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April 30, 2008

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or get rid of capitalism and with it the contradictory nature of capitalist production which produces the business cycle in the first place (not to mention other blights such as hierarchy and inequality). In the end, the only solution to crisis is to get rid of the system which created it by workers seizing their means of production and abolishing the state. When this happens, then production for the profit of the few will be ended and so, too, the contradictions this generates.

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Contents

Are wages really too high? . . . 6
Flexploitation . . . 8
Keynesianism versus Keynes . . . 9
An unscientific science . . . 15
Not-so marginal problems . . . 17
Cutting wages and reality . . . 20
Supply curve issues . . . 21
Unemployment and high wages . . . 25
Economics in more than one lesson . . . 30
What now? . . . 32
Bibliography . . . 34

individual workers and corporate capital. The importance of labour market bargaining power for the distribution of income, means that unions are a fundamental prop for widespread prosperity. Weakening unions does not create a 'natural' market: it just creates a market in which business has the power to dominate labour.

"The notion of perfect natural markets is built on the assumption that market participants have no power. In reality, the process of labour exchange is characterised not only by the presence of power, but also by gross inequality of power. An individual worker is at a great disadvantage in dealing with large corporations that have access to massive pools of capital and can organise in a fashion that renders every individual dispensible … Unions help rectify the imbalance of power in labour markets, and they therefore correct market failure rather than causing it."[31]

Given this, it is understandable why bosses hate unions and any state aid which undermines their economic power. This must be supplemented by community organising to support workplace struggle as well as to resist wage increases in commodities (bosses will try to maintain profits by increasing prices) as well as rent and basic utilities. This is not to suggest that economic struggles are the only focus of struggle, simply that it is difficult to fight against all forms of hierarchy when you are worried about whether you will have enough to eat or a roof over your head. This must be placed in the context of social change, the ending of capitalism and its state and the creation of a free society.

The *"hallmark"* of the neo-liberal age *"is an economic environment that pits citizen against citizen for the benefit of those who own and manage"* a country.[32] Our task is to build a movement rooted in solidarity. So we have two options — accept a deeper depression in order to start the boom-bust cycle again

[31] Palley, pp. 36–7
[32] Palley, p. 203

What now?

To conclude, a cut in wages may deepen any slump, making it deeper and longer than it otherwise would be. Rather than being the solution to unemployment, cutting wages will make it worse. The capitalist solution to crisis is based on working class people paying for capitalism's contradictions. For, according to the mainstream theory, when the production capacity of a good exceeds any reasonable demand for it, the workers must be laid off and/or have their wages cut to make the company profitable again. Meanwhile the company executives — the people responsible for the bad decisions to build lots of factories — continue to collect their fat salaries, bonuses and pensions, and get to stay on to help manage the company through its problems. For, after all, who better, to return a company to profitability than those who in their wisdom ran it into bankruptcy? Strange, though, no matter how high their salaries and bonuses get, managers and executives **never** price **themselves** out of work.

This suggests that the task of anarchists, in the short run, is to encourage attempts to organise unions and resist wage cuts in the workplace as well as taking over closing workplaces and placing them under self-management (if sensible). While "free market" economics protrays unions as a form of market failure, an interference with the natural workings of the market system and recommend that the state should eliminate them or ensure that they are basically powerless to act, this simply does not reflect the real world. Any real economy is marked by the economic power of big business. Unless workers organise then they are in a weak position and will be even more exploited by their economic masters. Left-wing economist Thomas I. Palley presents the correct analysis of working class organisation when he wrote:

"The reality is that unions are a correction of market failure, namely the massive imbalance of power that exists between

The "free market" capitalist argument is that unemployment is caused by the real wage of labour being higher than the market clearing level.

The basic argument is that the market for labour is like any other market and as the price of a commodity increases, the demand for it falls. In terms of labour, high prices (wages) causes lower demand (unemployment). Workers, it is claimed, are more interested in money wages than real wages (which is the amount of goods they can buy with their money wages). This leads them to resist wage cuts even when prices are falling, leading to a rise in their real wages and so they price themselves out of work without realising it. From this analysis comes the argument that if workers were allowed to compete 'freely' among themselves for jobs, real wages would decrease and so unemployment would fall. State intervention (e.g. unemployment benefit, social welfare programmes, legal rights to organise, minimum wage laws, etc.) and labour union activity are, according to this theory, the cause of unemployment, as such intervention and activity forces wages above their market level and so force employers to "let people go." The key to ending unemployment is simple: cut wages.

So wages must be cut as profits provide the motive power for business activity. Yet wage cutting is advocated despite workers not setting interest rates nor making investment decisions. Thus working class people must pay the price of the profit seeking activities of their economic masters who not only profited in good times, but can expect others to pay the price in bad ones. In the current economic climate, it is useful to explain the flaws in the economics which rationalises this position in order to better combat such arguments and present an alternative to bolster our activity.

Are wages really too high?

First, we must question the underlying assumption. On the face of it, arguing that unemployment in America today is caused by wages being too high is hard to support. Its current economic expansion looks like being the first ever in which median household income fails to recover its previous peak. Job growth has been tepid for most of it and the employment-to-population ratio has remained well below its previous peak. This comes on top of three decades of wage stagnation during which household income only grew because of longer working hours and having both household heads work.

Only the late 1990 boom (based on the previous, dot.com, bubble) saw marked improvements for workers. Yet the reality of the much praised American labour market "flexibility" was shown when then head of the US Federal Reserve Alan Greenspan explained in 1997 why unemployment managed to fall below the standard NAIRU rate without inflation increasing:

"Increases in hourly compensation … have continued to fall far short of what they would have been had historical relationships between compensation gains and the degree of labour market tightness held … As I see it, heightened job insecurity explains a significant part of the restraint on compensation and the consequent muted price inflation … The continued reluctance of workers to leave their jobs to seek other employment as the labour market has tightened provides further evidence of such concern, as does the tendency toward longer labour union contracts … The low level of work stoppages of recent years also attests to concern about job security … The continued decline in the share of the private workforce in labour unions has likely made wages more responsive to market forces … Owing in part to the subdued be-

example, unions, by putting purchasing power in the hands of workers, stimulates demand and keeps employment higher than the level it would have been. Moreover, wages are generally spent immediately and completely whilst profits are not. A shift from profits to wages may stimulate the economy since more money is spent but there will be a delayed cut in consumption out of profits. All this should be obvious, as wages (and benefits) may be costs for some firms but they are revenue for even more. Moreover, labour is not like other commodities and reacts in changes in price in different ways.

Given the dynamics of the labour "market" (if such a term makes much sense given its atypical nature), any policies based on applying "economics 101" to it will be doomed to failure. As such, any book entitled **Economics in One Lesson** must be viewed with suspicion unless it admits that what it expounds has little or no bearing to reality and urges the reader to take at least the second lesson. Of course, it is irrelevant that it is much easier to demand that workers' real wages be reduced when you are sitting in a tenured post in academia. True to their ideals and "science", it is refreshing to see how many of these "free market" economists renounce tenure so that their wages can adjust automatically as the market demand for their ideologically charged comments changes.

So when economic theories extol suffering for future benefits, it is always worth asking who suffers, and who benefits. The notion of wage cutting emerges from theoretical claims that price flexibility can restore full employment, and it rests dubious logic, absurd assumptions and on a false analogy comparing the labour market with the market for peanuts. Which, ironically, is appropriate as the logic of the model is that workers will end up working for peanuts!

(or dismiss) the importance of economic power and the social context within which individuals make their choices.

So, in summary, the available evidence suggests that **high** wages are associated with **low** levels of unemployment. While this should be the expected result from any realistic analysis of the economic power which marks capitalist economies, it does not provide much support for claims that only by cutting real wages can unemployment be reduced. The "free market" capitalist position and one based on reality have radically different conclusions as well as political implications. Ultimately, most laissez-faire economic analysis is unpersuasive both in terms of the facts and their logic. While economics may be marked by axiomatic reasoning which renders everything the markets does as optimal, the problem is precisely that it is pure axiomatic reasoning with little or no regard for the real world. Moreover, by some strange coincidence, they usually involve policy implications which generally make the rich richer by weakening the working class. Unsurprisingly, decades of empirical evidence have not shifted the faith of those who think that the simple axioms of economics take precedence over the real world nor has this faith lost its utility to the economically powerful.

Economics in more than one lesson

So, as radical economists have correctly observe, such considerations undercut the "free market" capitalist contention that labour unions and state intervention are responsible for unemployment (or that depressions will easily or naturally end by the workings of the market). To the contrary, insofar as labour unions and various welfare provisions prevent demand from falling as low as it might otherwise go during a slump, they apply a brake to the downward spiral. Far from being responsible for unemployment, they actually mitigate it. For

haviour of wages, profits and rates of return on capital have risen to high levels."[1]

Under such circumstances, it is obvious why unemployment could drop and inflation remain steady. Yet there is a massive contradiction in Greenspan's account. As well as showing how keen the Federal Reserve investigates the state of the class struggle, ready to intervene when the workers may be winning, it also suggests that flexibility works just one way:

*"Some of the features highlighted by Greenspan reflect precisely a **lack** of flexibility in the labour market: a lack of response of compensation to tight labour markets, a reluctance of workers to leave their jobs, and the prevalence of long-term contracts that lock employment arrangements for six or more years at a time. And so Greenspan's portrayal of the unique features of the US model suggests that something more than flexibility is the key ingredient at work — or at least that 'flexibility' is being interpreted once again from an unbalanced and one-sided perspective. It is, rather, a high degree of labour market **discipline** that seems to be the operative force. US workers remain insecure despite a relatively low unemployment rate, and hence compensation gains … were muted. This implies a consequent redistribution of income from labour to capital … Greenspan's story is more about **fear** than it is about flexibility — and hence this famous testimony has come to be known as Greenspan's 'fear factor' hypothesis, in which he concisely described the importance of labour market discipline for his conduct of monetary policy."*[2]

[1] quoted by Jim Stanford, *"Testing the Flexibility Paradigm: Canadian Labor Market Performance in International Context,"* pp. 119–155, **Fighting Unemployment**, David R. Howell (ed.), pp. 139–40

[2] Jim Stanford, **Op. Cit.**, p. 140

Flexploitation

So while this attack on the wages, working conditions and social welfare is conducted under the pre-Keynesian notion of wages being *"sticky"* downwards, the underlying desire is to impose a "flexibility" which ensures that wages are *"sticky"* **upwards.** This suggests a certain one-sidedness to the "flexibility" of modern labour markets: employers enjoy the ability to practice flexpoilation but the flexibility of workers to resist is reduced.

There is a unspoken paradox to this. If we look at the stated, public, rationale behind "flexibility" we find a strange fact. While the labour market is to be made more "flexible" and in line with ideal of "perfect competition", on the capitalist side no attempt is being made to bring **it** into line with that model. Let us not forget that perfect competition (the theoretical condition in which all resources, including labour, will be efficiently utilised) states that there must be a large number of buyers and sellers. This is the case on the sellers side of the "flexible" labour market, but this is **not** the case on the buyers (where oligopoly reigns). Most who favour labour market "flexibility" are also those most against the breaking up of big business and oligopolistic markets or are against attempts to stop mergers between dominant companies in and across markets. Yet the model requires **both** sides to be made up of numerous small firms without market influence or power. So why expect making one side more "flexible" will have a positive effect on the whole?

There is no logical reason for this to be the case — in an economy with both unions and big business, removing the former while retaining the latter will **not** bring it closer to the ideal of perfect competition. With the resulting shift in power on the labour market things will get worse as income is distributed from labour to capital. Which is, we must stress, precisely what

20% of the US population increased its share of national income)[29]. Strangely, though, this obvious fact seems lost on most economists. In fact, if you took their arguments seriously then you would have to conclude that depressions and recessions are the periods during which working class people do the best!

This is on two levels. First, in neo-classical economics work is considered a disutility and workers decide not to work at the market-clearing real wage because they prefer leisure to working. Leisure is assumed to be intrinsically good and the wage the means by which workers are encouraged to sacrifice it. Thus high unemployment must be a good thing as it gives many more people leisure time. Second, for those in work their real wages are higher than before, so their income has risen. Alfred Marshall, for example, argued that in depressions money wages fell but not as fast as prices. A *"powerful friction"* stopped this, which *"establish[ed] a higher standard of living among the working classes"* and a *"diminish[ing of] the inequalities of wealth."* When asked whether during a period of depression the employed working classes got more than they did before, he replied *"[m]ore than they did before, on the average."*[30]

Thus, apparently, working class people do worse in booms than in slumps and, moreover, they can resist wage cuts more in the face of mass unemployment than in periods approaching full employment. That the theory which produced these conclusions could be taken remotely seriously shows the dangers of deducing an economic ideology from a few simple axioms rather than trusting in empirical evidence and common sense derived from experience. Nor should it come as too great a surprise, as "free market" capitalist economics tends to ignore

[29] Palley, p. 55 and p. 58
[30] quoted by Keynes, p. 396

Unemployment was highest where real wages were lowest and nowhere had falling wages being followed by rising employment or falling unemployment. Blanchflower and Oswald stated that their conclusion is that employees *"who work in areas of high unemployment earn less, other things constant, than those who are surrounded by low unemployment."*[28] This relationship, the exact opposite of that predicted by "free market" capitalist economics, was found in many different countries and time periods, with the curve being similar for different countries. Thus, the evidence suggests that high unemployment is associated with low earnings, not high, and vice versa.

While this evidence may come as a shock to those who subscribe to the arguments put forward by those who think capitalist economics reflect the reality of that system, it fits well with the anarchist analysis. For anarchists, unemployment is a means of disciplining labour and maintaining a suitable rate of profit (i.e. unemployment is a key means of ensuring that workers are exploited). As full employment is approached, labour's power increases, so reducing the rate of exploitation and so increasing labour's share of the value it produces (and so higher wages). Thus, the fact that wages are higher in areas of low unemployment is not a surprise, nor is the phenomenon of pro-cyclical real wages. After all, the ratio between wages and profits are, to a large degree, a product of bargaining power and so we would expect real wages to grow in the upswing of the business cycle, fall in the slump and be high in areas of low unemployment.

It is difficult for workers to resist wage cuts and speeds-up when faced with the fear of mass unemployment. As such, higher rates of unemployment *"reduce labour's bargaining power vis-a-vis business, and this helps explain why wages have declined and workers have not received their share of productivity growth"* (between 1970 and 1993, only the top

[28] **The Wage Curve**, p. 360

has happened since the 1980s and the much lauded "reforms" of the labour market.

All this is unsurprising for anarchists as we recognise that "flexibility" just means weakening the bargaining power of labour in order to increase the power and profits of the rich (hence the expression ***"flexploitation"***!). A "flexible" labour market basically means one in which workers are glad to have any job and face increased insecurity at work (actually, ***"insecurity"*** would be a more honest word to use to describe the ideal of a competitive labour market rather than *"flexibility"* but such honesty would let the cat out of the bag).

Keynesianism versus Keynes

The chain of logic in this explanation for unemployment is rooted in many of the key assumptions of neo-classical economics – a firm's demand for labour is the marginal physical product of labour multiplied by the price of the output and so it is dependent on marginal productivity theory. It is assumed that there are diminishing returns and marginal productivity as only this produces a downward-sloping labour demand curve. For labour, it is assumed that its supply curve is upwards slopping. So marginal productivity theory lies at the core of neo-classical theories of output and distribution and so the marginal product of labour is interpreted as the labour demand curve. This enforces the viewpoint that unemployment is caused by wages being too high as firms adjust production to bring the marginal cost of their products (the cost of producing one more item) into equality with the product's market-determined price. So a drop in labour costs theoretically leads to an expansion in production, producing jobs for the "temporarily" unemployed and moving the economy toward full-employment.

Sadly for these arguments, the assumptions required to reach it are absurd as the conclusions (namely, that there is no involuntary unemployment as markets are fully efficient). More perniciously, when confronted with the reality of unemployment, most supporters of this view argue that it arises only because of government-imposed rigidities and trade unions. In their "ideal" world without either, there would, they claim, be no unemployment. Of course, it is much easier to demand that nothing should be done to alleviate unemployment and that workers' real wages be reduced when you are sitting in a tenured post in academia save from the labour market forces you wish others to be subjected to (in their own interests).

This perspective suffered during the Great Depression and the threat of revolution produced by persistent mass unemployment meant that dissident economists had space to question the orthodoxy. At the head of this re-evaluation was Keynes who presented an alternative analysis and solution to the problem of unemployment in his 1936 book **The General Theory of Employment, Interest and Money**.[3]

Somewhat ironically, given the abuse he has suffered at the hands of the right (and some of his self-proclaimed followers), Keynes took the assumptions of neo-classical economics on the labour market as the starting point of his analysis, namely that unemployment was caused by wages being too high. However, he was at pains to stress that even with ideally flexible labour markets cutting real wages would **not** reduce unemployment.

Keynes argued that unemployment was **not** caused by labour resisting wage cuts or by "sticky" wages. Indeed, any "Keynesian" economist who does argue that "sticky" wages are responsible for unemployment shows that he or she has not

[3] It should be noted that the Polish socialist economist Michal Kalecki independently developed a similar theory a few years before Keynes but without the neo-classical baggage Keynes brought into his work.

"In defiance of market theory, the demand for labour tends strongly to vary ***with*** *its price, not inversely to it. Wages are high when there is full employment. Wages — especially for the least-skilled and lowest paid — are lowest when there is least employment. The causes chiefly run from the employment to the wages, rather than the other way. Unemployment weakens the bargaining power, worsens the job security and working conditions, and lowers the pay of those still in jobs.*

"The lower wages do not induce employers to create more jobs … most business firms have no reason to take on more hands if wages decline. Only empty warehouses, or the prospect of more sales can get them to do that, and these conditions rarely coincide with falling employment and wages. The causes tend to work the other way: unemployment lowers wages, and the lower wages do not restore the lost employment."[26]

Will Hutton, the British neo-Keynesian economist, summarises research by two other economists that suggests high wages do not cause unemployment:

"the British economists David Blanchflower and Andrew Oswald [examined] … the data in twelve countries about the actual relation between wages and unemployment — and what they have discovered is another major challenge to the free market account of the labour market. Free market theory would predict that low wages would be correlated with low local unemployment; and high wages with high local unemployment.

"Blanchflower and Oswald have found precisely the opposite relationship. The higher the wages, the lower the local unemployment — and the lower the wages, the higher the local unemployment. As they say, this is not a conclusion that can be squared with free market text-book theories of how a competitive labour market should work."[27]

[26] Stetton, pp. 401–2

[27] **The State We're In**, p. 102

are falling, real wages are no more likely to rise than to fall.” Keynes admitted that in **The General Theory** he was *“accepting, without taking care to check the facts”*, a *“widely held”* belief. He discussed where this belief came from, namely leading 19th century British economist Alfred Marshall who had produced a *“generalisation”* from a six year period between 1880–86 which was not true for the subsequent business cycles of 1886 to 1914. He also quotes another leading economist, Arthur Pigou, from 1927 on how *“the upper halves of trade cycles have, on the whole, been associated with higher rates of real wages than the lower halves”* and indicates that he provided evidence on this from 1850 to 1910 (although this did not stop Pigou reverting to the *“Marshallian tradition”* during the Great Depression and blaming high unemployment on high wages).[24] Keynes conceded the point, arguing that he had tried to minimise differences between his analysis and the standard perspective. He stressed that while he assumed countercyclical real wages his argument did not depend on it and given the empirical evidence provided by labour economists he accepted that real wages were procyclical in nature.

The reason why this is the case is obvious. Labour does not control prices and so cannot control its own real wage. Looking at the Great Depression, it seems difficult to blame it on workers refusing to take pay cuts. The notion of all powerful unions or workers’ resistance to wage cuts causing high unemployment hardly fits these facts. Since then, economists have generally confirmed that real wage are procyclical. In fact, *“a great deal of empirical research has been conducted in this area — research which mostly contradicts the neo-classical assumption of an inverse relation between real wages and employment.”*[25] As Hugh Stretton summarises in his excellent introductory text on economics:

[24] Keynes, p. 394, p. 398 and p. 399

[25] Targetti, p. 50

read Keynes — Chapter two of the **General Theory** critiques precisely this argument. Taking neo-classical economists at its word, Keynes analyses what would happen **if** the labour market were perfect and so he assumes the same model as his neo-classical opponents, namely that unemployment is caused by wages being too high and there is flexibility in both commodity and labour markets. As he stressed, his *“criticism of the accepted [neo-]classical theory of economics has consisted not so much in finding logical flaws in its analysis as in pointing out that its tacit assumptions are seldom or never satisfied, with the result that it cannot solve the economic problems of the actual world.”*[4]

What Keynes did was to consider the **overall** effect of cutting wages on the economy as a whole. Given that wages make up a significant part of the costs of a commodity, *“if money-wages change, one would have expected the [neo-]classical school to argue that prices would change in almost the same proportion, leaving the real wage and the level of unemployment practically the same as before.”* However, this was not the case, causing Keynes to point out that they *“do not seem to have realised that … their supply curve for labour will shift bodily with every movement of prices.”* This was because labour cannot determine its own real wage as prices are controlled by bosses. Once this is recognised, it becomes obvious that workers do not control the cost of living (i.e., the real wage). Therefore trade unions *“do not raise the obstacle to any increase in aggregate employment which is attributed to them by the [neo-]classical school.”* So while workers could, in theory, control their wages by asking for less pay (or, more realistically, accepting any wage cuts imposed by their bosses as the alternative is unemployment) they do not have any control over the prices of the goods they produce. This means that they have **no** control over their real wages and so **cannot** reduce unemployment by pricing them-

[4] Keynes, **The General Theory**, p. 378

selves into work by accepting lower wages. Given these obvious facts, Keynes concluded that there was *"no ground for the belief that a flexible wage policy is capable of continuous full employment … The economic system cannot be made self-adjusting along these lines."*[5] As he summarised:

"the contention that the unemployment which characterises a depression is due to a refusal by labour to accept a reduction of money-wages is not clearly supported by the facts. It is not very plausible to assert that unemployment in the United States in 1932 was due either to labour obstinately refusing to accept a reduction of money-wages or to its demanding a real wage beyond what the productivity of the economic machine was capable of furnishing … Labour is not more truculent in the depression than in the boom — far from it. Nor is its physical productivity less. These facts from experience are a ***prima facie*** *ground for questioning the adequacy of the [neo-]classical analysis."*[6]

This means that the standard neo-classical argument was flawed. While cutting wages may make sense for one firm, it would not have this effect throughout the economy as is required to reduce unemployment as a whole. This is another example of the fallacy of composition. What may work with an individual worker or firm will not have the same effect on the economy as a whole for cutting wages for all workers would have a massive effect on the aggregate demand for their firm's products.

There were two possibilities if wages were cut. One possibility, which Keynes considered the most likely, would be that a cut in money wages across the whole economy would see a similar cut in prices. The net effect of this would be to leave real wages unchanged. The other assumes that as wages are cut, prices remain prices remained unchanged or only fell by a small amount (i.e. if wealth was redistributed from workers

[5] p. 12, pp. 8–9, p. 15 and p. 267
[6] p. 9

real wage to exceed their so-called *"reservation"* wage (i.e. the wage which will tempt them to forsake a life of leisure for the disutility of work). Rather, most workers have to take a job because they do not have a choice as the alternative is poverty (at best) or starvation and homelessness (at worse). The real wage influences the decision on how much labour to supply rather than the decision to work or not. This is because as workers and their families have a certain basic living standard to maintain and essential bills which need to be paid. As earnings increase, basic costs are covered and so people are more able to work less and so the supply of labour tends to fall. Conversely, if real earnings fall because the real wage is less then the supply of labour may **increase** as people work more hours and/or more family members start working to make enough to cover the bills (this is because, once in work, most people are obliged to accept the hours set by their bosses). This is the opposite of what happens in "normal" markets, where lower prices are meant to produce a **decrease** in the amount of the commodity supplied. In other words, the labour market is not a market, i.e. it reacts in different ways than other markets.[23]

Unemployment and high wages

Even ignoring the theoretical problems, the facts are that high wages are generally associated with booms rather than slumps and this has been known to mainstream economics since at least 1939 when in March of that year **The Economic Journal** printed an article by Keynes about the movement of real wages during a boom in which he evaluated the empirical analysis of two labour economists.

These studies showed that *"when money wages are rising, real wages have usually risen too; whilst, when money wages*

[23] Stretton provides a good summary of this argument (**Economics: A New Introduction**, pp. 403–4 and p. 491)

Keynesianism and incomplete nature of the "reforms" ensured that a deep spiral was avoided).

To understand why this is the case, it is necessary to think about how the impact of eliminating the minimum wage and trade unions would actually have. First, of course, there would be a drop in the wages of the poorest workers as the assertion is that these increase unemployment by forcing wages up. The assertion is that the bosses would then employ more workers as a result. However, this assumes that extra workers could easily be added to the existing capital stock which may not be the case. Assuming this is the case (and it **is** a big assumption), what happens to the workers who have had their pay cut? Obviously, they still need to pay their bills which means they either cut back on consumption and/or seek more work (assuming that prices have not fallen, as this would leave the real wage unchanged). If the former happens, then firms may find that they face reduced demand for their products and, consequently, have no need for the extra employees predicted by the theory. If the latter happens, then the ranks of those seeking work will increase as people look for extra jobs or people outside the labour market (like mothers and children) are forced into the job market. As the supply of workers increase, wages **must** drop according to the logic of the "free market" position. This does not mean that a recovery is impossible, just that in the short and medium terms cutting wages will make a recession worse and be unlikely to **reduce** unemployment for some time.

Within a capitalist economy the opposite assumption to that taken by economics is far more likely, namely that there **is** a backward sloping labour supply curve. This is because the decision to work is **not** one based on the choice between wages and leisure made by the individual worker. Most workers do **not** choose whether they work or not, and the hours spent working, by comparing their (given) preferences and the level of real wages. They do **not** practice voluntary leisure waiting for the

to their employers). This is the underlying assumption of "free market" argument that cutting wages would end the slump. In this theory, cutting real wages would increase profits and investment and this would make up for any decline in working class consumption and so its supporters reject the claim that cutting real wages would merely decrease the demand for consumer goods without automatically increasing investment sufficiently to compensate for this.

However, in order make this claim, the theory depends on three critical assumptions, namely that firms can expand production, that they will expand production, and that, if they do, they can sell their expanded production. This theory and its assumptions can be questioned.

The first assumption states that it is always possible for a company to take on new workers. Yet increasing production requires more than just labour. Tools, raw materials and work space are all required in addition to new workers. If production goods and facilities are not available, employment will not be increased. Therefore the assumption that labour can always be added to the existing stock to increase output is plainly unrealistic, particularly if we assume with neo-classical economics that all resources are fully utilised (for an economy operating at less than full capacity, the assumption is somewhat less inappropriate).

Next, will firms expand production when labour costs decline? Hardly. Increasing production will increase supply and eat into the excess profits resulting from the fall in wages (assuming, of course, that demand holds up in the face of falling wages). If unemployment did result in a lowering of the general market wage, companies might use the opportunity to replace their current workers or force them to take a pay cut. If this happened, neither production nor employment would increase. However, it could be argued that the excess profits would increase capital investment in the economy (a key assumption of neo-liberalism). The reply is obvious: perhaps,

perhaps not. A slumping economy might well induce financial caution and so capitalists could stall investment until they are convinced of the sustained higher profitability will last.

This feeds directly into the last assumption, namely that the produced goods will be sold. Assuming that money wages are cut, but prices remain the same then this would be a cut in real wages. But when wages decline, so does worker purchasing power, and if this is not offset by an increase in spending elsewhere, then total demand will decline. However, it can be argued that not everyone's real income would fall: incomes from profits would increase. But redistributing income from workers to capitalists, a group who tend to spend a smaller portion of their income on consumption than do workers, could reduce effective demand and increase unemployment. Moreover, business does not (cannot) instantaneously make use of the enlarged funds resulting from the shift of wages to profit for investment (either because of financial caution or lack of existing facilities). In addition, which sane company would increase investment in the face of falling demand for its products? So when wages decline, so does workers' purchasing power and this is unlikely to be offset by an increase in spending elsewhere. This will lead to a reduction in aggregate demand as profits are accumulated but unused, so leading to stocks of unsold goods and renewed price reductions. This means that the cut in real wages will be cancelled out by price cuts to sell unsold stock and unemployment remains. In other words, contrary to neo-classical economics, a fall in wages may result in the same or even more unemployment as aggregate demand drops and companies cannot find a market for their goods.

So, as is often the case, Keynes was simply including into mainstream economics perspectives which had long been held by critics of capitalism and dismissed by the orthodoxy. Keynes' critique of Say's Law essentially repeated Marx's while Proudhon pointed out in 1846 that *"if the producer earns less, he will buy less"* and this will *"engender … over-production*

Marglin points out, the *"indiscipline of the labouring classes, or more bluntly, their laziness, was widely noted by eighteenth century observers."* By laziness or indiscipline, these members of the ruling class meant the situation where *"as wages rose, workers chose to work less."* In economic terms, *"a backward bending labour supply curve is a most natural phenomenon as long as the individual worker controls the supply of labour."* However, *"the fact that higher wages led workers to choose more leisure … was disastrous"* for the capitalists. Unsurprisingly, the bosses did not meekly accept the workings of the invisible hand. Their *"first recourse was to the law"* and they *"utilised the legislative, police and judicial powers of the state"* to ensure that working class people had to supply as many hours as the bosses demanded.[21]

Looking at the US, we find evidence that supports this analysis. As the wages for the bottom 80% of the population fell in real terms under Reagan and Bush in the 1980s, the number of people with multiple jobs increased as did the number of mothers who entered the labour market. In fact, *"the only reason that family income was maintained is the massive increase in labour force participation of married women … Put simply, jobs paying family wages have been disappearing, and sustaining a family now requires that both adults work … The result has been a squeeze on the amount of time that people have for themselves … there is a loss of life quality associated with the decline in time for family … they have also been forced to work longer … Americans are working longer just to maintain their current position, and the quality of family life is likely declining. A time squeeze has therefore accompanied the wage squeeze."*[22] That is, the supply of labour **increased** as its price fell (Reagan's turn to military

[21] *"What do Bosses do?"*, pp. 60–112, **Review of Radical Political Economy**, Vol. 6, No. 2, pp. 91–4

[22] Thomas I. Palley, **Plenty of Nothing**, pp. 63–4

against minimum wage legislation, trade unions and demand management by government are all based on it. Yet, as Keen notes, such important policy positions *"should be based upon robust intellectual or empirical foundations, rather than the flimsy substrate of mere fancy. Economists are quite prone to dismiss alternative perspectives on labour market policy on this very basis — that they lack any theoretical or empirical foundations. Yet their own policy positions are based as much on wishful thinking as on wisdom."*[20]

The backward-bending supply curve of labour suggests that cutting real wages will have the opposite effect on the supply of labour than its supporters claim. It is commonly found that as real wages fall, hours at work become longer and the number of workers in a family increases. This is because the labour supply curve is negatively slopped as families need to work more (i.e., provide more labour) to make ends meet. This means that a fall in real wages may **increase** the supply of labour as workers are forced to work longer hours or take second jobs simply to survive. The net effect of increasing supply would be to **decrease** real wages even more and so, potentially, start a vicious circle and make the recession deeper.

Strong evidence that this model of the labour market can be found from the history of capitalism. Continually we see capitalists turn to the state to ensure low wages in order to ensure a steady supply of labour (this was a key aim of state intervention during the rise of capitalism, incidentally). For example, in central and southern Africa mining companies tried to get locals to labour. They had little need for money, so they worked a day or two then disappeared for the rest of the week. To avoid simply introducing slavery, some colonial administrators introduced and enforced a poll-tax. To earn enough to pay it, workers had to work a full week. Much the same was imposed on British workers at the dawn of capitalism. As Stephen

[20] Keen, pp. 121–2 and p. 123

and destitution." This was because *"though the workmen cost [the capitalist] something, they are [his] customers: what will you do with your products, when driven away by [him], they shall consume no longer?"* This means that cutting wages and employment would not work for they are *"not slow in dealing employers a counter-blow; for if production excludes consumption, it is soon obliged to stop itself."*[7]

An unscientific science

So far our critique of the "free market" position has, like Keynes's, been within the assumptions of that theory itself. More has to be said, though, as its assumptions are deeply flawed and unrealistic. It should be stressed that while Keynes's acceptance of much of the orthodoxy ensured that at least some of his ideas become part of the mainstream, Post-Keynesians like Joan Robinson would latter bemoan the fact that he sought a compromise rather than clean break with the orthodoxy. This lead to the rise of the post-war neo-classical synthesis, the so-called "Keynesian" argument that unemployment was caused by wages being "sticky" and the means by which the right could undermine social Keynesianism and ensure a return to neo-classical orthodoxy.

First, there is the role of diminishing returns. The assumption that the demand curve for labour is always downward sloping with respect to aggregate employment is rooted in the notion that industry operates, at least in the short run, under conditions of diminishing returns. However, diminishing returns are **not** a feature of industries in the real world. Thus the assumption that the downward sloping marginal product of labour curve is identical to the aggregate demand curve for labour is not true as it is inconsistent with empirical evidence. *"In a system at increasing returns,"* noted one economist, *"the*

[7] **System of Economical Contradictions**, p. 204 and p. 190

direct relation between real wages and employment tends to render the ordinary mechanism of wage adjustment ineffective and unstable."[8] In fact, without this assumption mainstream economics cannot show that unemployment is, in fact, caused by real wages being too high (along with many other things).

Significantly, actual corporate price is utterly different from the economic theory. This was discovered when researchers did what the original theorists did not think was relevant: they actually asked firms what they did and the researchers consistently found that, for the vast majority of manufacturing firms their average costs of production declined as output rose, their marginal costs were always well below their average costs, and substantially smaller than 'marginal revenue', and the concept of a 'demand curve' (and therefore its derivative 'marginal revenue') was simply irrelevant. Unsurprisingly, real firms set their prices prior to sales, based on a mark-up on costs at a target rate of output. In other words, they did not passively react to the market. These prices are an essential feature of capitalism as prices are set to maintain the long-term viability of the firm. This, and the underlying reality that per-unit costs fell as output levels rose, resulted in far more stable prices than were predicted by traditional economic theory.

No other science would think it appropriate to develop theory utterly independently of phenomenon under analysis. No other science would wait decades before testing a theory against reality. No other science would then simply ignore the facts which utterly contradicted the theory and continue to teach that theory as if it were a valid generalisation of the facts. But, then, economics is not a science. However, it makes sense once what happens when the assumption of increasing marginal costs is abandoned. As Steve Keen puts it:

"Strange as it may seem … this is a very big deal. If marginal returns are constant rather than falling, then the neo-classical

[8] Ferdinando Targetti, **Nicholas Kaldor**, p. 344

clearing function, and thus variations in the wage rate cannot eliminate unemployment."[18]

Supply curve issues

As such, the *"conventional economic analysis of markets … is unlikely to apply"* to the labour market and as a result *"wages are highly unlikely to reflect workers' contributions to production."* This is because economists treat labour as no different from other commodities yet *"economic theory supports no such conclusion."* At its most basic, labour is **not** produced for profit and the *"supply curve for labour can 'slope backward' — so that a fall in wages can cause an increase in the supply of workers."* In fact, the idea of a backward sloping supply curve for labour is just as easy to derive from the assumptions used by economists to derive their standard one. This is because workers may prefer to work less as the wage rate rises as they will be better off even if they do not work more. Conversely, very low wage rates are likely to produce a very high supply of labour as workers need to work more to meet their basic needs.[19]

This means that the market supply curve *"could have any shape at all"* and so economic theory *"fails to prove that employment is determined by supply and demand, and reinforces the real world observation that involuntary unemployment can exist"* as reducing the wage need not bring the demand and supply of labour into alignment. While the possibility of backward-bending labour supply curves is sometimes pointed out in textbooks, the assumption of an upward sloping supply curve is taken as the normal situation but *"there is no theoretical — or empirical — justification for this."* Sadly for the world, this assumption is used to draw very strong conclusions by economists. The standard arguments

[18] King, p. 65
[19] Steve Keen, **Debunking Economics**, pp. 111–2 and pp. 119–23

Cutting wages and reality

Thus, if we accept reality, we must end up *"denying the inevitability of a negative relationship between real wages and employment."* Post-Keynesian economists have not found any empirical links between the growth of unemployment since the early in 1970s and changes in the relationship between productivity and wages and so there is *"no theoretical reason to expect a negative relationship between employment and the real wage, even at the level of the individual firm."* Even the beloved marginal analysis cannot be used in the labour market, as *"[m]ost jobs are offered on a take-it-or-leave-it basis. Workers have little or no scope to vary hours of work, thereby making marginal trade-offs between income and leisure. There is thus no worker sovereignty corresponding to the (very controversial) notion of consumer sovereignty."* Over all, *"if a relationship exists between aggregate employment and the real wage, it is employment that determines wages. Employment and unemployment are product market variables, not labour market variables. Thus attempts to restore full employment by cutting wages are fundamentally misguided."*[16] In addition:

"Neo-classical theorists themselves have conceded that a negative relationship between the real wage and the level of employment can be established only in a one-commodity model; in a multi-commodity framework no such generalisation is possible. This confines neo-classical theory to an economy without money and makes it inapplicable to a capitalist or entrepreneurial economy."[17]

All this means that *"neither the demand for labour nor the supply of labour depends on the real wage. It follows from this that the labour market is not a true market, for the price associated with it, the wage rate, is incapable of performing any market-*

[16] John E. King, *"Labor and Unemployment,"* pp. 65–78, Holt and Pressman (eds.), **Op. Cit.**, p. 68, pp. 67–8, p. 72, p. 68 and p. 72

[17] King, p. 71

explanation of everything collapses. Not only can economic theory no longer explain how much a firm produces, it can explain nothing else.

"Take, for example, the economic theory of employment and wage determination … The theory asserts that the real wage is equivalent to the marginal product of labour … An employer will employ an additional worker if the amount the worker adds to output — the worker's marginal product — exceeds the real wage … [This] explains the economic predilection for blaming everything on wages being too high — neo-classical economics can be summed up, as [John Kenneth] Galbraith once remarked, in the twin propositions that the poor don't work hard enough because they're paid too much, and the rich don't work hard enough because they're not paid enough …

*"If in fact the output to employment relationship is relatively constant, then the neo-classical explanation for employment and output determination collapses. With a flat production function, the marginal product of labour will be constant, and it will **never** intersect the real wage. The output of the form then can't be explained by the cost of employing labour… [This means that] neo-classical economics simply cannot explain anything: neither the level of employment, nor output, nor, ultimately, what determines the real wage …the entire edifice of economics collapses."*[9]

Not-so marginal problems

The argument that unemployment is caused by wages being too high is related to the marginalist theory of distribution.[10] In that theory, the marginal product of labour is interpreted

[9] **Debunking Economics**, pp. 76–7

[10] Significantly, Joan Robinson and Piero Sraffa had successfully debunked this theory in the 1950s. *"Yet for psychological and political reasons,"* notes James K. Galbraith, *"rather than for logical and mathematical ones, the capital critique has not penetrated mainstream economics. It likely never will. Today only a handful of economists seem aware of it."*(*"The distribution of*

as the labour demand curve as the firm's demand for labour is the marginal physical product of labour multiplied by the price of the output and this produces the viewpoint that unemployment is caused by wages being too high. The assumption that adding more labour to capital is always possible flows from the assumption of marginal productivity theory which treats "capital" like an ectoplasm and can be moulded into whatever form is required by the labour available. Take, for example, leading neoclassical Dennis Robertson's 1931 attempt to explain the marginal productivity of labour when holding "capital" constant:

"If ten men are to be set out to dig a hole instead of nine, they will be furnished with ten cheaper spades instead of nine more expensive ones; or perhaps if there is no room for him to dig comfortably, the tenth man will be furnished with a bucket and sent to fetch beer for the other nine."[11]

So to work out the marginal productivity of the factors involved, *"ten cheaper spades"* somehow equals nine more expensive spades? How is this keeping capital constant? And how does this reflect reality? Surely, any real world example would involve sending the tenth digger to get another spade? And how do nine expensive spades become ten cheaper ones? In the real world, this is impossible but in neoclassical economics this is not only possible but required for the theory to work. As Robinson argued, in neo-classical theory the *"concept of capital all the man-made factors are boiled into one, which we may call **leets** … [which], though all made up of one physical substance, is endowed with the capacity to embody various techniques of production … and a change of technique can be made simply by squeezing up or spreading out leets, instantaneously and without cost."*[12] While this allows economics to avoid the obvious aggregation problems with "capital" it also ensures reality has to be ignored and so economic theory need not discuss any practical questions:

"When equipment is made of leets, there is no distinction between long and short-period problems … Nine spades are lumps of leets; when the tenth man turns up it is squeezed out to provide him with a share of equipment nine-tenths of what each man had before … There is no room for imperfect competition. There is no possibility of disappointed expectations … There is no problem of unemployment … Unemployed workers would bid down wages and the pre-existing quantity of leets would be spread out to accommodate them."[13]

Of course, it is not meant to be taken literally, it is only a parable, but without it the whole argument collapses. Once capital equipment is admitted to being actual, specific objects that cannot be squeezed, without cost, into new objects to accommodate more or less workers, such comforting notions that profits equal the (marginal) contribution of "capital" or that unemployment is caused by wages being too high have to be discarded for the wishful thinking they most surely are.

Hence Joan Robinson's dismissal of this assumption, for *"with 'malleable' capital the demand for labour depends on the level of wages."*[14] Moreover, *"labour and capital are not often as smoothly substitutable for each other as the [neo-classical] model requires … You can't use one without the other. You can't measure the marginal productivity of one without the other."* Demand for capital and labour is, sometimes, a **joint** demand and so it is often impossible to adjust wages to a worker's marginal productivity independent of the cost of capital.[15]

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income", pp. 32–41, Richard P. F. Holt and Steven Pressman (eds.), **A New Guide to Post Keynesian Economics**, p. 34)

[11] *"Wage-grumbles"*, **Economic Fragments**, p. 226

[12] **Contributions to Modern Economics**, p. 106

[13] p. 107

[14] p. 6

[15] Hugh Stretton, **Economics: A New Introduction**, p. 401