Keynes and Keynesian Economics in Light of the Financial Crisis

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Keynes, Wages and Employment in Light of the Great Depression

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I. Introduction

The wage-employment relationship is one of the central and most controversial issues in the General Theory. At the beginning Keynes makes the assumption of a given money wage as a preliminary working hypothesis. “But this simplification, with which we shall dispense later, is introduced solely to facilitate the exposition. The essential character of the argument is precisely the same whether or not money-wages, etc., are liable to change” (JMK, CW VII, p.27). Despite this clear statement Keynes has often been interpreted that he assumes rigid wages. Due to the complex interdependencies between the different markets in the economy it takes until chapter 19 that Keynes dispenses with his preliminary assumption. Here Keynes argues against the ‘classical doctrine’ that a downward flexibility of money wages will systematical lead to full employment. On the contrary, lower nominal wages would nurture deflation, lead to higher bankruptcies and thereby would make things worse.

Although Keynes states clearly that his analysis of the unemployment problem and the main conclusions of the General Theory, in contrast to the theory of his ‘classical’ predecessors and contemporaries, do not depend on the assumption of rigid money wages, Haberler in a widespread retrospective assessment of Keynes’s famous work could state as the dominant interpretation in 1962 without hardly any opposition:

“It is now almost generally recognized that the Keynesian theoretical system proper… depends on the assumption of wage rigidity. If that assumption is not made, the Keynesian system simply breaks down or, to put it differently, it loses its distinctive and differentiating quality which sets it apart from what is loosely called the ‘classical’ system” (Haberler 1962: 291).

A quarter of a century later Allan Meltzer, a leading monetarist, in his interpretation of the ignorance and misstatements of central Keynesian ideas rightly came to the conclusion that “[w]age rigidity, if accepted as the main message, deprives the General Theory of its novel or revolutionary aspect” (Meltzer 1988: 256).

Keynes considered downward inflexibility of money wages due to social and historical forces as an empirical fact which was not new but also held in Great Britain in the 1920s. “Since 1924
money wages have remained for all practical purposes fixed” (JMK, CW XX: 67). A flexible wage policy could not function in democratic societies with a decentralized wage bargaining process since workers would resist a cut in money wages which would worsen their relative position. In contrast, a reduction in the real purchasing power of wages due to an increase in the general price level would hit all groups simultaneously. It is this relative wage hypothesis and not an irrationality postulate with which Keynes explains the resistance of workers against money wage reductions and thereby their asymmetric reaction. Keynes’s departure from the equilibrating mechanism of classical economics, which relies on the downward flexibility of money wages, in no way is based on money illusion, a hypothesis for which no proofs can be found in Keynes. The assumption of irrational behavior on the side of workers is also unconvincing since consumption demand is a function of real income expressed in wage units.

Why should workers act in a rational way on the demand side of the goods market and irrational on the supply side of the labour market? It was never Keynes’s view that the explanation of involuntary unemployment would require the hypothesis of rigid money wages. On the contrary, such a view was a decidedly ‘classical’ idea: “A classical economist may sympathise with labour in refusing to accept a cut in its money-wage…; but scientific integrity forces him to declare that this refusal is, nevertheless, at the bottom of the trouble” (JMK, CW VII: 16).

Keynes could observe that money wages in Great Britain remained relatively stable even in the early 1930s when unemployment rose considerably in the years of the Great Depression. Keynes emphasised this stability of money wages in his critique of Pigou’s Theory of Unemployment (1933) for whom a reduction in wages seemed to be the solution to the unemployment problem although he never explicitly was an advocate of wage cuts.

“Yet it might be a provisional assumption of rigidity of money-wages, rather than of real wages, which would bring our theory nearest to the facts. …A theory cannot claim to be a general theory, unless it is applicable to the case where … money-wages are fixed, just as much as to any other case. Politicians are entitled to complain that money-wages ought to be highly flexible; but a theorist must be prepared to deal indifferently with either state of affairs. A scientific theory cannot require the facts to conform to its own assumptions” (JMK, CW VII: 276)

The British experience of a relative stability of money wages in the period 1924-34 was a main reason for Keynes to make his preliminary working hypothesis of a given money wage, i.e. to opt
for the money wage as a standard of value. Money wages thus provide an anchor for prices in the
*General Theory*.

II. Money wage cuts: an appropriate means against unemployment?

It is Keynes’s fundamental proposition that the level of employment in an economy is determined by effective demand. His attack against the classical view that whenever unemployment exists it could be reduced by a lowering of money wages is based on the necessity to consider the repercussions of wage changes via income and demand effects on the overall production and employment level. The incorporation of these complex interdependencies does not allow to transfer conclusions from a partial analysis to the level of the economy as a whole.

“For, whilst no one would wish to deny the proposition that a reduction in money-wages *accompanied by the same aggregate effective demand as before* will be associated with an increase in employment, the precise question at issue is whether the reduction in money-wages will or will not be accompanied by the same aggregate effective demand as before measured in money, or, at any rate, by an aggregate effective demand which is not reduced in full proportion to the reduction in money-wages (i.e. which is somewhat greater measured in wage units). But if the classical theory is not allowed to extend by analogy its conclusions in respect of a particular industry to industry as a whole, it is wholly unable to answer the question what effect on employment a reduction in money wages will have” (JMK, CW VII: 259-60)

Thus the impact of a reduction in money wages on the three main determinants of income and employment – the propensity to consume, the marginal efficiency of capital and the interest rate – is the decisive question. A reduction in money wages surely will lower costs of production and thereby prices. However, in contrast to the orthodox view which only considers the cost effect of a wage cut and the resulting increase in employment, Keynes emphasises “that the volume of employment is uniquely correlated with the volume of effective demand measured in wage-units” (JMK, CW XIII: 260), i.e. a downward flexibility of money wages could only contribute to a reduction in unemployment if it would stimulate aggregate demand. The outcome of the indirect effects of wage cuts on aggregate and effective demand is ambiguous.¹

¹ For an excellent analysis see Chick (1983, chpt. 7).
In one of his many re-examinations of Keynesian economics Hicks was emphasising “a principle, very important to Keynes” which he termed “the wage-theorem. When there is a general (proportional) rise in money wages, says the theorem, the normal effect is that all prices rise in the same proportion – provided that the money supply is increased in the same proportion (whence the rate of interest will be unchanged” (Hicks 1974: 60) Transformed from the period of high inflation in the early 1970s into the period of the Great Depression of the early 1930s, the ‘wage-theorem’ would imply that under certain conditions, such as proportionality of total marginal costs to wage costs and perfect competition on goods markets, decreases in money wages would lead to proportional decreases in the price level. In that case real wages, and according to the first ‘classical postulate’ labour demand, would remain unchanged. The problem then would consist in the rigidity of real wages and not money wages.

However, it would be a mistake to conclude that Keynes’s employment theory is based on rigid real wages. According to the Keynesian causal nexus it is not the real wage which determines the employment level. Real wages are not fixed by the actors on the labour market but, given productivity and competitive conditions, the result of macroeconomic processes which determine the equilibrium level of employment.

“Real wages seem to me to come in as a by-product of the remedies which we adopt to restore equilibrium. They come in at the end of the argument rather than at the beginning. … Employment is not a function of real wages in the sense that a given degree of employment requires a determinate level of real wages, irrespective of how the employment is brought about” (IMK, CW XIII: 180).

Concerning the repercussions of money-wage reductions on the propensity to consume and the marginal efficiency of capital and thereby on employment Keynes comes to rather negative conclusions for a closed economy. There remains the possibility of a positive employment effect due to an increase in investment through a decrease in the rate of interest as a consequence of money-wage cuts. As is well known, Keynes had not wait for long until Haberler and Pigou made the attempt to refute the Keynesian idea of an underemployment ‘equilibrium’ with flexible wages and prices. They pointed out that even with a perfectly interest-elastic demand for money (liquidity trap) or investment being completely insensitive to a fall in the interest rate unemployment is no stable equilibrium position. “Obviously, under-employment equilibrium
with flexible wages is impossible.’” (Haberler 1947: 167). They refer to the possibility admitted by Keynes (JMK, CW VII: 266-267) that a reduction in money wages could induce a positive effect on income and employment – falling prices release money from the transactions sphere, interest rates fall thereby stimulating investment until full employment is attained. This “Keynes effect” (Haberler) is a very indirect effect in which several links in the chain are quite fragile. Furthermore, the same effect could be achieved via an increase in the quantity of money which would be the alternative preferred by Keynes who nevertheless pointed out the limitations of both routes to restoring full employment:

“In contrast to the indirect and fragile causal chain of the ‘Keynes effect’, the Pigou effect or real balance effect is of a direct nature. Falling money wages and prices can directly exert their salubrious effects. As the result of declining prices during a recession real wealth or the purchasing power of prior savings increase. Being wealthier in real terms, people therefore would spend more for consumption and thereby stimulate production. The problem of high unemployment therefore would tend to be self-correcting provided wages and prices would be flexible. The Pigou effect destroys the correspondence between wage deflation and an expansionary monetary policy referred to by Keynes. However, Pigou directed more attention to the long-run consequences but was sceptical concerning the empirical relevance of his effect in the short- and medium-run. The decisive limitation of the Pigou effect consists in the comparative-static type of analysis which does not allow statements for a dynamic theory of income and employment. The theoretical existence of a full-employment equilibrium does not imply that it will occur automatically in an adjustment process. In the debate on wage / price-flexibility and full employment Patinkin has recognized early that the fundamental question being asked by Keynes was the stability of the dynamic system:

“Whether or not an underemployment equilibrium exists; whether or not full employment equilibrium always will be generated in a static system – all this is irrelevant. The fundamental issue raised by Keynesian economics is the stability of the dynamic system: its ability to return
automatically to a full-employment equilibrium within a reasonable time … if it is subjected to … shocks and disturbances” (Patinkin, 1948: 562-3)

There are three main arguments which substantiate the view that with flexible wages and prices a full-employment equilibrium may exist but will not be reached in a dynamic process.

1. Keynes puts main emphasis on *elastic price expectations* which have a destabilising effect. If with falling money wages and prices people would expect further wage and price reductions in the future, the effect of these expectations on current investment and consumption would be negative because of a postponement of purchases into the future. Deflationary price expectations cause a higher propensity to save and to hold money and a reduction in the marginal efficiency of capital and the inducement to invest. Thus the current crisis would aggravate and the deflationary process could proceed for quite a time.

2. Lower prices increase the *real burden of debt* for companies which have financed their real investment by credit as well as for farmers or home-owners. A stronger process of deflation thus quickly leads into an increasing number of insolvencies and bankruptcies. Business confidence is even more shaken, and the effects on investment are severely negative. There is a great danger that a vicious circle sets in. Hahn identifies here “one of Keynes’s most interesting points”, namely that the deflationary process of falling money wages would cause bankruptcies” (Hahn 1984: 57)

3. Tobin has pointed out that “[f]or Fisher in 1932-3, more even than Keynes in 1936, raising prices was a step indispensable to recovery, not just an incidental byproduct of other measures” (Tobin 1980: 9). Thus reflation was an important remedy to avoid the high number of bankruptcies due to the increasing real burden of debt in the deflation and to get out of the trap of a vicious circle. In a period of a strong process of disinflation causing a high number of bankruptcies in the United States with severely adverse effects on investment, output and employment, Tobin reminded us of the insights Irving Fisher had gained on the severe consequences of deflation on the real value of long-term debts in his important article “The Debt Theory of Great Depressions” (Fisher 1933) and emphasised another *Fisher effect*. The

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2 There exists an important asymmetry between inflation and deflation which is not fully anticipated in nominal interest rates. The debtor benefits from inflation, the creditor only benefits from deflation as long as the debtor remains solvent.

3 See Keynes (CW VII: 264 and 268 and CW IX: 150-158).

effectiveness of the Pigou effect or real balance effect is limited to outside money. Private debts and credits are not included but the magnitude of these “inside assets”, which are also affected by (unexpected) deflation, disinflation or inflation, is much larger. A deflation causes a redistribution of real wealth from debtors to creditors. Since it is highly probable that debtors have a higher propensity to spend than creditors, the additional demand of creditors is insufficient to compensate the collapse of demand on the side of the debtors. Thus a negative structural effect of deflation on aggregate effective demand arises which counteracts the Pigou effect and could be large enough to neutralise or dominate it.

Money wages decreases therefore are an unreliable remedy. It is a medicine which instead of curing the disease could make it worse. Keynes’s considerations on the consequences of changes in money wages are summed up: “There is … no ground for the belief that a flexible wage policy is capable of maintaining a state of continuous full employment” (JMK, CW VII: 267). Frank Hahn has “shown that even with modern assumptions Keynes’s distrust of the money wage mechanism is not without foundation” (Hahn 1984: 58).

III. The Return to the Gold Standard and the Question of High Wages

Keynes’s analysis in the General Theory hardly deals with two important themes relevant for a full consideration of the wage-employment nexus: technical progress and the modifications arising for an open economy. However, Keynes was well aware of these issues which played a major role in the British debate which arose after the return to the gold standard in April 1925 at the pre-WW I parity of $ 4.86 for the pound sterling. Keynes had heavily but unsuccessfully opposed this “dangerous and unnecessary decision” which he then criticized in his pamphlet “The Economic Consequences of Mr. Churchill”. Keynes calculated the level of money wages to be 10 per cent too high as a consequence of the overvaluation of the pound due to the return to the gold standard. The predicted problems for the British export industry and balance of trade soon materialized. In contrast to the United States and some Western European countries, the United Kingdom since 1925 therefore had a severe unemployment problem which first arose in export industries but soon affected the whole economy. The question of a sustainable improvement of the international competitiveness and a wage-employment debate came up, which had many parallels with the one which had arisen in Germany because of the reparation payments imposed
by the Versailles Treaty and which intensified during the Great Depression at the end of the Weimar Republic.

Since it is impossible in the gold standard system to reduce domestic money wages via devaluation relatively to the money wages abroad to improve the trade balance, stimulate investment and reduce capital exports, the painful process of an income deflation seemed unavoidable to counteract the negative effects of the return to the gold standard at the pre-war parity on output and employment. Keynes criticised “the authorities at the Treasury and at the Bank of England” for knowing “nothing about the difference between an income deflation and a profit deflation, with the result that they greatly over-estimated the efficacy of their weapons of credit restriction and bank rate” (Treatise, JMK, CW VI: 163). The attempt by the entrepreneurs to counter-act profit deflation by a wage deflation to regain international price competitiveness culminated in the general strike of 1926. Although money wages decreased significantly in particular industries, it finally failed. The overall level of money wages in 1930 corresponded to the level in 1924. However, it was associated with an enormous loss of output and employment due to the return to the gold standard at an unsuitable parity, which Churchill later committed as a great error, and the failed attempt to force an adjustment of internal costs by means of a high bank rate and/or the contraction of credit which would have been appropriate to bring about a profit deflation but not an income deflation to adjust wage costs to the currency parity adopted.

Against this background it is understandable that Keynes in his argument against the purchasing power theory, which in Britain was represented by Maurice Dobb (1929), confronted the ‘high wage party’ with the competitive argument. In his paper “The Question of High Wages” Keynes (1930) pointed out the restrictions of wage policy in an open economy with a high mobility of international capital and compared the effects of higher wages with those of higher taxes on profits and the decisions of investors. Keynes favoured the ‘liberal’ over the ‘trade union’ solution as a strategy to better the conditions of the working class.

If we want to better the condition of the working class, it is inexpedient to attempt to do it by the method which reduces the rewards of capital below what is obtained in other countries. Or, at any rate, if we do adopt this method, we must supplement it by abandoning or diminishing the existing freedom of foreign investment. For it never pays to render the entrepreneur poor and seedy. It is impossible in the present
order of society to secure the optimum level of output and employment by any way than by paying the capitalist his full rate, and, if anything, a little over . . . . In short, we must not starve the goose that lays the golden eggs before we have discovered how to replace her. We must tax her eggs instead. (Keynes, 1930: 11-12)

The liberal solution which Keynes regarded as an alternative to the higher wages of the trade union solution comprises a whole catalogue of welfare state measures, in the areas of social policy, education, health and house-building. Keynes saw the real objection to a high-tax policy in “the difficulty of making sure that they would be an alternative and not an addition to higher wages. If the business man has already been weakened by higher wages, we should think twice before adding the burden of higher taxes” (Ibid: 15). In other words, the feedback effects of the taxation of profits on investors’ decisions are seriously considered by Keynes. An important argument for Keynes to favour the tax solution is the fact that with the trade union solution more labour-intensive sectors of production suffer and may lose their international competitiveness whereas, on the other hand, profitable financial firms have to face only a small burden. For that reason Keynes also pleaded for a tax financing of social insurance which thus doesn’t increase the wage costs directly. Since in a gold standard system real wages cannot be lowered by depreciation of the national currency and a consequential increase in the price level, Keynes advocated “squeezing the higher wages out of increased efficiency” (Ibid: 11, my italics), that is, relative instead of absolute wage reductions to regain international price competitiveness. The often-made statement that Keynes regarded an increase in employment only possible via an increase in the inflation rate must be rejected. Keynes recognized that the wage mechanism is at work, at least in the form that high and persistent unemployment causes a relative reduction in money wages (even with absolute downward inflexibility), that is, in proportion to the productivity (and price) level.

This argument was also made by Keynes in his Treatise in the same year: “Thus one could only hope for an increase in efficiency by which lower money earnings per unit of output might be compatible with unchanged money earnings per unit of the factors of production. At long last, perhaps, this will be the way of escape” (JMK, CW VI: 165). Before the Macmillan committee Keynes calculated that ‘efficiency’ (labour productivity) had grown at 1.5 per cent per year since 1925, i.e. by an accumulated rate of 7.5 per cent in the five years until 1930. However, “[t]o get back to equilibrium with the gold standard would have meant [a] 10 per cent [cut in money
wages], but with the subsequent fall of world prices it has meant 20 per cent, so while we were 10 per cent out in 1925 we are 12.5 per cent out now” (JMK, CW XX: 58). Furthermore, in an open economy and a regime with fixed exchange rates as in the gold standard such improvements in efficiency are a medicine which works only very slowly: “in order to help foreign trade the increase of efficiency relatively to money wages must mature faster at home than abroad” (JMK, CW VI: 166).

Keynes’s reflections on the role of productivity growth, which also characterise his essay on “The Economic Possibilities for our Grandchildren” published in the same year, and his modifications for an open economy elucidate that Keynes acknowledged the cost effect of higher (lower) wages. No doubt the cost effect gains relative weight against the purchasing power effect in an open economy which also explains Keynes’s reference in the *General Theory* that the employment consequences of a reduction in money wages traditionally had been considered more positively in Great Britain than in the relatively more closed US economy with its much larger domestic market.\(^5\)

Kahn had directed attention to “Keynes’s growing awareness that if unemployment ceased to be a serious problem, it would be replaced by the problem of pressure to raise money wages faster than productivity” (Kahn 1978: 557). Already in the *General Theory* Keynes pointed out that the (in)stability of prices in the long run “will depend on the strength of the upward trend of the wage unit (or, more precisely, of the cost unit) compared with the rate of increase in the efficiency of the productive system” (JMK, CW VII: 309). At the end of his life he became more worried about the wage problem in a full-employment economy and the dangers to maintain full employment over time if wages increase faster than productivity. He now pointed out: “The task of keeping efficiency wages reasonably stable (I am sure they will creep up steadily in spite of our best efforts) is a political rather than an economic problem” (JMK, CW XXVI: 38).

This foreshadows problems of an anti-inflationary incomes policy, although Keynes probably under-estimated the dimension this problem later in the 1970s took in Great Britain and other countries. However, it makes clear that Keynes would have considered wage increases running

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\(^5\) See JMK, CW VII: 263.
ahead of productivity increases as a problematic contribution to solve the employment problem, whether in Britain in the 1970s, East Germany in the 1990s or in Southern European countries in the early 2000s after the introduction of the Euro.

Wages are not the only cost factor. Capital costs matter too. It is an important message of the General Theory that the money rate of interest, which in normal times has a stronger influence on investment decisions, should be kept low and stable. However, the Great Depression was no ‘normal’ period, and due to deflation real rates of interest were quite high despite low money rates of interest. In that situation Keynes did not believe in the efficacy of monetary policy. He was also sceptical concerning the impulse of money wage cuts stimulating investment via reductions in the interest rate or increases in the marginal efficacy of capital. When neither ‘cheap money’ nor lower wages work for private investment to recover from the collapse in the slump, the government had to fill the gap. Thus among the seven potential remedies Keynes elaborated to the Macmillan committee in 1930 his “favourite remedy – the one to which I attach much the greatest importance” (JMK; CW XX: 126) was government investment or public works. Here he had to face and fight against the “Treasury view” emphasising that any increase in government expenses on public works will crowd out private investment of an equivalent amount, and therefore fail to cure unemployment. Whereas the crowding-out argument makes some sense for a full-employment situation when loan-financed public investment can stimulate inflationary pressures, Keynes considered this Treasury view in a severe slump as a “pure logical delusion” (Ibid: 130).

Interestingly, in the parallel German debate Gerhard Colm and Hans Neisser who initially had opposed credit-financed public works with modern sounding crowding-out arguments, with the deepening of the crisis in 1930 changed their position and did not only argue strongly against recommendations to lower wages but also made a plea for moderate credit creation and public works programs as a cure against mass unemployment (see Hagemann 1999).6

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6 Due to the shortage of the domestic supply of capital as the consequence of the annihilation of money wealth in the hyperinflation of the early 1920s and the political risk premium after the electoral success of the Nazi party in the September 1930 elections to the Reichstag, interest rates were much higher in Germany than in Britain during the Great Depression.
IV. Keynes’s Preface to the German Edition of the General Theory

As has been pointed out, Keynes considered elastic price expectations to have a destabilising effect. Whereas it is highly probable that a gradual downward tendency of money wages would stimulate such expectations of a further decline of money-wages and prices in the future and therefore would be “most unfavourable”, an improvement in investment due to an increase in the marginal efficiency of capital would appear if people believe that money wages “have touched bottom” (JMK, CW VII: 265). In that sense there exists an important difference between democratic systems with de-centralized wage bargaining and “highly authoritarian” systems for which the problem of destabilizing elastic price expectations in the process of deflationary wage policies does not exist:

“To suppose that a flexible wage policy is a right and proper adjunct of a system which on the whole is one of laissez-faire, is the opposite of the truth. It is only in a highly authoritarian society, where sudden, substantial, all-round changes could be decreed that a flexible wage policy could function with success. One can imagine it in operation in Italy, Germany or Russia, but not in France, the United States, or Great Britain” (JMK, CW VII: 269).

If one takes this distinction Keynes made in chapter 19 on changes in money wages, then the more recent controversies (see Hagemann 2014) which have arisen on the Preface of the German language edition of the General Theory, published in the very same year when the Olympic Games took place in Nazi Germany, appear more like a tempest in the teapot.

It all boils down to the following passage of the German Preface:

“[…] For I confess that much of the following book is illustrated and expounded mainly with reference to the conditions existing in the Anglo-Saxon countries. Nevertheless the theory of output as a whole, which is what the following book purports to provide, is much more easily adapted to the conditions of a totalitarian state [the German text carries the official expression: Totaler Staat], than is the theory of the production and distribution of a given output produced under conditions of free competition and a large measure of laissez-faire. This is one of the reasons which justify calling my theory a General [emphasis in the original] theory. Since it is based on less narrow assumptions than the orthodox theory, it is also more easily adapted to a large area of different circumstances. Although I have thus worked it out having the conditions in the Anglo-Saxon countries in view—where a great deal of laissez-faire still prevails—it yet remains applicable to situations in which national leadership [staatliche Führung] is more pronounced.
For the theory of psychological laws relating consumption and saving, the influence of loan expenditure on prices and real wages, the part played by the rate of interest—these remain as necessary ingredients in our scheme of thought under such conditions, too.”

(Keynes, taken from the foreword to the German translation in Schefold 1980)

As Bertram Schefold (1980) first came to notice there is an important difference between Keynes’s original English version, as printed in the Royal Economic Society edition of his Collected Writings (Keynes 1973), and the text which actually was published in Germany in 1936 which Schefold (1980: 175) noted as “more explicit and more coherent”, with the text in italics being added.

Due to the destruction of the archive of Keynes’s German publisher Duncker & Humblot in the bombing of Berlin in WW II and the fact that the Keynes papers at King’s College do not contain copies of all of his letters, Schefold (1980: 176) came to the conclusion “that there remains a margin of doubt as to the responsibility for the text which finally appeared in German.” Nevertheless it does not change the main message of the General Theory that an austerity policy with an downward flexibility of money wages in a severe crisis does not contribute to a reduction of unemployment (or of budget deficits) except in authoritarian societies where all wages can be changed substantially and simultaneously so that the problems of destabilising expectations and relative wages between different groups don’t arise.
References


