The Pigou-Keynes Controversy About Involuntary Unemployment: A Half-Century Reinterpretation

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The fifth anniversary of The General Theory of Employment, Interest and Money is being observed amidst widespread concern in Europe and America about the magnitude of the problem of unemployment. It thus seems relevant to reexamine the concept of involuntary unemployment which figured so prominently in The General Theory, after its identification by AC Pigou almost two decades before the Great Depression (Pigou, 1914). The essential point of the distinction between voluntary and involuntary unemployment, even prior to the prominence to which Keynes' argument raised it, is that it underscores the growing awareness, between World War I and the 1930's, that unemployment is chiefly a problem inherent in the industrial system. Yet, the neoclassical synthesis proposed by Hicks (1937) and subsequently refined by Modigliani (1944) and Patinkin (1966) led back to the conventional conclusion that the price system can be relied upon to clear markets, including that in which labor services are given employment. Though presented in a Keynesian framework, the essence of their argument was that, in the absence of "frictions" and "rigidities", there is no obstacle to the full employment of persons who are willing to work at a reduced real wage. More recently, various "post-Walrasian" reformulations (Grundau and Laroque, 1976; Lalloynefeld, 1971; Meitzen, 1977) further eroded the status of the concept of involuntary unemployment by attributing short-run unemployment to uncertainties and failure expectations which temporarily impede the market mechanism. Even at the centenary conference held at Cambridge University in 1983 to assess the relevance of Keynes' ideas for the world today, little effort was made to restore the concept of involuntary unemployment to its central importance given it in The General Theory. It is something of an irony that a favorable reception was accorded (Kaldor 1983, p. 15) to a recent "proof" of the impossibility of involuntary unemployment under constant returns to scale on the grounds that, under these conditions, the unemployed could go into business for themselves (Meitzen, 1982).

The failure on the part of conference participants to restore the concept of involuntary unemployment stems, first, from their return, with arguments both pro and con, to the misguided question of the centrality of downward inflexibility (or at least inertia) of normal wages to Keynes' argument. (Tobin, pp. 33-54; Kaldor, p. 35, 66; Meitzen, p. 55; Samuelson, p. 216). More importantly, while denying Keynes' causal treatment of the microeconomic aspects of market behavior, conference participants (Kaldor, Department of Economics, Temple University, Philadelphia, PA 19122.)
Hahn, Solow) neglected to recognize that Keynes’ controversy with Pigou about voluntary unemployment doesn’t offer a causal argument about labor market behavior that is neither casual or trivial. Keynes was, no doubt, at fault for his failure in Chapter 2 and the appendix to Chapter 19, to categorically reject the conventional specification of the labor supply function as a fixed. But, it is his readers who are at fault for not understanding that the essential point of Keynes exchange with Pigou is his argument that labor’s perverse response to a real wage cut denies the premise of intertemporal substitution between work and leisure. Real wage cuts may, instead of reducing the supply of labor, call forth a positive response which is appropriately represented in terms of a shift in the labor supply curve. This interpretation of the Keynes-Pigou controversy renders Keynes’ conventional formal definition of involuntary unemployment completely intelligible. It also leads to the conclusion that Keynes’ conception of the supply of labor is essentially classical. Specifically, his argument is consistent with the classical view that the supply price of labor reflects the requirement of a worker and his family for a socially established requirement for “food and necessaries” and that some portion of the labor supply is always redundant. By reinterpreting the Pigou-Keynes controversy from this perspective, the concept of involuntary unemployment reemerges in a way which cannot readily be subverted by those who interpret unemployment as a voluntary state.

The Controversy

The fundamentals underlying the Keynes-Pigou controversy about involuntary unemployment were in the process of being laid down as early as 1914, at which time Keynes’ political interests had not yet been specifically directed to the unemployment problem at that time (1956, p. 129). Keynes’ concern was clearly for the short run, and his reservations about trying to use monetary policy to lower real wages for a cure for unemployment in the long run. Such a policy would not only come to be known as the ‘MacMillan Committee’, whose membership included Keynes, he elaborated on the likely reasons for the stickiness of money wages. We also expressed his reservations about trying to use monetary policy to reduce real wages for a cure for unemployment in the long run. Such a policy would not only come to be known as the ‘MacMillan Committee’. His concern was clearly for the short run, and his reservations about trying to use monetary policy to lower real wages for a cure for unemployment in the long run. Such a policy would not only come to be known as the ‘MacMillan Committee’. His concern was clearly for the short run, and his reservations about trying to use monetary policy to lower real wages for a cure for unemployment in the long run. Such a policy would not only come to be known as the ‘MacMillan Committee’. His concern was clearly for the short run, and his reservations about trying to use monetary policy to lower real wages for a cure for unemployment in the long run. Such a policy would not only come to be known as the ‘MacMillan Committee’.

It is in the context of the use of monetary policy as a short term technique for addressing the unemployment problem that the controversy between Keynes and Pigou took shape. It is evident from Keynes’ correspondence with Dennis Robertson and Roy Harrod that his controversy with Pigou dates at least from the time of his participation in the Macmillan Committee, when he was also enquiring through the Treatise towards the General Theory.

Pigou’s insistence that the employment effect of a cut in money wage rates depends on bank policy obscured a major issue of his exchange with Keynes. Pigou argued that, given bank policy aimed at keeping interest rates low, such a cut in money wage rates would have the effect of raising the demand for labor. Keynes underestimated the change in the demand for labor which would occur when money wage rates cut back towards the level of demand in the macroeconomy. Pigou’s part in the controversy continued in his 1937 Econ. J. paper, "The Short Period in Macroeconomics." This paper set forth a model illustrating that the normal banking policy of increasing the money supply when the employment picture worsens, is likely to be accompanied by a fall in interest rates which will eventually stimulate employment. Pigou insisted, however, that if the demand for labor is not so easily stimulated by a cut in money wage rates because, when banks again return to their original practice, employment will likely return to its previous level. His argument is that it is only by also reducing the money wage rate that, after a temporary fall in the interest rate, employment will increase permanently above the original level. Thus Pigou concludes that "in all conditions in which a real wage cut (operating via the interest rate) will come employment will expand. Money wage cut will also have that effect..." (1957, p. 420). Moreover, in the long run, even when the supply of employment is no longer fixed, "there

Collected Works, well into the post General Theory period. When Pigou’s Theory of Unemployment (1933) was published, Keynes insisted the latter is "only valid in conditions which ensure that there is no unemployment" (letter to Robertson, September 5, 1933). He accuses Pigou of "arbitrarily taking two items, namely employment and real wages out of a ... system and ... treat[ing] them... as being analytic situations of one another. But they are not independent variables." Later, Keynes again wrote to Robertson (26 October, 1935) that Pigou is "showing in what way the amount of employment is related to the real supply price of labor, when there is full employment". Thus, from Keynes’ perspective, Pigou’s book failed to properly address the phenomenon of involuntary unemployment.

Pigou’s review of the General Theory, published in Economic, May, 1936, undertakes to defend against Keynes’ General Theory criticisms. Keynes charged Pigou and the classical school with arguing that a rise in money prices, without an equivalent rise in money wages, will cause the supply of labor to decrease in response to the fall in the real wage offered. Pigou, in his turn, responded that Keynes’ argument implies "that monetary happenings are incapable of affecting the real supply schedule of labor." (1936, p. 129). Differently stated, the central issue of the Pigou-Keynes controversy about the phenomenon of involuntary unemployment concerns the question of how the labor supply curve should be specified if changes in both the wage rate and the price level are to be captured. By its very nature, this question reflects Keynes’ dissent from the conventional specification of the labor supply function in which the price level is an exogenous constant established by monetary variables.

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will emerge, as a delayed consequence of the general wage cut, additions to equipment and, because labor and capital are predominantly complementary, there will be a further stimulus towards increasing the volume of employment. Thus, from Pigou's perspective, it is clearly the impact of wage cuts on the demand for labor which is important.

Interpreting the General Theory

While Pigou's rebuttal to Keynes focused on the likely effect of a monetary wage cut on the demand for labor, a careful reading of Chapter 2 and, more particularly, the Appendix to Chapter 1 of *The General Theory* makes it clear that Keynes's argument about involuntary unemployment is concerned chiefly with the nature and behavior of the labor supply curve. There is more to his criticism than his well-known barb that Pigou's *Theory of Unemployment* has a title which is a "slanower" [1936, p. 275] and that the book is "a non-causal investigation ... which is not capable of telling us what determines the actual level of employment; and on the problem of involuntary unemployment it has no direct bearing" (Keynes, 1936, p. 275).

The basis for Keynes' rebuttal then addresses Pigou's analytical interpretation of the demand for labor. This analysis maintains that the real demand for labor depends strictly on the real output of labor in the wage goods industries; the latter depends on the physical conditions of production in this sector and the functional relationship $\phi(u)$ between employment in the wage-goods sector and total employment. In Keynes' view it is difficult to see why these characteristics should change, except over the long run. The conditions of production in the wage goods industries can change only slowly and are likely to improve in a technically progressive community, while $\phi(u)$ "will remain stable, unless we suppose a sudden outbreak of thrift in the working classes, or more generally a sudden shift in the propensity to consume." [1936, p. 275] It is precisely because workers are unlikely to exhibit "a sudden outbreak of thrift" that Keynes rejected Pigou's theory of unemployment. Pigou errs, in Keynes' judgment, because he assumes that "the supply of labor is a function of the real wage falling directly when this declines" [1936, p. 274]. Keynes thus rejected Pigou's argument that "every rise in the cost of living, however moderate relatively to the money wage, will cause the withdrawal from the labor market of a number of workers greater than that of all existing unemployed" [1936, p. 277]. Expressed in terms of the labor supply curve, Keynes was criticizing Pigou for accepting the conventional view that the fall in real wages which accompanies an increase in the general price level will cause workers to move along their supply curves and offer less labor. The premise is that consumption of leisure in the current period is highly substitutable for leisure (and goods) in other periods.

Whereas Pigou argued that worker acceptance of money wage cuts would clear the labor market via their effect on real wages. [Pigou, p. 225], Keynes maintained that the money wage bargains workers make do not determine the real wage levels which govern employment decisions. [Keynes, 1936, p. 278]. Involuntary unemployment is thus experienced if, in the event of a small rise in the price of wage goods relatively to the money wage, both the aggregate supply of labor willing to work for the current
axis, is determined by the effective demand for output, as in Figure 1A, and is consistent with a real wage w/P. Given an assumed labor supply function \( S(P) \) the aggregate market supply of labor at a real wage of w/P is \( S' \). Since \( S' \) exceeds \( S_0 = D' \), familiar questions relating to the possibility and mechanisms for market clearing arise. Pigou argued that the use of bank policy to raise the price of wage goods will increase the value of labor's marginal product, and thereby stimulate employer demands for labor's services. Keynes concurred that this "first postulate" of classical theory (i.e., the favorable effect of a real wage cut on the demand for labor) can be satisfied via market responses to appropriate bank policy.

What Keynes identified as "the second postulate" of classical theory requires that workers reduce their supply of labor, say to \( S(P) = 0 \) in Figure 1B, in response to a decline in their real wage. Were this response to be forthcoming, both aggregate demand and supply would be higher and the labor market would clear at an employment level consistent with \( S(P) = 0 \). However, Keynes argued that the second postulate cannot be satisfied without a "sudden outbreak of thrift in the working classes." Not only do workers not supply more labor at a greater disutility \( D' = D'' \), but also, they attach diminished disutility to each additional unit of effort. "Disutility must here be understood to cover every kind of reason which might lead a man, or a body of men, to withhold their labor rather than accept a wage which had to them a utility below a certain minimum" (Keynes, 1936, p. 6).

Keynes' point was that the real wage rate is not a measure of the disutility of labor; its deficiency in this regard renders the market mechanism inefficient in assuring the satisfaction of the second postulate. The neoclassical assumption that \( a w = b w = -a w / P \) implies that workers respond to a real wage cut brought about by a rise in wage goods prices, money wages remaining the same, in the same way as they respond to a cut in money wages, goods prices remaining the same. But Keynes argues that a rise in the price of wage goods "causes both the aggregate supply of labor willing to work for the current money wage and the aggregate demand for it [to be] greater than the existing volume of employment." (Keynes, 1936, p. 15). As shown in Figure 1B, this supply response can be forthcoming only if the labor supply curve shifts rightward to \( S(P) = 0 \) in the real wage-employment space rather than leftward to \( S(P) = 0 \) as required by the premise that \( a w / w = -a w / P \), to which Pigou subscribed (Riis, 1936). Such a rightward shift would be a denial of "a sudden outbreak of thrift on the part of workers" and render the market mechanism incapable of fulfilling the second postulate.

Whereas the neoclassical argument has it that the real wage cut is consistent with labor market clearing at employment level \( S = D \), the essential message of Keynes' Chapter 2 argument derives that workers will choose to substitute leisure for other goods if the prices of the commodities they buy rise. A remarkably luminous passage maintains that "although a reduction in the existing money wage would lead to a withdrawal of labor, it does not follow that a fall in the value of the existing money wage in terms of wage goods would do so, if it were due to a rise in the price of the latter.... They (the classical school) ... do not seem to have realized that unless their supply curve labor will shift bodily with every movement in prices" (Keynes, 1936, p. 8-9). This passage is consistent with our representation of the labor market response to rising commodity prices as depicted in Figure 1B by the shift of the labor supply curve from \( S(P) \) to \( S(P) '' \). It reflects Keynes' denial of Pigou's assumption that workers offer less labor in consequence of a real wage cut that follows upon a rise in the price level. Pigou's argument, and the specification of the labor supply function which follows from it, has it that the income effect of a real wage change invariably dominates the substitution effect or, to put it differently, that workers choose more leisure rather than work when real wage rates are reduced by inflation. According to Keynes, however, this is not likely to be the case without "a sudden shift in the propensity to consume", i.e., a reduction in the disutility of work. The labor supply response is likely to be perverse in the sense that workers choose to offer more rather than fewer hours of labor at lower real wage levels in order to maintain customary levels of living. The labor supply curve will, therefore, shift rightward to \( S(P) = 0 \) so that the market supply of labor will be \( S' \). If this labor supply response to real wage cuts accompanies an employer response which, consistent with the first postulate, raises their aggregate labor demand curve to \( D_0 = D_2 \), then involuntary unemployment can readily be identified as the distance \( S' \) minus the distance \( S_2 = D_0 \) on the abscissa of Figure 1B.

This demonstration provides an analytical basis for the view (e.g., Estwell and Milgore 1963) that Keynes' argument about the impotence of the price mechanism in clearing the labor market is not attributable to money wage rate inflexibility fostered by money illusion.

**Classical Value Theory and Labor Supply Function**

The classical notion that value can be viewed alternatively from a "labor command" or a "labor purchase" perspective has relevance for the Keynes-Pigou controversy. The "labor command" value of a commodity bundle is the number of labor units (whether reckoned in persons or time) that an employer can employ at a given real wage. Analogously, the "labor purchase" or "value of a commodity bundle is its supply price in terms of labor. Interpreted in terms of an employer's perspective, the "labor command" or "capability of a commodity bundle" is the classical counterpart of the temporary real wage concept. It represents the number of units of labor employers are willing to hire in exchange for the money wage at prevailing wage goods prices, which is consistent with the first postulate that the wage is equal to the marginal product of labor.

Similarly, when interpreted from the workers' perspective, the real wage they are paid represents the "labor purchase" equivalent of their commodity bundle. It is their supply price of labor in terms of the number of units of work that must be offered to prospective employers at the prevailing wage-price level in order to command the "commodity bundle" represented by their conventional family standard of living.
Keynes' argument that the labor supply curve shifts in response to an increase in wage goods prices, which was later interpreted to mean an increase in the commodity "price of labor," is conceptually consistent with a classical view of the commodity market. The Pigovian view that an inflation-induced increase in real wages is an effective mechanism for clearing labor markets conceives of the commodity market as the commodity bundle employers stand ready to offer. But this outcome will fail to be forthcoming if real wage cuts are achieved by increasing wage goods prices. For this policy measure (and Pigou's argument) neglects to take into account is the CONCURRENT EFFECT of inflation on the "labor purchase" equivalent of the conventional commodity bundle. As the labor purchase price of the commodity bundle rises with inflation, workers will have to increase the supply of labor offered to the market to maintain the conventional standard implicit in the commodity bundle. Either the price mechanism or monetary policy can be relied on to generate equivalent increases in the "labor command" value and the "labor purchase" value of the commodity bundle that represents the conventional standard of living. This is the case, in classical terms, of involuntary unemployment. What Keynes was arguing fifty years ago is that there is no mechanism that can assure that the number of commodity bundles employers will be able or willing to make available toward employing labor will be equal to the increased labor purchase price of the conventional commodity bundle.

The classical argument that workers respond to the increased labor command value of the conventional commodity bundle by reducing the amount of labor they offer to supply (i.e., substituting leisure for consumption) is to disregard their conventional standard of living. When, as in Figure 18, a decline in the real wage rate calls forth an increase in the aggregate supply of labor, which exceeds the additional employment opportunities generated by the real wage cut, the "labor purchase" equivalent of the wage goods needed by workers to maintain their relative real standard of living. Workers are thus rendered "redundant." Keynes' involuntary unemployment is thus analogous to the "labor redundancy" which was greatly concerned Thomas Malthus and John Stuart Mill.

Concluding Comments

This paper has argued that reinterpretation of the controversy between Keynes and Pigou about the employment effects of a cut in real wages (brought about by the conventional prescription of using monetary policy to increase wage goods prices) provides an analytical basis for restoring the concept of involuntary unemployment to the central importance Keynes intended in The General Theory. This interpretation is consistent with the argument that the classical labor supply function is misspecified and that Keynes' recognition of this misspecification underlies his conclusion that the labor market is in need of respect to fulfilling the second postulate.

Keynes' intent was to challenge the long-standing premise that the market has "equilibrating" and "optimizing" capabilities. Unfortunately, his policy measure (and Pigou's argument) neglected to take into account the CONCURRENT EFFECT of inflation on the "labor purchase" equivalent of the commodity bundle. As the labor purchase price of the commodity bundle rises with inflation, workers will have to increase the supply of labor offered to the market to maintain the conventional standard implicit in the commodity bundle. Either the price mechanism or monetary policy can be relied on to generate equivalent increases in the "labor command" value and the "labor purchase" value of the commodity bundle that represents the conventional standard of living. This is the case, in classical terms, of involuntary unemployment. What Keynes was arguing fifty years ago is that there is no mechanism that can assure that the number of commodity bundles employers will be able or willing to make available toward employing labor will be equal to the increased labor purchase price of the conventional commodity bundle.

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Notes

This "classical" interpretation of the dual significance of the real wage has some similarity to George L.S. Shackle's interpretation of involuntary unemployment as reflecting a "gulf" between the composition of the wage desired by income earners in terms of consumption or saving and the composition of the pay which employers are willing to offer. (G.L.S. Shackle, 1972, Chapter 17). Shackle does not, however, limit his argument to a respacificied labor supply curve and overlooks the criticality of the appendix to Chapter 19 of The General Theory for understanding Chapter 2.

References


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