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The David Gordon Memorial Lecture

The "Reserve Army of Labor" and the "Natural Rate of Unemployment": Can Marx, Kalecki, Friedman, and Wall Street All Be Wrong?

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I was extremely honored when the URPE Steering Committee invited me to give the first annual David Gordon Memorial Lecture at the URPE summer conference. In fact, in preparing for the lecture, I began jotting down some of the reasons why I felt honored. I quickly realized that I could spend my whole allotted time going through that list. But exercising self-restraint, I will just mention two crucial things.

First, as long as I knew David Gordon—and by this I literally mean from the first day I met David as a student in his 1975 New School class on workers' control until our last conversations—I knew him as a committed URPE worker. I want to emphasize my choice of words. David really did *work* for URPE. He did lots of work, including lots of the grubby work that is the foundation of any shoestring left organization. Almost all of this work he did quietly but relentlessly. He continued making contributions to URPE even after he became seriously ill.

Second, David made fundamental contributions in opening up a new research approach in political economy. It was research that made the best possible use of existing formal empirical techniques to address questions that concerned us on the left. In doing this, David—and others who have followed his approach—have been able to challenge orthodox pretensions on their own terms.

I am grateful for the stimulating comments of many participants at the initial presentation of this paper at the 1997 URPE summer conference, including John Miller, Tom Palley, and Jerry Epstein.

His research was also policy-oriented in that it recognized with open eyes the world where it is right now. David correspondingly thought a lot about how to move the world from where it is today to where we want it to be: how to get from here to there. Part of the reason David thought in this way was because of his long-term active involvement in the U.S. labor movement, even at a time when many on the left felt uncomfortable being connected with mainstream labor institutions. David took this approach without wavering even one inch from his commitment to democratic socialist ideals. His approach seems especially prescient today—two years after his death—as the U.S. labor movement is undergoing such an exciting revival.

Given David's research concerns and political commitments, it was inevitable that he would spend much time reflecting on the subject of my lecture—the "reserve army of labor" and the "natural rate of unemployment." In 1987–88, David published two important papers explicitly on the natural rate and its offspring, the NAIRU, or non-accelerating inflation rate of unemployment. But using different terminology, almost all of David's work on social structures of accumulation was about the same issues that occupy discussions about the "reserve army" and the "natural rate"—i.e., how labor markets really work; the role of unions and other institutional forces in the economy; and the connections between an economy's macro performance and how that performance affects the well-being of ordinary people. I want to draw out some of those connections later. But I first want to recount a bit of the last conversation I had with David, while he was in the hospital, waiting for his heart transplant operation.

Believe it or not, we spent much of the time talking about the natural rate and NAIRU. We had both reached the conclusion that these were the single most powerful ideas in mainstream macroeconomics. We also agreed that these ideas were wrong, but we were not entirely clear on all the specific ways they were wrong. David said then that he really wanted to concentrate on this as soon as he got out of the hospital.

Since my last conversation with David, I have tried to become more clear in my thinking on this issue. I still believe that the natural rate and NAIRU are obviously wrong in some important ways and seriously misleading in others. But I also think that the natural rate/NAIRU are not wrong in other important ways, as I will try to explain. Moreover, I will argue that it is dangerous politically to dismiss entirely the ideas associated with the natural rate and NAIRU even though they are wrong in significant ways. I say this because I believe dismissing the natural rate and NAIRU because of the ways they are wrong can invite complacency in evaluating the very real and serious obstacles to sustaining full employment in capitalist economies.

Let me try to flesh out some of these points.

THE "NATURAL RATE": THE POWER TO DO HARM

There are things about the contemporary idea of a natural rate or NAIRU about which someone on the left can justifiably feel hostile or at least suspicious. For starters, the idea originates with Milton Friedman (1968)[1]—as David Gordon said, "a person rarely noted for his irrepressible sympathies for the downtrodden and jobless," (1987, 225). But Friedman primarily just repackaged and gave a new name to an argument that had deep roots within classical economics and the so-called "classical dichotomy." The classical dichotomy asserts that endowments, tastes, and technology alone determine employment, incomes, and productivity, and that government-controlled monetary forces alone determine fluctuations in the price level.

The way employment and incomes specifically are determined by endowments, tastes, and technology is that, in a competitive labor market environment, businesses will be forced to pay workers a wage equal to their marginal product. Wages can rise from this competitive equilibrium level, but only when productivity increases through technical change. At a given level of technology, workers can either accept a job at the equilibrium wage, or they can choose leisure over labor and become *voluntarily* unemployed. In Friedman's terminology then, the "natural rate" of *involuntary* unemployment is thus effectively zero (after allowing for frictional joblessness) as long as all workers earn their equilibrium wage. The natural rate of unemployment will become positive only when workers refuse to accept the equilibrium wage, or when non-market forces, such as labor unions, prevent the wage from falling to its full employment equilibrium point.

We know that packaging is crucial to selling a product. Friedman's restatement of the classical labor market model gave new life to an idea that was predominant among mainstream economists before Keynes: that unemployment is really the fault of workers themselves and their putative representatives, the labor unions. But building from Friedman, the natural rate concept really takes flight in some of the wild claims of Robert Lucas and other "new classical" economists. These claims include

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[1] To be precise, Edmund Phelps was the co-originator of the modern version of the natural rate theory, though Friedman has priority in the use of the term. Two important references are Carlin and Soskice (1990) and Cross (1995).

the idea that markets always clear instantaneously, so that—contrary to even Friedman's position—government policies to increase aggregate demand cannot have a positive impact on employment or real incomes even in the short run. New classicals have also argued that workers somehow massively chose leisure over labor during the Great Depression.

But more important than having just inspired such academic tall-tales, the natural rate idea has also had pernicious effects in the area of real-world policy formation, through giving the stamp of scientific respectability to all sorts of attacks on working people. Such attacks include Thatcherism and Reaganism in the 1980s, as well as the ongoing resistance in financial markets to any tendencies suggesting that workers' living standards might be improving. How many times in recent years have we heard about Wall Street becoming exercised over falling unemployment or prospects of wage increases, and responding exuberantly when, quarter after quarter, real wages fail to rise? Of course, the natural rate theory is not the cause, but only one expression of anti-working class politics. But it certainly has done a stellar job reinforcing anti-worker perspectives that already exist. It is therefore easy to feel legitimate hostility toward anything connected with the natural rate.

UNEMPLOYMENT AS AN INSTRUMENT OF CLASS STRUGGLE

But before letting this justified hostility overtake us, we need to confront the ideas of Marx and Kalecki on a parallel concept—that is, on the reserve army of unemployed. In his justly famous chapter 25 of Volume I of *Capital* (1967) "The General Law of Capitalist Accumulation," Marx makes clear his view that unemployment is functional to capitalism. That is, when a capitalist economy is growing rapidly enough so that the reserve army of unemployed is depleted, then workers will utilize their increased bargaining power to raise wages and shift the distribution of income in their favor. Profits are correspondingly squeezed. As a result, capitalists' animal spirits are dampened and they reduce investment spending. This then leads to a fall in job creation, higher unemployment, and a replenishment of the reserve army. In other words, the reserve army of unemployed is the instrument capitalists use to prevent significant wage increases and thereby maintain profitability.

Kalecki makes parallel though distinct arguments in his also justly famous essay, "The Political Aspects of Full Employment" (1971). Kalecki is writing in 1943, immediately after the Depression had ended and the Keynesian revolution—to which Kalecki was himself a major contributor—was gathering its head of steam. Combining his understanding of Marx with his perspective on the Keynesian revolution, Kalecki advanced three important points:

1. We now have sufficient understanding of the economics of aggregate demand such that we can devise workable policies to sustain a capitalist economy at full employment.
2. Contrary to Marx, full employment can be beneficial to the level of profits if not the rate of profit, because the economy will be operating at its highest possible rate of capacity utilization. Capitalists may well get a smaller share of the pie at full employment, but will nevertheless benefit from the full-employment economy because the size of the pie is growing far more rapidly than would be possible with significant positive rates of unemployment.
3. Even though capitalists can benefit from full employment, they still will not support it because full employment will threaten their control over the workplace, the pace and direction of economic activity, and even political institutions.

Relative to Marx, Kalecki thus focuses more on the broader social and political problems capitalists face due to full employment rather than prospects for a full-employment profit squeeze. From this perspective, Kalecki then also reasoned that full employment was sustainable under capitalism if these challenges to capitalists' social and political hegemony could be contained. This is why he held that fascist social and political institutions could well provide one "solution" to capitalism's unemployment problem: workers would have jobs, but they would never be permitted to exercise the political and economic power that would otherwise accrue to them in a full-employment economy.

Despite these differences with Marx, Kalecki does nevertheless clearly embrace the central thrust of the Marxian position: that some significant level of unemployment is functional to the operation of capitalist economies. But I want to push this notion of a common thread further. In my view, Marx and Kalecki also share a common conclusion with natural rate proponents, in that they would all agree that positive unemployment rates are the outgrowth of class struggle over the distribution of income and political power. Of course, Friedman and the New Classicals reach this conclusion via analytic and political perspectives that are diametrically opposite to those of Marx and Kalecki. To put it in a nutshell, mass unemployment results in the Friedmanite/New Classical view when workers demand more than they deserve, while for Marx and Kalecki, capitalists use the weapon of unemployment to prevent workers from getting their just due.

Liberal Keynesians are the only real opponents of the idea that unemployment serves a function in capitalist societies. Of course, John Maynard Keynes himself held that unemployment was irrational since it meant wasting available resources. Keynes was convinced that the wise application of well-designed policies could create and sustain full employment capitalism. Contemporary liberal Keynesians—and here I include some of our best allies, such as Prof. Robert Eisner—hold firm to this view. Eisner himself has done important research (1997) demonstrating fundamental errors in the empirical specification of NAIRU. Among other prominent liberal Keynesians, Eisner has also emphasized the irony that right-wing economists such as Friedman seem to have appropriated an idea that originates with Karl Marx.

A BURIED TRUTH AMID ERRORS

The world would certainly be a more civilized place if, by exposing all the sloppy research, logical errors, and downright foolishness bound up with the natural rate and NAIRU, we could then also conclude that unemployment serves no function in capitalism; as liberal Keynesians would have it, mass unemployment is just a big mistake. But let us examine some of the most obvious and egregious errors associated with the natural rate and NAIRU, and consider where these errors actually lead.

One point on which many natural rate critics, including David Gordon, have pounced is that there is nothing really natural about the natural rate. But we need not expend much energy trying to win that argument. Even Milton Friedman accepts the point. He stated this quite clearly in his initial 1967 American Economic Association Presidential Address in which he introduced the natural rate concept:

> [B]y using the term "natural" rate of unemployment, I do not mean to suggest that it is immutable and unchangeable. On the contrary, many of the market characteristics that determine its level are man-made and policy-made. In the United States, for example, legal minimum wage rates, the Walsh-Healy and Davis-Bacon Acts, and the strength of labor unions all make the natural rate of unemployment higher than it would otherwise be (1968, 9).

So let us be clear here. The "natural rate" term has worked well for the right as an advertising concept, and we should be adamant in opposing false advertising. Scratch this surface though, and look at what Friedman himself is really saying: that what he terms the natural rate is really a social phenomenon measuring the class strength of working people, as indicated through their ability to organize effective unions and establish a livable minimum wage.[2]

Critics of the natural rate and NAIRU also correctly point out, again and again, that there is no set unemployment rate at which inflation reliably accelerates, either in the United States or elsewhere. This, of course, is irrefutable. For example, in 1990, unemployment in the United States was 5.6 percent and inflation, as measured by the Consumer Price Index, was 5.4 percent. By 1997, unemployment was down to 4.9 percent, while inflation, far from accelerating, had fallen to 2.3 percent.

But even recognizing such recent patterns, as well as the wider variety of inconsistent inflation/unemployment relationships that have prevailed over the past 30 years, this does not mean that there is "no" relationship between workers gaining in terms of employment and higher wages and inflation. In this regard, it will be useful to consider some of the main results of the Winter 1997 *Journal of Economic Perspectives* symposium on NAIRU. One paper is by Robert Gordon, David's brother (1997). It summarizes the extensive econometric evidence he has assembled over the past two decades, on the basis of which he concludes that a "time-varying" NAIRU exists. For example, according to Robert Gordon, the NAIRU fell from 6.2 percent in 1990 to 5.6 percent by mid-1996.

Douglas Staiger, James Stock, and Mark Watson also summarize extensive econometric research into this question (1997). They also conclude that a NAIRU does exist, but that it is subject to wide variations. They find that, as a point estimate, NAIRU in 1997 was between 5.5 and 5.9 percent, which was a full percentage point below its level for the early 1980s. They also find that "the most striking feature of these estimates is their lack of precision." Indeed, for their current point estimate of 5.5–5.9 percent, the 95 percent confidence interval ranges between 4.3 and 7.3 percent. So their NAIRU estimate not only varies over time but also has the capacity to range widely at a given point in time.

The discussions by Joseph Stiglitz and Olivier Blanchard and Lawrence Katz in the same symposium offer similar empirical

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2 Actually Marx himself comes much closer to drawing a parallel between the movements of the reserve army and the laws of nature. He writes in ch. 25, "The whole form of the movement of modern industry depends, therefore, upon the constant transformation of a part of the labouring population into unemployed or half-employed hands...As the heavenly bodies, once thrown into a certain definite motion, always repeat this, so it is with social production as soon as it is once thrown into this movement of alternate expansion and contraction" (1967, 633).

conclusions. I do not see any reason to dispute the general thrust of these findings. Indeed, it is difficult to dispute them precisely because they are so broad. But focusing exclusively on point estimates, confidence intervals, and their variation over time really misses the point. There is a fundamental question jumping out at us from these results which is almost entirely neglected in all the papers. That is, what makes the "time-varying" NAIRU vary in the first place? It is remarkable that leading economists who have devoted so much time to estimating values for NAIRU almost completely neglect this question. Nevertheless, a few hints are dropped as asides. Robert Gordon, for example writes,

> The two especially large changes in the NAIRU...are the increase between the early and late 1960s and the decrease in the 1990s. The late 1960s were a time of labor militancy, relatively strong unions, a relatively high minimum wage, and a marked increase in labor's share in national income. The 1990s have been a time of labor peace, relatively weak unions, a relatively low minimum wage, and a slight decline in labor's income share (1997, 30).

Gordon also cites the role of increased global competition in product and labor markets and the increase of unskilled immigrant labor as contributing to the declining NAIRU in the United States. Though again these observations are mere asides in Gordon's paper, let us still look at what he is saying: that changes in the relative power of capitalists and workers, and the related increase in the extent to which the U.S. economy has become integrated into the global economy, are the major factors that have forced the NAIRU to fall. Thus, even if by partial inadvertence, and in any case almost completely camouflaged amid a welter of econometric detail, Robert Gordon's conclusion returns the discussion of unemployment to where Marx and Kalecki wanted it to be: to the analysis of class struggle and the distribution of income and power.

FROM NATURAL RATE TO EGALITARIAN SOCIAL STRUCTURE OF ACCUMULATION

Class struggle is the spectre haunting the analysis of the natural rate and NAIRU: this is the consistent message beginning with Milton Friedman in 1968 and continuing through to Robert Gordon in 1997, with most other stops in between. Once we recognize this, many other issues in the analysis of unemployment also become much clearer. Let me raise just a few:

1. While economists have long studied how workers' wage demands cause inflation as unemployment falls, it is never the case that such wage demands directly cause inflation. This is definitionally true, since inflation refers to a general rise in product prices. Workers, by definition, do not have the power to raise product prices. Capitalists raise product prices. Inflation happens as unemployment is falling when capitalists respond to workers' increasingly successful wage demands by raising product prices so that they can maintain profitability by passing on their increased costs. If workers were simply to receive a higher share of national income, it would follow that lower unemployment and higher wages need not cause inflation at all. It is therefore always and everywhere the case that capitalists, not workers, directly cause inflation when unemployment falls.

2. There is little mystery as to why, at present, the "time-varying" NAIRU has diminished to a near vanishing point, with unemployment at a 25-year low while inflation remains dormant. The main explanation is the one alluded to by Robert Gordon—that workers' economic power has been eroding dramatically through the 1990s.[3] Workers have been almost completely unable to win wage increases over the course of the economic expansion that by now is seven years old. Indeed, by the end of 1997, the average wage for non-supervisory workers was still 14 percent below the level of 1973, even though the U.S. economy was 34 percent more productive than it was in 1973. A recent econometric study by Cara S. Lown and Robert Rich (1997) of the New York Federal Reserve confirms this perspective. They found that, between 1990-95, the absence of wage and benefit increases itself fully explains the lack of inflationary pressures at such low levels of unemployment.

3. This experience over the past seven years, with unemployment falling but workers showing almost no income gains, demonstrates dramatically the crucial point that full employment alone can never be an adequate demand of the left, even as a transitional "non-reformist" reform; it was not under German fascism, as Kalecki pointed out, and it is not today. The importance of this point was conveyed vividly to me when I was working in Bolivia in 1990 as part of an economic advising team led by Prof. Keith Griffin of UC Riverside. Griffin and his team were brought to Bolivia primarily to develop a program that would address the human devastation wrought by the "shock therapy"

3 The solid class analysis offered by Robert Gordon certainly invites one to speculate—especially on the occasion of the David Gordon Memorial Lecture—whether, toward the end of David's life, Robert had allowed his youngest brother to start talking sense to him.

program designed by Jeffrey Sachs to end the Bolivian hyperinflation of the 1980s.

Prof. Griffin asked me to examine employment policies. I began by paying a visit to the economists at the Ministry of Planning. When I requested that we discuss the country's employment problems, they explained, to my surprise, that the country *had no employment problems*. When I suggested we consider the situation of the people begging, shining shoes, or hawking batteries and Chiclets in the street just below the window where we stood, their response was that these people *were* employed. And of course they were, in that they were actively engaged in trying to scratch out a living. It was clear that I had to specify the problem at hand far more precisely. Similarly, in the United States today, we have to be much more specific as to what workers should be getting in a fair economy: jobs, of course, but also living wages, benefits, reasonable job security, and a healthy work environment.

4. In our current low unemployment economy, should workers, at long last, succeed in winning higher wages and better benefits, some inflationary pressures are likely to emerge, even though global competition has increased the difficulties of firms successfully raising product prices. However, if inflation does not accelerate after wage increases are won, this would mean that the distribution of income is shifting in favor of workers. But the main point is this: in response to *either* inflationary pressures or a downward shift in national income, we should then expect that many, if not most, segments of the business community will welcome a Federal Reserve policy that would slow the economy and raise the unemployment rate. Put another way, it is not likely that, should wages and benefits start rising significantly, most businesses will come to their Keynesian senses and embrace the universal virtues of a full employment economy.

Does this mean that, until the hour of the big bang when the capitalist system is supplanted, capitalist control over the reserve army of labor must remain the dominant force establishing the limits of workers' strivings for jobs, security, and living wages? It will be useful to consider this question in terms of David Gordon's concept of social structures of accumulation. The challenge for the progressive movement in the United States today is to think through the features of a new social structure of accumulation through which full employment at living wages can be achieved and sustained. Of course, for this exercise to be at all useful, one must first and foremost take the full measure of how unemployment does serve capitalists' interests. But, at the same time, unless we are only interested in interpreting the world in various ways and not in changing it, this recognition should be only the beginning point, not the end, of our analysis.

Especially given the dismal trajectory of real wage decline over the past generation, workers should of course continue to push for wage increases. But it will also be crucial to advance these demands within a broader framework of proposals. One important component within a broader package would be incomes policies, i.e. explicit efforts at regulating the relative growth of wages and profits. Such policies obviously represent a form of class compromise. This is intrinsically neither good or bad. The question is the terms under which the compromise is achieved. Workers should be willing to link wage increases to productivity; after all, if the average wage had just risen at exactly the rate of productivity growth since 1973 and not a penny more, the average hourly wage today for nonsupervisory workers would be $19.07 rather than $12.24.

But linking wages to productivity also raises the question of who controls the decisions that determine the rate of productivity growth. As David Gordon was among the most forceful in arguing, substantial productivity gains are attainable through operating a less hierarchical workplace and building strong democratic internal labor market institutions. This was the central point of David's last book, *Fat and Mean* (1996).

But productivity growth does also still result from both the public and private sector investing in capital goods. Investing in capital goods has the additional benefit that it increases aggregate demand within the domestic economy. A pro-worker economic policy will therefore also have to be concerned with influencing the level and composition of investment. Many specific policy measures are needed to achieve that end, including expanding public investments, the strategic allocation of pension funds, and a set of monetary and financial regulatory policies to circumscribe speculative finance and promote the productive allocation of credit. Such a package of investment policies will also serve to reduce the hypermobility of international capital flows, which has had such destructive consequences throughout the world in recent years.[4]

In proposing such a policy approach, have I forgotten the lesson that Marx and Kalecki taught us, that unemployment is functional to capitalism? Given that this lesson has become part of the standard mode of thinking among mainstream economists ranging from Milton Friedman to Robert Gordon, I would hope that I have not let it slip from view. My point nevertheless is that through changing power relationships at the workplace and the decision-making process through which investment decisions get

4 Some details on designing investment and labor market policies to promote sustained full employment in the United States are presented in Pollin and Zahrt (1997).

made, labor and the left can then also achieve a more egalitarian social structure of accumulation, one in which capitalists' power to brandish the weapon of unemployment is greatly circumscribed. If the labor movement and left neglect issues of control over investment and the workplace, we will continue to live amid a Bolivian solution to the unemployment problem, where full employment is the by-product of workers' vulnerability, not their strength.

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