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THE PRICE OF UNEMPLOYMENT AND INFLATION
AND WHO PAYS

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The Employment vs. Inflation Debate

Since the early 1960's many economists and policy makers have contended that full employment and price stability are unattainable goals. Stimulated by the works of A. W. Phillips, a British economist, they have argued that there is an inverse relationship between inflation and unemployment; that is, as unemployment decreases, inflation increases. Phillips in his original article, "The Relationship between Unemployment and the Rate of Change in Money Wage Rates in the United Kingdom,"¹ cautiously reasoned that when demand for commodities, services or labor was high relative to supply, prices increase. Increasing prices for labor draw out unemployed people into the labor market. The more people that are drawn out of unemployment, the higher the wages and the higher the total spending. Conversely, when demand for commodities, services or labor was low, relative to supply, prices decreased. Decreasing prices in commodities and services usually result in higher unemployment, because of "lay-offs." Decreasing prices for labor do make workers reluctant to enter the market for less than the prevailing rates when demand is low and unemployment is high. Consequently total spending is reduced. Based on the analysis of his data, Phillips hypothesized that as unemployment increased wages tended to decrease.

Although Phillips spoke of the relationship between wages and unemployment, the connection between wages and prices is quite direct: periods of high employment stimulate higher wages which in turn increase business operating costs. These increases in cost are passed on to the consumer in terms of higher prices. Consequently, during periods of high employment prices tend to increase and vice versa. In short, there appears to be a trade-off between

inflation and unemployment. This simple but powerful piece of research has influenced many policy makers all over the world. The Phillips curve, as this relationship is called, has had, and continues to have profound economic, political and social implications as we shall shortly see.

By no means is the Phillips curve noncontroversial or fully accepted. Many economists, policy makers and lay persons refute the notion of a trade-off between unemployment and inflation. Some critics, on the basis of their studies, argue that the foundation of the trade-off thesis is based on classical price theory, a theory which no longer explains market pricing because of the lack of competition in the market.² A frequent example used, although there are many others,³ occurred during 1975 when demand for United States made automobiles decreased, but prices for these automobiles actually increased by about \$1,000 per car. This happened because the falling demand increased the per unit cost of production. Large oligopolies must compensate for a drop in demand by increasing prices to meet cost and maintain target or projected profit levels. Given the concentration of large corporations in the economy and the lack of competition, prices rise at the will of large firms, in spite of the demand and employment or unemployment situation. Thus the causes of inflation are more complex and require action on several levels and fronts.⁴

Other studies have shown that the inflation-unemployment thesis is too simple and does not account for external factors which influence our economy, e.g., oil embargo, devaluation of the dollar, foreign imports, grain sales, etc. For example, in 1974, because of the oil extortion and the grain deal, food prices accounted for about half of the inflation increase.⁵

Another argument commonly heard against the Phillips curve, is that the actual inverse relationship data does not hold true for the United States in recent years. Figure 1 presents data for inflation and unemployment,⁶ and what has come to be known as stagflation.⁷ This empirical data does not support, statistically, an inverse relationship between unemployment and inflation.

Finally, and by no means have all the opposing arguments and findings been covered, Bach argues that consumers and business have come to anticipate inflation and by doing so, have increased the inflation rate by their spending habits, irrespective of unemployment rates.

In a world of excess income claims and government insertion of new money to avoid (reduce) unemployment, everyone will come to understand the inflationary process or, at least, to anticipate continued inflation. Thus wage earners, businessmen, borrowers, lenders--all the participants in the economic process--will begin to build inflation anticipations into bargains on wages, prices and interest rates on loans. But once they do, the government's power to reduce unemployment by government spending of new money is undercut. The main way expansionary government monetary-fiscal policy creates more jobs is by expanding demand, which induces businesses to hire more workers. But if workers push up wage costs as fast as demand increases and prices rise, businesses have no incentive to expand output and hire more workers. The result is simply higher wages, costs, and prices all around, but no more jobs. And the more government spends to reduce unemployment, and more inflationary expectations will rise and the more inflation will occur, without more than temporarily reducing unemployment.⁸

These then are some of the major findings in opposition to the inflation-unemployment thesis. They are responsible works which have been substantively developed by respectable economists and policy analysts. Yet, the impact which these findings have had on changing economic policy or many peoples' minds about the Phillips curve has been nil.

Figure 1

CHANGES IN CONSUMER PRICES AND
UNEMPLOYMENT RATES FOR THE
UNITED STATES, 1953-1977

Year	Percent Increase in Annual Average Consumer Prices	Percent Unemploy- ment
1953	.8	2.9
1954	.5	5.5
1955	- .4	4.4
1956	1.5	4.1
1957	3.6	4.3
1958	2.7	6.8
1959	.8	5.5
1960	1.6	5.5
1961	1.0	6.7
1962	1.1	5.5
1963	1.2	5.7
1964	1.3	5.2
1965	1.7	4.5
1966	2.9	3.8
1967	2.9	3.8
1968	4.2	3.6
1969	5.4	3.5
1970	5.9	4.9
1971	4.3	5.9
1972	3.3	5.6
1973	6.2	4.9
1974	11.0	5.6
1975	9.1	8.5
1976	5.8	7.7
1977	6.5	7.0

Source: U.S. Department of Labor, Monthly Labor Review.

Why have we as a nation carried out our economic policies during the past two decades on the basis of a theory which is at best only partially valid? The answer to this question lies in the economic, political, social and moral arena of our society. It concerns a redistribution of resources, a reallocation of status, and a redefinition of group and personal relationship.⁹ Because ultimately, behind the theoretical analysis of the inflation-unemployment tradeoff is the real issue of cost, and who shall pay the greater burden of the cost. The following analysis will attempt to elucidate these costs.

Inflation

During periods of high inflation everyone in society is affected, but in different ways. Not too many years ago it was conventional wisdom that inflation was bad because it affected those least able to afford it: the poor and persons on fixed incomes. While this was, and still is, true it is only half of the truth. Inflation affects the non-poor and business firms also, but in different ways. During his inflationary periods, the poor and people on fixed incomes spend a greater percentage of their income on basic needs--food, shelter, clothing, etc. Consequently, they have less additional money for other necessities. As prices continue to increase they begin to substitute and often eliminate some goods and services; this situation creates great hardships. The non-poor and business firms do not face such hardships of having to substitute or eliminate basic necessities; though they too have to pay more for their basic needs and business costs. A major difference is that they have additional resources, income, savings, etc., which they can use, if they wish to continue their standard of living or business operations. The poor and persons on fixed incomes generally do not have additional resources; they must make do with their incomes, pensions, or welfare allowances. If these are not enough, they must go without, beg, borrow or steal.

On the other hand, during periods of high inflation, savers, lenders, some investors and many corporate firms lose large sums of money in terms of real income and returns on interest rates. Generally

speaking the more money that is tied up in savings, loans or production just prior to an increase in inflation, the greater the loss of real money value. This was the case during 1973 and 1974 when inflation nearly doubled each year. For example, a lending institution which in 1972 made a single loan for \$100,000, to be paid back in two years at 7% interest and in 1973 and 1974 inflation increased 3% and 6% respectively, from a previous 3% annual rate, lost approximately \$6,400 in two years. Put more dramatically, the anticipated returns when the loan was first issued was \$10,500 in two years. The actual returns with the increase of inflation was \$4,100, a loss of over 50% on this one loan.

By reversing this example to apply to an investor, say a person with a savings account, we can also see how inflation is a costly matter. Suppose that a person or firm had \$100,000 invested and was receiving a 7% annual interest return. During the first year, using the above 3% and 6% inflation rate increases, this investor is really only receiving 4% returns or losing \$3,000 in interest. In the second year, this investor is only receiving a 1% return and losing \$6,000 in returns - a total of \$9,000 in two years.

Multiplying these two examples by the thousands of lending institutions and the millions of loans they make and the millions of investors, one can see that inflation is a very costly matter. It is for this reason that entrepreneurs do not favor inflation: they simply stand to lose large sums of profits and real income.* For this reason, it will not be surprising to hear about a "fluctuating interest rate" tied to an inflation indicator. This will be a safeguard against inflation losses if the inflation rate should increase. In fact, this practice is now common with many lending institutions. The net consequence of this practice is a guaranteed profit margin to lenders.

* It should also be pointed out that during his inflationary periods, borrowers fare better than lenders, in that they are paying back loans at a lower value rate than they originally borrowed.

This also means that the traditional justification of profit due to risk taking is no longer valid since with the fluctuating interest rate tied to inflation, there is no risk, in terms of returns, involved.

It should also be pointed out that with fluctuating interest rates, interest payments would be lowered when inflation decreases. Nevertheless, the above consequence still stands.

Unemployment

Just as inflation affects everyone in society, so does unemployment; though again, the consequences affect different groups differently. It is common knowledge and a matter of fact that unemployment affects members of minority groups, the young, the elderly, and women disproportionately.

The ratio of unemployment for members of these groups is 2:1 and even 3:1 among labor force participants. It is also common knowledge that the actual unemployment rate of these groups is double and triple that of the official reported figures. Prolonged unemployment for members of these groups often means exhausting any possible savings, borrowing from relatives and friends, selling personal belongings, going on public assistance, increase family conflicts, loss of personal pride, self-worth, self-respect, and an overwhelming sense of uselessness. The road from unemployment to humiliation to poverty to alienation is well documented.* What is not well documented is how unemployment affects everyone, even the employed.

The costs of unemployment to society are extremely high and quite often invisible. Unemployment is a very costly social problem which we all pay for, whether we like it or not. We pay billions of dollars annually for unemployment in terms of lost production of goods and services; a loss which could never be recovered. A decrease in production due to unemployment

* See Michael Borrero, "The Emotional and Psychological Impact of Unemployment," in this Volume.

means fewer tax revenue dollars being collected, while at the same time an increase in expenditures for social programs. As unemployment increases so do the expenditures for unemployment insurance, aid to dependent families, food stamps, medicaid, general assistance, psychiatric hospitalization, penal rehabilitation, employment training programs, to name but a few of the more visible costs. If we were to figure out the opportunity cost involved in just these few programs the cost would be staggering.

We pay for unemployment in terms of increases in crimes, suicides, emotional disturbances, mortalities, juvenile delinquency, alcoholism, and violence against women and children. We pay in terms of family deterioration, greater conflict between parents and children and spouses; even the children of the unemployed have been found to achieve less in school. But perhaps the greatest price we all pay for unemployment is the tremendous waste of human creativity and productivity. To deprive a person of work, in an age when personal meaning, identity and one's self-worth are derived from work, it is to deprive one from belonging to the community and society. Such denial of active membership can only lead to greater hostilities toward those who are withholding full social participation.

Dealing with The Dilemma

There seems little doubt that behind the choice between price stability and full employment or unemployment and inflation, is the concept of cost and the assumption that the cost of high levels of unemployment is a lower and lesser price for society to pay than is the cost for high rates of inflation. The reasoning behind this concept is not difficult to figure out: while inflation affects everyone, it affects most, in monetary terms, those persons and groups with greater monetary assets, large corporations, lending institutions, wealthy individuals, etc. Unemployment, while it too affects everyone, it mainly affects the employment vulnerable: ethnic minorities, the young, women and the elderly. It is not difficult to see that a result of a price stability policy perpetuates racism, sexism, and the oppression of the young and elderly. It is a policy

the protects the economically and politically powerful at the expense of the economically and politically weak.

It is also clear that a full employment policy at a 1% or 2% level given our market and corporate structure, e.g., lack of competition and market monopolies, etc., would create very high levels of inflation. Our economic and political policies in dealing with the unemployment-inflation dilemma have been merely reactionary and see-saw like: when inflation is "too high" we cool down the economy which means increased levels of unemployment; conversely, when unemployment is "too high" we stimulate the economy by pumping more money and consequently more jobs. And so continues our see-saw economic and political policies; we merely release the pressure valve when the steam gets too "high."

There are other alternatives to deal with this dilemma, though they too have their problems. For example, dismantling our oligopolies and monopolies would create greater competition, more jobs, more investments, greater efficiency, probably greater distribution of wealth, lower prices and not necessarily higher inflation. This, however, would be taking on the muscle of capitalism and the threat of corporate dissolution. We could attempt again, a more strategic plan and enforcement of price and wage controls. The goal here would be to reach a better balance between unemployment and inflation; that is, to achieve lower levels of unemployment and inflation. However, wage and price control is not a popular idea, let alone a practice. It contradicts free enterprise and it is difficult and costly to enforce. Finally, we could attempt some combination of the above. We could dismantle many conglomerates, oligopolies and monopolies, and in those areas which this is not feasible, we could develop stringent, clear and enforceable wage and price controls. Thus, it appears that unless and until we change our market and corporate structure, our economic policies will merely continue to be reactive rather than pro-active, "see-saw like," and those policies will not address the fundamental issues and problems identified in this paper.

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