the first full year of the proposed measure is about the same as the expected cost of the food subsidies which were introduced this year but without the *ad infinitum* escalation in cost. The initial net loss of revenue could be fully recoverable by savings in expenditure within eighteen months. Over 40 per cent of the employers' contributions are already paid by the government either directly as employers or by way of grants and subsidies to public corporations and local authorities. The loss from private sector contributions would be partly offset by the increased yield of corporation tax, a reduction in payments for unemployment, and by a cut in REP. Since the greatest benefits would accrue to those firms making losses and others located in the less prosperous areas the increases in REP and other government expenditures recently proposed by Mr Healey cease to be necessary.

Observation shows the road back from the brink rink of economic disaster to be long and hard but it also shows that it does not traverse the north face of the Eiger. The empirical law of inflation will not be ignored and is poised to exact just retribution but if we choose it offers a solution to our economic difficulties.

Ronald Burgess has been Director of the Economic Study Association since its incorporation in 1966 and has published Enquiry into Prices and Incomes (1968), Local Government Finance (1970) *and* Fanfare to Action – Income Distribution as a Cause of Inflation (1973)

Editor's note:

Anthony Barber served as Chancellor of the Exchequer in the Conservative government of Edward Heath. After the election of a minority Labour government in February 1974, and again in October 1974, Barber was replaced by Denis Healey. The Selective Employment Tax (SET) was introduced as a weekly payroll tax in August 1966 with the intention that services should subsidise manufacturing in the depressed regions. It was withdrawn in April 1973 but the associated Regional Employment Premium (REP) continued until 1976. Food subsidies on milk, butter, bread, cheese, flour and tea were introduced under the Prices Act of March 1974 at a cost of £400 million per year, with the aim of protecting poorer households from the effects of increasing price inflation. The annual rate of inflation rose to 16%.

Ronald Burgess was invited to write this article for *The Spectator* magazine's special budget issue. It was published on 16th November 1974, shortly after Chancellor Denis Healey's budget of 12th November 1974.

The contributors to the series of six articles on *Inflation and Stabilisation* were:

19th October	Prof. Joan Robinson	A neoKeynesian view
26th October	Dr. Michael Jefferson	Less intervention, please!
2nd November	Prof. Alan Walters	Moderation in monetarism
9th November	Prof. Sir James Ball	Bowing before the storm
16th November	Ronald Burgess	Sound money, practical policy
23rd November	Prof. R. C. Bellan	Would Keynes be a Keynesian?