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Tax and Unemployment

Any tax sooner or later inflates the aggregate supply price and, in an open trading economy the extent to which this causes firms to become uncompetitive, must lead to some unemployment. More importantly, in the conditions prevailing throughout the western industrialised economies, some methods of taxation operate directly not only to increase unemployment but also to destroy jobs permanently. To earn a living in a trading economy it is necessary to trade and to trade one must have something to sell. When, as is the general case in contemporary trading economies, those who supply the labour to productive enterprises have no title to the the resulting output, then they have nothing to sell but their labour. The complement to this is that those who expect to enjoy title to the output must buy in, along with everything else, the labour necessary to produce that output. Thus, in addition to markets for output, there arises a labour market in which the buyers and the sellers of labour come together and through the process of bargaining determine what is, in effect, a market price for labour. Given this condition, withholding taxes assessed on the gross pay of employees and payroll taxes imposed on employers combine to reduce directly the prospects for employment by distorting the labour market through the effect of these taxes on both the bargaining process and the market price for labour. In addition these forms of taxation directly destroy jobs by acting as a subsidy on what from the employers' point of view are labour-saving investments. In fact these kinds of

investments are motivated by the employers' need to avoid tax in order to sustain competitiveness.

The Price of Labour

In economic theory the market price for labour is usually called 'wages', but this term is open to many conflicting interpretations. Professor A. W. Phillips, when formulating what has become known as the 'Phillips curve hypothesis', took money wages to be the market price for labour.[1] This view of wages was described by Milton Friedman as being 'utterly fallacious' and he called upon 'every economic theorist from Adam Smith to the present' in support of his contention that the market price for labour is 'real wages'.[2] In this instance Milton Friedman underrated Adam Smith's perspicacity. In *The Wealth of Nations* Adam Smith wrote: 'The money price of labour is necessarily regulated by two circumstances; the demand for labour, and the price of the necessaries and conveniences of life'.[3] He acknowledged also that this money price depended on an agreement between employer and employee 'whose interests are by no means the same'.

In the closing decade of the twentieth century Adam Smith's second circumstance refers to the purchasing power of take-home pay (gross pay including benefits in kind less withholding taxes) in terms of what, following Pigou, are called 'wage goods'. This aspect of pay is of little direct concern to employers but it is of direct concern to employees. It is a factor determining the bottom limit below which an employee, as a seller of labour, is not prepared to settle with an employer. As has been argued (p. 52) when the purchasing power of take-home pay is eroded by rising prices, it is employees who react. When the most employers are prepared to offer as take-home pay is less than the money sum represented by this bottom limit, employees withdraw from the market as suppliers of labour. Thus Adam Smith did

not argue real wages to be the market price for labour, as Milton Friedman claimed and others often imply, but rather that real wages are only one of the factors determining the money price and the supply of labour.

The first circumstance noted by Adam Smith as regulating the market price for labour is determined today by the demand from firms for the labour supplied by employees. This demand for labour is a *derived* demand — a demand derived by firms from the demand for the outputs produced by that labour. Thus the demand for labour is determined not so much by conditions in the labour market as by conditions in the markets for outputs. These markets for outputs determine also the per-unit market prices of outputs. As a result, therefore, the most firms can afford to pay for the labour demanded is determined by the conditions in the markets for output rather than by labour market conditions. As the markets for outputs move in favour of the sellers of outputs (firms) then the demand for labour will tend to increase and the most firms can afford to pay for that labour will tend to rise. As the markets for outputs move in favour of the buyers of outputs then, the demand for labour will tend to contract and the most firms can afford to pay for the labour demanded will tend to fall. In the general case firms can effectively demand labour only to the extent that it is profitable for them to do so at the current market price they must pay out for labour.

Pay Bargaining

In the process of pay bargaining the top limit above which the price for labour cannot rise is set by the most firms can afford to pay for the labour they demand. The theory of Keynes leads to the conclusion that pay settlements tend towards this top limit rather than, as generations of economists and others have asserted or implied, the least employees are prepared to accept. According to Keynes' theory

the take-home pay included in the aggregate supply price is an aggregate determined by the top limits set by firms in the process of pay bargaining. This is so by definition, for the take-home pay included within the aggregate supply price is, after allowing for expected total tax liability, the most firms can afford to pay directly to their employees consistent with the expectation of a minimum profit just sufficient to induce them to produce the output from an amount of labour represented by that take-home pay. If for some reason, other than a change in withholding tax, actual take-home pay turned out to be less than that expected by firms at any level of activity, then actual profit would exceed that amount of profit the expectation of which was just sufficient to induce firms to operate at that level of activity. In this event the competitive struggle would cause firms to revise their individual supply prices downwards consistent with a minimum profit after taking into account the lower market price for labour in terms of take-home pay. This revision would lead to a shift downwards of the aggregate supply price curve (Figure 1, p.24) and, assuming an unchanged demand price curve, the point of intersection would move to the right corresponding to a higher level of activity. This higher level of activity would be that at which firms expected the most they could afford to pay out as take-home pay would approximate to actual settlements. Conversely, if for some reason, other than a change in withholding tax, actual take-home pay settlements turned out to be more than firms expected at any given level of activity, then actual profit would be insufficient to induce firms to sustain that level of activity. The upward revision of their individual supply prices would lead to an upward shift of the aggregate supply price curve and, assuming an unchanged aggregate demand price curve, a contraction of activity. The lower level of activity would be again that at which firms expected the most they could afford to pay out as take-home pay for labour would approximate to actual settlements.

The assumption of an unchanged aggregate demand price does not invalidate the conclusion that take-home pay settlements tend towards the most employers can afford to pay, although it may exaggerate the resulting changes in the level of activity. When settlements turn out to be less than expected, then spending on consumption is likely to be less than expected. However, since the propensity to spend on consumption out of disposable income is generally less than unity, the shortfall in consumption demand is unlikely to be as great as the shortfall in take-home pay settlements. The propensity of government to spend out of tax revenue plus borrowing requirement is always (p.26) equal to unity, but spending on investment is more a matter of conjecture. Larger profits than expected will tend to increase investment spending while a shortfall in the expected spending on consumption will tend to contract investment spending. Taking all relevant factors into account it is to be expected that the downward shift of aggregate demand curve will be somewhat less than the downward shift of the aggregate supply curve. As a result of this the expansion of activity would be less than if the aggregate demand curve was unchanged. Nonetheless, the economy would still tend towards a level of activity at which expected take-home pay settlements and actual settlements were close to each other. Conversely, when actual take-home pay settlements turn out to be more than expected the aggregate demand price curve will shift upwards, but by something less than the aggregate supply price curve. The contraction of activity will be less than would be the case with an unchanged aggregate demand price curve but, again, the economy would tend towards a level of activity at which firms expected the most they can afford to pay out as take-home pay approximated to actual settlements.

It is implicit in Keynes' general theory of employment that pay settlements tend towards the most firms expect they will be able to afford to pay for the amount of labour being

demanded. From an employer's point of view this 'most' refers to labour cost (inclusive of taxes on employment) rather than take-home pay, and this offers an explanation for the process of pay bargaining seeming not to operate in some, especially the non-unionised, sections of the labour market. It has become commonplace for firms to offer jobs at a certain stated gross pay (i.e. inclusive of withholding taxes), giving no bargaining position to a prospective employee other than taking or not taking the job. When the sum being offered is the most an employer expects to be able to afford to pay, there is no room for bargaining in an upwards direction, although if the offer is above the least an employee is prepared to accept then, in an effort to secure the job, the employee may offer to accept less. On the other side, when a prospective employer does not get any applicants, or suitable applicants, at the sum offered, the options are either to withdraw from the market or to find some means of improving the offer so as to attract those able to supply the labour required. Should there be a mass of suitable applicants, then the employer will either take care to select the employee who seems likely to give the most in return for the pay offered or withdraw temporarily from the market and re-advertise at a lower figure. In these cases it appears to the job applicant that the pay offered is a fixed price rather than a market price. Thus the revolutionary conclusion to be drawn from Keynes' theory, that pay settlements tend towards the most employers expect to be able to afford, admits to the possibility, from the point of view of an employee, that in some cases the pay bargaining process may be more covert than overt. This fact of experience is one the labour market has in common with many other markets — especially trade in western countries between retailers and final consumers.

The Pay Bargain Gap

In pay bargaining both sides expect to gain an advantage from the eventual settlement, for, in common with other bargaining, it is not a zero sum game. Thus for the pay bargaining process to reach a negotiated agreed settlement, there must exist a positive gap, *the pay bargain gap*, between the most employers can afford to pay employees for the labour demanded and the least employees, or prospective employees, are prepared to accept in return for supplying that labour. Given both a pay bargain gap and settlements tending towards the most employers can afford to pay, then actual settlements will be responsive, like other market prices, to the general conditions in the markets for output, and also will *appear* to be responsive to conditions in the labour market. With a contraction in demand for outputs the aggregate demand price curve will shift downwards, tending to reduce the demand for labour and the most employers can afford to pay for that labour. In the labour market, an increasing deficiency in demand for labour will be associated with a fall in the average level of settlements, or at least settlements will be lower than might otherwise have been the case. As the average level of settlements falls the competitive struggle between firms will drive employers to revise their expectations in respect of labour costs in a way tending to shift the aggregate supply price curve downwards. As this happens market forces begin to work towards a slowing down and eventual reversal of the downswing in activity. Conversely, with an upswing of activity following upon an expansion of demand for outputs, market forces will work towards a slowing down and eventual reversal of the upswing. As the aggregate demand price curve shifts upwards with the upswing of activity then the demand for labour by employers will expand and the most they can afford to pay for that labour will rise. In these circumstances the average level of pay settlements will rise, causing

employers to revise their expectations in respect of labour costs in a way tending to shift the aggregate supply price curve upwards.

Given circumstances that allow for both pay bargaining and the free play of market forces, then Keynes' general theory of employment supports the hypothesis of a Phillips curve relationship between the rate of change of pay settlements and the rate of unemployment. When an economy is on an upswing of activity the rate of unemployment will tend to fall and be associated with a tendency for pay settlements to rise. Conversely, when an economy is on a downswing a rising rate of unemployment will be associated with a tendency for pay settlements to fall. However, this conclusion appears to be inconsistent with Keynes' hypothesis of an economy being in stable equilibrium in slumpy conditions, as illustrated in Figure 1 (p.24), with 'involuntary unemployment' accounting for a significant mass of the unemployed. For Keynes' hypothesis to be sustained it needs to be shown that in certain cases the pay bargain gap ceases to exist, preventing the free play of market forces.

Maynard Keynes formulated his general theory of employment during the early 1930s, a period of world-wide depression following upon, particularly in the United Kingdom, a decade of persistent deflation. The domestic purchasing power of sterling rose by 60 per cent from 1920 to 1930, that is to say 12s/6d (62.5p) in 1930 was equal to the purchasing power of £1 in 1920. In combination, depression and deflation will cause the aggregate demand price curve to shift downwards substantially and relatively quickly and with this the most employers can afford to pay for labour will fall sharply. On the other side, the least employees are prepared to accept in return for supplying their labour is determined more by psychological forces than by market forces and as a consequence will respond only slowly to the changing economic conditions. Thus the pay bargain gap is

closed, or may even become negative, and the least employees are prepared to accept becomes the determining factor for pay settlements. Once this has happened market forces will not work towards a recovery except in the very long run. This long run will last for as long as it takes economic and social conditions to break through the psychological barriers of employees and force down the least they are prepared to accept in return for supplying their labour to something less than employers can afford to pay. During the 1930s Keynes and others advised giving the economic system an external shock by increasing government expenditure on public works and encouraging a small rise in the general price level as a way out of that particular depression. Certainly it is arguable that such a policy might well have increased the most employers could afford to pay for labour relative to the least employees were prepared to accept. However, while this may offer an explanation and solution for the 1930s it does not apply to the present time. In the United Kingdom the domestic purchasing power of the pound sterling has been falling continously for over fifty years, and during the decade of the 1980s declined by over 40 per cent. For more than the past twenty years in the United Kingdom persistent inflation, as well as unemployment, has always been significant and sometimes very high indeed.

Taxes on Employment

An alternative explanation for the high rates of unemployment during the last quarter of the twentieth century is offered by the monetarist school of economic thought. A sharp fall in the rate of inflation, they argue, will affect immediately the most employers can afford to pay for labour, but on the employees' side inflationary expectations will adjust far more slowly. This circumstance may lead also to a closing of the pay bargain gap and cause employers to

contract their demand for labour as the market price, determined by the least employees are prepared to accept, becomes more than employers can afford to pay. In this case the hump in unemployment will last as long as it takes employees to revise their inflationary expectations and stop holding out for substantial annual pay increases. This monetarist account does explain at least part of recent high levels of unemployment, but it does not explain a major part of the problem in countries such as the United Kingdom where unemployment has been on a rising trend since the mid-1950s. In cases such as these the major cause of unemployment is the persistent squeezing of the pay bargain gap by an increasing reliance by succeeding governments on the revenue from payroll and withholding taxes, assessed on the gross pay of employees. In combination these two methods of raising tax revenue are the most effective in destroying employment opportunities, and they may be accurately described, therefore, as *taxes on employment*.

The imposition of a payroll tax does not affect the most employers can afford to pay for labour in total, but it does reduce immediately, by the full amount of the tax, the most employers can afford as gross pay to their employees. In this way all payroll taxes act directly and immediately by their formal incidence to close the pay bargain gap. United Kingdom examples of this method of taxation are the former selective employment tax and national insurance surcharge and the current employers' national insurance contributions. Of greater importance in the longer run, is the fact that such payroll taxes act in a way to subsidise so-called 'labour-saving investment'. As this tax effect operates over the longer run, its results are far more difficult to correct. If an employer can replace an employee by a machine then the liability for payroll tax is avoided. In the multitude of marginal cases it is just this element of tax avoidance that makes the new labour-saving investment profitable. Once the investment has been made it will last for a long time and

so set up a new pattern of production and trade. Thus to avoid tax, jobs are destroyed, perhaps for ever. Whether this new pattern is real progress or a distortion of the economy is a matter of chance. Much of this tax-induced labour-saving investment is not saving labour from the point of view of the community as a whole. Often the result is no more than a transfer from paid labour to unpaid labour.

For example, it was no accident that the move to self-service retailing in the United Kingdom coincided with the imposition of selective employment tax in 1966 by the then Labour Chancellor of the Exchequer. The new tax was intended to help expand employment in the manufacturing sector by increasing the cost of labour in the service sector. The intention of the administrators was in one part fulfilled. The new tax hit the multitude of small and family owned retailers hard and their trade was taken away by large, groups with sufficient funds available to avoid the tax by investment in self-service stores. From the narrow point of view of the retail trade this investment was labour saving and brought about measurable improvements in productivity. From the point of view of householders it was quite the reverse. It ceased to be commonplace for a householder to place an order with a shopkeeper and have the goods delivered to the doorstep by a roundsman or errand boy. The tax priced the overwhelming majority of householders out of the market for such personal services. Today a householder has to get out the car, drive to the supermarket, have the hassle of finding a parking space, trudge round the supermarket and collect the goods needed from the shelves, queue at the checkout point, load the car, drive back and then unload the car — all very time-consuming unpaid hard labour. Did the enormous investment in response to the tax really save labour? Certainly the tax contracted the field open to profitable trade and in so doing destroyed paid jobs. Selective employment tax has long been abolished but the new pattern of retailing, having been set up, continues to

grow apace. The old success story of errand boy to boss is a possibility no longer — taxation has knocked out the bottom rungs of the ladder. The possibility of a success story is replaced by the actuality of the young unemployed who, lacking work experience, are unable to get jobs.

As with payroll taxes so withholding taxes assessed on the gross pay of employees also close the pay bargain gap. The imposition of a withholding tax does not affect the least employees are prepared to accept as take-home pay, but by its formal incidence it does increase by the full amount of the tax the least employees are prepared to settle with an employer in terms of gross pay. As has been argued already (p.52), withholding taxes are shifted by employees onto their immediate employers and so eventually inflate the cost of labour to an employer. Through the tax shifting process this method of raising tax revenue, like payroll taxes, destroys jobs as the resulting high cost of labour encourages labour saving investment. Other deleterious effects include a tendency for employees to be less willing to supply additional labour when required. They prefer to spend their extra time in activities which do not attract tax. 'Why should I work for the taxman?' becomes the all too frequent response to an employer's request for overtime working. A flourishing black economy is the end result.

Taxes on employment (payroll and withholding taxes on gross pay combined) not only work directly to close the pay bargain gap and so make both pay negotiations more difficult and poor industrial relations more likely, they also destroy jobs, distort an economy, and, by encouraging the black economy, bring the law itself into disrepute. From time to time it is argued that the authorities should clamp down on the black economy as the revenue gained would enable some other tax rate (usually income tax is chosen) to be halved, or some such substantial reduction. This is nonsense. Given the continuation of employment taxes, if the black economy were to be brought within the tax net, there

would be no net gain in revenue as the output it currently produces would cease to be produced. The economy as a whole would be that much the poorer. The black economy exists and thrives on tax evasion: at tax-inflated prices its effective demand would vanish. The first step towards eradicating the black economy can only be the removal of its major cause by the abolition of taxes on employment.

When taxes on employment are increased to a point where they close the pay bargain gap completely, then a fundamental change takes place in the operation of the labour market. The most employers can afford to pay for the labour they demand becomes, after allowing for employment tax liabilities, no more than the least employees are prepared to accept as take-home pay for supplying that labour. There is no room for bargaining. With this the labour market ceases to operate to bring buyers and sellers of labour together, so they may negotiate and agree a market price for labour advantageous to both parties. The market begins to operate as if it were a fixed price monopoly market. Since the least employees are prepared to accept as take-home pay is unresponsive to changes in market conditions, employers find themselves faced with a fixed price, or cost, for labour which is determined exogenously by government effectively at the time it legislates to fix the amount of taxes on employment.

When, by means of taxes on employment, governments close the pay bargain gap and create a fixed price labour market then both employees and employers find themselves in a take-it-or-leave-it situation. In this circumstance a kind of Phillips curve relationship continues to hold but, after allowing for changes in the purchasing power of money, the direction of causation from the standpoint of unemployment is reversed. The rate of unemployment ceases to be the independent variable and becomes the dependent variable. Instead of pay settlements appearing to respond to conditions in the labour market, as Professor Phillips hypothe-

sised, it is the total amount of taxes on employment that determines conditions in the labour market. United Kingdom experience during the second half of this century shows that when employment taxes are increased then, 12 to 15 months later, the rate of unemployment begins to rise. On those fewer occasions when employment taxes have been truly cut, then, 12 to 15 months later, the rate of unemployment begins to fall. In the United Kingdom there have been times when some part of a temporary hump in the rate of unemployment may have resulted from a slowing down in the rate of inflation, but the major part always was, and continues to be, the direct result of tax policies pursued since World War II by successive governments at Westminster.

1. A.W. Phillips, 'The Relationship between Unemployment and the Rate of Change in Money Wage Rates in the United Kingdom, 1861-1957', *Economica*, Vol 25, pp.283-99.
2. Milton Friedman, *Unemployment versus Inflation*, Institute of Economic Affairs, 1975, p.15.
3. Adam Smith, *The Wealth of Nations*, Bk.I, Ch.VIII.