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Arthur P. Becker

## ***Full Employment Without Inflation***

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Since 1933 persistent and reoccurring unemployment has produced pressure for increased federal spending, resulting in higher taxes, deficits and prices. Government intervention has grown to the point where the public sector now comprises 35 percent of Gross National Product and 40 percent of national income.

Nevertheless, unemployment is worse today than at any time since the Great Depression and inflationary pressures in the past few years have been greater than at any time since World War II. Of course, much of this growth was stimulated for other purposes (such as the development of the Great Society programs) rather than merely for countering persistently high unemployment.

Persistently high unemployment accompanied by even moderate inflation stems from one condition. Our present economic system cannot maintain general equilibrium without motivating full employment through appropriate adjustments in the real income of factors of production.

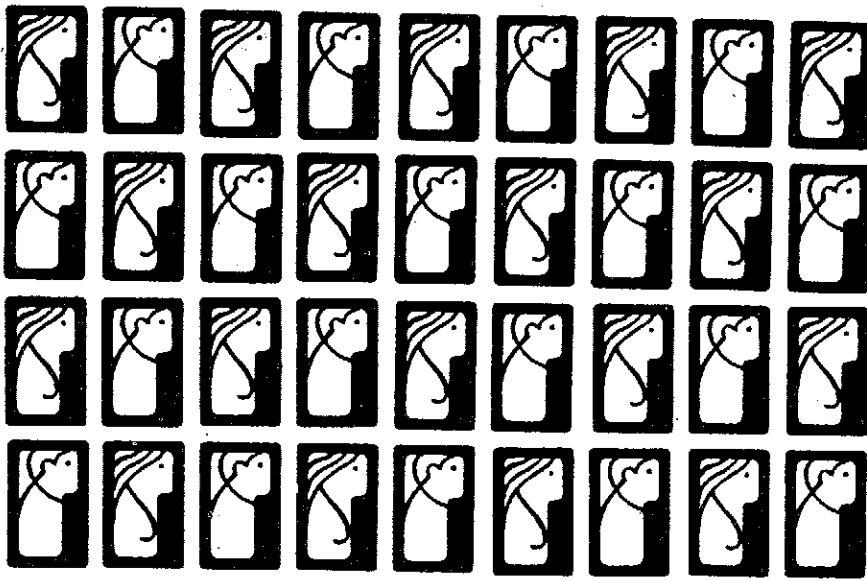
According to Keynesian monetary and fiscal demand management policies, high unemployment should be countered with a combination of such actions as an increase in the total money supply, a reduction in taxes or an increase in government spending through an "appropriate" deficit. This increase in aggregate demand with moderate price increases will supposedly create profit opportunities and incentives for business to borrow at prevailing or lower rates of interest.<sup>1</sup>

However, economic experience during the 1970s has shown that demand management policies are not successful when inflation is substantial and continual. With this kind of inflation lenders will boost interest rates in an effort to protect the purchasing power of the funds they lend. Thus, inflationary expectations induced by commodity shortages or overly expansionary monetary and fiscal policies will make interest rates rise. High interest rates will reduce profit expectations (reflected in the fall of stock prices) and investment incentives.

More specific remedies are needed to deal with the energy crisis, the world food shortage and irresponsible government spending which are largely responsible for the recent siege of inflation and unemployment. Specific remedies are also needed to treat persistent large-scale unemployment which directly or indirectly contributes to much of our

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inflationary pressure. Supply management policies that will increase economic incentives for investment and work are the specific remedies for long-term, and often short-term, unemployment and inflation.

According to modern economic theory, the major purpose of monetary and fiscal policies for demand management is to reduce real wages, thereby increasing profit expectations, production, investment and employment.<sup>2</sup> However, it would be far more equitable to increase expectations in higher real income for investors and workers by reducing the real income of unnecessary and undeserving nonproducers.

In our system of private enterprise, the immediate goal of supply management programs is to provide adequate incentives and opportunities for individuals and businesses to increase production voluntarily by working, saving and investing. This approach toward full employment contrasts with demand management policies which "accept" the weakened condition of incentives and try to revive real investment incentives and job opportunities by means of inflation.

Economic incentive to invest and work and thereby to increase employment and production (which in turn could prevent prices from rising as much) is maximized when all of the national income is channeled into the hands of those who contribute to

production. This does not preclude public sector activities which are supported by the majority of producers, both workers and investors. Unfortunately, the private enterprise system in the United States has suffered an erosion of those very incentives upon which its well-being depends.

The rivulets of erosion of economic incentive are countless. However, it seems that most of the real national income which is drained off to nonproductive individuals can be grouped into the following categories: the economic rent of land, monopoly and the restraint of competition, waste and inefficiency, crime, and transfer payments. These conditions drain the productive vitality of the private enterprise system siphoning off a large portion of the real national income from the potential real wages of workers and potential real profits of investors in capital.<sup>3</sup> Each of these drains, in one way or another, increases costs of production, reduces profits and wages, discourages investment and the desire to work, decreases productivity and increases unemployment and inflation.

While these income drains can more fully account for the endemic unemployment and inflation of our system of private enterprise, they are also at least partially responsible for the acute symptoms of these economic ailments. There seems to be ample evidence that the economic rents and values of land,

monopoly profits, waste, inefficiency and crime increase at faster rates than the Gross National Product during periods of relatively full employment and prosperity. These drains on investment and worker income tend to reduce investment and work incentives to the point where total employment increases very little or not at all, and the rate of unemployment may rise.<sup>4</sup>

What is the nature of these non-productive drains on national income and their macro-economic significance? We should take a closer look at each of these income drains.

#### The Economic Rent or Price of Land

The drain of the economic rent of land is the most pervasive income drain of all. Since land and its services are supplied by nature, the economic rent of land constitutes a surplus payment for production and therefore one variety of nonproductive income. Because all economic activity requires the use of land for space and for other resources as well, the drain imposed by land rents for leasing or land values for purchase is inevitable and enormous, ranging all the way from choice urban land sites to oil lands.

The barriers which this income drain imposes on investment opportunities are largely hidden in debt instruments of vast magnitude and high or prohibitive fixed interest charges. As an example, a young farmer may have to pay \$250,000 for 360 acres of tillable wheat land that can net him an economic rent of \$25,000 per annum. The purchase price would reflect the capitalized value of the economic rent at a rate of 10 percent. Now, our young farmer must pay a 10 percent rate of interest on the \$250,000 mortgage loan to buy the farm land. The net economic rent of land is converted in this manner into a fixed interest obligation.

Higher economic rents of land (net of taxes on the land) caused by general inflation or scarcities of land resources, such as oil, are capitalized into higher market prices. The acquisition of these resources for use will require a larger volume of borrowing and fixed interest

charges. Thus, the marginal efficiency of investment is reduced as the returns to owners of natural resources increase (absolutely and relatively) and are capitalized into higher values. Dollar investments must constantly rise in order to have the same employment effect. Simply maintaining dollar investments will lead to increasing unemployment. In this sense, high speculative land values lower profitable investment opportunities and lead to unemployment.<sup>5</sup>

If land ownership were distributed according to the ownership of capital and if such ownership reflected entrepreneurship, the drain would coincide with the productive contributions of the investor-capitalist. However, the business investor often is neither the owner of land nor capital (real or money) and therefore finds himself exceedingly vulnerable to a decline in gross income. A small decline in gross income may turn the marginal efficiency of investment to negative values and jeopardize the business enterprise and the employment opportunities which it affords. Thus, as the economic rents and prices of land rise to new heights during prosperity and inflation, the marginal efficiency of capital falls and investment and employment opportunities fall along with it.

#### Monopoly and Restraining Competition

The practices of monopoly and restraining competition traditionally have been viewed as problems of equity. The theory of aggregate supply considers them primarily as problems of the inefficient allocation of real income and resources causing the underemployment of labor. Thus, many businesses which dominate their markets, including inadequately regulated public utilities, set their prices and output at levels that maximize profits. On the other hand, if they are faced with competition or adequate regulation, output and employment opportunities would be increased. Similarly, as the bargaining power of labor or minimum wage legislation causes the cost of labor to rise, business usually must either cut back output and employment to maximize

profits (or minimize losses) or substitute capital for labor.

The macro-economic significance of the practices of monopoly and the restraint of competition are already recognized to some extent, inasmuch as they are often cited as the causes of cost-push inflation. Thus, "administering prices" by some business organizations and "collective bargaining" by powerful labor organizations result in price and wage increases that often exceed the annual rate of growth in national productivity. These practices essentially are conducive to greater unemployment, whereas competition and downward flexibility or stability of prices and wages are compatible with full employment.

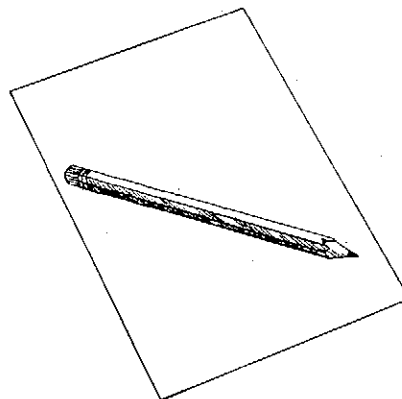
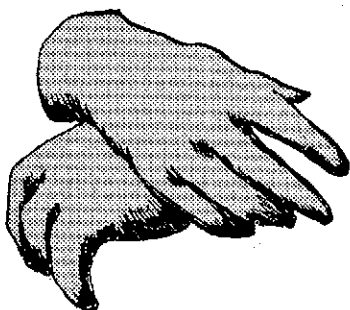
The problem of inefficient allocation of resources and large scale unemployment is influenced by practices that restrain competition other than those directly affecting prices and wages. These practices are too numerous to list completely. However, a few might be mentioned to suggest their scope: dividing markets, allocating products, limiting production, buying up and sitting on patents, and bribery. These merely reveal some of what business can do to restrain competition. Even in the absence of monopoly, many industries are dominated by just a few firms which find ways to cooperate for their mutual advantage against the small independents in each industry.

Occasionally, the bargaining power of labor organizations is too great for

either public or private employers to oppose. This may well be why the wages of some workers, such as those in steel, auto manufacturing, trucking and sanitation, are surprisingly high and constitute compensation that may be in excess of what is necessary to fill these jobs. Moreover, labor organizations, especially those involving some skill and training, not only limit membership but also require membership in order to work for business or government. Labor organizations also establish arbitrary work rules that affect the rate of production and often the quality of the product which may be higher or lower than what the market demands.

Many professional associations clearly engage in restrictive practices. These organizations determine who will be admitted. Qualified men and women who wish to practice a certain craft or profession for a competitive wage are arbitrarily restricted from entering the craft or profession. Thus, these practices increase the real income of members of certain labor organizations and professions and are responsible for the unemployment of those denied entrance to them. Moreover, the aggregate supply of goods and services produced by restricting employment is less.

The role of government in creating and supporting monopoly and in reducing competition is well known. The controls over fares and entry into the transportation industry are good illustrations of excessive interference. When a little regulation is good, it is not



justified to conclude that a lot of regulation is better. A greater degree of competition in trucking, airline passenger service, and even in railroads may be highly desirable from the consumer's viewpoint and poses no threat to the industry as a whole. Yet many transportation firms fear greater competition.

The government may itself provide direct services through a monopoly such as the U.S. Postal Service. Or in a given community there may be little or no alternative to the local public school system. Such government monopolies tend to lead to mediocre service as well as to inefficiency, waste and high costs of providing the service.

Government at all levels exerts a pervasive influence on wages, prices and interest rates. This ranges from minimum wage laws, wages and salaries paid to government workers in comparable jobs with the private sector, and the size of government debt as well as debt management policies. It includes even direct rent controls in New York City. These serve as guidelines or minimums for the private sector and either directly or indirectly affect the taxes and costs of production in the private sector. As these costs are ratcheted upward, the marginal efficiency of capital falls, and with it investment and employment opportunities decline.

#### Waste and Inefficiency

Waste and inefficiency constitute a real income drain to labor and capital

which is often overlooked. For convenience we can separate and trace this drain in both the private and public sectors of the economy. Waste and inefficiency in the private sector may be due to bigness and its inflexibility, lack of capital or incompetent or irresponsible managers and employees. Union work rules and government regulations may reduce productivity or force the hiring or retention of less competent and productive workers.

The tax structure can affect the extent of waste and inefficiency in many ways. For example, taxes based on net income single out those businesses that succeed in producing efficiently, whereas inefficient businesses are exempted. Another tax that is enormously inefficient is the real property tax on improvements. This ad valorem tax increases the cost of additional investment in improvements, lowers investment in improvements and restricts employment opportunities.

Taxes on employment increase labor costs for the employer as well as reduce the real income of the worker. The difference between the wages paid by a business firm and the wages received by employees should be regarded as a disincentive "wedge."<sup>6</sup>

The wedge includes not only payroll taxes but also fringe benefits and costs of complying with government taxes and regulations, since they do not add directly to the productivity of the firm. This growing wedge will cause some employers to go out of business while those remaining will hire fewer workers. Moreover, as the wedge grows the real wages of employees often shrink and the willingness of some to work will be impaired. All of these effects will decrease productivity generally, lower supplies of goods and increase prices.

The Full Employment and Balanced Growth Act of 1976 provides for an increase in the tax wedge during recessions and a decrease in the wedge during prosperity. This policy is just the reverse of what is necessary to increase profitable employment during a recession and curb inflation during full employment.

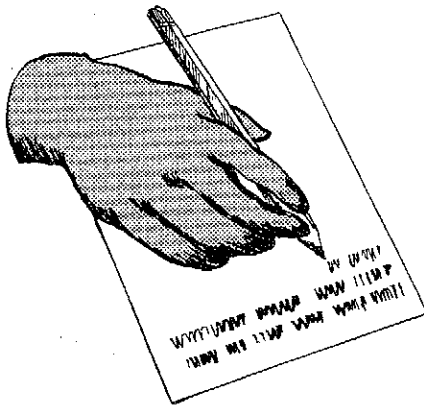
In reality, the act makes the unemployment problem even worse than it is already.

It is a fact that many services rendered by the public sector provide benefits such as lower costs of production and a higher real income equivalent for productive workers, thereby adding to incentives for investment and work. While this may not ease the disincentive for investment and work in a given firm or industry, it would reduce the "gross wedge" to a smaller "net wedge" in the aggregate.

Waste and inefficiency in the public sector is probably greater than in the private sector. This is because there is no profit motive, no market discipline and lessened concern when the enterprise is not managed by the owner. Consequently, employment objectives, productivity standards and rules frequently counteract productive efficiency and conservation, particularly in the amount of labor required to achieve certain tasks.

It is exceedingly difficult, and often impossible to determine voters' true preferences for certain public services and projects. The election of government representatives and administrators all too often is not an expression of the preferences of the electorate, especially when candidates are vague and inconsistent on various expenditure matters. Furthermore, once elected, public officials do not always make a sincere and reasonable effort to sense the dominant and changing preferences of their constituents.

It seems reasonable to believe that the public projects and services actually provided substantially exceed what a majority of the voters actually prefer. Many government projects are approved by clever subterfuge and misinformation or inadequate information. For example, the initial phase of a project is funded frequently without voters or legislators having any estimates of the total cost of the completed project. Some departments may make self-serving benefit-cost studies to justify certain projects of limited value. What is needed is an evaluation by competent



and disinterested analysts outside of government.

### The Costs of Crime

Somehow the macro-economic significance of the costs of crime are disregarded. Yet, the real income drains that these costs place on productive capital and labor exceed those of national defense, according to the estimate of the Joint Economic Committee.<sup>7</sup>

Undoubtedly, many legitimate businesses succumb to the increased cost, taxes, losses, wastes and inefficiencies due to all sorts of crime. White collar crime alone is estimated to cause losses (\$44 billion in 1976) twice as great as that spent on the entire criminal justice system.

The cost of narcotics and other dangerous drugs is approximately equal to that of the criminal justice system, whereas violent crimes (including murder) and crimes against property cost about one half as much. However, when we examine the nature of certain "victimless crimes" such as illegal gambling

and prostitution, we find that a great deal of disagreement exists as to their net cost. The same is true of illegal immigration.

York where benefits are three times larger.<sup>8</sup>

I am not suggesting that all transfer payments and other government activities of little or no productive value should be put to an end. Humane and equity considerations will require substantial expenditures. However, a method of income maintenance must be devised that does not destroy incentives to work.

Transfer payments, subsidies and consumer-type public services affect the willingness of unemployed labor to work. They also affect the willingness of workers to continue their employment since payroll taxes for social security are levied on earnings up to \$16,500 for 1977. These taxes constitute real income drains on all taxpaying workers and owners of capital who employ those workers.

Large real income drains on productive labor and capital arise out of well-meaning government subsidies which are capitalized into higher land values. For example, government payments for producing or not producing

at increasing the real income of producers in the private sector in order to realize higher investment and employment targets. Furthermore, the real income of capital and labor should be achieved by redistributing a portion of the numerous income drains in favor of capital investors and workers without increasing fiscal deficits and monetary expansion.

Tax policies in supply management should establish as a first priority the taxing of the producers' surplus of land, labor and capital. Implementing this goal will require a skillful design. It is not sufficient for total tax burdens to be less than total producers' surplus. Incentives can be impaired if some portions of the supply of labor and capital are taxed in excess of their producers' surplus while other portions of labor and capital are taxed at less than their producers' surplus. If labor and capital are sufficiently mobile these disparities may be overcome in time, otherwise they will persist with the consequences of lower real incomes in the overtaxed areas and industries, as well as lower investment, employment and output.

Expenditure policies in supply management should limit nonproductive public services, i.e., consumer-type services and transfer payments, to the producers' surplus that is taxed. Public expenditures for productive public services may justify taxing the real income of capital and labor beyond their producers' surplus, since such expenditures increase efficiency, lower production costs, increase total output, and thus increase real wages or the marginal efficiency of capital in real terms.

Since the Great Depression of the 1930s and the simultaneous birth of Keynesian economic theories, the nation has been conditioned to believe that only the federal government is capable of coping with the problem of mass unemployment. The expenditures required to raise aggregate demand require fiscal and monetary resources that only the federal government can command. Thus, the very nature and scale of operation required by demand management policies are such that state and

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### Transfer Payments and Subsidies

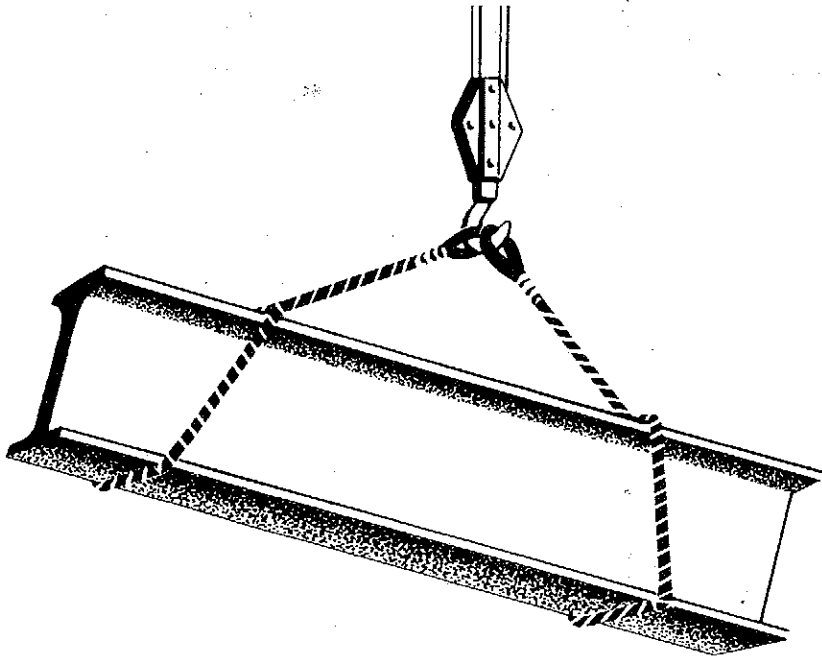
Transfer payments such as unemployment compensation, welfare payments, food stamps, rent subsidies, etc. further serve to solidify the floor to money-wage fixing by contract or law. There is little incentive for many to accept employment at a wage lower than available transfer payments. Moreover, higher welfare and unemployment benefits increase the length of time that recipients remain unemployed. The incentive and success in finding work by unemployed persons is inversely related to the level of welfare and jobless benefits. For example, Texas families remain on welfare for an average of 11 months compared to 34 months in New

certain crops does not help new farmers as much as those who owned the land when the subsidies began. An inevitable result of this practice has been to increase the values and economic rents of farmland dramatically.<sup>9</sup>

The value of farmland has increased to the point where today farm ownership for the new generation is virtually prohibitive, and farm subsidies share a large part of the responsibility for that critical problem. Moreover, there is good reason to believe that much of the benefit of government expenditures on expressways, urban renewal and Medicaid, to name but a few, goes to landowners rather than investors in capital, labor or professional service.

### Supply Management Policies

The brief preceding sketch of a theory of aggregate supply implies that supply management policies should aim



local governments are regarded as impotent bystanders. Citizens feel persuaded, although somewhat reluctantly, to support a highly centralized and powerful federal government.

This theory of aggregate supply should encourage those who have lamented the helplessness of state and local government as well as those who have viewed with grave concern the awesome power that has been assumed by the federal government. As a matter of fact, state and local governments can perform a major role in supply management policies inasmuch as many of these policies fall within their constitutional authority.

Moreover, these governments can take many effective supply management measures that also lie within their financial capacities. Indeed, if properly conceived, supply management policies could place a lesser strain upon the financial capacity of our economy as well as on all levels of government.

It may shock many to realize that state and local governments can assume an important role in macro-economic policy. They are in a key position for initiating a wide variety of policies aimed at reducing nonproductive income drains and increasing the real income of labor and capital. The seriousness and magnitude of real income drains vary among cities and states.

Once these are identified, each city and state can devise its own multi-pronged attack against those drains.

A comprehensive program designed to reduce nonproductive real income drains will require far more than measures in public finance alone. For example, state and local governments can take measures for facilitating the entry of labor and business into existing markets, increasing freedom and flexibility in wage and price competition, and repealing minimum wage laws. The cost of crime can be cut by enacting more effective laws, establishing administrative practices and securing community involvement for crime prevention. Reducing delays in the criminal justice process, increasing certainty and uniformity in penalties for similar offenses, and discouraging the release of habitual criminals back into society may help cut the enormous costs of crime.

A reduction in nonproductive real income drains requires that total expenditures be limited to minimize the taxation of the nonsurplus income of labor and capital, unless the productive benefits of certain expenditures exceed such taxes. This will necessitate a careful review of state and local budgets to reduce waste in capital and operating outlays. Public service and capital expenditures should be made only after careful study and with the support of a

clear and strong majority of the electorate. Serious efforts must be made in improving administrative efficiency and eliminating waste.

Tax measures require that top priority be given to reforming the property tax to reduce or exempt the ad valorem tax on capital and to increase the tax on land values.<sup>10</sup> In addition, as many public services as possible, such as sewer and water services, should be financed by service charges rather than taxes.<sup>11</sup>

If the services are essential, low income families can be assisted with transfer payments. Property tax reform and greater reliance on service charges certainly are not new. However, their significance as important measures for increasing investment, employment and productivity can be accepted with confidence and urgency. ■

1. The lower interest rates are normally expected to occur with government induced increases in the supply of money.
2. William Fellner, "Lessons From the Failure of Demand-Management Policies; A Look at the Theoretical Foundations," *The Journal of Economic Literature*, March 1976, Vol. 14, No. 1, pp. 34-53.
3. Capital is defined here in the traditional economic sense to mean man-made goods intended for further production, thus excluding land and other natural resources.
4. If the work force itself increases as it has during the 1970s, it is possible for both total employment and the rate of unemployment to rise simultaneously.
5. Henry George, *Progress and Poverty*, 1879 (New York: Robert Schalkenbach Foundation, 1942), pp. 263-281.
6. Arthur B. Laffer, "The Iniquitous Wedge," *The Wall Street Journal*, July 28, 1976, editorial page.
7. "The Costly White Collar Mob," *The New York Times*, January 2, 1977, p. 15.
8. June Kronholz, "No Welfare State," *The Wall Street Journal*, November 11, 1976, p. 1.
9. Robert F. Boxley, and William D. Anderson, "The Incidence of Benefits from Commodity Price-Support Programs," *Government Spending and Land Values*, C. Lowell Harriss, Editor, Madison, 1971.
10. Arthur P. Becker, "Arguments for Changing the Real Estate Tax to a Land Value Tax," *Land Value Taxation: Pro and Con*, Arthur P. Becker, C. Lowell Harriss, Manuel Gottlieb and A. H. Schaaf, *Tax Policy*, Princeton, 1970.
11. Werner Z. Hirsch, *The Economics of State and Local Government*, New York, 1970.