KEYNES LECTURE IN ECONOMICS

THE POLITICAL ECONOMY OF INFLATION

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I

MAY I begin by expressing my appreciation of the honour you have done me by inviting me to deliver the fifth of the Keynes Lectures. The invitation to do so was accompanied by the suggestion that my subject might be 'Inflation'. I have adopted this suggestion, but I have taken as my title: 'The Political Economy of Inflation.' This may call for a few preliminary words of explanation.

Inflation is a monetary phenomenon. That is so by definition —by any definition. But inflation cannot be adequately understood if attention is narrowly confined to the monetary mechanism. For the roots of inflation are widely spread and reach out to many parts of political and social life. Nor can the cure of inflation be effected without regard to these broader issues. The study of inflation may therefore lead us at times into some territory with which we are professionally unfamiliar; but we shall do well to recall the advice given by Professor Henry Phelps Brown: 'The economist's studies should be field-determined, not discipline-determined. . . . Let the scope of our inquiries be determined not by the customary blinkering of our field of view but by what the subject matter presents.'[1] It is for this reason that I have introduced the term 'Political Economy' into the title of my paper.

To claim in this way that the study of inflation must be broadly based may seem to be labouring the obvious. But the school of thought that has attracted most attention in recent years is the monetarist school, and its members take a different view. They maintain that inflation is caused by increases in the amount of money, and these increases are said to afford an explanation that is not only necessary but also sufficient. There is no need to look further. It is pointless to suggest that the trade unions, for their

[1] 'The Underdevelopment of Economics', *Economic Journal*, March 1972, p. 7.

part, can cause inflation, and foolish to waste time on any of the more general explanations which the monetarists describe somewhat loosely as 'sociological'. For these 'sociological' explanations are vague and non-operational and are not, in any case, required. By contrast, the monetarist theory appears to have the merit of great analytical neatness. Why must we spoil the freshness and clarity of the picture by superimposing upon it some slap-dash daubs of sociological explanation?

Of course the monetarists are right to insist upon the need for simplification and selection. Ambitious attempts at comprehensiveness may produce no coherent answer at all. But simplification and selection can be carried too far, and this is what the monetarists, for their part, have done. On general grounds it would surely be surprising if changes in the stock of money had alone been responsible for instability, when there are other important disturbing forces that are so obviously capable of pushing the economy this way or that. Nor does their case look more convincing on closer inspection. They have simply claimed much too much. In recognizing that this is so, we must be careful, however, not to neglect the role of monetary policy. For the other potentially disturbing forces would not be capable by themselves of causing inflation if increases did not also occur in the stock of active money. Even if these increases in the money stock are not the sole initiating cause, they play an essential permissive role. It is fair to add that some of the more general sociological theories go to the opposite extreme and pay scant regard to the indispensable role of the monetary mechanism.

I suggest, therefore, that we need to adopt a position that is both more moderate and more realistic. If this is done, it is no longer necessary to make a desperate choice between monetary and non-monetary explanations. That this is so can be illustrated by considering a challenge issued by two leading monetarists, Professors Laidler and Parkin, in the review they have prepared for the Royal Economic Society.[1] Their challenge is this. The rate of inflation has changed over time and those who advance non-monetary explanations should be able to explain these changes. Have there, in fact, been variations in the strength of the sociological pressures that can be related to these variations in the intensity of inflation? If, for example, one of these factors is discontent with the distribution of income, has the force of

[1] 'Inflation: A Survey', published in the *Economic Journal*, December 1975. (Circulated as Manchester Inflation Workshop Paper, 1975.)

this discontent varied appropriately? Or can we detect appropriate changes in trade-union militancy, or in the feeling of frustration that is said to have been engendered by Britain's slow economic growth? This is a fair challenge and it is not one that has been adequately met. For my part. I shall attempt only a brief comment, but my task is simplified because the monetarists are wont to choose a particular period which, as it happens, illustrates rather well the inadequacy of the explanations offered from both of the more extreme positions. This period is the latter part of the nineteen-sixties. The monetarists' explanation is that the U.S.A., then fighting an unpopular war, resorted to inflation, and this inflation flooded over fixed exchange rates into the economies of other countries. The extreme non-monetarists, for their part, would emphasize the growth of militancy as seen, for example, in the events that occurred in France in 1968. Thus we have two rival explanations and neither side seems much inclined to listen to what the other is saying. But there is surely no need to make an exclusive choice. The social pressures may indeed erupt with particular violence on certain occasions, and when such an eruption coincides, as it did in the late sixties, with a large increase in the world's money supply, the stage is set for accelerating inflation.

Let us now consider in more general terms the effect of conflicts about the distribution of income. Such conflicts are no new phenomenon, although there may have been a sharpening and intensification in recent years in Britain and, perhaps, elsewhere. These conflicts have always been there, but while the growth in the supply of money was restricted, as under the gold standard, they could not find an outlet in rising prices. When monetary policy is more lax, however, then the pressures can burst through and sweep the price-level upwards with them. The monetarists have objected that a non-negotiable conflict of interests cannot give rise to inflationary pressure unless people are under some kind of illusion. But this argument would seem to rest on the assumption that all bargains are struck at the same time with full knowledge of all the implications. In particular they ignore the 'psychology of leap-frogging'—if I may be permitted that somewhat quaint expression.

There may also be important interactions. Rivalry may help to cause inflation but rivalry may also grow with inflation. Inflation adds to uncertainty which affords a powerful stimulus to vigorous action by each group in order to defend its interests. The conflicts about the distribution of income may thus be magnified by inflation and the threat to stability correspondingly increased. There is, it is true, a different and conflicting theory to the effect that inflation may be a way of soothing conflicts and averting the sharp confrontations that could otherwise occur. Both theories have some plausibility. Perhaps the answer depends upon the pace of the inflation. A slow and steady inflation may calm the disputes; a rapidly accelerating inflation may aggravate them. But this is largely speculation. I have now strayed, as I said I would, beyond the bounds of economic science into an interesting but poorly surveyed border area.

The conflicts about distribution may not only take the form of struggles between rich and poor or between horizontal occupational groups. We must also take into account the unrelenting struggle between Government departments. Russia affords the most striking illustration. It is surely extraordinary that inflationary pressures should be present at all in so tightly planned an economy. What we must not forget, however, is the strong political pressure exerted even in a totalitarian society by the different claimants—by the armed forces, by agriculture, by the steel industry, and so on. It is Gosplan's duty to scale down these claims but apparently it fails to do so with complete success. Thus an inflationary gap remains which is reflected rather more in shortages, queues, and waiting lists than in rising prices. And it is not only in Russia that such unresolved departmental conflicts can add to the inflationary pressure. In Britain, as we well know, the Treasury has a formidable task in dealing with the central departments and still more difficulty in dealing with the local authorities. The net borrowing requirement has thus become a large and wildly unstable residual.

May I now sum up this part of my remarks? First may I say that I fully accept the monetarists' contention that the supply of money is a crucially important factor? But we must also try to understand the nature of the forces that lie behind the control of the money supply. There have been occasions when the monetarists, for their part, have gone so far as to concede the legitimacy of doing so, but have then imposed strange implicit restrictions on the permissible scope of the inquiry. For they confine their attention to the wickedness of Governments that want to despoil the rentier, to make off with the proceeds of fiscal drag, and to gain popularity by reducing unemployment—and to the foolishness of Governments that continue to submit to a monstrous regiment of neo-Keynesian advisers! One would like to believe that some of these complaints are more valid than others! One cannot help feeling that, if this topic is to be profitably pursued, this must be done less casually and over a wider front.

II

The rather eclectic approach I have followed so far will be maintained in what I shall now have to say about policy. It is convenient to consider policy under two broad headings:

first, the measures required to halt inflation or at least to slow it down to an acceptable rate;

secondly, the measures designed to ensure that reasonable stability is subsequently maintained.

Although the distinction between these two phases is convenient, it must always be kept in mind that the manner of dealing with the first phase can affect the subsequent task of holding whatever has been gained and of preventing a fresh outbreak of inflation.

Let us begin with the first period—the period of stabilization. Perhaps we have devoted relatively too much attention recently to theoretical controversies—some of them rather pointless controversies—about the causes of inflation, and too little to studying the experience acquired in different countries during previous periods of stabilization. I think we should find that really tough action to control expenditure has often been successful and more quickly successful than is always realized.

We may dismiss at the outset one of the objections sometimes raised against such measures: the objection that the control of monetary expenditure will be rendered ineffective by changes in the velocity of circulation of money. In the great inflations, such as those that took place in Europe in the nineteen-twenties, enormous increases in velocity did in fact occur, but there were also enormous increases in the amount of money. The situation was not one in which tight fiscal and monetary policies were thwarted by soaring velocity, but rather one in which the frenzied activity of the printing presses made people fear the consequences of holding cash. Of course these were desperate situations. Even in situations that are less desperate, however, quite sharp changes can occur in velocity—even in the velocity of M_1 balances (cash and current accounts) apart from any mobilization of deposit accounts for the active circulation. Financial planning may therefore be made more difficult. What we need not anticipate, however, is a rise in velocity so large, so swift, and so uncontrollable as to frustrate all attempts to cope with inflation by limiting the rate of growth of the money supply. This, after all, is a sound Keynesian conclusion.

Unfortunately the real difficulties have still to be mentioned. These are formidable. First there is the fiscal problem which cannot be separated from that of controlling the money supply. The previous inflationary rise in expenditure will usually have reflected a public deficit. I think it is a sound generalization to say that all steep inflations have been fed by public deficits. For an inflationary boom based on private investment is likely to be broken before long by the accelerator or some other market force. In the past this problem of eliminating inflationary public deficits had to be faced somehow by those countries that were suffering from hyper-inflation, but any hardships entailed may have seemed small as compared with those caused by the collapse of the monetary system. When, however, inflation has gone less far and has caused less hurt, there may be a corresponding reluctance to face up to the problems of fiscal control. Moreover, in Germany in 1923, it was possible to remove the main cause of inflation by abandoning the policy of subsidizing passive resistance in the Ruhr. There is no single act of policy that could accomplish as much in Britain today.

The second difficulty is the hardship and loss that may be experienced during the period of stabilization. Again this must have seemed worth accepting in order to end the miseries of hyper-inflation. In his classical work,[1] Bresciani Turoni described how the great inflation of the twenties shattered the social and economic life of Germany. There was even the danger of starvation in the cities because supplies were ceasing to move in a country bereft of an effective means of exchange. This, of course, was inflation on a scale not yet experienced in Britain. If I have devoted a few moments to hyper-inflation, this is because one sometimes hears the view expressed that until we too experience its horrors we shall not bring ourselves to display the resolution required for a strong anti-inflationary policy. It is scarcely a contention one would wish to accept; but it is one that can only be disproved by events.

In deciding what would be entailed by such a policy we must, however, take into account another exceedingly important fact: the fact that unemployment may be experienced at the same time as inflation. Unemployment in 1975 is high and is still increasing. By earlier standards the situation is surely quite extraordinary. In order to cope with this unemployment, the

[1] *The Economics of Inflation.*

traditional Keynesian remedy would be for the public authorities to run a deficit; but there is already an enormous deficit equivalent to well over 10 per cent of GNP. With so huge a deficit, financed in part by new money, we might have expected to have over-full employment and a raging demand inflation. Instead we have had too much unemployment and a raging cost-inflation. The push for higher wages may derive its force from anticipations created by a previous demand inflation, or from some fresh upsurge of militancy, or from some other source. The important point is that rising unemployment and rising wages may go together. In part the cost inflation has been imported. Thus, in 1972, the price of grain was pushed sharply upwards by the heavy Russian buying in America and a crisis of communism was neatly turned into a crisis of capitalism. Subsequently the vast rise in oil prices afforded a still more striking example. The monetarists have a valid point when they object that a rise in import prices cannot bring about the successive increase in costs and prices implied by the term 'inflation' unless total monetary expenditure is allowed to rise. This in turn implies an increase in the amount of money or in its velocity of circulation. The point is neither invalid nor trivial; but it does not follow in the least that nothing more is required than to control the supply of money.

These considerations suggest that stabilization policy should consist of two main elements:

first, there must be a reasonable degree of control over the rate of growth of monetary expenditure;

secondly, direct measures should be designed to hold down demands for higher pay.

These policies should be regarded as complementary to one another, not as alternatives. The adoption of both should strengthen the calming effect on inflationary anticipations. The fear that prices may rise is one of the factors that causes them to rise. On this point, at least, both monetarists and non-monetarists are agreed. Adouble-barrelled policy of this kind is an indication that Government is determined to end inflation and is obtaining co-operation in doing so. Surely it's not necessary to tread the weary round of adaptive expectations before anything can be done to soothe the widespread fear that prices are still going up and up, faster and faster. One of the most discouraging features of monetarism is the very long lag that is said to be necessary before inflation can be checked and before unemployment returns to its mysterious natural level. Here, if ever, is a time to quote again that much-quoted remark by Keynes: 'In the long-run we are all dead.' Perhaps this should be modified to: 'In the long-run we are all red.'

If the growth of expenditure has been such as to create an excessive demand for labour, then an attempt to control incomes directly will not work well and will not survive for long. This is a familiar point and one that can scarcely be disputed. What is so unfortunate is that it may be necessary to hold down the growth of expenditure even when there is a surplus supply in the labour market. It may be necessary to do so if the demand for increased pay is still being pressed on an immoderate scale. Government is under a clear obligation to prevent the currency from being destroyed by rapidly accelerating inflation with the disastrous consequences this would have for the balance of payments, the standard of living, and the level of employment itself. Expenditure must therefore be limited. If the unions continue to make excessive demands, they will then meet with more resistance from the employers; if, nevertheless, they achieve their demands, they will have brought upon themselves the penalty of rising unemployment. The unions have been warned often enough that this could happen, but it may be the case that only experience will carry conviction. It is, however, most desirable that the Government should not then allow its policy to be represented as one of using unemployment as a deliberate instrument of policy. The unions themselves will be responsible for the unemployment of which they complain, not the Government. If the Government were to follow a purely passive policy and to impose no restrictions on expenditure, unemployment would not in any case be avoided. It would come for different reasons, possibly a little later in time, probably much heavier in volume. I believe that this is a fair enough representation of an exceedingly ugly situation.

What I have just said should not be interpreted as an attempt to resurrect in its old form the Phillips curve which traced an inverse relationship between the rate of increase in wages and the level of unemployment. The Phillips curve in that old form is dead—a fact that must cause equal satisfaction, though for very different reasons, to Professor Friedman and to Lord Kahn. It may be that attempts to introduce into the equation an additional argument for price expectations will give more reliable results. All I myself have suggested above is that there is some very broad negative relationship between wage inflation and unemployment, even if the relationship cannot be represented as a statistical trade-off that can be confidently predicted.

There is much uncertainty about these matters which might ultimately be reduced by experience. But, for my own part, I should not wish there to be any sustained empirical test of the effect of controlling expenditure without other important supporting measures. For I do not believe that it is sufficient simply to raise a warning finger and then to shake one's head in sorrow if the warning is disregarded by the unions. Some of the trade union leaders may indeed be ill-informed and inattentive. Some may be ill-intentioned. But there are others of whom these things cannot possibly be said. The problem for them is to know what they can achieve in isolation without sacrificing the interests of their own members. For it is asking a great deal of union leaders or any group of employees to opt out of the game of leap-frog unless they can be sure that others will do the same. May I borrow terms from the theory of public finance—and mix up the metaphors a bit—by saying that the control of inflation is a 'public good' and even the most responsible citizens may be daunted and inhibited by their fear of 'free-riders'? By a 'public good' we mean a benefit that is common to all—a benefit that cannot be shared out in some relationship to the individual contributions made. By 'free-riders' we mean those who benefit but do not pay. A policy of direct control should be designed to remove the fear of free-riders. Moreover, if the adoption of such a policy carries with it some degree of conviction, then this will also reduce inflationary expectations. It will then be a case of success breeding success.

This is the kind of consideration that Keynes had in mind when he was discussing deflation. I quote:

> Since there is, as a rule, no means of securing a simultaneous and equal reduction of money wages in all industries, it is in the interest of workers to resist a reduction in their own particular case.[1]

It is not just a question of money illusion as the monetarists suppose.

What makes the present British problem so difficult is the extent to which the pattern of expenditure has been distorted by inflation and rendered inappropriate by exogenous developments in foreign trade. Inflation is always likely to produce distortions but their removal need not always make the control of wages more difficult during a period of stabilization.

[1] *General Theory of Employment, Interest and Money*, p. 264.

Let us suppose that inflation had been marked by a shift in the distribution of incomes in favour of profits. In much of the earlier literature on inflation it was confidently predicted that this is what would happen. In the *Treatise on Money*, Keynes made this assumption and so did Hayek in his theory of the trade cycle. It is now an integral part of Friedman's theory of departures from what he calls the 'natural' level of unemployment.[1] In fact there *may* be no such shift to profits at the expense of real wages even in a demand inflation. To use John Hicks's terminology,[2] many firms may follow a 'fixprice' rather than a 'flexprice' policy, and excessive demand may hit the labour market as quickly and as strongly as it hits the product market. In any case the theory relates essentially to demand inflation and the situation is obviously different when prices have been pushed up from below by rising costs.

If an inflation had followed the traditional pattern with a shift to profits and an investment boom, it might be possible during the period of stabilization to ease the pressure on real wages at the expense of profits and to ease the pressure on personal consumption at the expense of investment. But there is no scope for doing so in Britain in the mid seventies. The share of profits, already on a downward trend, has been pushed further down, partly by the nature of the inflation, partly by price control, and partly by the anomalies of an archaic tax system. Thus Britain finds herself in a remarkably difficult position. A larger proportion of the national output must be devoted to reducing the foreign deficit. Of the part left for domestic use, a larger proportion must be devoted to investment. The meeting of these requirements must obviously add to the difficulty of restraining demands for pay, even if these are designed to do no more than maintain existing standards of living.

If, then, consumption cannot be protected at the expense of industrial investment and real wages cannot be protected at the expense of profits, we must ask whether the state cannot help directly by reducing its own enormous claims. Here we come to another unfortunate aspect of the situation. For public expenditure is not only high but has been growing more rapidly than any of the other principal categories of expenditure. The

[1] 'The Role of Monetary Policy', *American Economic Review*, April 1968; Unemployment *v.* Inflation (with David Laidler), Institute of Economic Affairs, 1975.

[2] *Capital and Growth* and *The Crisis in Keynesian Economics.*

need to reduce this rate of growth is not, I think, open to serious question. The practical difficulty is to do so on a sufficient scale with sufficient speed. The heavy volume of public expenditure on goods and services needs to be cut; but this takes time. Subsidies can be cut more quickly, but the consequential rise in prices may place a further strain on incomes policy. The main social transfer payments are indexed and, in any case, if socially acceptable economies were to be made, these should be obtained by some new imaginative approach that ensured adequate protection for those in need. But such reforms take time.

The choices would be less hard and the correction of distortions less painful if we could raise the total volume of output. We are indeed in a sorry situation to be so perplexed by the allocation of scarce resources when our resources are not being fully used. If the measures needed to reduce unemployment could safely be taken, it would be that much easier to cope with the distortions I have mentioned. May I add that if the time for some fiscal stimulus had really come, the right method would be to cut taxation? For it would be an act of egregious folly to try to provide such a stimulus by a further net increase in public expenditure. There is, however, the tactical problem of deciding when the time for action has come. The net borrowing requirement for 1975/6 is already so vast as to be a threat to stabilization policy. Moreover any premature reflation might lead to an early resumption of cost-inflation that could not be contained by direct control. Fortunately it is no part of my task today to speculate about timing. My point is simply that, as more resources come to be used for reducing the foreign deficit and increasing industrial investment, the real burden may be met in part by making fuller use of the labour force. If the growth in output per head can also be resumed that will, of course, provide still more scope. For we must not think of growth as simply a long-term factor. Even over a period as short as a year, growth could substantially reduce the sacrifices required to bring about the relative sectoral changes—even growth at the low average rate achieved by Britain in the past.

What is of crucial importance, in circumstances such as these, is to prevent the whole process of adjustment from being checked by a new upsurge in demands for increased pay. For restraint in the labour market is a condition for reducing unemployment, and restraint is also a condition for a higher standard of living. Paradoxical though it may seem to individual workers, large increases in money incomes would damage, not improve, the prospect of getting increases in real income. As Keynes said in 1940: 'If all alike spend more, no one benefits.'[1]

III

Let us now address our attention to the longer-term measures that may be appropriate in order to prevent a recurrence of accelerating inflation. To do so may appear to be no more than a hypothetical exercise, for we are now starting with the assumption that the measures taken during the first phase have been sufficiently successful to achieve some kind of stability. This may sound like an invitation to explore some dreamy world of wish-fulfilment. But this is not so. For accelerating inflation *must* be checked. Admittedly it may not be checked in some circumstances until a particular currency has been destroyed; but a new currency must then be introduced and must be protected. We cannot live with ever-accelerating inflation. We cannot do so because a complex modern economy must have money, and money cannot perform its essential function for very long if inflation is accelerating. This is not an expression of wish-fulfilment. It is a statement of fact.

This leads at once to the question: what is meant by stabilization? Is it to be assumed that the price level has ceased to rise at all? Perhaps not. It might be too much to hope for complete stability of prices.

We come then to another question of basic importance. Is it possible to contrive to live with moderate inflation? Or is it rather in the nature of a moderate inflation to become immoderate with the passage of time? These are old questions but, until recent years, we may have been inclined to concentrate relatively too much attention on the danger of a rising velocity of circulation. The monetarists have taught us to direct rather more of our attention to the effect of inflationary anticipations on demands for pay and have, in this sense, made a real contribution to the understanding of cost inflation, however much they dislike that term! All this is of crucial importance. When the view is expressed, as it sometimes is, that inflation may not do a great deal of harm, it is being implicitly assumed that the inflation will not accelerate. Harry Johnson must have been assuming as much when he wrote: 'Either we will vanquish inflation at relatively little cost, or we will get used to it.'[2] We shall not get used to it if the pace gets faster and faster—as

[1] *How to Pay for the War*, 1940, p. 5.
[2] *Encounter*, April 1971, p. 32.

Keynes, of course, was well aware. Even if one remains puzzled and sceptical by the monetarists' concept of a natural rate of unemployment, their distinction between anticipated and unanticipated inflation is clearly important in this context.

This is, I think, still a field where more work both analytical and empirical needs to be done. This work should include, among other things, a consideration of the whole question of indexation. To attempt wide-scale indexation for the first time in the middle of a crisis might be rash, even if it were administratively possible. But at a later stage this item should be on the agenda. Indexation is, of course, only one of a large number of important questions that call for extended discussion. The field is vast and in my closing remarks I can attempt to do no more than make some brief observations on a few central issues. Unfortunately I shall be unable to discuss the important question of exchange-rate policy, but I may simply say in passing that, after the period of violent instability is passed, there may be a stronger case for returning to an adjustable peg system than it has been fashionable of late to suppose.

The first question I shall try to discuss is whether the ending of control in the labour market is not likely to be followed, as it has been in the past, by a new wave of inflationary wage demands. A wage freeze has proved to be reasonably successful on various occasions but a freeze cannot be continued indefinitely. The danger that a subsequent thaw will be followed by a flood is a very real one and the case for transitional arrangements has often been stated. We must, of course, remember that the pent-up demands of this kind cannot cause a fresh inflationary round unless additional finance is forthcoming. To refuse to permit any such financing would raise once more the problems that are only too familiar; but at least an attempt can be made to ensure that the financial position is not made unduly easy.

Some reasonable control of monetary expenditure will continue to be of crucial importance. But will it suffice? Or must we now conclude, in the light of experience, that we also need a permanent incomes policy? The question has been put often enough, but it is really unanswerable unless one knows what is meant by an incomes policy. At one extreme this might be taken to mean a policy of detailed control after the Soviet pattern. If so, its adoption would entail a great restriction of liberty in economic affairs; it would also require an authoritarian political system in order to secure its adoption and permit its enforcement. Nor is this all. For controls of this kind can also entail much inefficiency. We should do well to pay heed to Professor Nove's recent advice and to try to learn 'from Soviet experience about the difficulties which must arise even when the state own all industry and trade unions are emasculated, let alone in the very different situation in which we find ourselves'.[1]

Presumably many of the advocates of a permanent incomes policy do not really want anything so draconian as the Russian arrangement but what is, in fact, being proposed is not always clear. Fairly detailed control appears at times to be envisaged with the market largely superseded by administrative arrangements. Sometimes one can perceive in these proposals an engaging but unreal image of a group of impartial and high-minded men who would be able both to discern what equity entails and to enforce their rulings. As Sir John Hicks has recently remarked, it may often be hard in this context to decide what 'fairness' requires.[2] This may be hard to do, even apart from any differences in the value judgements held by different people. For these wise men would rarely be adjudicating between Dives and Lazarus. Their main task would be to assess the different claims of different occupations and industries. Nor is it realistic to suppose that the control of incomes would be in the hands of a group of people who could be described, in Adam Smith's language, as 'impartial spectators'.

The term incomes policy may be given a more limited interpretation and proposals may be so devised as to leave more scope for the market. Some of the proposals put forward can, indeed, best be described as proposals for the reform of the labour market. It would be a great help if mobility could be improved, although Swedish experience does not suggest that this would be sufficient in itself. Another familiar example is the proposal to ensure that all the main settlements take place at about the same time. This synchronization would presumably be necessary if there were to be a detailed incomes policy; even without such a policy, synchronization would help if leap-frogging were to be discouraged.

More than this may, however, be contemplated. Indeed more than this is inescapably required if only because the State itself is such a large employer of labour in Britain. In dealing with its own employees the State needs to have a policy and this policy should take into account the implications for the rest of the economy. Is still more really needed? It has been suggested,

[1] *The Times*, 31 Oct., 1974.

[2] *The Crisis in Keynesian Economics*, p. 64.

from time to time, that if a few key settlements could be influenced, this would be a great help and would allow some moderating pressure to be exercised without this involving detailed interference over the whole market. The problem is not only to know *how* to influence such settlements directly but also to know, in advance, *which ones* will prove to be the key settlements.

General guide-lines for the labour market as a whole are another possibility. In the past little has been achieved by guide-lines backed by exhortation; but guide-lines backed by penalties may seem more promising. These penalties may be made to fall on the employer and the appropriate use of price control is one technique. But permanent price control is a daunting prospect. Methods other than price control can, of course, be devised for imposing penalties on employers who grant extravagant wage increases and it is fair to say that selective penalties would have some advantage over severe monetary restriction which punishes both the 'just' and the 'unjust'. But again there is the danger of imposing an over-rigid pattern. It is important to distinguish between measures that may be appropriate for a short time in an emergency from measures suitable for a long-term policy.

The penalties might be made to fall not on the employers but on the workers. Again there may be various alternatives but, presumably, the critical issue would be to impose some sanctions on those who went on strike in order to obtain increases in pay well in excess of the guide-lines that could not be justified on special grounds. Suggestions have been made by a number of people, including Professor James Meade,[1] and attempts have been made to provide some measure of flexibility.

I have used the words 'penalties' and 'sanctions' but this may be a mistake. For the situation could be vastly improved if the tax system and the social security system were not so devised as, in effect, to subsidize strikes. I have now entered a mine-field. I am well aware that I may be accused of wishing to impose cruel hardship on the wives and children of strikers by denying them supplementary benefit. But this is not what I have in mind! We may protect the innocent from hardship but it does not follow that the cost need fall only on the taxpayer. Meade has suggested that we might explore ways of recouping the cost subsequently from the strikers after they had returned to work or from the unions themselves. There is, however, another aspect of the situation that is sometimes overlooked. This is that a large

[1] *Wages and Prices in a Mixed Economy*, Second Wincott Lecture, Institute of Economic Affairs, 1971.

plant may be brought to a standstill because a minority of those employed, perhaps quite a small minority, go on strike. The others are then entitled, not only to tax rebates, but to short-term unemployment pay and *that* is generous. In many cases their incomes will not then be reduced a great deal. In some cases they may actually be better off. The strikers will not then meet the same opposition from their work mates. The desirability of looking afresh at the arrangements for social security payments and tax rebates seems to be clear enough. It is a tribute to the moderation of the unions that, with our present arrangements, we have not had even more strikes than we have had. If the reform of these arrangements should prove to be impossible, the uneven weighting of the scales might be partly remedied by making payments to employers who are resisting unreasonable demands—payments on roughly the same scale as those made to employees. Of course this would only be relevant when it was thought necessary to buttress the resistance to claims based on the exploitation of monopoly power by the unions.

A market that is dominated by powerful monopolies is not likely to operate very satisfactorily, and monopoly power in the labour market is now far more important than monopoly power in product markets. But the latter is subject to investigation and some rules of the game are enforced. Any corresponding restrictions on the unions may appear to be out of the question for political reasons, but it may not be altogether inconceivable that those union leaders who take a constructive view would in time come to accept the need for some measure of restraint if the alternative were an authoritarian system, whether Communist or Fascist, that would put an end to free trade unions. That this may indeed be the alternative is a warning that needs to be given and to be repeated.

We are obliged to conclude by saying that the possibility of coping with a monopolized labour market within a free society remains an open question.

Unfortunately this already difficult problem has been made still more difficult in Britain by the characteristics of our party politics and by our electoral system. It would be generally agreed that our short-term freezes have been more successful than our experiments with more flexible incomes policies. But, as David Stout has pointed out,[1] these incomes policies have not had the backing of a Parliamentary consensus. When a policy has been

[1] 'Incomes Policy and the Costs of the Adversary System' in *Adversary Politics and Electoral Reform*, edited by S. E. Finer.

adopted, it has been attacked by the Opposition and when the Government has changed, policies have been changed. The particular party in power has also, on some occasions, made a sharp about-turn. This lack of continuity in policy together with the lack of support from the Opposition which could be so helpful, has added to the difficulty of coping with inflationary wage-demands backed by monopoly power. Electoral reform *might* help to provide more continuity. Here then is a good example of what is meant by 'political economy' and of what Adam Smith meant by that term.

Electoral reform may lie well in the future but, meanwhile, we can derive some comfort from the fact that the problem of controlling costs and prices in the past has been caused, in part, by demand inflation. If severe bouts of demand inflation could be prevented in the future, the continuing problem of cost inflation might then be somewhat less troublesome. In saying this, I am parting company with those economists at the opposite extreme from monetarism who claim that all inflation nowadays is cost inflation. After all, we experienced quite strong demand inflation as recently as 1973. Moreover, it is extraordinarily difficult to determine what is meant nowadays by excessive unemployment caused by a deficiency of effective demand. The statistics are hard to interpret. The labour market is immensely complicated. Even in 1975 there are shortages of labour, even of unskilled labour, even in labour-surplus areas such as Clydeside or Northern Ireland. We desperately need to acquire a better understanding of the labour market.

The fact remains that, even if we had done as much as we could reasonably hope to do in order to improve the functioning of the labour market in a free society, we should have to expect that, for various familiar reasons, there would be forces at work that would make for rising prices. I need do no more than refer to the familiar fact that in some occupations wage demands are closely related to rising productivity; in others, where productivity may be rising very little, demands are based on comparability. We may also have to cope more often in the future with adverse movements in the terms of trade. Prices may, therefore, tend to rise. But is this something that need cause concern? In what circumstances is inflation less likely to accelerate? How can such circumstances be brought about? Thus we are back to the crucially important question I mentioned before. There is another reason this issue is important. Although it should be the object of policy to avoid demand inflation, we should be indifferent to experience if we were to place too much reliance on fine-tuning. To be realistic we must expect some periods of demand inflation in addition to the other forces of a more structural nature that will make for rising prices. If we were to try too hard to prevent this from happening we should have to accept an average level of unemployment over the years that was higher than we should wish to contemplate either from a humanitarian point of view or from the point of view of efficiency. We must therefore expect some inflation to be a permanent feature of economic life and we must recognize that, from time to time, actual inflation will exceed anticipated inflation. The danger of acceleration will be there. A few years ago James Tobin observed that this danger is often exaggerated.[1] I do not know whether he would say the same today. Admittedly it is hard to assess the seriousness of the danger but it would be rash to make no provision against it.

The danger might be less if monetary policy had to operate within some known statutory framework. What I have in mind is a limit to the permissible rate of growth of the stock of money. (This is not, of course, to be confused with Professor Friedman's proposal that the money supply should—somehow—be increased each year by some predetermined proportion.) The limit to the rate of growth of the money supply should not be oppressive. It should be sufficiently high to accommodate the growth of real output at a fairly substantial average rate and to allow for some margin of inflation. The limit might be as high as 10 per cent—and that would be quite high after the stabilization period. It might never be approached in practice. It would be wrong to suppose that the actual money supply would always be pushed up to the ceiling in the belief that is what happens every time with all ceilings. On the contrary a close approach to the ceiling would mean so much uncertainty and embarrassment in the capital market and the money market that the authorities should be cautious about venturing so far. Even if the ceiling were ineffective in the sense that it was never closely approached, it could still serve a real purpose. For it would be a way of saying that the Government recognized its obligation to protect the currency and would not be prepared to finance indefinite inflation from an indefinitely augmented supply of money. Other policies, including the Government's own policies, would have to be reconciled with this fact. The anticipation of future increases in the price level might then be damped to some

[1] 'Inflation and Unemployment', *American Economic Review*, 1972.

extent. Statutes can, of course, be repealed, but to repeal a statute of this kind would be a serious affair, both at home and abroad, if the reason for doing so was clearly to provide scope for greater inflation. This is one tentative proposal. Perhaps there is not much political likelihood of its being adopted. But the need will remain to devise *some* safeguard against a future acceleration of prices that is more convincing than the day-to-day exercise of discretion by politicians.

Indexation may seem to afford a ready means of reducing the feeling of uncertainty that can give rise to accelerating inflation. The monetarists, for their part, maintain very strongly that this is so and many others who are not monetarists agree with them. Unfortunately this particular claim for indexation appears to be somewhat exaggerated and over-simplified. That this may be the case can be seen by turning our attention, first, to the state pension in Britain and then by moving on to wages. For a good many years pensions have been adjusted annually to bring them up to a fairly steady proportion of average earnings—to about one-third in the case of a man and wife. After a rise has been made, the pension will start to fall gradually relatively to wages and will continue to do so for the next fifty-two weeks at the end of which the pension will be raised again to its previous relationship with average earnings. These reviews have, indeed, protected the pensioner over the trend but not in the short run. His vulnerability in the short run will obviously be still greater if the rise in average earnings is accelerating. He will sink still deeper over a year, before he is hauled to the surface again at the next review and then after this review, he will sink deeper still over the following year.[1] So much for pensions. A similar conclusion applies to the adjustment of wages or salaries relatively to a price level that is rising steadily or at an accelerating pace. Again indexation will give some long-term protection but there will be sufficient danger of loss in the short-run to leave the workers and their unions with a continuing incentive to leap-frog. This incentive could admittedly be reduced in two ways: by providing retrospective compensation or by having more frequent changes in pay—say every six months or every three months or whatever. Greater reassurance could be provided in these ways; but the cost of administering such schemes might then rise quite formidably.

There is another reason why indexation might do less than the monetarists suppose to reduce inflationary wage claims.

[1] *Pensions, Inflation and Growth*, edited by Thomas Wilson, pp. 374–6.

Traditionally it is the job of trade union officials to win as large increases in pay as they can. Their skill as bargainers will be judged accordingly. Let us now suppose that wages in some occupations are pushed up by, say, 10 per cent. In one situation this might be entirely the outcome of wage negotiations without indexation; in another three-quarters might come from indexation and only a quarter from the efforts of the trade union itself. It would surely be naïve to expect that the union leaders would be indifferent between these two methods of achieving the same outcome. They might well hope to secure something like 10 per cent *in addition* to the indexed increase.

For all these reasons, indexation may not provide as simple and easy a solution as is sometimes supposed. This is not to deny that, on a more realistic assessment, there remains a case for a good deal of indexation if we must indeed resign ourselves to, at best, some fairly steady decline in the value of money.

So far three conclusions about policy have been put forward. The first is that ways may be devised of making the labour market work in a less inflationary manner although it is not realistic to suppose that detailed regulation after the Soviet model is either feasible or desirable for Britain. The second conclusion is that some statutory limit to the rate of growth of the money supply might be reassuring and discourage the growth of inflationary anticipations. The third is that indexation might now afford reassurance even although some of the claims that have been advanced for it have been exaggerated. There is also a fourth line which might help by reducing the pressure for increased pay. This fourth method is a reduction in Government expenditure relatively to gross national product, as this in time becomes possible. This reduction would be accompanied by cuts in taxation on a substantial, though not necessarily an equal, scale.

It is true that Britain is not the only country where public expenditure is a high proportion of GNP, but it is also true that Britain is not the only country to have suffered from inflation. The relative growth of public expenditure is surely one of the factors that contributed to the upsurge of inflation throughout the developed countries of the West. Admittedly there is no simple international correlation between its importance relatively to GNP and the rate of increase of prices; but that is scarcely surprising when other things are so emphatically not equal.

There is general agreement, I think, that the fast growth of public expenditure has contributed to Britain's inflationary problems in recent years but some economists have been reluctant to admit that the high level of this expenditure relatively to GNP is also a relevant factor.[1] This proportion has risen from about a third of GNP to more than a half over the past twenty years. If it were only the speed of movement that mattered and not the ultimate destination then it could be argued that even if public expenditure accounted for three-quarters of GNP, or nine-tenths, that would have no inflationary implications! Not, I suggest, a convincing doctrine!

A high relative level of public expenditure is inflationary in that it makes the task of monetary management more difficult. But it is also inflationary in so far as severe taxation gives additional strength to the demands for higher gross incomes. It appears to be a fact that people do not regard more public goods, more merit goods, or even increases in the 'social wage' as adequate substitutes for private disposable net income. Some observers may feel that they should do so; but our concern here is simply with the fact of the case. The fact is that we are schizophrenic. We vote cheerfully enough for increased public expenditure but we do not accept the consequences when it comes to bargaining about our own incomes. Let us recall once more the theory of public goods. It has been recognized at least from the time of David Hume and Adam Smith that the financing of public goods cannot be done on a voluntary basis. Taxation has appeared to provide the answer by removing the danger that some will derive the benefit but evade the obligation. This solution rests, however, on the assumption that the gross incomes on which taxation is levied will not be raised in order to compensate for the taxation itself. Perhaps it was not an unreasonable assumption when public expenditure was quite low but the situation looks very different in the mid seventies. We have, indeed, been aware for a long time that higher indirect taxation may be a stimulus to higher wage demands, but we must surely concede that this is also true of direct taxation.

The view that high taxation tends to be inflationary has been pressed very strongly in recent years by Jackson, Turner, and Wilkinson at Cambridge[2] and by Johnston and Timbrell at Manchester.[3] If they are right, a reduction in the relative

[1] Memorandum submitted by Lord Kahn and Mr. Michael Posner to Expenditure Committee (Ninth Report from the Expenditure Committee, session 1974, p. 67, paragraph 10).

[2] *Do Trade Unions Cause Inflation?*, Cambridge, second edition 1975.

[3] 'Empirical Tests of a Bargaining Theory of Wage Determination', *The Manchester School*, 1973.

importance of public expenditure should be one constituent of anti-inflation policy. There is little need to stress that attempts to achieve such a reduction would encounter administrative difficulties and meet with opposition from many pressure groups. But there is more than this to be said. For cuts on a significant scale will raise difficult questions of social ethics. Presumably we should all accept as a principle of policy the need to ensure that the cuts are of such a kind as not to impose additional hardship on poor people. A good deal of ingenuity may be required if this principle is to be strictly observed and substantial economies achieved, but the task should not be impossible. In considering what should be done we must begin by recognizing that the amount spent in Britain on the various social schemes for income maintenance is not high relative to GNP by international standards. Our pensions, in particular, are not outstandingly generous. It does not follow, however, that the money could not be spent to better effect in assisting the elderly and the same can, of course, be said of the health service and various other branches of the welfare state. Short-term unemployment pay—as distinct from long-term unemployment pay—is perhaps the outstanding case where our arrangements have got out of hand. On grounds of social justice, as well as on grounds of economy, those who work should obtain a substantial net monetary advantage from doing so but many get little more at work than they would on short-term unemployment pay when taxation, the cost of travel to work, and so on are taken into account. Reform is needed although we need not expect to save a lot of money from cutting this particular item.

I have returned to this question of short-term unemployment pay not only because it is of some importance in its effect on the labour market but because it affords rather a good illustration of the obstacles we have to encounter in coping with inflation, as with much else in our divided society. No one can seriously doubt that any change would encounter fierce opposition—even a change in the tax law which would rule that unemployment pay, like pensions, should be assessed. Housing policy is another example of the difficulty of changing policies for reasons of humanity and efficiency as well as economy. More generally, suspicion and hostility add to the problem of coping with wage inflation which would, in any case, be difficult enough. For it is surely a fact that many people who are quite reasonable, responsible, and moderate will support inflated demands for increased pay, not only because there is leap-frogging, but also because they believe that there is still a large pool of high personal incomes, earned and unearned. Why then should they be content with only modest increases in wages? Why should they respond to appeals for sacrifices? In particular there is widespread misunderstanding about the purpose of profits and the uses to which profits are put. Consider, for example, the results of the ICI survey which revealed that in the opinion of most of those interviewed, profits simply went into the pockets of the directors. Business has been miserably incompetent about explaining what it is all about and the political parties have not been much more successful in presenting the facts of the case. Nor am I convinced that our own profession has done as much as it should have done to foster a better and wider understanding of these matters. The work of the Royal Commission on the Distribution of Income and Wealth should be a great help provided—and this is crucial—its findings receive the general attention they deserve. For it is not enough to say that conflicts over the distribution of income are one of the reasons for inflationary pressure. We must also recognize that widespread and strongly held misapprehensions about this distribution can add to that pressure.

In saying this I must guard against misinterpretation. It is far from my intention to deny that there are serious inequalities in our society. It would be hard for anyone who lives in Glasgow, as I do, to be unaware that this is so. There are, however, two errors, one of the Left and one of the Right, and both are harmful. The Left Wing error is to suppose that what is thought to be inequitable is also of great quantitative importance; the Right Wing error is to pretend that what is quantitatively of little importance, can, by and large, be disregarded. These are both false views and both need to be combated. If we could achieve a better understanding of these matters—an understanding that is more realistic but not less generous—then we should, I believe, have a much better chance of achieving that national concensus which would make it much easier to cope satisfactorily with the Political Economy of Inflation.