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Policy and Poverty, Part 3

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First Draft

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Policy and Poverty (Part 111)

by

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VI The Feedbacks from Sustained Tight Full Employment

The general success of Keynesian economic policy during the eight Kennedy-Johnson years is not to be doubted even though the last period, which is perhaps of greatest interest, might be classified as a "classical" war rather than a "Keynesian" innovative period in economic policy. The validity of an employment strategy as the rock upon which a serious anti-poverty war is to be based is clear from the experience of the past four years. In effect during these years a poorly designed employment policy was associated with a sharp decrease in the population in poverty.

The employment policy was poorly designed from the point of view of a campaign to eliminate poverty. It was not directed at the poor but rather at a perceived generalized deficiency in aggregate demand. During this period, the available socially and politically approved spending was heavily biased toward military spending (the war in Vietnam was helpful), which in an age of research directly benefits the well-to-do. Furthermore the tax relief granted during this period in order to sustain demand benefited property owners and other high incomes. The employment strategy was implemented by trickle-down tactics.

Nevertheless, even though the target of spending was not the poor, the very fact that tight labor markets were attained and sustained for many months has resulted in an improvement in the lot of the poor. If tight labor markets were continued, a further increase in the proportion of the population in the pool of experienced workers could be expected to take place. Sustaining tight full employment is necessary to hold the gains that have been made as well as to make further gains possible. Are there any fundamental and strong forces in a capitalist economy which tend to make the sustaining of full employment politically unpopular, unproductive in reducing poverty, or very difficult?

The answer to the question is that there are. "Inflation", especially if it is accelerating, decreases the political popularity of full employment. A rise in the relative wages of urban civic employees (teachers, policemen, firemen, etc.) may, given the limited fiscal power of urban governments, lead to a deterioration of the income provided through public goods. In addition, the upward instability of investment demand combined with the financial repercussions of an investment boom may make it very difficult to sustain full employment.

A. Inflation:

Milton Friedman and some of his disciples have taken to characterizing the decrease in unemployment rates in the recent past as "inflation induced" decreases in unemployment. This terminology runs counter to the Phillips' curve language, popular in this country following a terrific performance put on by Samuelson and Solow at the annual meetings of the Economists in December, 1960, 1/ which

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1/ Paul A. Samuelson and Robert N. Solow, "Analytical Aspects of Anti-Inflation Policy". American Economic Review, May, 1960 pp/ 177-194.

associates the rate of change in money wages with the unemployment rate. The rate of change in money prices is less than the rate of change in money wages because of productivity increases. Thus in the Samuelson-Solow-Phillips model a tightening of labor markets is associated with rising prices and wages, but as wages rise faster than prices, the real wage increases. In this world the previously employed and the newly employed both benefit--in fact, as the differential between the rate at which wages and prices change is often assumed to be an invariant, reflecting productivity changes, the improvement of the continuously employed worker's lot is independent of the unemployment rate. Thus as it costs the previously employed workers nothing, they might as well accept the decrease in unemployment. It is a world of "social harmony".

The Friedman world is not a world of social harmony--class conflicts can rage. An excess of aggregate demand over aggregate supply (the excessive aggregate demand is due to too large a rate of growth in the money supply) raises prices relative to wages. This lowers the real wage of workers and as a result employment increases. The rise in prices in excess of the rise in wages lowers the real income of the previously employed workers, making them worse off; the workers moving from being unemployed to being employed are better off. Thus in the Friedmanite world, the profit taker, who gains from rising prices, and the poor benefit from tight labor markets, the regularly employed worker loses.

It seems as if the Friedmanite picture had some validity in 1968. The previous year or so had seen industrial workers' wage rates lag a bit behind price increases. Thus resentment at the state of the world which was improving the lot of the others at the expense of the steadily employed existed and perhaps found a political expression in Wallace sentiment.

Thus the wage rate increases associated with low unemployment generates inflation view looks upon inflation as socially benign, the inflation induced view of how low unemployment rates are achieved sees inflation as socially corrosive. If benign, low unemployment rates plus inflation can continue indefinitely and need not accelerate; if corrosive, then low unemployment rates cannot continue indefinitely, especially in a non-homogeneous society, and as the losers, or non-gainers, try to maintain or improve their position it might very well accelerate.

Sustained low unemployment rates is an exotic environment; American Capitalism hasn't been in this climate for at least forty years, if ever. The question of whether a given rate of inflation will be associated with a given unemployment rate depends in the Friedmanite view upon whether the productivity of the workers whose employment is induced by inflation is permanently increased. If so, then high employment will no longer depend upon a lowering of real wages through inflation. The "natural" or "non-inflationary" employment level is increased.

In the Phillips' view a similar leavening process would shift the relation between price level increases and employment, so that each unemployment rate is associated with a smaller rise in prices.

If the need for inflation to induce lower unemployment is transitory, then in time the inflation induced decline in income of the prior employed will come to a halt. The period of social conflict between the newly and the steadily employed will be relatively short and perhaps we can afford it. If no such shift occurred, then socially the aggregate demand technique for ending poverty via employment is a blocked path.

B. The Wages of Public Employees

Income includes the services received in kind from the public sector. Most of these services, especially the traditional education, health, recreation and public protection, can be considered to be labor intensive. As was shown earlier, these sections may be both non-progressive and blessed with an income elastic demand. Thus as time goes on the labor supply and the relative burden associated with these sectors may increase. However, there is another important element, quite independent of the progress and demand factors, that will make the costs of public sector output rise relative to the cost of private goods.

The expectation that full employment will be sustained affects the relative attractiveness of different occupations. Highly seasonal and cyclical industries and occupations need to pay a premium in hourly or weekly wages over occupations which are not affected by such fluctuations. This is necessary in order to compensate the workers for the uncertainty they carry.

The expected utility to workers from different occupations for those free to choose among occupations will be equal. But to risk averters the expected utility associated with a fluctuating income is less than the expected utility associated with a stable income with the same expected value. That is, making \$100 a week half the time and \$200 a week the other half of the time yields a smaller expected utility than earning \$150 a week all the time.

The simple expected utility calculus needs to be modified depending upon whether fluctuations in income are associated with leisure as a good and whether fluctuating amounts of leisure per week are preferred or are inferior to an equal average but stable amount of leisure per week. However, the main modification that has to be made is whether the fluctuating pattern is known with certainty (fully anticipated) or conjectural.

We can assume that seasonal patterns of employment are known with well nigh certainty and that cyclical patterns are conjectural. Thus if there were only seasonal (fully anticipated) fluctuations in employment, the average income over a set of seasons of like labor in different occupations would tend to equalize. However, occupations with unanticipated fluctuations in employment, fluctuations that cannot be forecast with certainty,will need to pay a premium income in order to attract a given class of labor: the expected income in the occupations with cyclically fluctuating incomes will need to be greater than the expected income from cyclically stable occupations.

Public service employment is insulated from all but truly major business declines. The hours, wages, and incomes enjoy large protections against cyclical declines in income. Thus, in a world in which cyclical fluctuations in income are important, public employees can be expected to earn less on the average than employees in the cyclically sensitive private sector.

If due to a change in the performance of the economy the expectation that cyclical fluctuations are expected to occur is diminished, then the premium of cyclical over stable incomes will need to decrease. However such an attenuation of the expectations that business depressions will occur takes place only after an extended run of prosperous times. Thus it will be associated with full employment and sectoral excess demand for labor. The adjustment of the two classes of wages to the change in expectations will take place by a rapid increase of public sector wages in order to catch up with private sector wages. There will be an independent impact from full employment expectations tending to make the public sector's costs rise relatively to those in the private sector.

As a result of this phenomenon, a deterioration of the public sector or a sharp rise in costs may be expected to occur after an extended period of full employment. To the extend that the anti-poverty strategy is based upon full employment plus a rise in public goods production, the rise in relative wages of public sector employees as a result of full employment is a barrier that might frustrate the policy goal. However, this barrier depends upon the political and social reaction to higher taxes--and will in part depend upon whether the gains from full employment and the income from improvements in public goods are so shared as to be conducive to an acceptance of higher relative costs.

C. The Financial Barrier to Sustaining Full Employment

The 1960's to date have been a most successful period, if success is measured by the absence of a recession, the growth in real Gross National Product and the reduction in the percentage of the population measured as living in poverty. Aside from the accelerated rise in price level since 1964 (which was coincident with the reduction in the unemployment rate and the proportion of non-whites in poverty), the major flaw of the 1960's is that wants expanded at least as fast as output--especially wants for wars and other public goods--so that a feeling of general impoverishment has accompanied the great enrichment. Obviously the problem of scarcity remains as long as wants are expandable; true affluence will follow upon a restriction of wants.

However, even though wants expand as fast or faster than capacity, it nevertheless is true that much of the observed decline in poverty is the result of the expansion being sustained since 1961. The population in poverty would increase sharply if unemployment rates ever jumped to, say, 6.8% or 8.8% from the 3.6% of 1968. Continued success in reducing poverty depends critically upon sustaining full employment and even making labor markets tighter than they have been to date.

However, it may very well be that sustaining an expansion is inherently impossible in an economy such as the United States. The United States is an intensely financial and basically a highly competitive capitalist economy. The very productivity and responsiveness of output to consumer preferences is due to the way in which investment responds to profit opportunities and the way in which financing for such investment is made available through a flexible financial system. Thus the essential characteristic of American Capitalism is a widespread willingness and ability to engage in speculation.

In a world where the memory of past recessions and depressions persists, a run of very good years will tend to attenuate if not erase such memories. But these memories find their expression in liability structures of firms and preferred asset holdings of both households and financial institutions. An attenuation or erasure of such memories will lead to sharp changes in portfolio preference. These changes have two results, an investment boom and a sharp rise in interest rates as demand for investment and position taking financing increases. The rise in interest rates causes both losses to owners of previously issued long-term debt securities, and a higher ratio of cash payment committments to expected cash receipts by those financing either investment or positions in inherited assets.

The investment boom together with its financial repercussions will initially lead to an accelerating expansion that carries demand beyond full employment demand--which means price level increases. Either because of endogenous limits to how much financing can be extracted from a given financial system or policy actions designed to dampen an inflationary expansion, a break in the explosive expansion will take place. This can lead to a sharp decline in asset values and, following a "liquidity crisis", a sharp reduction in investment demand. A rather serious recession or depression can follow.[1]

In 1966 such a process occurred, leading to a mini-panic (called the crunch) around Labor Day of that year. The serious recession or depression did not occur because fiscal policy stepped in well-nigh immediately with a sharp rise in Vietnam war expenditures. The rise in military expenditures in 1966-67 really is a well-nigh perfect example of how government expenditures should rise to prevent a near crash in the financial sector from accelerating to a full blown panic and to abort a sharp decline in income and employment.

It is also evident from the events of 1966-67 that a well-nigh perfect use of coordinated monetary and fiscal policy can prevent the quite awful consequences of a sharp fall in income from occurring, but only at a price that includes a quite quick

1. The model in which full employment growth cannot be sustained because of financial factors is stated in greater detail in H.P. Minsky, "Private Sector Asset Management and the Effectiveness of Monetary Policy: Theory and Practice", Journal of Finance, May 1967. See also H. P. Minsky, "The Crunch and Its Aftermath", Bankers Magazine, February, March 1968, and "The Crunch of 1966--Model for a New Financial Crisis," Transaction Magazine, March 1968.

recovery of the inflationary pressures. To constrain the explosive tendencies of American capitalism it might very well be true that a more serious set of financial losses and declines in production than occurred on 1966-67 may be needed. This would carry with it a rise in poverty via a rise in unemployment.

Thus it may be true that the explosive forces in American Capitalism make it impossible to sustain extended periods of full employment, such as we have enjoyed in the 1960's. Thus the path to universal affluence through perpetual prosperity may be blocked.

VII Conclusion

By any reasonable view of how fast is fast, the years since 1964 have seen a sharp reduction of the population in measured poverty. This success has been mainly due to the rise in employment--including the armed forces--and little or none of it can be imputed to an improvement in the relative incomes of the low paid employed worker. That is, poverty has been reduced because of a change from unemployment, not because the relative income of those in poverty, even though fully employed during the year, has risen. The industrial wage structure has not changed in the desired way.

It also seems evident that there are sharp limitations on what can be done by transfer payments. In particular the labor force participation and the savings reaction together with the Gross National Product and economic growth targets make it likely that any broad improvement in the transfer payments schemes will be inflated out. Thus if transfer payment schemes are introduced, they should be accompanied with incentives for labor market participation by revising social security, lowering school leaving age, preferential tax treatment of apprentice income and costs, etc. Ever since the Keynesian Revolution, those facets of the welfare system that were in effect introduced to lower labor market participation have been obsolete.

It also seems true that a highly urbanized environment, carrying with it a demand for labor intensive services, may be growth retarding. Thus the possibilities of alleviating poverty or generating equality by biasing the distribution of increments to income may be limited by a slowdown in the rate of growth of income.

If we add to this urbanization phenomenon the impact of the attenuation of uncertainty upon relative wages it seems clear that the cost per unit of publicly supplied "goods and services" as well as the relative quantity of such goods and services in Gross National Product will rise with both economic growth and economic success. The shift in the proportions of public to private output will obviously have an impact upon the willingness of taxpayers to support programs which yield them no obvious or perceived benefits.

It also seems evident that sustained full employment may not affect relative wages in such a manner as to raise low wages relative to high wages: the terms of trade do not seem to move in favor of the low wage earner during sustained prosperity.

The marked decrease in the numbers living in poverty during the 1960's was mainly due to a run of prosperous years. The financial disruption of 1966 and the even tighter financial market conditions of recent months indicates that it may be impossible to sustain tight full employment and economic growth. If this is so, then the goal of eliminating poverty or equalizing income is even more difficult to attain within our institutional structure than the success of the past few years would indicate.

A gimmick or a good idea is not sufficient for successful economic policy. Meaningful economic policy must be consistent with the underlying behavioral rules of the economy. One behavioral rule is that a willingness to pay taxes and support programs that involve taxes depends upon the benefits the tax payer perceives. A welfare program yields little--once true starvation and public begging is eliminated--to all but the most altruistic of taxpayers. Parks, public safety, clean streets, and even the education of others yields perceptable or available benefits to well-nigh all taxpayers. The ability to achieve a radical--or even a modest--income equalization through public expenditures depends upon the public program yielding perceived benefits to those who sacrifice in the form of taxes for the project. If a growth in the public sector can be achieved which yields the equivalent of a $\frac{1}{2}$ percent per year increase in private income to the representative taxpayer (as well as a somewhat larger income equivalent to lower income households), then it is possible that radical income equalization would be acceptable. That is, a work program that yields rapidly rising money income to the additional public employees while it yields perceptable and recognized benefits to others than those employed in the program is a feasible way of equalizing income.

Whether it takes the form of wage subsidies to privately employed workers or government direct demand for labor and supply of particular outputs is not relevant. What is most relevant is that any program of income equalization yield benefits--such as postal services, or even cheap food--to those who pay the taxes. Expensive income equalization programs cannot depend upon altruism--public goods may provide the vehicle by which self interest is consistent with income equalization. Thus,no income equalization program is truly feasible unless it provides for an increase of labor force participation and in output.

Suggestions have been made that the government be the employer of last resort. In any such program the government would presumably set a wage rate at which it is willing to employ all available workers. This wage rate immediately becomes a wage floor for all sectors, hence I labeled an employer of last resort program as a wage support law; the terms upon which the government stands ready to employ all is · analogous to the farm price support programs.

If we look upon wage support as a technique for generating services from the public sector, then there will be benefits to all from the program. If it is possible to constrain the highest wage industries while allowing the wage support level to rise faster than prices, then a wage support law might be able to narrow the range of wages. One of the very high wage industries is contract construction. The government is a major purchaser of the output of contract construction. The government might be able to set a ceiling on how rapidly it will allow such wages to increase. Such a program of restraint in high wages will need to be accompanied by equitable and biting taxation of property and other high incomes.

The urban plight calls for an enlarged public and urban service sector. The needs of wage equalization calls for expanded government employment at improving wages. Such programs could yield visible benefits to the not poor, thus it may be feasible.

Poverty in America will not be eliminated by simple programs which naively assume that all is possible. There is a serious doubt that a program can be devised to overcome or circumvent what are the more obvious barriers to success in such an effort; however without awareness of the barriers it truly would be a fluke if a successful program were devised.