VI. The Unemployment Controversy

A. The Problem

Wants are limitless, production is limited only by labor, thus labor is implicitly scarce. Why is there unemployment?

B. Productionist/Classical Economics' Answer*

1. Inappropriate relationship between prices and wages on the one side and quantity of money and volume of spending on the other—especially in depression context.

2. Inflation—artificial money creation—raises V, sets stage for later drop in V and reduction in M, too. When this happens, spending drops, including spending for labor. Unemployment develops. (Review the discussion in Chapter 12 of how more rapid increases in the quantity of money operate to raise the velocity of money, which then must drop back when the increases stop, moderate, or perhaps merely fail to accelerate. Also the discussion of the deflationary potential in a fractional reserve banking system.)

3. Unemployment, which usually comes into existence on a large scale in just this way, could be eliminated by a drop in wage rates and prices. The lesser spending could buy all that the previously greater spending bought if prices and wage rates were lower. The wage-level formula together with the price-level formula show this. For the wage-level formula, see *Capitalism*, p. 581.

4. For ease of analysis, we assume full vertical integration—e.g., that GM owns its own steel mills, iron mines, etc., etc., and similarly for all other companies. Thus wages appear as the only cost of production and consumer demand as the only sales revenue. For purposes of illustration and ease of arithmetic, assume that initially the demands for goods and labor both fall by 10 percent, creating 10 percent unemployment. Full employment and full production could be restored at the reduced levels of spending, if wages and prices fell by 10 percent.

   a. The same aggregate money demand for labor can be stretched to pay an indefinitely larger number of workers at inversely proportionate wage rates. (See *Capitalism*, Figure 13–4, p. 581.)
   b. Further: the fall in wage rates and rise in employment reduces prices—output is expanded and prices fall as the result of the larger supply; also the larger supply is produced at lower unit costs because of the fall in wage rates. Thus prices fall both because of more supply and lower production costs.

5. Major implications

   a. Average business profitability is not reduced by virtue of the fall in prices, since it is preceded by a fall in unit costs to the same extent. Roughly speaking, total business profits equal the demand for consumers' goods minus the demand for labor. If these demands are stable at the lower levels, then total profits are not affected by changes in employment and output and wages and prices.
   b. If the productivity of labor (the output per unit of labor) stays the same, average *real* wages also do not fall, and, indeed, actually *increase*, because prices fall as much as wages, and the burden of supporting the unemployed is eliminated. (Note: this refers to *average* real wages, not real wages in each and every case.)
   c. Sequence is: lower wage rates permit more employment, by stretching the ability of the same total payrolls to employ labor. More employment means more production and lower prices. Profitability is not re-

* The consumptionist/Keynesian side of the unemployment controversy will be dealt with in depth in Week 12. Those interested in an immediate account can consult *Capitalism*, Chapter 18.

duced because unit costs are cut to the same extent as prices. Real wages are not reduced because prices fall and the burden of supporting the unemployed is eliminated.

6. Freedom of competition and the pursuit of self-interest by the unemployed and by employers would achieve these results by driving down wage rates.

7. The obstacles to full employment—government intervention to keep up wage rates, forcibly prevent individuals from acting for their self-interests.

a. Minimum wage and prounion legislation.
b. Easy relief and employer altruism.
c. Government pressure—Pres. Hoover's White House Conferences in the 1929 depression.

A Problem to Test Your Understanding

Assume that total spending for consumers' goods and labor in the economic system both fall by 20 percent from 2000 and 1800 monetary units respectively.

1. If wage rates and prices stay the same, how much unemployment will be created in percentage terms?

2. How much must wage rates and prices fall to restore full employment?

3. Assuming that total business profits equal the demand for consumers' goods minus the demand for labor, what is the magnitude of total business profits:

a. Before the fall in total spending?
b. After the fall in total spending but before the fall in wage rates and prices?
c. After the fall in wage rates and prices?

4. If the productivity of labor remains the same, and during the period of unemployment the average worker was contributing ten percent of his salary for the support of the unemployed, what is the effect on average real wages of the fall in money wages and prices?

Answers: 1) 20%; 2) 20%, 3a) 200, 3b) 160, 3c) 160, 4) they rise in the ratio of 10/9

C. Unemployment and the 1929 Depression

The result of preceding inflation and a fractional reserve banking system. Deepened by government intervention preventing wage rates from falling, which caused a further contraction in investment spending, and thus in business sales revenues and the ability to repay debts. Decline in the quantity of money by more than one-fourth.

D. Unemployment, the New Deal and World War II

1. Throughout the middle and late '30s, the quantity of money and volume of spending in the economic system were stepped up by the adoption of Keynesian policies, and yet unemployment remained a massive problem, because growing labor union power raised wages almost as fast, with the result that growing payrolls were not able to employ correspondingly larger quantities of labor.

2. And much of the additional employment that did take place was in the form of government employment, of a make-work variety, and actually caused a drop in the standard of living of those who already were employed, since they had to produce the goods and services which the government workers consumed, and received no comparable output in return.

3. Full employment was achieved only with the coming of World War II—not because war is necessary to full employment, but because the war was financed by massive inflation of the money supply *coupled with wage and price controls.* This combination generated sharply rising payrolls and spending of all types, and wage rates and prices were prohibited from keeping pace. The result was rapidly growing quantities demanded of everything, and the emergence of shortages, including a labor shortage. The full employment of World War II was accompanied by a sharp *decline* in the standard of living of the average person, who had to work longer and harder and who got much less in the way of goods for his efforts.

4. Full employment *with prosperity* was achieved only *after* World War II, as the result of the massive reduction in the size of government spending and deficits (from 1945 to 1946, Federal Government spending fell from approximately $93 billion to approximately $45 billion and the deficit was virtually eliminated). The prosperity resulted from the release of funds from the government back to the citizens, the corresponding massive transfer of productive capacity from producing for the war effort to civilian production, and the transfer of roughly twelve million government workers (most of the army and navy) back to private employment. The citizens now had vastly greater control of their own incomes and previously unproductive labor was now available for production. The abolition of price and wage controls and the ending of large-scale inflation also played a major role in the return to prosperity.

E. A Rational Full Employment Policy

A policy that would actually achieve full employment and would do so with growing benefit to everyone, would be the establishment of a free labor market, so that wage rates would free to adjust to changes in the demand and supply of labor, and a 100-percent-reserve gold standard, so that the spending for labor would not be subject to sudden sharp contractions.

F. More on Why Real Wage Rates Need Not Fall in Achieving Full Employment

Analysis of arguments claiming that a fall in money wages would be accompanied by some fall in real wages as well. Diminishing returns and the need for profit recovery. The elimination of the burden of supporting the unemployed and the basis for believing that the productivity of labor rises with recovery from mass unemployment.

VII. The Productivity Theory of Wages

A. An Alternative to the Exploitation Theory

1. Plausibility of exploitation theory based on ideas of worker need and employer greed—both irrelevant: the cases of the used car and the art auction

2. Labor useful and scarce—money wage rates fall no lower than corresponds to full employment point (occupation by occupation, place by place). Any further fall is against the self-interests of the employers. For then the scarcity of labor is felt. (See *Capitalism*, pp. 613–618, especially Figures 14–1, 14–2, and 14–3 on pp. 615 and 616.)

3. Such a drop in wage rates (to the full employment point) doesn't mean subsistence by the back door—the elimination of unemployment that the fall in wage rates brings about means more production and a fall in costs of production. Both mean lower prices. Real wages actually rise with the elimination of unemployment: not only lower prices corresponding to the lower wages, but also the elimination of the burden of supporting the unemployed—thus take home pay drops less than prices. (Recall discussion of elimination of unemployment.)

B. The Productivity Theory of Wages

1. Real wages depend on the productivity of labor—the output per worker.

2. Demonstration of how productivity works—go to page 3A

Some Problems

These are problems to test your understanding of the above. (Answers can be arrived at by following out the analysis in *Capitalism.* They are also given below, so that you can check your own against them and then go back and figure out why a discrepancy, if any, exists.)

1. Assume that the quantity of money, the aggregate monetary demands for consumers' goods and labor, and the supply of labor all remain the same, while the productivity of labor and thus the supply of consumers' goods double.

a. What is the change in the general consumer price level?

4. Real wages depend on the productivity of labor—the output per worker. Demonstration of how productivity works:

$$\text{Average money wage rate} = \frac{\textit{Demand} \text{ for } \textit{Labor} \ (D_L)}{\textit{Supply of Labor Employed} \ (S_L)}$$

$$\text{General consumer price level} = \frac{\textit{Demand} \text{ for } \textit{Consumers' Goods} \ (D_C)}{\textit{Supply of Consumers' Goods Sold} \ (S_C)}$$

a. Money supply (and thus monetary demands for labor and goods) constant, population constant, productivity of labor rising.
b. Money supply and thus monetary demands rising, population and productivity constant.
c. Money supply and productivity rising, population constant.
d. Money supply and productivity constant, population rising.
e. Money supply constant, productivity and population rising.
f. Money supply, productivity, and population rising.

5. An algebraic demonstration of the role of productivity in determining real wage rates:

Where
W = the average money wage rate
P = the general consumer price level
D_L = the aggregate demand for labor (total business payrolls)
D_C = the aggregate demand for consumers's goods (total expenditure to buy consumers' goods)
S_L = the supply of labor employed
S_C = the supply of consumers' goods sold
then

1. The average real wage (what the worker's money wages actually buy) = $\frac{W}{P}$

2. $W = \frac{D_L}{S_L}$

3. $P = \frac{D_C}{S_C}$

By substituting equations 2 and 3 into equation 1, we obtain

4. The average real wage = $\frac{D_L}{S_L} \div \frac{D_C}{S_C}$

By following the rule of inverting and then multiplying with the second fraction, we obtain

5. $\frac{D_L}{S_L} \times \frac{S_C}{D_C}$

Finally, by changing the order of multiplication, we obtain

6. $\frac{D_L}{D_C} \times \frac{S_C}{S_L}$

The supply of consumers' goods relative to the supply of labor reflects the productivity of labor. The demand for labor relative to the demand for consumers' goods can be called the "distribution" factor. It represents the extent to which wage payments are the source of consumption expenditure versus other sources of consumption expenditure, such as dividends. Return to page 3.

b. What is the change in average money wage rates?
c. What is the change in average real wage rates?

2. Assume that the quantity of money and thus the aggregate monetary demands for consumers' goods and labor both double, while the supply of labor, the productivity of labor, and the supply of consumers' goods all remain the same.

a. What is the change in the general consumer price level?
b. What is the change in average money wage rates?
c. What is the change in average real wage rates?

3. Assume that the quantity of money, the aggregate monetary demands for consumers goods and labor, and the productivity of labor and supply of consumers' goods all double, while the supply of labor remains the same.

a. What is the change in the general consumer price level?
b. What is the change in average money wage rates?
c. What is the change in average real wage rates?

4. Assume that the quantity of money, the aggregate monetary demands for consumers' goods and labor, the productivity of labor, and the supply of labor all double.

a. What is the change in the general consumer price level?
b. What is the change in average money wage rates?
c. What is the change in average real wage rates?

5. What factor in the problems determines the change, if any, in average real wage rates?

6. What factors in the same problems determine the change, if any, in average money wage rates?

7. What factors in the above sets of problems determine the change, if any, in the general consumer price level?

[Answers to questions 1-7: 1a. halves, 1b. none, 1c. doubles; 2a. doubles, 2b. doubles, 2c. none; 3a. none, 3b. doubles, 3c. doubles; 4a. halves, 4b. none, 4c. doubles; 5. The productivity of labor. 6. Demand for and supply of labor. 7. Demand for and supply of consumers' goods]

C. The Productivity of Labor and Capitalism

1. Dependence of real wages on the economic degree of capitalism—i.e., the higher is productive expenditure relative to sales revenues, the higher is the demand for labor by business relative to the demand for consumers' goods and the higher is the demand for capital goods relative to the demand for consumers' goods. Thus the higher is the wage share of consumption and the more rapidly rising the productivity of labor (because of the higher capital goods share of total output).

2. The increase in the supply of capital goods and the rise in the productivity of labor also depends on the efficiency of the economic system—the productivity of capital goods. The higher the productivity of capital goods, the lower is the maintenance proportion and thus the more rapid the accumulation of capital for any given higher relative production of capital goods.

3. Both the wage share, the relative production of capital goods, and the productivity of capital goods depend on the security of property and economic freedom—viz., on capitalism.

D. The Productivity Theory of Wages and the Interpretation of Modern Economic History

1. The cause of low real wages and bad conditions in the past.

2. How things improved—rise in the productivity of labor the only possible cause.

3. Uselessness of more money.

4. Virtual uselessness of more monetary demand for labor from any other cause.

5. Uselessness/harm of less supply of labor.

E. The Productivity Theory of Wages and a Critique of the Intellectual Foundations of the Welfare State

1. Uselessness and harm of redistribution

   a. Almost nothing to redistribute
   b. Attempt to seize it cuts production: less saving, incentives, and capital accumulation, lower demand for labor relative to the demand for consumers' goods—the chaos of socialism

2. Labor unions

   a. Artificial wage inequalities if unions limited in ability to raise wages.
   b. Unemployment if raise wage rates through whole system.
   c. Lower productivity of labor because of unions' opposition to labor saving machinery and worker competition, and because of featherbedding practices and misallocation of labor.
   d. The unions' wrong idea of how to raise the standard of living—they seek to raise money wages, when actually the standard of living rises only through improvements in the productivity of labor, which they fight. Money wages, free competition of individuals, and the fallacy of composition.

3. Minimum wage laws

   a. Unemployment, lower skill and lower pay long-term, because the unemployed workers don't gain experience.
   b. Preventing the less skilled from competing with the more skilled.

4. Maximum hours and child labor legislation

Forced reduction in amount of labor performed—e.g., D_L divided by $3/4S_L$ results in $3/4S_C$ and $4/3P$ (because D_C divided by $3/4S_C = 4/3P$). Even if weekly money income the same, there is a loss in real terms. If workers work less, get less.

5. Forced improvements in working conditions (the kind that don't pay for themselves)

   Forced improvements in conditions equivalent to forced wage increase: result is unemployment and higher prices; workers who keep jobs lose, because while prices go up, their take home pay the same (in addition, they must support the unemployed); if unemployment is to be avoided, the take home wages must drop to offset the rise in the cost of the improvements. Either way, they are at the expense of the workers, who can't afford them.