Unemployment solved !

A breakthrough in economic theory

Since the early 1970s Western economies have been plagued by mass unemployment and the threat of inflation. Over the years since then various economists have proposed various possible solutions, but never quite convincing ones. Now there is a novel analysis that means a breakthrough in economic theory. The present author is quite certain that the “missing link in the model” has been found. If true, this analysis offers guidelines for full employment under price stability, just as Western economies enjoyed in the 1950s. The main point is: don’t tax lowly productive labour. Why ? To keep it competitive so that more productive labour will not demand inflationary pay rises.

Though this new analysis is only in the stage of presentation and introduction at the scientific fora, there is no reason to withhold the present rough scetch for a general public.

It is well-recognised these years that Western economies have a problem with jobs with a low level of productivity and thus a low level of market-earned income. The United States tolerate more poverty - the working poor - while Europe sets its minimum wage much higher so that Europa has more unemployment.

This problem with low productivity jobs finds various explanations, notably those of technology, globalisation, and inflexibility - the latter ornate for “welfare state sclerosis”. Policies based on these latter explanations have been enacted for some time now. For quite some time, in fact; while little is being achieved. It is proper that we pose the question: why is it that we don’t achieve much ?

Unemployment obviously has a much longer history than the current problem. Also, the Western track record on unemployment can only be understood when the record on inflation is taken into account too. Economic science has much to say on the complex relationship between inflation and unemployment. Now, we are forced to be brief here. We will concentrate on what is new and on why it is new.

We set out with the empirical evidence since 1950. This track record can be divided in meaningful decades:

- The 1950s had low unemployment and low inflation.
- The 1960s had the threat of unemployment, and governments accommodating inflation in order to actually prevent it.
- The 1970s nevertheless had mass unemployment bursting into the open, and governments accommodating high and accelerating inflation to battle it.
- The 1980s-till-now had governments come down hard on inflation, and accepting high levels of unemployment as the price for stability.

One sees a certain “trade-off” between unemployment and inflation. From the 1950s till the end of the 1980s the common view among economists and policy makers was that the unemployment in the trade-off was “general” unemployment.

Nowadays we tend to link unemployment to lowly productive labour. For us it may be obvious, but compared to the earlier view it is revolutionary that the once-thought-to-be “general” unemployment now turns up as a rather specific type. To make the revolution specific: we will hold that the unemployment in the trade-off has *always* been related to the distribution of productivity across labour.

The crucial insight is that the people who can demand pay rises need not be the people who run the risk of unemployment thereof. High productivity workers run less risk of unemployment and can more easily demand pay rises, while low productivity workers run the larger risk of unemployment. High productivity workers are more versatile and are able to shift the risk of unemployment to the lower income groups. When jobs are scarce, the high productivity workers even crowd out others from the labour market.

Now obviously, when this is new, then it has not been recognised before, and then it has likely been missing in policy. And policy that was based on a wrong analysis, is likely to have been the cause of the very problem that it wanted to solve.

Let us see how it went wrong. Regard the legal minimum wage and note that people are not allowed to work below that minimum. Note too that there *hence* will be no earnings that can be taxed in that range. We can call this range the “tax void” or “tax vacuum”. However, tax statutes are defined in that range anyhow. Tax statutes in that void are actually used to define the gross minimum wage. In Europe, the high gross wage will cause unemployment and its related benefit burden. In the US, the void is reduced a bit by accepting poverty. In common economic terms: tax policy and social-economic policy are badly co-ordinated.

How this has come about is a story of a more technical nature. First note that OECD countries adjust their taxes for inflation. Tax exemption in 1996 will often be close to the inflation-adjusted real value of 1950. On the other hand, research in social psychology shows that subsistence tends to rise with the general level of income, the growth of which consists of inflation and real growth. So there is “differential indexation”. In the 1950s exemption was pretty close to subsistence, so that there was no void to speak of. Since then, exemption has lagged behind the standard of living. The inflation-adjusted subsistence of 1950 may be only a third of 1996 subsistence. When tax exemption lags behind net subsistence, then there is a multiplier effect on gross subsistence, with a fast increase of the tax void.

The alternative and new policy would be to scratch taxes in that void and to allow people to earn their own - decent and untaxed - living. This alternative policy reminds of an old rule. The Dutch economist Cohen Stuart proposed in 1889 to put tax exemption at the level of subsistence. To drive the point home he drafted the following analogy: “A bridge must carry its own weight before it can carry a load.” In 1996 there is the additional argument that abolishing void taxes will not cost anything, and that nations will save benefit payments due to more employment.

More employment.... Does that not fuel inflation ? The pieces of the puzzle fall into their places when the tax void is related to the unemployment & inflation problem. The steady rise of the void explains the track record of unemployment and inflation. The 1950s have been characterized by relatively low taxes on low

income earners, and this allowed for full employment and low inflation. From the 1960s onwards the lagging tax exemption started causing problems with unemployment. The tax policy of the last 35 years enhanced the imbalance of the internal bargaining positions of labour instead of counter-balancing it. Hence inflation was persistent, and high levels of unemployment were required to achieve price stability.

How governments reacted depended upon the view of the day. Since the proper solution was not known, the problem did not go away. The differential indexation of tax exemption and the social minimum did not draw attention to itself. Each year adds only a slight gap which is hard to see. But over the years the gap has accumulated, and with huge consequences. And the problem will remain with us in the future unless policy changes.

Current policy is based upon other explanations. Notably those of technology, globalisation and flexibility. The ineffectiveness of current policy can be explained by the fact that these views are not entirely logical. The arguments of technology, globalisation and flexibility run up against contradictions. Technology is a source of wealth, and it boosts the productivity of the lowly productive jobs, making the problem of poverty and unemployment less serious than it would otherwise have been. “Globalisation” is a scare word for “trade”. Trade however is another source of wealth, and it too has been with us for ages. Rising wealth in distant countries means rising wages over there, and trade itself thus puts limits to foreign competition. Japan over the last 40 years is a prime example of this phenomenon, but every rich nation has had the same experience. Finally the “flexibility” or “welfare state sclerosis” argument can only explain that the US has poverty and Europe unemployment, but it does not explain that there is a problem with low productivity jobs in the first place.

The present situation bears another surprise. We diagnose current unemployment as inefficient. Be sure that you see what inefficiency means: it means that there is a solution that is beneficial to some and that does not hurt others. Having a bright idea always means a “win-win” situation or a free lunch. In this case it is the move to full employment under price stability. The present unemployed will find jobs. The higher productivity group will have a theoretically larger risk of unemployment, but in practice this risk will be modest as in the 1950s. Their real gain will come from the services that will be provided by the jobs of the present unemployed.

Policy makers will be hesitant about an overhaul of the tax system. Note, then, that the tax system defines our notion of a subsidy. A wrongly levied tax, in this case the tax void, can be compensated for by a wage cost subsidy. Abolishing the tax void is more sensible in the long run, but when this can only be done gradually, then some general subsidy directed at lowly productive jobs would speed up short term adjustment. If only those subsidies are reduced when tax exemption rises towards subsistence.

This was it, in a nutshell. Now I beg your understanding. My analysis is more complex than can be stated in these few lines. Both tax policy and social policy are quite complex themselves, and this certainly holds for their interaction with inflation and unemployment. For example, you may ask why I haven’t discussed income redistribution effects. Actually, this is because the alternative policy could

be neutral to the income distribution. The reason for this is that the analysis focusses only on the link between wage costs and productivity. But you might want to hear more about this. Also, you might ask whether above explanation covers all possible cases of unemployment and inflation. Of course it doesn't. The analysis does help to clarify that other types of unemployment need other types of policy, such as education and so on. But you might want to hear more on that too. These are just examples of issues, and there are many more issues that need to be dealt with. Which space forbids. However, given that my model amends existing economic models, much of the required explaining is 'common economics'.

There remains one major point. That tax exemption is low, is defended by OECD governments with the argument that it keeps marginal rates down. And the attractiveness of low marginal rates is that they spur economic activity. My finding however is that the latter claim is only true when the marginal rate has been defined properly. Thus I agree with the claim, but it must concern the proper marginal tax rate. There is a difference between the proper rate, which is dynamic, and the rate used by OECD governments, which is the static and statutory rate. Dynamic analysis shows that the proper marginal rate will be close to the average rate. This part of my analysis is important for economic growth. Having less unemployment will mean lower average taxes, and thus lower proper marginal rates, and thus more incentives for sustainable growth. For many of my fellow economists it is this part of my analysis that will come as the greatest surprise of all. However, this is not an issue that can be settled in this review, and here I definitively have to refer to my extensive analysis.

This novel explanation is in the tradition of Keynes and Tinbergen while it fits in with mainstream economics. When my fellow economist check and confirm these findings, our economies are likely to enter into a new high growth path with full employment and low inflation.

Allow me to add the personal note that I am overjoyed by these findings.

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Consultancy & Econometrics, March 24 1996

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