Chapter 5
Inflation and unemployment – a critique of Meade's solutions

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It is generally agreed that wages are central to the problem of inflation but there is much dispute about how wages are and should be fixed. This chapter gives a critique of Professor Meade's recent writing* on stagflation – the combination of inflation and high unemployment which has been manifest in Britain and other Western countries during much of the past decade. The first part of the chapter sets out Meade's hypothesis and his policy proposals. The remaining sections argue that he makes the wrong assumptions about how markets, in particular the labour market, can and should function in a modern economy.

5.1 Meade's hypothesis and proposals

It is important at the outset to differentiate Meade's views from those of monetarist economists who assume that growth of the money supply is the cause of inflation and who therefore deny, explicitly or implicitly, that trade unions can be held responsible. The extreme monetarist position is that markets, including the labour market, conform to laws of pure competition – or at least that the economy functions as if this were the case. Meade's starting point, which is probably more representative of the views of the majority of academic economists, is that product markets are more-or-less competitive but that the labour market in very important respects is not.

The main cause of inflation, according to Meade, is the capacity of trade unions to press excessive wage claims even when labour is in excess supply. The power of trade unions to secure wage increases has been buttressed by legislation giving them legal immunities and by social security provisions which reduce the financial cost to workers of going on strike and lessen their fear of unemployment. Moreover government commitments to the maintenance of high employment through expansion of aggregate demand have made it possible for trade unions to achieve large money wage increases without causing aggregate unemployment to rise in the short run. Trade union power has grown for other reasons too – not only because of government policies. Technological changes have increased the leverage of many particular groups of workers and industry-wide bargaining keeps down competitive risks associated with wage increases as well as making the damage inflicted by strikes more widespread.

The power of trade unions has also been responsible, in Meade's view, for long-term increases in unemployment. Pay rises have squeezed company profits, causing firms to curtail investment with job losses as the eventual result.

The policy conclusion drawn by Meade is that unless the capacity of trade unions to press wage claims is reduced, governments can only contain inflation by causing or allowing stagnation of aggregate demand at the expense of still higher unemployment. Restriction of trade union power and reform of wage bargaining arrangements are the main necessary conditions for a simultaneous recovery of employment and reduction in inflation.

Meade puts forward a number of proposals, starting with a national wage guideline and demand-management policy (operated through conventional fiscal and monetary adjustments) which should be designed to ensure that aggregate demand grows in money terms at a rate consistent with the wage guideline, allowing for a suitable expansion of real demand and employment. He assumes that there would be no serious obstacle to the government's macro-economic plans arising from the state of the balance of payments since he believes that changes in the exchange rate can adjust the levels of exports and imports.

The main danger which Meade emphasises is that wage increases might, on average, exceed the national guideline, implying a possibly catastrophic shortfall in real demand (unless the government changed its fiscal and monetary policies to allow faster growth of aggregate demand in money terms).

The crucial element in his proposals is therefore a series of measures intended to ensure, so far as possible, that the average increase in money wages conforms with the national guideline. These measures include the removal of legal immunities

*As presented, principally, in J.E. Meade, *Stagflation, Volume I: Wage Fixing*, London, Allen and Unwin, 1982.

granted to trade unions, decentralisation of wage bargaining to the local level, and a system of arbitration which either party in a wage negotiation may invoke if agreement is not reached. Meade also recommends measures to increase the mobility of labour, including the banning of closed shops, improved training opportunities and the abolition of rent controls and housing subsidies (which discourage people from moving). Finally, he favours measures to increase competition and curb monopoly profits in product markets.

Meade's norm with regard to wage fixing is that wages should rise more for jobs which attract insufficient applicants and less for jobs which attract too many applicants – in other words that money wages should adjust so as to clear the job market in each locality and occupation. This is explicitly the criterion to be adopted for arbitration. Traditional considerations of comparability, differentials, productivity and cost-of-living increases should be set aside and awards should be determined mainly with reference to the national guideline and the balance of supply and demand for labour in the particular occupation and area under review. The logic behind this criterion is that if wages were generally fixed so as to balance labour supply and demand, there could be no involuntary unemployment. The average increase in money wages must then turn out to be consistent with the government's guideline and its demand-management policy.

Meade notes that if wages are fixed so as to clear labour markets, any consequent problems of low pay and socially undesirable income distribution will have to be dealt with by taxation and the social security system.

5.2 Critique of Meade's assumptions about product markets and profits

It is clear that Meade's proposals rest heavily on his view about how the labour market ought to function. But to set arguments about the labour market in perspective let us first note some wider points of agreement and disagreement.

We share with Meade the view that demand management, employing both fiscal and monetary instruments, is a crucial government responsibility and we broadly agree with him about how it works. In particular, if demand management is designed to achieve a certain increase in aggregate money expenditure, wage inflation in excess of the planning assumption may cause a shortfall in real demand and jeopardise aggregate employment.

We do not agree, however, that demand management can be operated more or less independently of the state of the balance of payments. Manipulation of the exchange rate does not in practice give the British government sufficient control over exports and import penetration to balance trade at anywhere near a full-employment level of aggregate demand. Moreover changes in the exchange rate have an important feedback on the rate of inflation. The difference of opinion between us and Meade about the possibilities of balance of payments adjustment is not only a matter of empirical observation. It derives in part from a disagreement about the nature of competition in product markets. Meade implicitly assumes that price changes can readily alter market shares and, in our view, downgrades the significance of product differentiation and other forms of non-price competition.

A related issue is the process by which prices, profits and investment are determined. Meade attributes low profits and low investment to excessive increases in money wages. This is how he explains the long-term rise in unemployment. We believe the evidence that firms generally pass wage increases through into prices. In practice the main causes of low profits are recession of demand, when price mark-ups become inadequate to cover the higher ratio of overhead costs to sales revenue, and over-valuation of the exchange rate which forces exporters to reduce profit margins. A squeeze on profits may occur for either of these reasons, regardless of the rate of wage inflation, but does not occur because of wage inflation *per se.* Nor do we agree that low investment is a direct cause of unemployment. As argued in Chapters 1 and 2 of this *Review,* the main reason for high unemployment in Britain is a weak performance in external trade which cannot readily be corrected by devaluation and which is both the cause and the consequence of cumulative industrial decline. It follows that Meade's proposals, even if they were capable of curing inflation, would not solve the long-term problem of high unemployment.

5.3 Critique of Meade's view of the labour market

Meade evidently believes that the labour market does not function according to the laws of pure competition but considers that it should be made to function more nearly in accordance with those laws. His intention is that wages should vary in each area and occupation so as to match supply and demand for labour and that employees should move as freely as possible from one job to another. He attributes the fact that the labour market does not at present operate in these ways almost entirely to the existence and power of trade unions. These views take little account of how labour markets have evolved, why their institutions take the form they now have, and what the benefits as well as the disadvantages of present arrangements are.

We have no desire to assert that the present form of labour markets is in any sense the most desirable one, nor to minimise their contribution to inflation. But, as will become apparent, we do not think that Professor Meade's proposals are either feasible or desirable.

For most employees, jobs are the main source of income. Equally, the most critical factor in the success of most businesses is the contribution of the workforce. In modern production processes, labour is highly specialised; there is a huge variety of jobs with widely differing characteristics. The high productivity of modern production relies heavily on this specialisation.

The above observations about the labour market in modern economies are virtually independent of how the labour market as such is organised. They are, rather, circumstances with which any actual or proposed labour market arrangements have to contend. We may now briefly summarise how the labour market has in practice evolved in Britain and add some suggestions as to why it has evolved in such a manner.

The general characteristic of labour markets, whether unionised or not, is that workers are not free to move from one job to another. Whilst individuals are free to vacate an existing job, their access to others is severely curtailed. Access to vacant jobs is carefully controlled, and the higher the pay and status the more restrictive the rules of entry. Rules of exclusion operate on all groups at all levels and are mutually re-inforcing in the sense that workers in each labour market group, excluded from better jobs, more carefully protect those within their control. The few jobs which are accessible to almost anyone are generally those which almost nobody would want.

Access to particular jobs, and the incomes associated with them, often depends on social circumstances as much as ability and qualifications. The social position of married women, for instance, has made them willing to accept jobs of low skill and little responsibility which attract relatively low wages. Their choice of position in the labour market hierarchy is restricted by social constraints even though on purely economic criteria their productivity would open up a wider selection of occupations. In a similar way access to the smaller number of 'good' jobs towards the top of the labour market hierarchy is restricted by trade union and professional association rules and restrictions which are supported by custom and social acceptance.

The fact that the labour market is divided into largely non-competing occupational groups does not mean that it is inflexible. A part of the flexibility is achieved through changes in the supply of labour, by expansion or contraction of the fraction of the population seeking work, by variation in hours worked and multiple job-holding, by migration, inter-industry shifts, education and training. Among those people already in the labour force, flexibility is achieved by lower tiers serving as reserves of labour for higher tiers and as safety-nets for workers displaced downwards. The adjustment which takes place as job opportunities arise or disappear at different points in the hierarchy is limited to sequences or chains of small individual moves by the fact that jobs with different levels of pay reflect not only job content but also the social status of the occupation. One of the effects is that unemployment and the least attractive jobs tend to be highly concentrated in particular social groups.

Most labour market groups have well-defined aspirations founded on strong notions of an appropriate pattern of life which changes as real living standards adapt to economic growth. These are generally respected by employers and indeed are often encouraged by them. The degree to which the economic system is capable of fulfilling these aspirations in practice influences labour relations, the development of trade unions and the pattern of wage-fixing.

Periods of sustained wage inflation are caused by worsening inconsistency between workers' aspirations and the level of real wages which they actually receive. In Britain such circumstances have always led to a strengthening of formal bargaining through trade unions. Thus in the century from 1851 to 1951 there were two periods of rapid inflation – the first from about 1895 to 1920 and the second from 1933 to 1951. In both periods* there was a substantial growth of trade union membership amongst blue-collar workers and growth of national collective bargaining covering large parts of the economy. By contrast non-inflationary periods were marked by constant or declining trade union membership and less change in the pattern of bargaining. Much the same has been true since 1951. During the 1950s when real wages increased steadily the rate of increase in money wages slowed down and trade unions were quiescent. In the 1960s when real wages grew more slowly the rate of inflation began to rise, trade union membership increased (particularly amongst women and white-collar workers), and in many industries national wage bargaining began to be replaced by plant and company bargaining. In the public sector where national bargaining continued to prevail there was a sharply increased incidence of industrial disputes.

This historical record leaves little doubt that, while trade unions can cause inflation, inflation can also cause changes in trade union membership and organisation. A fall, or slowdown, in growth of real wages tends to increase money wage claims by the well-organised. This need not accelerate inflation if the real wages of less well-organised groups are reduced to compensate. But any squeeze on living standards of less-organised groups tends to induce a strengthening of their organisation. As inflation continues, organised wage bargaining spreads and the interval between negotiations shortens.

The development of collective bargaining in Britain can therefore be seen as an evolution of increasingly comprehensive wage indexation which has advanced more rapidly whenever real wages have been squeezed. Government attempts

*For an analysis of developments up to 1920 see Tarling and Wilkinson, 'The movement of real wages and the development of collective bargaining in the period 1855 to 1920' in *Contributions to Political Economy*, supplement to the *Cambridge Journal of Economics*, 1982.

to curb this process by introducing incomes policies have ultimately been counter-productive because they have depressed the real wages of many groups, especially in the public sector, provoking a militant response which has caused increased inflation as incomes policies have broken down.*

The background to this history of wage indexation and extension of trade union organisation is the underlying pattern of labour market organisation described earlier. Workers and employers have generally cooperated in formalising this pattern of organisation and extending the role of trade unions within formal bargaining machinery. The possibility of dramatically reducing this power of organised labour by political and legal means seems unlikely. Since the legitimisation of trade union activity in the 1870s periodic attempts have been made both by the courts and by parliament to reduce the degree of protection afforded to organised labour. Such legislative action, was, however, subsequently reversed by parliaments more sympathetic to the aspirations of working people.+ Governments in the past have played a central role in establishing improved conditions of employment and in setting the legal framework for effective bargaining by trade unions. The evolution of the British system of collective bargaining has been both an industrial and a political process. Working people have influenced the outcome of the collective bargaining process both directly through changing their industrial organisation and indirectly by giving electoral support to political parties. Thus the evolution of the British system of collective bargaining and its forms of representative government are closely related. The fundamental question at stake in any proposals for change is why labour markets are organised on the basis of largely non-competing groups with well-defined aspirations, and how this type of organisation has evolved and is maintained.

We can only suggest the answers to these questions. The pattern is so pervasive that there is little direct evidence of how any different organisational form – in particular the more widely competitive form recommended by Meade – would work out. It seems probable that the present limitation of competition provides the stability of employment and income required by both workers and employers if the highly-specialised division of labour characteristic of modern production is to be a success. Unnecessary job movements would involve a great waste of experience and skill.

If stabilisation of labour markets is a crucial need, so evidently is flexibility. But flexibility can be achieved in many ways, some of which are more compatible with stability than others. Under present arrangements wages do not provide the 'signals' for movement which Meade would like to see them provide. Instead movements are mainly prompted by job availability.

The function of wages in the labour market is therefore an important issue. In his study of the relationships between growth and structural change, Salter asserted that uniformity of wages would strengthen the pressure for movement from low to high productivity jobs. As he puts it:

> The argument that an industry cannot 'afford' higher wages is, in the long run, extremely dangerous. If it were accepted and wages were based on 'capacity to pay' employment would be perpetuated (unless labour deserted them) in industries which should properly decline to make way for more vigorous industries. Equally dangerous is the argument that industries which are prosperous because of new techniques have the 'capacity to pay' high wages.

(W.E.G. Salter, *Productivity and Technical Change,* CUP, 1966, p.153)

Against Salter's view there is the argument that if wages are low for low-productivity jobs and for those for which there is an excess of applicants, and correspondingly wages are high for high-productivity jobs and for those for which there are comparatively few applicants, appropriate signals are being given directly to workers to encourage them to move in a manner which will increase the overall efficiency of employment. Which view is right? The answer must depend mainly on the reasons why people are in practice to be found in low-paid jobs. If they are there out of choice, low wages may be providing an incentive which they have freely decided to ignore. But if, as many studies suggest, they are there because they have few or no other employment opportunities, low wages may indeed, as Salter says, perpetuate a situation which is inefficient as well as being unjust.*

The notion that wages should adjust in the short run to clear labour markets, if taken at all literally, would rather obviously lead to absurd instability of wage levels and employment. The labour market could not possibly be operated like the stock market or the foreign exchange market where prices continuously perform the function of balancing supply and demand. Not only would workers' income be hopelessly unstable (since unlike investors they could not hold highly-diversified portfolios) but also people would rush from job to job making the task of production

*See Tarling and Wilkinson, 'The Social Contract: post-war incomes policies and their inflationary impact', *Cambridge Journal of Economics,* 1977.

+ Thus the legal immunity afforded to trade unions by the 1906 Trade Disputes Act resulted from a landslide victory of the Liberal Party resulting directly from anti-trade union activity of the courts culminating in the Taff Vale judgement. Moreover Labour Governments of 1945-51, 1964-70 and 1974-79 took legislative action both to restore rights eroded by legal or statutory changes and further to improve the position of labour.

*For an elaboration of these views, see Craig, Rubery, Tarling and Wilkinson, *Labour market structure, industrial organisation and low pay,* CUP (forthcoming).

almost impossible to perform.

But, even with a longer-term adjustment period, the setting of wages to induce a more orderly pattern of change by welding 'not so compulsory arbitration' onto a system of collective bargaining which effectively functions as part of the wage determining process would not provide the desired signals. The existing system of collective bargaining has operated very effectively and remarkably peacefully and even in the most strike prone years only a very small proportion of wage agreements are affected. There is no doubt that arbitration serves a useful function in many industries but there is equally no doubt that it can only operate effectively if there is a basis for compromise between the competing demands of the two sides. In his discussion of arbitration Meade envisaged that the system might make awards higher or lower than the guideline in the interests of increasing employment. In practice, however, the number of awards higher than the norm handed down by the arbitration board would be relatively small: where firms can afford high wage increases settlement is seldom difficult. Consequently the main function of the arbitration system would be fixing and enforcing low settlements. This could have a general effect of exerting a downward pressure on wage settlements – bargainers would settle if they believed arbitration would award them less – but it is unlikely to generate the sort of credibility Meade sees as essential for the effective operation of his system. Moreover, it is unlikely that arbitration would be of any use in resolving such major disputes as the miners' strikes of the early 1970s and the use of a wide range of sanctions suggested by Meade to enforce settlements generally regarded as unfair would provoke wide and organised opposition. The essential factor which is missing from the proposal is the basis for co-operation between employers and employees where workers and employers are least well-organised and where employers are under the strongest cost pressure either because of relative inefficiency or because of competitive pressure.

5.4 How could stagflation be tackled?

Meade is wrong to attribute restriction of competition in the labour market mainly to the existence of trade unions and wrong to imagine that the labour market could be made to conform with the economist's ideal of a market cleared by price signals. It follows that collective bargaining is indispensable and that wage-fixing must have regard to workers' aspirations and to the hierarchies based on social custom and values as well as job content which regulate labour market movements. But these hierarchies are not intractable problems imposed on the workings of the labour market and the economic process. Rather their evolution, the institutions which accompany them, and the legislation which supports them are an integral part of the operation of the labour market, and indeed are deeply embedded in the social, economic and political fabric of the British economy and its democratic system. This fundamental reality cannot be brushed aside as the 'uncontrolled power of labour monopolies'.

If Meade's specific proposals for reducing trade union power and changing arrangements for wage-fixing are largely unworkable, then his entire vision of how stagflation should be brought to an end must also fail. For, as he admits, the demand-management part of his proposals is likely to have catastrophic consequences unless the average increase in money wages conforms with the national wage guideline on which his scheme for demand-management would be based. Nor, in the light of past experience, can a national wage guideline be enforced for more than a temporary period by traditional forms of incomes policy.

The Policy Assessment and Chapter 1 of this *Review* set out ways in which the stagnation component of stagflation could realistically be tackled. A recovery of employment and output growth would also provide better real wages and therefore, in the long run, help to reduce inflation by allowing aspirations to be met more fully.

But economic recovery will not solve the problem of inflation and by improving job security may well encourage higher money wage increases in the short run. However we doubt that inflation in Britain could accelerate in a cumulatively unstable manner. If inflation becomes intolerable to the majority of workers and employers, any government can certainly expect cooperation from employers and trade unions with respect to temporary solutions, as has been well demonstrated in the past, but it must not expect those temporary solutions to become permanent. Long-run alleviation of inflationary pressures will depend mainly on developing systems of production and labour organisation which are fairer and more efficient than those at present in existence. If this is not achieved in the workplace, the conflict can quite easily erupt outside the workplace with potentially disastrous consequences. A satisfactory programme for reducing inflation therefore requires more, not less, collective bargaining.