

# **Eradication of Global Poverty and Unemployment\***

by

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**Abstract:** The Great Recession began in December 2007 and was declared over in mid-2009, some 18 months later. However, the global economy has been more or less stagnant even since 2009, while poverty in the United States is now the worst in over 50 years. Many nations in the Euro-Zone still have unemployment rates exceeding 15 percent. This paper offers a new theory of recession and unemployment and goes on to prescribe free-market type of policies to ensure that the real wage rises proportionately with productivity.

The purpose of this paper is to find the true cause of global poverty and unemployment, and offer new ways for their eradication. Plainly speaking, poverty arises mainly from political corruption, which takes a variety of forms around the globe. In democratic nations such as the United States and Euro-Zone, the corruption is hidden and expresses itself in economic policies that favor the super-rich, who finance election campaigns of those in power, whereas in other countries, corruption sometimes occurs openly with government officials taking bribes or rewarding themselves with enormous salaries. However, we show that a single model is capable of explaining why political sleaze is perhaps the one and only cause of destitution throughout our planet.

## **The Theory of the Wage Gap**

Poverty arises from two reasons—high unemployment and low wages. Macroeconomics offers a variety of theories of joblessness, but this paper argues that the main cause of a recession and unemployment is a persistent rise in the wage gap. There is only one ultimate cause, although there are a lot of symptoms that masquerade as causes in popular macro models. The classical and neoclassical theorists argue that real wage rigidity induced by powerful labor unions or the minimum wage legislation results in long-term unemployment. Few policy makers take this idea seriously, although it still resonates with a lot of economists. On the other side, Keynesians and

neo-Keynesians blame recessions on inadequate aggregate demand and see expansionary monetary and fiscal policies as panaceas to end a crisis. Such policies were indeed successful for a long time in ending recessions, but their record is dubious in the aftermath of the Great Recession that started in 2007.

Let us begin with the concept of the wage gap, which may be defined as the excess of a nation's labor productivity over its real wage. Suppose this excess is symbolized by  $E$ , then

$$E = (A - w)/w = (A/w) - 1 = g - 1$$

where  $A$  is the average product of labor, commonly called productivity, and  $w$  is the real wage, and where

$$g = A/w$$

Thus,  $E$  is the wage gap, and moves up or down in accordance with variations in  $g$ ; so,  $g$  is an index of the wage gap. Let  $Y$  stand for real GDP or a nation's output, and  $L$  for the employment of labor. Then by definition

$$A = Y/L$$

Normally, the wage-gap index remains constant over time as the real wage rises roughly in the same proportion as productivity, but once in a while it goes up in some decades. That is when trouble follows.

Table 1 furnishes the behavior of the US wage gap over two time periods, once from 1919 to 1929 and then from 1962 to 2014. Column 4 displays the wage-gap index during the 1920s and shows that it jumped sharply from 111 in 1919 to 156 in 1929, or by 40 percent in just one decade. This was the fastest rise in the index in US history and, as argued later, this could not but generate the worst depression. In any case, this information will come as a surprise to neoclassical economists, who believe that the real wage equals the marginal product of labor, which in turn is proportional to labor's average product, so that the wage gap is fairly constant in the neoclassical world.

Column 2 presents the behavior of the wage gap between 1962 and 2014; these are the years for which the relevant data are readily available from the *Economic Report of the President for 2012 and 2015*, and so the information is furnished for 5 decades to see how the wage gap

behaves in good and bad times. This column is obtained by dividing the figures for hourly output in the business sector by real hourly compensation. The data start from 1962 and end in 2014.

**Table 1: The Wage-Gap Index in the United States in Selected Years  
1920s and 1962 – 2014**

(1)	(2)	(3)	(4)
Year	Wage Gap	Year	Wage Gap
1962	72	1919	111
1965	74	1921	128
1970	73	1923	130
1975	77	1925	148
1980	77	1927	154
1985	84	1929	156
1990	86		
1995	88		
2000	94		
2005	100		
2010	103*		
2014	106*		

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Source: Column 2 from Table B-49 of *The Economic Report of the President*, 2012, Council of Economic Advisers, Washington D.C.; the figures for 2010 and 2014 are from the 2015 Economic Report; Column 4 from *The Historical Statistics of the United States: Colonial Times to 1970* (Washington D. C., U. S. Department of Commerce, 1975), series D 685, D 727, and D 802.

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The table shows that the wage gap remained fairly constant during the 1960s and rose slightly in the 1970s. For all practical purposes, there was little change in the gap during these two decades, as its index varied between 72 and 77 over 18 years. However, from 1980 on, the wage gap began to rise steadily, as its index rose from 77 in 1980 to 106 in 2014, or by roughly 38 percent over three decades. Thus, the gap rose steadily, but compared to the 1920s it was a much slower rise.

By now we have seen that the wage gap rocketed during the 1920s and was followed by the

worst depression, and then it rose steadily from 1980 on and was followed by the Great Recession. Is it a mere coincidence that in both cases trouble followed the rise in the wage gap? The next section argues that this was not a coincidence but an inevitable consequence of the growing gap.

### **A Simple Model of the Wage Gap**

In order to clearly demonstrate our result, we begin with one simplifying assumption, namely all wage earnings go into consumption, and other types of incomes from interest, rent and dividends go into savings. In other words, people do not save anything out of their wages. This is just a simplifying assumption and will be relaxed later, although it is close to reality for the US economy where the general public lives from paycheck to paycheck, has little income from non-labor sources and its rate of saving since 2000 has been close to zero. With this assumption, the consumption function is given by

$$C = wL \quad (1)$$

where  $C$  is the pre-tax level of consumer spending. As our starting point, let the economy be closed with little government spending and no debt at all. Then

$$AD = C + I \quad (2)$$

where  $AD$  is income-based aggregate demand equaling consumption and pre-tax planned investment ( $I$ ). Let us assume that investment is proportional to  $C$ , so that

$$I = bC \quad (3)$$

where  $b$  is the response of investment to consumer spending and is assumed to be constant. This is reasonable because if  $C$  rises, then firms expand their business and raise their investment. This is also borne out by US experience over the long run. Unless specified otherwise, all variables are in real terms.

In view of (3),

$$AD = (1 + b)C$$

Let AS be aggregate supply, then

$$AS = Y = (Y/L)L = AL \quad (4)$$

In equilibrium,

$$AS = AD = Y \quad (5)$$

To all this we add our index of the wage gap given by

$$g = A/w \quad (6)$$

Now suppose productivity rises over time because of investment and new technology or for some other reason. A recession and layoffs in any economy occur when  $AD < AS$  and there is overproduction, which is denoted by  $Q$ , so that

$$\begin{aligned} Q &= AS - AD = Y - (C + I) \\ &= AL - (1 + b)C = AL - (1 + b)wL \end{aligned} \quad (7)$$

or

$$Q = wL[g - (1 + b)] \quad (8)$$

In deriving (8), all the equations presented above have been utilized. Note that  $Q$  is the value of unsold goods, which equal zero in equilibrium. At that point

$$g - (1 + b) = 0 \quad (9)$$

By differentiating (8) and using (9) we get:

$$dQ/dg = wL > 0 \quad (10)$$

which suggests that a rise in  $g$  or the wage gap index disturbs the equilibrium and raises  $Q$  or overproduction that must lead to layoffs. Since layoffs occur only in a recession, the main cause of a recession is the rise in the wage gap. The economic reason for this conclusion is very simple. Given the level of employment, productivity is the main source of aggregate supply and the real wage is the main source of aggregate demand. If productivity rises faster than the real wage, supply rises faster than demand, leading to overproduction and hence layoffs along with a recession. Hence a growing wage gap is perhaps the only cause of rising poverty in an advanced economy, where some factories may stay idle owing to faltering demand.

This simple model refutes the classical theory, where the real wage equals the marginal product of labor and is proportional to its average product. Let us now focus on the fallacy of the

Keynesian theory, which argues that expansionary monetary and/or fiscal policies are cures for joblessness and poverty. It is well known that monetary expansion leads to a rise in consumer borrowing (CB), whereas fiscal expansion raises government borrowing (GB), and both add to aggregate demand. In view of such policies,

$$AD = C + I + CB + GB \quad (11)$$

so that

$$Q = wL[g - (1 + b)] - B^* \quad (12)$$

where  $B^*$  is total borrowing or new debt in the economy, which, for simplicity, is zero initially. For  $Q$  to be zero

$$wL[g - (1 + b)] = B^* \quad (13)$$

(Note that the concept of aggregate demand given by (11) appears to be different from the traditional concept, where  $AD = C + I + G$ , and where  $C$  and  $I$  are after-tax variables. However, in our model, these are pre-tax variables, and the tax element is included in  $GB$ , which equals  $(G - T)$ , with  $G$  being government spending and  $T$  being tax receipts.)

Differentiating (12) with respect to  $g$  yields:

$$dB^*/dg = wL + g(dwL + Ldw)/dg \quad (14)$$

Avoiding layoffs or preserving employment means that  $dL = 0$ , so that (14) becomes

$$dB^*/dg = wL + gLdw/dg = wL(1 + e) > 0 \quad (15)$$

where  $e = gdw/wdg$  is the defacto elasticity of the real wage with respect to the change in the wage gap index. In the United States, since 1981 the real wage has risen faster than the wage gap, so that this elasticity has exceeded one, while the gap itself has been growing. However the main point is that for  $dL$  to be zero,  $dB^*/dg$  must be positive. In other words, even with a rising wage gap, layoffs can be avoided using Keynesian policies by raising debt. But a time comes when such policies lose their effectiveness and work extremely slowly, if at all. Such has been the case

since the Great Recession, in fact since the start of the new millennium. For instance, during the 1990s, total debt grew 70 percent, while real GDP grew at the rate of 3.2 percent per year, whereas between 2000 and 2014, debt more than doubled, while annual growth fell to a paltry 2 percent. Above all, in 2014 poverty was the worst in over 50 years.

Keynesian remedies only postpone the problem, not solve them, because a time comes when the general public runs out of good collateral, and the banks curtail their lending. As debt growth falls, AS exceeds AD, profits crash and a recession ensues. At this point, government borrowing skyrockets because of sinking tax receipts. This is what explains the rocketing federal debt since 2000 along with paltry economic growth.

### **The Element of Corruption**

Now the question is: where is the element of official corruption in the arrival of the Great Recession and soaring poverty? *It has been demonstrated above that when the wage gap rises layoffs quickly follow, unless consumer and government debt rises sufficiently.* Another question is: why do politicians follow policies that maximize debt. When layoffs occur or even threaten to occur, the elected official becomes worried, because the unemployed have the right to vote. The politician dislikes a recession almost as much as the public, which could vote him out of office. With rising layoffs, the politician also worries about his own layoff. At this point the policy-maker has three choices. Either adopt policies that bring the real wage in line with productivity, or follow Keynesian remedies that raise AD artificially to the level of AS. The third choice is what the classical economists advocate, which is to do nothing. This choice may be ruled out altogether, because it has been seldom followed.

If the real wage rises in the same proportion as productivity, there is no problem in the economy, because then AD rises as fast as AS, so that not only employment stays high, the living standard rises for society as a whole and poverty steadily declines. However, policies that stabilize the wage gap through the continual rise in the real wage contradict the self interest of the rich multinational corporations, which detest high wages. So politicians also detest them, because they need large sums of money to finance their election campaigns, and such sums are provided only by the wealthy. Most elected officials and their appointees favor policies that raise profits but not wages. For instance, whenever wages threaten to rise fast, the Federal Reserve restrains money growth in the name of controlling inflation. The Fed should know that so long as the real wage grows no faster than labor productivity, there cannot be any cost-push inflation.

However, the corporations are not just magnanimous donors; they expect and do receive large favors in the form of corporate tax cuts and subsidies among other boondoggles from

elected officials. All this is nothing but political corruption. Corporations offer bribes, which politicians are eager to receive in exchange for keeping a lid on wage growth, thereby raising poverty.

### **The Corrupted Policies**

Let us now examine some policies that have been adopted in the United States since 1981. How does the government either restrain wages relative to productivity or enrich the rich? Let us examine the important official economic measures adopted since 1981 and contained in the following list.

1. The income tax cut of 1981 that enriched the rich, but made it necessary to sharply raise almost all other federal taxes in 1982 and 1983, paid mostly by the poor and the middle class, to finance that tax cut.

2. Unenforced antitrust laws resulting in mergers among large and profitable firms and eliminating lucrative jobs in numerous industries.

3. Permitting oil industry mergers in the 1990s that prevented oil prices from falling between 2009 and 2012 in the middle of the worst slump or stagnation since the 1930s.

4. Permitting relentless mergers among pharmaceuticals and health insurance companies, so that the United States now spends almost 15 percent of GDP on health care, which is mediocre by European and Japanese standards.

5. Unchecked use of outsourcing that eliminates good jobs in manufacturing and services.

6. Ignoring the persistent trade deficit that has all but destroyed American manufacturing base.

7. The 1999 repeal of the Glass-Steagall Act under President Clinton.

8. The Bush tax cuts and bailouts that further benefited the rich while nearly doubling the government debt.

9. And finally, the decimation of the real minimum wage by President Reagan and other Republicans.<sup>1</sup>

Looking at this list, is there any government program that a multinational corporation would dislike? Furthermore, is there any measure that has helped the middle class? None comes to mind. Thus, ever since 1981 virtually every measure supposed to benefit the people actually ended up hurting them. Mergers, outsourcing and corporate tax cuts to spur investment raise productivity, but also lower wages, whereas other provisions of the above list directly reward the wealthy.

Politicians adopted these policies in exchange for hefty donations from the beneficiaries, and that is pure corruption.

### **Proper Economic Policy**

It should be clear by now that unless the real wage rises in proportion to productivity, consumer and government debt will have to grow indefinitely to maintain even the paltry growth rate of 2 percent per year, without creating any dent in poverty. Clearly the policies of the past must be abandoned to restore prosperity. The following measures are needed to ensure that wages catch up with labor productivity.

1. Enforcing anti-trust laws and breaking-up large conglomerates into smaller units.
2. Raising the minimum wage periodically or just linking it to the rate of inflation and productivity growth.
3. Eliminating the trade deficit while keeping free trade through non-tariff barriers that most nations have used in the past.
4. Imposing a hefty tax on outsourcing that raises productivity sharply while reducing domestic labor demand and hence the real wage.
5. Introducing free trade regarding the import of patented medicines.

These measures will ensure that the real wage catches up with growing productivity because they raise labor demand and bring down the cost of health care for workers.

\*Paper presented at the ASSA meeting in San Francisco in January 2016

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<sup>1</sup> For a detailed examination of the list of economic policies adopted since 1981, see Ravi Batra, *Greenspan's Fraud*, New York, Palgrave/Macmillan, 2005, and *End Unemployment Now: How to Eliminate Joblessness, Debt and Poverty Despite Congress*, New York, Palgrave/Macmillan, 2015.