Class Conflict and the "Natural Rate of Unemployment"

Robert Pollin

There might well be a natural rate of unemployment below which inflation will accelerate. But this economist argues that the reasons may be different from those suggested by conventional theory.

EARLY last September, the world's financial press reported a familiar story: that the U.S. stock market had surged on reports that conditions for U.S. workers had turned less favorable. The lead headline in the *Financial Times* for September 3, 1998, was typical: "Inflation fears ease as U.S. jobs growth slows. Markets surge after chances of another rate rise are reduced."

At the time of this news report, the most up-to-date monthly figures reported unemployment in the United States at 4.2 percent and the rate for the first eight months of 1999 was also 4.2 percent. Most orthodox macroeconomists had long predicted that an unemployment rate this low would lead to virtually uncontrollable acceleration of inflation, and they had therefore argued that policymakers were obligated to maintain unemployment at

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a higher level, perhaps as high as 6 percent. However, the inflation rate for the first seven months of 1999 was 1.8 percent, a rate only slightly above the 1.6 percent figure for all of 1998, and otherwise lower than that for any twelve-month period over the past thirty-four years. What, then, are we to make of economists' ability to understand, much less predict, the performance of the economy?

The argument that low rates of unemployment would lead to accelerating inflation stems, of course, from the so-called "natural rate of unemployment theory," a term first advanced in 1968 by Milton Friedman (though Edmund Phelps was the independent co-originator of the theory in its modern form). The Friedman theory was subsequently developed by many macroeconomists under the term "non-accelerating inflation rate of unemployment," or NAIRU, a remarkably clumsy term for expressing the simple concept of a threshold unemployment rate below which the inflation rate begins to rise.

Based on this theory, Friedman and others have long argued that governments should never actively intervene in the economy to promote full employment or better jobs for workers, since it will be a futile exercise, whose end result will only be higher inflation. Over the past generation, this conclusion has had a far-reaching influence throughout the world. In the United States and Western Europe, it has provided a stamp of scientific respectability to a whole range of conservative policies, most clearly the Reaganite and Thatcherite programs in the United States and United Kingdom in the 1980s. But even into the 1990s, as the Democrats took power in the United States, the Labour Party won office in Britain, and Social Democrats won elections throughout Europe, governments have still been committed to stringent fiscal and monetary policies, whose primary goal has been to prevent inflation. In Western Europe this has produced an average unemployment rate of more than 10 percent from 1990 to 1998. In the United States, unemployment rates have fallen sharply in the 1990s, but, as an alternative symptom of stringent fiscal and monetary policies, real wages for U.S. workers have also declined dramatically over the past generation. As of 1998, the average real wage for nonsupervisory workers in the United States was 13.1 percent below its peak in 1973, even though average worker productivity had risen between 1973 and 1998 by 36 percent.

Why have governments in the United States and Europe remained committed to the idea of fiscal and monetary stringency, if the natural rate theory on which such policies are based appears so obviously wrong? The explanation is that the natural rate theory is not just about predicting a precise unemployment-rate figure below which inflation must inexorably accelerate, even though many mainstream economists have presented the natural rate theory in this way. At a deeper level, the natural rate theory is an expression of the idea that, in a capitalist economy, sustaining full employment at decent wages is a difficult proposition that depends on how the inherent conflicts between workers and capitalists are resolved. As such, the natural rate theory actually contains a legitimate foundation in truth amid a welter of sloppy and even silly predictions.

The "Natural Rate" Theory Is About Class Conflict

In his 1967 American Economic Association presidential address, in which he introduced the natural rate theory, Milton Friedman made clear that there was really nothing "natural" about the natural rate theory. Instead, Friedman emphasized that

> by 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 . . . and the strength of labor unions all make the natural rate of unemployment higher than it would otherwise be. (1968, p. 9)

In other words, according to Friedman, what he terms the "natural rate" is really a social phenomenon measuring the bargaining strength of working people, as indicated through their ability to organize effective unions and establish a livable minimum wage.

But what happened to Friedman's basic insight as NAIRU literature developed? Much of the literature around NAIRU has been focused on establishing a set unemployment rate at which inflation reliably accelerates. The history of the past thirty years, in the United States and elsewhere, has demonstrated irrefutably that this is a futile exercise. But this does not mean that there is *no* relationship between inflation and workers' gaining in terms of employment and higher wages.

This becomes clear when considering some of the main findings, for example, in the winter 1997 *Journal of Economic Perspectives* symposium on NAIRU, a leading reference on this topic. Robert Gordon's paper in this symposium 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 Gordon, NAIRU fell from 6.2 percent in 1990 to 5.6 percent by mid-1996.

Also summarizing extensive econometric research, Douglas Staiger, James Stock, and Mark Watson, like Gordon, conclude that NAIRU does exist but 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 1997 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 general thrust of these broad econometric findings appears solid. 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 misses a fundamental question jumping out at us from these results. 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. 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, p. 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, the overall point is clear: 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 NAIRU to fall.

Thus, even if by partial inadvertence, and in any case almost completely camouflaged amid a mass of econometric detail, Gordon's conclusion returns the discussion of unemployment to the analysis of class conflict and the distribution of income and power. Class conflict, in other words, is the specter haunting the analysis of the natural rate and NAIRU: This is the consistent message stretching from Milton Friedman in the 1960s to Robert Gordon in the 1990s.

Marx, Kalecki, and the "Reserve Army of Unemployed"

Stated in this way, the "natural rate" idea does, ironically, bear a close family resemblance to the ideas of two of the greatest economic thinkers of the left, Karl Marx and Michal Kalecki, on a parallel concept—the so-called 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 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 decline in job creation, higher unemployment, and a replenishment of the reserve army. In other words, the reserve army of unemployed is the instrument that 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 himself was a major contributor—was gathering 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 so 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 uti-

lization. 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 won't support it because full employment will threaten their control over the workplace, the pace and direction of economic activity, and even political institutions.

Compared to Marx, Kalecki thus focuses more on the broader social and political problems capitalists face because of full employment than on 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 democratic full-employment economy.

The Political Economy of Unemployment

Once the analysis of unemployment in capitalist economies is properly understood within the framework of class conflict, several important issues in our contemporary economic situation become much more clear. Let me just raise a few:

1. Within the natural rate and NAIRU research program, economists have long studied how workers' wage demands cause inflation as unemployment falls. However, it is never the case that such demands directly cause inflation. This is true by definition, since inflation refers to a general rise in product prices. Workers,

by definition, do not have the power to raise product prices. Business owners raise product prices. Inflation happens as unemployment is falling when business owners respond to workers' increasingly successful wage demands by raising product prices so that they can maintain profitability by passing on their increasing 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.

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 twenty-seven-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 most of the 1980s and 1990s. A recent econometric study by Cara S. Lown and Robert Rich (1997) of the New York Federal Reserve supports this perspective. They found that, between 1990 and 1995, 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 most of the past expansion, with unemployment falling but workers showing almost no income gains, demonstrates dramatically the crucial point that full employment alone can never be an adequate measure of well-being for working people. This point was once expressed dramatically to me by a colleague of Chicago pedigree. He explained that we could easily achieve sustained full employment simply by passing a law whereby people who declared themselves unemployed would be shot. In a fair economy, workers should have jobs, of course, but also livable wages and benefits, reasonable job security, and a healthy work environment.

4. In our current tight labor market, should workers continue to succeed in winning higher wages and benefits, some inflationary pressures are likely to emerge, even though global competi-

tion has increased the difficulties of firms successfully raising product prices. But if inflation does not accelerate after wage increases are won, this would mean that the distribution of income is shifting in favor of workers. In any case, in response to *either* inflationary pressures or a downward shift in national income, we should expect that many, if not most, segments of the business community will increasingly support a Federal Reserve policy that would slow the economy and raise the unemployment rate, even if it means risking a recession.

There is a solution out of this trap suggested by Kalecki's analysis: that capitalists embrace the higher profits they will earn through higher levels of capacity utilization and a full employment economy, even if such a situation entails that they relinquish a degree of political and economic power. But until various political forces coalesce around the virtues of this approach, we will continue to live in a world framed by the limits of the natural rate/NAIRU analysis. This is because, despite the numerous and sometimes egregious failings of the model, it still captures—along with the Marx/Kalecki framework—basic truths about the nature of class conflict in our contemporary economy.

For Further Reading

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