

Comment on "The Case against the Case against the Guideposts," by Robert M. Solow.* In *Guidelines, Informal Controls, and the Market Place: Policy Choices in a Full Employment Economy*, edited by George P. Shultz and Robert Z. Aliber, pp. 55-61. Chicago: University of Chicago Press, 1966.

Obviously, the title of my comments now must be "The Case against 'The Case against the Case against the Guideposts.'" And, of course, when Bob [Solow] replies, he will resort to exponents instead of spelling out all the words.

I am delighted to join Bob on some of his suggestions and to find such a large measure of overlap with my own views.

In particular, I would like to commend him for suggesting that the Davis-Bacon Act be repealed, although I would urge that he extend his views to include as well the Walsh-Healy Act and minimum wage laws—all of which have the effect of producing unemployment. These are governmental actions whose *result*—not necessarily their *intention*—is to increase unemployment. It certainly would promote a more efficient use of our resources to eliminate them. The same is true of his comments on lower tariffs in international trade and greater competition at home. All are desirable and would promote the efficiency of the economy.

But, in my opinion, none of these items has very much to do with our present problem—the problem of *inflation*. They have to do with the average level of unemployment that is, in a sense, structural or normal or natural in a well-adjusted economic system. All of these measures would reduce that average level of unemployment and would make output higher, but none of them has very much to do with the problem of inflation, which is what the guideposts are supposedly concerned with.

I agree further with a point that is implicit in much of Bob's paper: that the analysis in the 1962 Report of the Council was extremely sophisticated—an analysis that, if rumor has it right,

he was not unacquainted or unassociated with. It was in the main a correct analysis of the way competitive markets work and would serve as an admirable part of a text on the operation of labor markets.

But I do not believe one can defend the guideposts by defending that section. It was an exercise that was bound to have further consequences. If one is going to defend the guideposts of the 1962 Report, one must look not at the intentions of the author but at what consequences could be expected to flow from the approach outlined.

Those consequences have since then been spelled out very clearly. The relevant and appropriate qualifications in the 1962 statement have disappeared. The elements of flexibility and adaptability have gone beneath the surface. There has remained and has appeared above the surface a single *number* as a guide to the appropriate wage change, and a rigid notion that, except in really extraordinary cases, it is possible for somebody to consult some mystical set of figures about productivity and always come out with the finding that the correct number is 3.2.

Such consequences were to be expected. They were not an accident. It was to be expected that, if one is going to proceed with a policy which will tolerate the intervention of governmental officials in the setting of wages or in the setting of prices, then this must lead to relatively simple formulas combined with much give-and-take, not on the basis of academic economic considerations, but in response to political pressures.

I believe that we must go beyond the 1962 statement and look at the whole series of statements and at the present status of the guideposts. In doing so, let me try to analyze the logic that underlies the guideposts and that is expressed in Bob's paper, because I believe that logic is basically wrong.

What is wrong with the guideposts is not so much that there is no way of calculating what is the correct rise in productivity and not so much that they involve governmental intervention in the wage and price system, as that *they really have nothing to do with inflation. They cannot in any*

way, in my opinion, have a significant effect under current or foreseeable conditions on the rate of price rise correctly measured.

I want to go to the logic underlying the guideposts. This logic is that there is market power lying around, and that, when times are reasonably good, market power is likely to be exercised in ways that contribute to premature inflation. One thing that always impresses me about this argument is how briefly it is alluded to *when* it is alluded to—at all. In paper after paper in the discussion of guideposts and cost-push inflation, or of market power as a source of inflation, you discover that there is but a sentence or two, and then the author goes on to other things. The reason for that is very clear—the logic of the analysis is wrong. Insofar as market power has anything to do with possible inflation, what is important is not the *level* of market power, but whether market power is *growing* or not. If there is an existing state of monopolies all over the lot, but the degree of monopoly has not been increasing, this monopoly power *will not* and *cannot be* a source of pressure for inflation. The argument made by those who assert it can be is that in the sector with market power, people with monopoly power will “naturally” push prices up, and these will rise while in the competitive sector prices are rigid, hence prices will not go down. The net effect, therefore, is said to be a general rise in prices.

But then you face the uncomfortable question: Why did these foolish monopolies charge such a low price before? Why were they so restrained? Why is it that in the past they haven’t exploited their market power? Does anybody really believe that the carpenters and plumbers and all of the other long-standing unions have not all the time been getting the maximum—the maximum real income and real wage rate that they thought it was worth their while to get?

Historically, there is one case in American experience—outlined in my paper—which corresponds to the correct theoretical analysis of market power and of cost-push inflation.

From 1933 to 1938, there was a very rapid increase in the degree of market power: first, because of NRA and, second, because of what was happening on the labor front when you had

the Wagner Act and other factors that produced growth in union power. In those circumstances, there was *growing* market power, *growing* monopoly, and therefore this sector did push their wages and their prices up relative to wages and prices in the rest of the economy. I believe that is one of the reasons why, in the period from 1933 to 1937, although national income went up very rapidly, a large part of it was absorbed by rising prices—despite the very high volume of unemployment. You had high unemployment all along, yet prices rose. And this was because of a growing market power. But today, there is no sign of any widespread growth in market power. Monopolies are not on the increase. The degree of union power is not increasing. In any event, the argument presented in Bob's paper is that market power alone—regardless of whether it is growing—is a source of upward pressure on prices. This seems to me almost entirely false.

Another defect in the logic underlying the guideposts is the *confusion of part of the economy with the whole economy*. Let's suppose that the analysis were to some extent correct. Would it follow that holding down wages or prices in one area did in fact reduce inflationary pressures throughout the economy? That depends on not looking at where the excess purchasing power that was available to hire the labor or buy the goods will go when it is diverted.

A third and, in my opinion, the most serious logical fallacy underlying the analysis of cost-push inflation in the guideposts is the *confusion of nominal magnitudes with real magnitudes*—of dollars with real quantities or what a dollar will buy. This fallacy is very deep and effects a great many current views. The basic fallacy is to suppose that there is a trade-off between inflation and employment; that is, to suppose that by inflating more over any long period of time, you can have on the average a lower level of unemployment. This is the notion underlying the desire to maintain a great deal of pressure on aggregate demand and, when you want to avoid the symptoms of inflation, to try to suppress them by guideposts, guidelines, and the like.

As in all such fallacies, there is an element of validity in it. The correct argument is rather sophisticated, and that's why the simple argument tends to be accepted. To suggest to you briefly

why I say this is a fallacy, I ask you to consider the experience of some countries that have gone much further along this line than we have. The most dramatic example I know of is Brazil which, two or three years ago when the present government came into power, was having price inflation at the rate of about 90 per cent a year. Through “tight” monetary policies, they cut the rate of inflation down to about 45 per cent a year—still, you would think, a fairly healthy inflation. Unemployment rose to 15 per cent, at least for a time. Now, by Bob’s logic, you would say that this is a trade-off between inflation and unemployment, that the Phillips curve in Brazil is such that in order to maintain an acceptable level of unemployment, you have to have price inflation of 90 per cent a year. I think almost everybody would agree that that is an absurd statement. And so it is. What is true is that you have a trade-off between unemployment *today* and unemployment *tomorrow*, between unemployment now and unemployment later on.

Go back to the Brazilian case. They could have maintained unemployment low by going from 90 per cent to 100 per cent to 125 per cent to 150 per cent inflation. After a time, they would have gotten to a point where even acceleration of inflation would not keep unemployment low. When they cut it down to 45 per cent, they of course got temporary unemployment. If they cut it down to zero, they will get temporary unemployment. But if they then hold it at zero, employment will again increase as people get adjusted and adapted to it. As inflationary expectations are broken, you will come back to a higher level of employment.

It’s the same way in the United States. By speeding up the rate of monetary expansion and aggregate demand, you can unquestionably increase output and employment temporarily. You *can* cut the level of unemployment down, but at what price? At the price of postponing the adjustment. What happens is that, as people get adapted to any given rate of price rise, as they come to anticipate a continuation of the price rise, the unemployment rate will creep up. Say you cut unemployment down to 3 per cent. Then, at the same rate of price rise, it will creep up. If you then try to hold it down by stepping up the rate of inflation from 3 per cent to 4 per cent or 5 per

cent, you will again be able to cut down unemployment, but, again, only temporarily—only until people adjust their anticipations.

I grant you immediately that “temporary” may be a fairly long period, and I understand very well the political temptations to an administration that is in power for a fairly short period to try to postpone the evil day to a later date. That explains, in my opinion, why, worldwide, governments have over and over again had a tendency to go down this line. It is so tempting. But, from a logical point of view, the true trade-off is between unemployment today and unemployment at a later date. It is not between unemployment and inflation. There is no long-run, stable trade-off between inflation and unemployment.

Hence, the alleged case for the guidelines seems to me to rest on two basic fallacies: first, that market power is a source of rising prices, and second—on the belief that somehow or other you can fool the people all the time—that by increasing the rate of monetary expansion, you can thereby induce people to maintain a permanently lower level of unemployment.

In a way, these points need to be linked a little bit more closely to Bob Solow’s argument, because it may not be clear to you that they really underlie it. But his argument that there is a very narrow range within which it is possible to increase employment, while holding down inflation, will be seen to rest basically on these two propositions: on the first because, in his opinion, the danger of price rise exists only in these sectors where there is strong market power; on the second because he wants to cut out these price rises in order to be able to maintain a higher level of aggregate demand than would otherwise be consistent with price stability.

I might summarize this final analysis by putting it in terms which I think are appropriate and which to some of you will be very reminiscent of Wicksell’s argument in another direction. In my opinion, there is what might be termed a “natural” level of unemployment in any society you can think of. This level of unemployment is the level at which there is no tendency for *real* wages to behave in a way different from that described in the 1962 Report.

The 1962 Report—if we go through it and analyze it in terms of real wages and not absolute wages—describes the circumstances under which unemployment would be at its “natural” level.

Let’s suppose that this “natural” level is 4 per cent, just to use a number which comes from good sources. Measures such as the kind that Bob suggested—like repealing the Davis-Bacon Act, the Walsh-Healy Act, and minimum wages, lowering tariffs, and getting greater competition at home—would reduce the natural level of unemployment to something less than 4 per cent, say, to 3 per cent or to 2½ per cent. But for any given labor market structure, there is some natural level of unemployment at which *real* wages would have a tendency to behave in accordance with productivity. If you try, through monetary measures, to keep unemployment below this natural level, you are committed to a path of perpetual inflation at an ever-increasing rate. There is no other way in which you can keep unemployment indefinitely below this natural level. If, by contrast, you were to take as an objective of employment policy a level of unemployment higher than the natural level, you could achieve it, but only by perpetual deflation. Finally, there is an infinitely large number of monetary policies and price behavior which will keep unemployment at its natural level—once people’s anticipations are adjusted to that pattern of price behavior.

Notes

* The paper that is the subject of this comment is printed in *Guidelines, Informal Controls, and the Market Place: Policy Choices in a Full Employment Economy*, edited by George P. Shultz and Robert Z. Aliber, pp. 41-54. Chicago: University of Chicago Press, 1966.