

THE EMPLOYMENT ACT OF 1946: THE ANALYSIS OF AGGREGATE SUPPLY/AGGREGATE DEMAND

A lot of people don't realize that unemployment, price inflation, or unacceptable rates of economic growth are all against the law in the United States. The **Employment Act of 1946** committed our government to the maintenance of full employment, stable prices, and a "reasonable" rate of economic growth.

Now, the interesting thing about that is that these three goals are very difficult to achieve simultaneously. For example, think about what might happen if the rate of unemployment is falling due to successful government programs to stimulate demand. Sounds great, doesn't it? We are achieving one of the goals out of the Employment Act. But there could be some additional problems.

For example, if unemployment is falling because the demand for goods and services is rising which, in turn, leads to increased demand for labor services, what will happen to wages? You're right, they increase. An increase in wages leads to increased cost of doing business. The increase in cost leads to a decrease in the supplies of various goods and services (isn't that what supply and demand tell us?), which then leads to what? You're right again, an increase in prices. But wait a minute. An increase in prices flies against one of the other goals of the Employment Act.

Conservatives would even argue that such a demand stimulation program would hinder economic growth as well. We don't want to dwell on that here because we have a section in this lecture that deals with the conservative position. However, as a preview of coming attractions, an increase in costs makes business less profitable. A decrease in expected profits leads to decreases in investment. Decreases in investment lead to less economic growth, and so it goes.

Another example. If we try to reduce the rate of inflation by restricting demand, unemployment might result. It really wouldn't be a bad exercise for you to try to figure out why this might be the case.

All of this has been summarized by economists through the introduction of concepts of **aggregate supply** and **aggregate demand**. Let's start with the case where unemployment is quite high. What is, "quite high"? Who knows? But at least it is high enough to where there is substantial excess capacity in our factories and several million people who want to work but who can not find jobs. Under these conditions, what would happen if there were an increase in demand, say stimulated by the federal government (Keynesian policy).

Well, there certainly wouldn't be any inflation. We have excess capacity. We would do anything to sell more goods and services. In essence, this means that the supply curve for these firms is horizontal and an increase in demand would only lead to increased sales. No price inflation.

The increase in sales would mean that more people would have to be hired to produce the additional goods and services.

Unemployment would fall. In short, Keynesian policy would work!!! And, without inflation!!!

Remember when Keynes wrote. It was during the so-called Great Depression. The description above certainly describes a depression scenario. Keynes was trying to understand and deal with the possibility of very long term unemployment.

That is the demand side strategy. What if we try the so-called supply side strategy when unemployment is so high. A supply side strategy would be one that tries to stimulate investment. Say we engage in monetary policy oriented towards reducing the interest rate. Such a reduction in the interest rate would have as its goal increasing investment.

Ask yourself, "Would investment increase under such conditions?" Of course not. I already said that there is substantial excess capacity in this scenario. Why would we want to increase capacity when we aren't using what we already have? Supply side strategy would fail under such conditions.

Now let's go to the opposite extreme. What if we have full employment. Our capacity is now being fully utilized. This isn't really hard, is it? If we have an increase in demand, what do you think would happen? The supply curve for most firms is now vertical. Any increase in demand would have to increase prices, wouldn't it? And a general increase in prices is called, "inflation". And if that isn't bad enough, increases in demand when the labor force is fully employed leads to increased wages, increase costs, and decreases in supply. In other words, the increases in costs are passed forward to the consumer (after supply decreases) in the form of higher prices yet.

What about a supply side policy? You guessed it. Supply side might work. If we increase investment (one of the major goals of supply side policy) we increase capacity. An increase in capacity leads to an increase in supply. An increase in supply leads to reduce pressure against prices.

But wait a minute. If we are already at full employment, wouldn't an increase in capacity lead to more pressure on wages. Not if the increased capacity is in the form of new technology. New technology makes the existing labor force more productive and increases in productivity are generally anti-inflationary. At the very least, increases in productivity can be used to justify non-inflationary wage increases.

You might well now ask, "But wait a minute. We are rarely at full employment and depression doesn't seem to be the norm either. What about conditions where we have some, but not depression levels, of unemployment and excess capacity?" Well then, any increase in demand will help both employment and cause some price inflation. Successful supply side policies would lead to decreases in prices and an increases in employment. What liberals and conservatives never seem to talk about is that a proper combination of demand and supply side policies could very well lead to significant increases in employment with price stability.

One word on this aggregate supply/aggregate demand business. The model we have just discussed came into popular use just when

supply side economics was becoming popular. It is a modification of earlier works that were much more demand side oriented. One might be suspicious that it became popular in order to explain the new? supply side orientation (see the discussion of classical economics in issue 7 to understand the question mark after the word, "new"). The model puts a slightly better light on the supply side approach than on the demand side. I just wanted you to have full information available when making up your own mind as to which of these two approaches better describes reality. Now let's get on with the discussion of conservative, liberal and radical approaches to this policy question.

THE CONSERVATIVE ARGUMENT

You might call the conservative argument and supply side economics one in the same. I already stated several times that the conservatives would mostly like for us to leave the market alone and let it do its work. The best policy is no policy under these conditions. If we are to have any policies, they should be oriented towards making the market work better. So how do we do this?

Argument #1: Less Government - Of course, one major impediment to the functioning market is the government itself. The conservatives argue that liberal tinkering hurts the economy rather than helps it.

Take government regulation for example. Regulation generally increases the cost of doing business. Increases in cost reduces supply. Reductions in supply lead to inflation. Such reductions also lead to reductions in the demand for labor creating lower wages and unemployment.

Less government reduces cost, increases productivity, makes firms more competitive, and increases employment. What more could you want?

The conservatives also think that the economy generally and naturally operates at or near full employment. This means that government demand side manipulations will generally be inflationary. Again, the less we have in the way of government macro policy, the better. Coupled with the call for less government is a call for a balanced budget.

Argument #2: The Monetary Policy Debate - As near as I can tell, the conservatives don't really agree on monetary policy. The majority view seems to agree with Milton Friedman. He argues that we should not only avoid government fiscal policy but that we should also avoid activist monetary policy. He argues that we should increase the money supply by enough to support any increased economic activity that occurs as a result of economic growth. Any additional policy is likely to result in a maladjusted economy with inflation being the most likely result.

There is another view that holds that monetary policy should be the only tool used (if any tool is used at all). I.e., fiscal policy should be avoided in favor of monetary policy.

We have already dealt with the conservative aversion to demand based government policy. However, if the government works

to keep its budget balanced, then monetary policy might be used as a supply side stimulus. By adjusting interest rates in a downward direction, or by keeping interest rates relatively low over the long run, investment is stimulated leading to supply side increases in productivity and industrial capacity. This view does require the balanced budget, however. In the absence of a balanced budget, the Friedman approach would be better.

Argument #3: Inflation is Always Worse than Unemployment - The conservatives are definitely more worried about inflation than they are about unemployment. Part of the reason is that the conservatives don't believe that unemployment is a long term problem. Another reason is that inflation generally occurs during periods of high employment. Inflation leads to higher costs of doing business which, in turn, leads to a loss of competitiveness in the international market. While inflation is generally good for short run economic profits, it hurts profits in the long run. Lower profits lead to reduced investment, reduced capacity, reduced supply, and increased inflation. Try to work through the market model to verify these results.

What is more, inflation, through the cost problems it creates, also creates the possibility for unemployment to occur over the long term. As costs rise and supplies fall, the demand for labor also falls. If the inflationary pressure is long term, unemployment might very well be long term as well.

Argument #4: The Rich are the Creators of Wealth and Economic Growth - Probably the most controversial of the conservative positions is the notion that higher income individuals are the ones that create economic growth through investment. The natural conclusion from this notion is that the rich should be left alone to do their work. In fact, the more income the rich have, the greater the likelihood for investment with positive supply side results.

The conservative argument (a bit oversimplified I admit) goes something like this. Investment comes out of savings. The tendency to save increases as income increases because the consumption needs of the rich are already met. Therefore, the more income the rich have, the greater the savings and resulting investment. And, of course, the rest of the supply argument follows. The greater the investment the greater the capacity when once utilized leads to greater economic growth. We suppose this brings us back to the less government argument again, but included in this less government is lower taxes, especially for the rich.

Argument #5: The Anti-Welfare Argument - You probably already know that the conservatives aren't too enthralled with the notion of welfare. There are several reasons for their lack of enthusiasm in this regard.

Welfare makes it easier for people to be unemployed. This "voluntary" unemployment reduces the supply of labor available to produce the nation's goods and services.. What happens when the

supply of labor is reduced? You got it, wages go up, profits go down, investment goes down, and inflation/unemployment results. By distorting the market for labor, welfare creates more problems than it solves (according to the conservatives).

Does this mean zero welfare? No. There are groups of people that will never fit into the labor market. Those with severe physical or mental disabilities would be an obvious example. These people should be taken care of from both the conservative and the liberal point of view. But to the conservative, there are far fewer people in this circumstance than currently receive welfare payments from our government.

Argument #6: The Long Run - The final argument highlights the conservative's emphasis on the long run. They readily admit that the economy can have what appears to be economic problems in the short run. That's what a business cycle offers from time to time.

However, if the market is left to do its thing, these problems are only temporary. Any attempt to rectify them will only lead to further problems due to market distortions.

There is much discussion over how long the long run really is. But this means little to the conservative who argues that any short run fixes lead to greater long run problems than would exist if nothing were done at all.

Conclusion - The obvious conclusion to all this is that the best government economic policy is no policy at all! If we must have policies, they should only be those that help the market to function better (low taxes for the rich, monetary policy when the federal budget is balanced, minimal welfare policies for those "truly in need", etc.).

All of this is based on the general argument that the supply side of the economy is the most important. Anything that interferes with productivity, profits, and resulting investment is "bad" to the conservative.

THE LIBERAL ARGUMENT

Remember that Keynes argued that the macroeconomy could be at equilibrium at less than full employment. Equilibrium between aggregate supply and aggregate demand can occur almost anywhere. This "fact" creates the argument for government intervention in the economy.

Liberals do admit that the possibility for inflation becomes larger as we approach full employment. Some industries will hit their capacity before others. As we approach full employment, those industries that hit capacity first will begin to raise their prices if and when further growth occurs. We could have, under such a circumstance and with further economic growth, some increase in employment with a coincident increase in inflation.

Keynesians also agree that any growth beyond "true" full employment will be purely inflationary. This is a so-called demand/pull inflation where further increases in demand when plant capacities are generally being utilized results in

increases in prices.

To the liberal, however, all this means is that society, just like any economic unit within society, has to make trade-offs in its policy decisions, . The trade-off here is somewhat between employment and inflation.

Most liberals would be willing to accept some inflation for a fully employed society. To always consider inflation to be the worst of the two problems most free enterprise economies face - inflation and unemployment - is to always battle inflation on the back of the common person. The common person is the one that finds him/herself unemployed when inflation is brought down. Liberals argue, if there has to be such a choice, the choice should be for the worker and not always for higher corporate profits.

There were some serious problems that were faced by the U.S. economy during the seventies. We had both high unemployment and inflation. The conservatives argued that Keynesian policy had supply side effects that brought such a negative situation into being.

"Not so", say the liberals. Unemployment and inflation are never purely the result of government policy. External shocks to the system can also cause the economy to go out of kilter. The seventies are an excellent example.

The early seventies found oil prices increasing at unprecedented rates due to the successful organization of the OPEC cartel. The increase in oil prices led the consumer to attempt to switch to other energy sources in the short run, and these increases in demands led to increases in energy based prices other than oil as well.

Energy is central to virtually all production. Rapid increases in energy prices led to supply side shocks all right. Prices increased across the board to help industry pay for their increased energy costs. These increases in prices led to labor's demand for increased wages so that the worker could afford to maintain his/her living standards. When wages did not keep up with inflation, the worker had to cut back on consumption. These cuts resulted in a decrease in aggregate demand and a resulting decrease in employment. The inflation in this case is called cost-push inflation.

You see, liberals are not entirely against neo-classical thought. Liberals are **not** the same as radicals! The liberal fully expects a shock such as OPEC price increases to cause problems within the economy and they fully expect the economy to adjust to these shocks in the long run. The liberal expects the consumer to begin to demand energy efficient cars and appliances. The liberal expects the consumer to look for alternative forms of transportation, such as mass transportation. The liberal expects the rate of inflation due to cost-push factors to wind down over the long run.

The problem to the liberal is, the long run is too long. The market might very well adjust to shocks as the neoclassicals predict. But why can't government help speed the process so that the adjustments are not so painful? When you add to cost-push

inflation the fact that after all neoclassical adjustments take place there is no guarantee that the economy will settle down at a full employment level, you have the argument for government planning and intervention.

To the liberal, sitting back and doing nothing will lead to much pain for the average citizen, certainly in the short run, but probably in the long run as well. Much of this pain could be prevented with sound governmental fiscal and industrial policies.

What is this Cost-Push, Demand-Pull Inflation Business Anyway? - We are not going to say a great deal about demand-pull inflation here. We have already talked about the possibility for aggregate demand to increase when the economy is at full employment causing inflation to occur. The obvious Keynesian policies to fight this type of inflation is to decrease government spending, increase taxes, and/or decrease the money supply.

The cost-push inflationary factor we have yet to discuss. Cost push occurs when there is an external shock to the economic system, such as the OPEC price increases discussed earlier, or when the economy adjusts to inflation by increasing wages, profits, and prices. Again, the shock scenario has already been discussed and need not be repeated here. We need to concentrate on the second form of cost-push inflation at this point.

Once inflation has taken hold, whether through demand pull or from an external shock, economic actors begin to anticipate that further inflation will occur. They will then adjust their behavior to maintain themselves in the best manner possible.

The most obvious way in which a person could do this is to attempt to insert a COLA (cost of living allowance) into their employment contract. A COLA would insure that the individual's wage would increase along with the rate of inflation.

Our measures of the cost of living are far from perfect. There are economists who argue that the consumer price index overstates price increases for a number of reasons. If this is true, and if COLA's are widespread, the costs of production would increase faster than the true rate of inflation. Industries, in order to make up for these costs, pass them on to the consumer, causing more inflation, causing larger wage increases, and so it goes.

Another consumer/worker strategy to fight inflation would be to purchase large ticket items, on credit if necessary, before their prices increase further. The increased demand for these items leads to price increases, i.e., inflation.

You might suspect that the liberal's answer to all this is some form of government intervention. While it would not be correct to say that wage and price controls are on all liberals' agenda, such controls are often promoted by at least some liberals. The idea would be to have the controls in place for a limited period of time until the expectation of inflation is eliminated. Such controls might be accompanied by a stimulative package of some kind to help eliminate the problems of unemployment.

A less desirable policy possibility from the liberal's point

of view is to recess the economy so markedly that the expectation of inflation is totally unreasonable. This would cause much hardship which is why such a policy is not promoted by many liberals.

If the cost-push problem were started by a shock such as the energy crisis, another interventionist alternative is to speed the market's process of switching to alternatives. Government sponsored research programs for new energy sources, government subsidy of mass transportation, government regulation of mileage requirements for cars sold in the United States, and other related programs come to mind. Perhaps all of the switches to new sources would take place anyway, but why wait for the market to figure things out when government intervention can both speed the process and help determine the direction of changes to take place.

Finally, many economists feel that cost-push inflation, if left alone, will cure itself. As cost pressures increase and resulting profits fall, businesses will adjust by laying people off. Unemployment increases as a result. Higher unemployment rates serve to relieve pressure on wages which eventually leads to reduced cost-push pressures.

The Introduction of Automatic Stabilizers - There are some automatic stabilizers that are in place, by and large due to past liberal policies. For example, a progressive income tax (one that taxes a larger percentage of higher incomes than lower incomes) would find the tax burden increasing as inflation occurred. An increase in taxes is exactly what the Keynesian doctor orders during inflationary time periods. Convince yourself through proper argument that the opposite occurs when the economy is contracting.

Welfare/unemployment compensations are other automatic stabilizers. Spending on these programs falls when the economy is expanding and increases when the economy is recessing. In other words, government spending on these programs is countercyclical, just as we might want if we agree with the Keynesian view of things.

There are other possible examples, but we think you get the idea. An automatic stabilizer is one that automatically adjusts as anti-cyclical policy would have it adjust during any phase of the business cycle. In fact, many liberals argue that these automatic stabilizers have recently helped work against many of the disruptive conservative policies encouraged by presidents Reagan and Bush and have prevented more serious downswings in the cycle due to excessive governmental and private debt. These might be the wisest "policies" of all because they are automatic and not as subject to the political process.

One Final Argument - The liberals do not generally claim to be able to fine tune the economy so that weaknesses never exist. However, they do feel that enlightened policy measures can help mitigate against some of the more serious weaknesses of a free enterprise economy.

The liberal will not accept responsibility for bad policy measures, however. Just because we have good theory doesn't mean

we have enlightened policy. If the government runs large deficits during inflationary time periods, further inflation will result. Many liberals feel we should balance the budget over the business cycle, running surpluses during expansionary periods and deficits during recessionary periods. Chronic budget deficits are not good Keynesian policy.

A balanced budget amendment to the constitution would be the worse of all policies because it takes discretion away from policy makers. Such an amendment necessarily puts all the pressure on monetary policy which might be much weaker during recessionary time periods than is fiscal policy. Enlightened policy measures means that policy makers must have the wisdom and courage to monitor the economy's performance and come up with strong measures to mitigate against weaknesses in that performance. Liberals feel that there is at least a reasonable chance that we can elect policy makers to carry on these tasks.

THE RADICAL ARGUMENT

Whenever you look for the radical argument, look for their continuous search for contradictions in the dominant mode of producing goods and services. Their most basic premise is that such contradictions lead to the need for basic change in the existing system and to understand these contradictions is to understand the nature of the change that is to take place.

Kind of a corollary to this idea is the notion that the contradictions take the form of conflict. The basic conflict in capitalism is between two great classes of individuals; those that are hired and those that do the hiring. Those that do the hiring are also those that control the productive capital within the system and are those that reap the profits from productive enterprises.

Some arguments emphasize the conflict between the rich and the poor. We do not disagree with that interpretation of what we are talking about here. The radical argument really goes beyond a simple discussion of rich and poor. The conflict, the contradiction, is between those that have to sell their labor on the open market and those that purchase that labor. The fact that those that own and control capital are also generally the rich and those that are forced to work for a living are generally poorer does not change the more fundamental conflict between worker and capital owner.

The Drive For Profits - The drive for profit is the fundamental reason for being under capitalism. But from where does that profit stem? From hiring workers to produce goods and services for sale. The more the value of sales relative to the value of wages paid, the greater the profit. Makes sense, doesn't it?

But think about this for a moment. What happens if wages increase relative to sales? Profits fall. But we just said that the drive for profits is the central motivation of capitalism. If profits fall because of higher wages, the owners of capital suffer. They respond just as both the liberals and the

conservatives claim they would respond, they withhold investment. The withheld investment causes a recession which causes unemployment which reduces the pressure on wages.

See the conflict? The conflict is between the worker and his/her search for a better life through higher wages and the capital owner that improves her/his own lifestyle through increased profits.

Now, who do you think is the more powerful in this conflict? To the radical, the answer to this question is quite clear. The capital owners are dominant. They are the ones that decide who is and who is not going to be hired. They are the ones that tend to have the wealth necessary to influence government decisions relative to worker-owner conflicts, and they are the ones that have the ability to shut the system down through lay-offs and reductions in production.

What this all means to the macroeconomy is that wages will always lose out to profits in government policy making (liberal) or in the absence of government policy making (conservative). And, if necessary, the wages will lose out through the creation of conditions of permanent unemployment within the economy. Unemployment is the key to keeping wages in line.

The conservatives would encourage unemployment by showing an excessive concern for inflation, always being willing to accept some unemployment in order to prevent inflationary pressure. The liberals do this by insisting on reductions in government spending or increases in taxes when national output is expanding and leading to real labor shortages.

There are several ways in which the poor are hurt more by either's policies than are the rich. Just substitute worker and owner for poor and rich and you get the more complete radical picture.

Now, if this picture isn't bad enough, the radicals have another surprise for us. The radical feels that there will be a natural tendency for profit rates to fall in a capitalist economy. The question, "why?" is rather complicated here, but let us take a stab at it.

Profits come from the employment of labor. One might feel from that statement that the employer would want to involve him/herself only in labor intensive processes. But this is not true.

The employment of capital makes workers more productive. Since workers are paid less than the value of production (where else would profits come from?), increased productivity leads to greater profits. So, owners try to employ more capital in their production processes. Those that do early in the process will find their profits increasing.

The trouble is, what is good for one producer is not good for all. As more and more capital is employed, the source of value, labor, is used less and less. Since profits come from labor, the employment of more capital leads to decreases in the rates of profit. In fact, as workers become more productive, they are more likely to demand a reward for productivity in the form of higher wages. We have said time and again that higher

wages lead to decreases in profit.

Why does all this make any difference. The real problem radicals have with the capitalist system is that it is based on one group (the owners) taking advantage of another group (the laborers). When profit rates fall, the need to exploit increases. Wages are kept in line with unemployment. Unemployment can be created by a owner strike through the withholding of investment. It can also be created through contractionary monetary and fiscal policies.

This problem transcends the liberal/conservative argument. It is a problem with the system itself and can be corrected only when the system changes from a system based on profit and competition to a system based on equality and cooperation.