

Unemployment as an Instituted Problem of Capitalist Economy and Policies to Resolve Unemployment

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I. Introduction

Unemployment is one of the most talked about issues in economics. It is defined as the failure to obtain employment that earns wages or salaries paid in money. According to Forstater (2003) it has a dire impact on the jobless person and is also associated with tremendous social and economic costs for society as a whole. Economists such as Sen (1999) have identified poverty not merely with inequality but also with unemployment. Sen also supports the right to work because unemployment has far-reaching consequences beyond the loss of income.

Modern day economic theories on unemployment have been developed in several directions. Economic orthodoxy treats unemployment as a form of choice which can be derived from an optimizing behavior of an agent. According to Moreton (1994, p.449) “one of the dysfunctional aspects of orthodox economics is that there is a failure, perhaps a refusal, to recognize and attach appropriate importance to the significant loss of quality of life experienced by those who become unemployed within market-dominated economies”. The neoclassical theory focuses on the idea that market systems possess an inherent tendency to full employment. It emphasizes on the market clearing function of wage flexibility and posits that the substitutability of labor and capital, combined with flexible wages and interest rates, is sufficient to remove any involuntary unemployment in the economy. Economic orthodoxy also sees existing unemployment in the economy as voluntary unemployment and has tried to come up with various reasons for the existence of unemployment. One type of orthodox model treats unemployment as a result of the inter-temporal substitution of leisure for work, another as a

choice of the length of time devoted to search for a job, while another introduces the concept of wage contracts in order to explain the phenomenon of unemployment. We can view these developments as an outcome of the dissatisfaction with the notion of "involuntary unemployment," as interpreted in Keynesian models¹ (Cornwall and Cornwall 1997).

In *The General Theory of Employment, Interest and Money*, Keynes (1936) rejected Say's Law and demonstrated the possibility and the likelihood that market systems do not tend to fully utilize resources, even under competitive conditions, due to insufficient effective demand. He showed that involuntary unemployment does not depend on real wage inflexibility and that it would persist even if real wages were to fall via "a small rise in the price of wage-goods relatively to the money-wage," because the "aggregate supply of labor willing to work for the current money-wage... would be greater than the existing volume of employment" (Keynes 1936, p.15). In chapter nineteen of the *General Theory*, Keynes further elaborated that a policy of wage flexibility would aggravate unemployment because of negative feedback on the aggregate effective demand². He argued that aggregate investment does not depend on savings but is governed by the complex of expectations of both investors and lenders, which may be highly volatile and unstable. Actually, investment is the independent variable that determines aggregate demand and thus aggregate output and employment via the relatively stable propensity to consume and the multiplier's feedback effects (Forstater 2001).

¹ "The classical economists had rejected any theory of labor market clearing and had always recognized the importance of the "reserve army of the unemployed" to discipline labor. Further, David Ricardo had famously worried that labor-saving capital might cause ubiquitous labor redundancy, Thomas Malthus had developed a (somewhat illegitimate) theory of a tendency for markets to face insufficient demand, and Karl Marx's two departments approach offered a variety of reasons to suspect that capitalism would not generate full employment. Still, it was Keynes who provided the clearest explanation of the problem: firms produce only the quantity of output they expect to sell and it would be highly unlikely that this would happen to coincide with full employment" (Wray 2009,p.2).

² Also see Forstater (2003); and Iacobacci and Seccareccia (1999)

Furthermore, the most important point to be understood in Keynes's theory is that unemployment is not caused by faulty operation of the labor market such as sticky wages, lazy workers or low levels of training and education. Rather, it is the existence of a preference for highly liquid assets such as money, which tends to force the economy to achieve equilibrium³ before reaching full employment. Keynes, like Marx and Ricardo did not see unemployment as a simple "market failure" but he argued that unemployment results from insufficient effective demand and the problem of unemployment can only be solved by creating more jobs. Creating more jobs also requires higher demand for the output generated by the additional workers. In other words, the capitalist economies tend to operate with excess capacity and unemployment. It is therefore unlikely for a capitalist economy to attain full employment on its own. Therefore, the problem of unemployment can only be solved by well-formulated policy, which is focused to raise aggregate demand, and hence to make more jobs available in the economy (Wray 2009).

The second section of this paper will discuss in detail how Keynes addressed the issue of unemployment in chapter 17 of *General Theory* and what were his policy prescriptions to resolve unemployment. The third section will briefly discuss the Keynesian and Post Keynesian position on existence of unemployment and their policy prescriptions to reach full employment. The fourth section will delve into details of the Employment of Last Resort (ELR) or the Government Job Guarantee proposal. The fifth section will discuss if there exists any barrier to full employment, or in other words if the government can afford full employment. The last section will conclude the paper.

³ Equilibrium is defined as the level of employment at which expected sales revenue is just sufficient to induce that level of production.

II. Keynes, Liquidity Preference Theory of Interest Rate and Unemployment

After publication of *General Theory* there had been various misunderstandings regarding Keynes's theory of interest rate. Some authors such as Bertil Ohlin, John Hicks and Dennis Robertson interpreted Keynes's rate of interest as determined by the equalization of the supply of and the demand for saving (Keynes 1937). This mechanism is exemplified by the loanable funds theory of the rate of interest, which Keynes attempted to overthrow in *The General Theory* (Bell 2003, Wray 1992a). However, Keynes himself was quite misleading regarding his theory of interest. It was quite obvious to misinterpret him by looking at his dispositions of interest rate theory as presented in chapters thirteen and fifteen of *General Theory*. Nevertheless, his best exposition of theory of interest rate can be found in chapter 17 of *GT* and his 1937 article *Alternative Theories of the Rate of Interest*.

The main difference between Keynes's liquidity preference theory of interest rate and the loanable funds theory of interest essentially boils down to a distinction between the economics of full employment and the economics of unemployment. In Keynes's view the loanable funds theory of interest rate was flawed because it treated saving and investment as the determinants of the system and the rate of interest as a determinate, while the truth is that savings and investments are the determinates of the system, and the rate of interest is a determinant. Keynes emphasized that because saving depends upon income and income depends upon investment, it was impossible to conceive of an independent shift in either schedule (Bell 2003, p.242). In chapter 17 of *General Theory* and his 1937 article Keynes argued that the rate of interest cannot be determined by the equalization of the supply of and demand for savings⁴. For Keynes, the rate

⁴ In the *GT*, Keynes defined liquidity preference "as the desire to hold liquid assets, which exists because of uncertainty about the future". Keynes emphasized that one exercises liquidity preference with regard to a stock of savings (Keynes 1936, p.194). "By doing so, he separated the decision to save from the decision regarding the form

of interest is a monetary phenomenon in the special sense that it is the own-rate of interest on money itself. That is, it equalizes the advantages of holding actual cash and a deferred claim on cash. Therefore, it is precisely the liquidity-premium on cash ruling in the market that determines the rate of interest. In Keynes's system, investment and saving are equalized *ex post* in the aggregate level not by the rate of interest but by the aggregate income. It is because investment is governed by the prospective yields of entrepreneurs through the marginal efficiency of capital and it is highly fluctuating as it depends on animal spirits. After planned investment is determined, it would determine the volume of effective demand and output by way of the multiplier effect. Finally, saving is determined since it is "the excess of income over consumption" (Keynes 1936, p. 62).

Kregel (1976) argues that the main difference between orthodoxy and Keynes is that the former assumes away "ill-informed expectations and uncertainty" and keeps the "conditions of perfect certainty and full information". Whereas, the latter had to find another way to explain the existing unemployment in the economy. Keynes assumes that although expectations and uncertainty are always present, yet different assumptions could be made about the constancy of expectations and their effect on the system. According to Kregel even though Keynes had three different models characterized in terms of three expectation factors, Keynes did not use the interpretations that rely on disappointed expectations as the cause of temporary unemployment equilibrium (Wray 2006, p.3). Rather, Keynes used the "purely static model, divorced from disappointment and shifts in expectations to demonstrate that unemployment was not a short-run disequilibrium phenomenon..." (Kregel 1976, p.213).

in which savings are to be held. The former would be determined primarily by income, the latter primarily by liquidity preference" (Wray 1994, p.247).

In chapter 17, Keynes emphasized a monetary determination of interest rates, which he considered “is nothing more than the percentage excess of a sum of money contracted for forward delivery, eg. a year hence, over what we may call the ‘spot’ or cash price of the sum thus contracted for forward delivery” (GT, p.222). This implies that for every kind of capital asset there must be an analogue of the rate of interest on money. “Thus for every durable commodity we have a rate of interest in terms of itself, a wheat rate of interest, a copper rate of interest, a house-rate of interest, even a steel-plant-rate of interest” (GT p.222-223). Each of these own rates can be stated in terms of money, which is the “greatest of the own-rates of interest”, hence, “rules the roost” because of the special properties of money (GT p.223).

Keynes’s LP theory of interest rate is theory of value for asset pricing ⁵. LP determines the whole price system- the whole structure of interest rates-on assets. The expected return on holding any asset measured in monetary terms is $q-c+l+a$. Where q is the asset’s expected yield, c is carrying costs, l is liquidity, and a is expected price appreciation. The composition of returns varies depending upon the type of asset. The return to illiquid assets is $q-c$, while return to holding highly liquid assets will have a return comprised mainly of return to liquidity, l . The total return from assets can be used to calculate marginal efficiency for each asset, including money. In equilibrium prices of all assets adjust so that the expected returns (marginal efficiencies) are equalized. Thus the own-rate approach leads directly to the determination of

⁵ See Townshend (1937), Kregel (1988) and Wray (1993).

Hugh Townshend (1937) was one of the first economists to correctly interpret Keynes’s liquidity preference (LP) theory of interest as a theory of value. In other words, how assets that can be carried through time are valued. Townshend contrasts Keynes’s theory of value with the marginalist theory and argues that Keynes theory is more complete. Townshend pointed out that Keynes’s theory of interest rate is independent of the money supply in the economy and instead is based on the liquidity premium. Keynes’s LP theory can be extended beyond monetary assets to encompass durable assets. Durable assets also have a value that attaches to them for future exchange which is independent of their present value. This value, based on future exchange, is determined by expectations. In equilibrium, the price of new assets and existing ones must be equal if the assets under consideration are qualitatively the same. In other words, for Townshend, interest rate movements had less to do with changes in the money supply and more to do with ongoing exchange value comparisons (whether to hoard money or to invest/ buy new assets).

demand prices for assets—where an asset can be physical capital, other commodities, or money-denominated financial assets, in other words, anything which can be carried through time.

Producible assets are supplied up to the point where the supply price equals the demand price. According to Keynes (GT p.228) “those assets of which the normal supply-price is less than the demand-price will be newly produced; and these will be those assets of which the marginal efficiency would be greater than the interest rate”. Keynes argued that, as the quantity of most types of assets is increased, own rates fall which also lowers demand prices⁶. When demand prices fall below supply prices, no more will be produced. However, this is not true for money due to its special properties.

The essential properties of money identified by Keynes (GT Ch 17) include a negligible elasticity of production; a negligible elasticity of substitution and low carrying costs. Since carrying costs are low, an increase in the volume of money will not raise total carrying costs (c); holding liquidity constant, the return to money ($l-c$) will not fall significantly as the quantity of money increases. Since wage and debt contracts are written in money terms, holding money always increase one’s ability to meet contractual obligations; thus money always provides a positive return (l) regardless of the quantity held as long as nominal wages are relatively sticky (Wray 1994). Given a low elasticity of substitution as the exchange value of money rises there is no tendency to substitute some other factor for it. “Not only is it impossible to turn more labor on to producing money when its labor-price rises, but money is a bottomless sink for purchasing power, when the demand for it increases, since there is no value for it at which demand is diverted—as in the case of other rent-factors—so as to slop over into a demand for other things.”

⁶ This can happen due to a number of reasons but it is not due to diminishing physical returns.

(GT Ch 17, p.231). Finally, given a low elasticity of production⁷, as liquidity preference rises, there is no tendency to move to full employment merely by allocating more labor to the production of money because money could not be “grown like crop or manufactured like a motor-car”.

According to Wray (1991, 1992b) liquidity preference can be interpreted as a theory of value for assets. If two assets have the same stream of expected returns, divergence of their demand prices will be uniquely determined by differences of liquidity. Given $q < i < a$, the degree of liquidity preference will determine demand prices for all assets. This, in turn will go into the determination of the levels of employment and output through impact on the levels of production of producible assets. Changing views about the future affect the demand prices of assets through impact on q 's and on the liquidity preference. When LP rises, the perceived value of i rises relative to that of q , this causes all asset prices to adjust so that the marginal efficiencies are again equalized. The most liquid asset, high-powered money (HPM), has a return that consists entirely of i (its carrying cost and yield are zero). This sets the minimum to be achieved by all assets, that is the reason why money rate of interest “rules the roost” (GT p.223). In order for any asset to be newly produced its expected return must exceed the i from HPM⁸. That is, Keynes's theory of liquidity preference is a psychological theory of asset prices (Kregel 1988). Changing expectations about the future have a significant role on the marginal efficiencies of various kinds of assets. When people are optimistic about the future economic performance the return on capital assets or the q s will rise. In that case, capital assets will be produced, that is

⁷ According to Keynes (GT p.230) “Elasticity of production means the response of the quantity of labor applied to producing it to a rise in the quantity of labor which a unit of it will command. Money that is to say, cannot be readily produced:- labor can not be turned on at will by entrepreneurs to produce money in increasing quantities as its price rises in terms of the wage-unit.” “If money could be grown like a crop or manufactured like a motor-car, depressions would be avoided or mitigated because, if the price of other assets was tending to fall in terms of money, more labor would be diverted into the production of money” (ibid p.231).

⁸ “If a producible asset's marginal efficiency falls back into line with the marginal efficiency of money, it is produced up to the point that its marginal efficiency falls back in line” (Wray 2006, p.3).

entrepreneurs will invest more and hence multiplier impact can be seen in the economy. This will also cause the adjustment in asset prices. Whereas, when people become pessimistic they will shift their portfolio preference from illiquid to liquid assets. That is, they will not invest in capital assets and hence unemployment originates⁹.

In short, as Keynes argued, in the real world, it is the desire for liquidity and the existence of assets whose return from liquidity exceeds carrying costs that prevent capitalist economies from achieving full employment. Actually, there is nothing “more anti-social than the fetish of liquidity” because “there is no such thing as liquidity of investment for the community as a whole (Keynes, GT p.155). Furthermore, Keynes goes on to argue that the main cause of unemployment in the capitalist economy is people’s irrational love for money. In his own words

Unemployment develops, that is to say, because people want the moon; -men cannot be employed when the object of desire (i.e money) is something which cannot be produced and the demand for which cannot be readily choked off. There is no remedy but to persuade the public that green cheese is practically the same thing and to have a green cheese factory (i.e. a central bank) under public control (Keynes GT p.235).

III. Policies to Resolve Unemployment

Effective demand and structural change problems are the two issues that the policies to address unemployment must recognize. Even though, Keynes’s impact on postwar policy was as great as his impact on theory it is questionable whether much of the policy that was called Keynesian really had strong roots in Keynes’s *General Theory*. Unfortunately, “Keynesian”

⁹ In this case money stock is constant, but as people have become pessimistic their liquidity preference has increased. And they will shift their portfolio preference from illiquid to liquid assets. Prices of more liquid assets will increase, whereas prices of illiquid assets will decrease. In sum, nominal prices are based on individuals’ expectations, hence, Md which is the stock of money cannot determine prices. Md is flow demand for finance (loans). The idea of LP Keynes is talking is Md for hoard which is a stock concept. Wray (1993) strengthens this arguments by pointing out that LP is not a theory of money demand but a theory of asset prices. Wray (1992a) gives a framework for asset price determination which allows LP(stock concept) to be clearly distinguished from money demand (flow concept) and argues that this framework is compatible with Keynes’s (1937) insistence that stocks determine the interest rate. It also supports Keynes’s statement in response to Hicks (1936) that an increase of spending need not increase interest rates: increase Md doesn’t necessarily lower asset prices and raise interest rates if banks react by supplying more money.

policy was eventually reduced to simplistic metaphors such as “pump-priming” and “fine-tuning”, which would keep aggregate demand at just the right level to maintain full employment (Wray 2007, p.6). Most post war policies usually consisted of measures to promote savings and investment. Promoting saving was inconsistent with Keynes and was based on the neoclassical loanable funds view that saving finances investment.

Traditional Keynesian policies directed to stimulate aggregate demand by stimulating the private sector to full employment using fiscal and monetary policies may address the aggregate demand problem but not the structural change problem. Actually attempting to maintain full employment by stimulating private investment would shift the distribution of income toward owners of capital. This would worsen inequality and thereby lower the society’s propensity to consume. Keynes in Chapter 24 of the *General Theory* addressed this problem. Minsky’s (1992) *Financial Instability Hypothesis* also raises similar concerns. Over time economy naturally evolves from one with a "robust" financial structure in which hedge positions dominate, toward a "fragile" financial structure dominated by speculative and even Ponzi positions. This transition occurs over the course of an economic boom that is led by investment spending. During this period, income flows are leveraged by debt and the ratio of safe assets to liabilities rises, which encourages the adoption of riskier positions. Eventually, either a high rise in cost of financing or a low income below expectation, leads to defaults on payment commitments. In these circumstances speculative and Ponzi positions replace hedge positions and the economy becomes vulnerable towards any one of several possible triggers that can set off a financial crisis. As a consequence, a potential for Fisher-type debt deflation increases, bankruptcies snowball through the economy. This also raises interest rates while reducing access to credit and spending¹⁰. The

¹⁰ See Wray (2007a)

recession proceeds until an expansionary fiscal policy and a central bank acting as a lender of last resort steps in to limit the scope of the recession.

Wray (2007a, p.8) argues that growth led by investment can also have both inflationary and exchange rate implications. In contrast to the orthodox theories¹¹ Keynes argued that “semi inflation” could arise long before full employment is reached. Giving a number of explanation including bottlenecks, structural problems and oligopoly pricing of output and unionized labor, many of Keynes’s followers argue that most of the real world experience with inflation occurs in conditions of insufficient aggregate demand. However, as argued by Bresser and Carlos (2007) an increase of demand due to private investment spending might actually be more inflationary than an increase attributed to government spending because of worsening trade balance and depreciating currency.

Some Post Keynesians have focused more on income distribution policies to deal with unemployment, whereas, others have tried to promote public works and the ‘socialization of investment’. The latter approach, if designed correctly, may be more effective than conventional fiscal stimulus in dealing with the structural change problem (Wray 2007a and Forstater 2003).

Minsky’s vision of the capitalist economy closely followed that of Keynes. Minsky (1973) endorsed Keynes’s chapter 24 claim that the two outstanding faults of capitalism are its failure to provide for full employment and its tendency to result in an excessively unequal distribution of income. In Minsky’s (1965, 1968, 1973) view, poverty can be resolved through a combination of policies that would euthanize the rentier and put in place a modest bias of taxes and transfers in favor of the poor; and maintain tight full employment¹². Minsky argued that the

¹¹ “Orthodox theory claims that inflation is mostly demand-driven. If expansionary fiscal or monetary policy raises demand above the full-employment level inflation results” (Wray 2007a, p.8).

¹² Minsky defined tight full employment as a condition such that over a broad range of occupations and industries, employers would like to employ more workers than they do. Tight full employment would help to reduce poverty by

focus of antipoverty programs would have to be tilted towards jobs creation and not towards transfers and welfare. To ameliorate the fundamental faults of capitalism, Minsky proposed to euthanize the rentier through low interest rate policy, by reducing the importance of the private financial system (Minsky 1973). He believed that this could be achieved by shifting the emphasis away from stimulation of private investment, which relies on external finance, and thus creates financial assets that become part of the rentier economy. Instead, Minsky focused on achievement of full employment through direct job creation, raising employment and wages at the low end of the labor market while checking the growth of wages and prices in the high end.

Wray (1998a, 1998b) summarizes an employment program that will guarantee true, full employment (or zero unemployment) for all. The program is much like that advocated in the early 1980s by Hyman Minsky (1986) and more recently by Warren Mosler (1995, 1997-98), Philip Harvey (1989), and Wendell Gordon (1996). Wray argues that true full employment is not "inflationary" and could even reduce inflationary pressures. Indeed, full employment can be sold as a means to stabilize prices, which is close to the position taken by Minsky and Mosler. Further, the full employment policy would help to reduce economic fluctuations through a powerful built-in automatic stabilizer. The next section will elaborate more on this proposal, which is also known as *Employer of Last Resort* after Minsky (1986) or *Government Job Guarantee* after Kregel (1991,1999) and Wray (1998a).

increasing the number of workers per family. Thus poor families benefit as the total hours worked rises and as wage rise (See Wray 2007b)

IV. Government as an Employer of Last Resort

Minsky (1965, 1968, 1973, 1986) advocated an ELR program that would provide employment to workers that fit their existing skills. He also pointed out many advantages of an ELR program. ELR can slow down undesired urban migration by providing jobs to workers in rural areas. ELR wage can serve as an effective minimum wage and can be used to raise wage floor. The first component of the ELR proposal is that the federal government can act as the employer of last resort and offer infinitely elastic demand for labor, ensuring that anyone willing to work at the going wage would be able to get a job (Wray 1998a, Wray 2007b)¹³.

According to Wray (1998a) under the ELR program the government simply announces the wage at which it will hire anyone who wants to work in the public sector, and then hires all who seek employment at that wage. This is called the basic public sector employment (BPSE) at the basic public sector wage (BPSW). However, many non-BPSE jobs that are not the component of the ELR that could pay wages above BPSW will still remain in the public sector. The purpose of ELR is not to displace existing public sector employments. The only concern of ELR is to ensure that all those ready, willing and able to work at the BPSW wage will be able to obtain a job at that wage. This is defined as a state of full employment or zero unemployment. ELR policy is intended to reduce or eliminate much social spending that is currently targeted to the unemployed. If unemployment benefits of people are replaced with government employment, all the disadvantages of unemployment compensation would be eliminated¹⁴.

¹³ In Hyman Minsky's words: "The policy problem is to develop a strategy for full employment that does not lead to instability, inflation, and unemployment. The main instrument of such a policy is the creation of an infinitely elastic demand for labor at a floor or minimum wage that does not depend upon long-run and short-run profit expectations of business. Since only government can divorce the offering of employment from the profitability of hiring workers, the infinitely elastic demand for labor must be created by government" (Minsky 1986, p.308)

¹⁴ Some disadvantage of unemployment benefits are many of the unemployed are not covered, creates incentive problems by providing limited benefits to people for not working (Wray 1998a. P.127).

With a fixed price, BPSW is perfectly stable and it also sets a wage floor for labor. With the implementation of ELR the jobs that pay lower than BPSW will experience a one-time increases of wages. This brings in the possibility of one-time jump in some product prices because employers will be forced to cover the high cost as a result of increased wages through a combination of higher product prices, greater labor productivity and lower realized profits. “However, this one time jump-no matter how large it is –is not inflation nor can it be accelerating inflation¹⁵” (ibid p.131).

Wray (1998a) also argues that with the implementation of ELR other wages are also likely to rise because with the achievement of full employment, the threat of unemployment is removed, thereby providing more bargaining power to the workers to demand for higher wages¹⁶. Essentially, BPSW determines the wage for the lowest productivity group, that is, the pool of unskilled and semi-skilled workers during periods of normal demand, whereas, more productive workers will find jobs in private sectors (ibid p.132). Assuming, there is a loose relationship between wages and productivity it is possible to raise individual wages after ELR policy is adopted. Nevertheless, as workers have the alternative to BPSW, the employers also have the opportunity of hiring workers from BPSE pool. Wray (1998a p.132) recognizes this as a primary “price stabilization” feature of the ELR program¹⁷. The ELR pool can be used by the government as a “buffer stock” to stabilize the price of non-BPSE labor as long as workers in the ELR pool are substitute for non-BPSE labor.

¹⁵ Economists define inflation as a continuously rising price level.

¹⁶ As Forstater (1998 p.559) and Wray (1998a) argue this is essentially the old Marxist “reserve army of the unemployed” argument with the workers moving between private sector and discretionary public sector unemployment, rather than between employment and unemployment. “As the private sector demand for labor increases, the discretionary public sector pool will presumably shrink, and as the private sector demand for labor falls, the discretionary public sector pool will presumably rise.”

¹⁷ According to Wray (1998a p.132) “ if the wage demands of workers in the private sector exceed by too great a margin the employer’s calculations of their productivity, the alternative is to obtain BPSE workers at a mark-up over the BPSW. This will help to offset the wage pressures caused by elimination of the fear of unemployment”.

With ELR the workers not employed in private sector have an alternative opportunity to find work, therefore their productivity would not depreciate quickly. True full employment with an ELR program would not be more inflationary than the current system because the current system pays unemployed labor for not working and allows labor to depreciate and in some cases unemployed labor might develop behaviors, which might act as barriers to private sector employment. Whereas, with ELR labor is paid for working, this leads to production of real goods and services and thereby increasing aggregate supply and placing downward pressures on prices, rather than causing inflation. Additionally, it is possible that ELR will generate deflationary pressure instead of inflationary pressure because ELR will reduce private and social spending associated with crime, which will lower overall aggregate demand. However, reducing taxes and/or increasing non-ELR government spending can mitigate this. In other words, ELR policy in action will make greater government spending more viable thereby avoiding deflation.

The ELR policy approach is different from “Keynesian” demand management policies since “the buffer stock aspects of ELR generate “loose” labor markets even as they ensure full employment” (ibid p.134). Whereas, the Keynesian demand enhancing policies designed to “prime the pump” could lead to “tight” labor markets due to bottlenecks in some productive sectors which could enhance the entire wage structure so that inflation would be generated long before full employment is reached.

V. Can the Government Afford ELR Program?

The most significant contribution of Abba Lerner (1943,1947) to economic literature is the principal of “functional finance”¹⁸ which opposes the orthodox notion of “sound finance.”

¹⁸ “The central idea is that government fiscal policy, its spending and taxing, its borrowing and repayment of loans, its issue of new money and its withdrawal of money, shall all be undertaken with an eye only to the results of these

From a functional finance perspective, “money is the creature of the state.” Money is created when the government spends, and is destroyed when the government levies taxes. The government does not need to “borrow” its own money from the public; rather it only “borrows” in order to withdraw excess money from the system and to give savers an alternative interest-bearing asset (bonds). Similarly, the government does not need to tax its population in order to finance expenditures; rather the government needs the public to demand its currency to give it a value. Hence, there can be no financial constraint on the monopoly-issuer of money, that is, the state. A sovereign state can make anything generally acceptable and call it “money”, as long as the state “is willing to accept the proposed money in payments of taxes and other obligations to itself” (Lerner 1947:313)¹⁹.

From this perspective, the government can offer to hire all unemployed workers at any price it chooses, allowing the government deficit to float as high as necessary to ensure that unemployment is eliminated²⁰. Therefore, all the worries about the deficit and the national debt become meaningless when compared to their function, which is financing full employment. The employer of last resort program can act as an automatic stabilizer to keep the rate of aggregate spending in the economy “neither greater nor less than that rate which at the current prices would buy all the goods and services that it is possible to produce.” If the rate of spending is too high, inflation will develop; and if it’s too low, there will be unemployment (Lerner 1943:39).

actions on the economy and not to any established traditional doctrine about what is sound and what is unsound... Government should adjust its rates of expenditure and taxation such that total spending in the economy is neither more nor less than that which is sufficient to purchase the full employment level of output at current prices. If this means there is a deficit, greater borrowing, “printing money,” etc., then these things in themselves are neither good nor bad, they are simply the means to the desired ends of full employment and price stability” (1943, p. 354).

¹⁹ Also see Wray 1998a and Bell 2000.

²⁰ It is important to note that “if the currency issued by the government were “backed by” and made convertible into a precious metal of relatively fixed supply, then the ELR proposal would become impossible to implement during times of crisis. The government would fear that if it were to hire all the unemployed and allow its deficit to float, then there would always be a run on its currency as the public attempted to convert government money to, say, gold” (Wray 1998a, p.138).

VI. Conclusion

Keynes envisioned capitalism as a “monetary production economy” with advanced credit instruments where production is for profit. There are highly organized markets for investment, and firms are characterized by the separation of ownership and management. According to Keynes aggregate investment does not depend upon savings but is ruled by the complex of expectations of both investors and lenders. He considers the major problems of modern capitalism to be “failure to provide full employment” and "its arbitrary and inequitable distribution of wealth and incomes" (1936, p. 372). He also identified special properties of money and people’s desire for money hoard as the main reason for existence of unemployment in the economy.

Keynes recognized that the working of free market mechanism does not ensure full employment and equitable distribution of wealth. Instead, he recommended government intervention in right amount and right direction to solve these problems. Keynes also showed that there is never any financial constraint to aggregate economic activity. This view was best understood by Abba Lerner , who advocated the idea of "functional finance".

Traditional Keynesian policies based on demand management might help some, but they will be unlikely to produce true full employment, and to the extent that they succeed in providing higher levels of employment in the private sector, they may be inflationary (Forstater 2001). The Government as Employer of Last Resort (ELR) program is an alternative to demand management and is consistent with a Keynesian analysis of the macroeconomy and the principles of functional finance. As long as there are any unemployed workers, this is an evidence that aggregate demand is too low. As workers get hired into public service, government spending increases, and continues to increase until full employment. Such a program thus serves as a

powerful automatic stabilizer ensuring that aggregate demand is always at the full employment level. As private sector demand declines (rises), the public service sector grows (shrinks), maintaining a constant level of full employment by varying the ratio of private to public employment.

In sum, ELR is the best policy proposal that can increase effective demand without bringing on structural rigidity and that can eliminate unemployment while finding some institutional mechanism for dealing with the functionality question.

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