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SUOMEN PANKKI D

Memorandum on incomes policy

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MEMORANDUM ON INCOMES POLICY

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## Memorandum on Incomes Policy

### 1. Introduction

At a meeting on March 15, 1965 Talousneuvosto (Economic Council) decided to request an expert opinion on "the problems and guidelines for a study on incomes policy". In this memorandum we give our views on incomes policy in general and suggest an approach for its application in Finland.

### 2. What is incomes policy?

In a full employment situation it is possible for firms and individuals to raise their incomes to such an extent and in such a way that there may be an inflationary increase in total income.

The need for an overall incomes policy is generally felt due to the fact that nominal income tends in present circumstances to increase considerably faster than real income.

It is inherent in the present economic system that not only do firms and households in the private sector wish to increase their money income rapidly, but also their organisations. This is reflected in the actions of the public sector as well.

In this memorandum a full employment situation is defined as a situation which is characterized by a monetary equilibrium in the goods and labour markets supported by an active employment policy. The natural tendency of firms and households to increase their income, especially in conditions of full employment, takes the form of price and wage increases.

It is characteristic of the workings of the market economy that once the rise in nominal income has exceeded substantially that of real income, price and wage increases tend to continue and to become stronger. Linkages between different prices, between different wages, and between prices and wages speed up the inflationary process.

This kind of inflationary process has several detrimental effects on the allocation of resources and on the balance of payments. A detailed consideration of these effects will not be made here. It may just be stated that the inflationary process cannot continue for very long. Due mainly to increasing balance of payments difficulties, such a situation of fundamental disequilibrium, where measures of employment policy are inadequate to secure full use of resources, will have to be faced.

On the basis of the above we draw the following conclusion:

A necessary prerequisite for a successful employment policy in Finland is the simultaneous implementation of a consistent incomes policy.

In a market economy changes in the demand for and supply of goods and factors of production will occur by means of changes in relative prices and wages. Therefore the price mechanism has to be flexible enough to enable these changes to take place. Since in a full employment situation prices and wages do not usually fall, the natural functioning of the price mechanism is reflected in continuous increases in the price and wage level.

The change in relative prices is reflected in this kind of a rise in prices and wages, assuming that prices are not flexible downwards. This is a phenomenon which, especially in the short term, cannot be stopped nor is it presumably desirable to do

this, since in a market economy this is a flexible factor unavoidably connected with the economic process. Price and wage increases resulting from the allocation mechanism of the economy and remaining within narrow limits do not present a specific incomes policy problem.

Many different factors set in motion an actual inflationary rise in prices and wages. In our opinion one of these may be an increase in the price and wage level due to changes in relative prices, especially if the price mechanism is susceptible to the inflationary momentum resulting from price and wage linkages referred to above.

A relevant problem from the point of view of a policy for incomes is thus:

How changes in relative prices can occur without at the same time acting as an impetus to the inflationary process. Since the purpose of an incomes policy is to curb the inflationary rise in incomes, ways have to be found to influence rises in the income of different income groups. Measures of incomes policy thus always imply some sort of standpoint as to the type of income distribution policy desired in the society. The implementation of an incomes policy consequently requires a clear and operational definition of "an equitable distribution of income" referred to in the Recommendations for a growth policy by Talousneuvosto.<sup>1</sup>

It is not easy to define this concept so as to make it a general guide for a comprehensive incomes policy. It involves on the one hand a political assessment of "what is best for the

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1. Cf. Report on Growth Policy in Finland 1965, p. 8.

citizens" in other words how disposable national income should be distributed between the citizens. Different interest groups and political parties cannot be expected to agree on this point: the Government should, however, define its stand on the matter as clearly as possible when decisions regarding an incomes policy are being made. On the other hand incomes policy is concerned with another, somewhat more technical question, i.e. what kind of incomes policy would best conform with the growth targets set for real national income.

Market forces and the actions of different interest groups as well as income transfers and other actions taken by the Government determine income distribution. The Government does not try to affect only disposable income directly. Determination of prices and distribution of factor income are also affected by means of subsidies, price controls, import duties etc. When affecting the distribution of factor income the Government can at the same time influence indirectly the allocation of factors of production, both regionally and between industries, and thus the structure of total production. An income distribution policy is not only concerned with economically the most effective means of achieving the goal set, but the very choice of measures often involves a political decision as well.

Due to the lack of clearly defined principles for income distribution policy in Finland at present, an incomes policy cannot be regarded as consisting only of a short term price and wage policy, as has been the interpretation in some other countries. A thorough consideration of the different factors affecting an income distribution policy has to be an inseparable part of an incomes policy.

Therefore, the following prerequisites are necessary for a successful incomes policy:

Studies, which are indispensable, on differences in the income levels between different industries, regions and population groups should be made urgently and continuously; a study should also be carried out on the means of linking incomes policy decisions with efforts to raise the growth rate of the real national product.

When planning the studies on income distribution it has to be borne in mind that the classification of incomes should be relevant to the problems of incomes policy.

The improvement of the tools of economic policy is a prerequisite of the aim that nominal income should not increase at a faster rate than real income. Since an income distribution policy is closely connected with an incomes policy, this involves more than merely extending governmental authority or inventing new economic policy measures.

One of the main tasks of an organization representing some income group is to adjust the contradictory aims within the organization to give it a collective target. In this task the organization has to consider the income distribution within the group and to evaluate prevailing economic conditions and tendencies.

The Government cannot in these circumstances pursue alone a successful incomes policy that presupposes the adjustment of different aims. Consequently, the implementation of an incomes policy is possible only on the condition that the different organizations also participate actively in formulating an incomes policy which embraces the whole economy.

In the Finnish context an incomes policy should in our



opinion be defined as follows:

Under the direction of the Government and in co-operation with employer and employee organizations a framework will be laid down regarding the distribution of factor income and disposable income so that price and wage development would be in harmony with the targets set for nominal incomes. One of the necessary conditions for an incomes policy is therefore that these organizations will set their income targets bearing in mind the size and distribution of national income and that they will accept the general principles of the incomes policy and specify their own targets in conformity with it.

In present circumstances it is undoubtedly difficult to fulfill this condition. Without a complete change in the attitude of both the Government and of the organizations towards sharing the responsibility for an incomes policy, we believe that it would be impossible to put a successful incomes policy into effect.

### 3. Difficulties

A comprehensive incomes policy concerns all income. It thus covers a larger field than does a price and wage policy, formerly pursued, which put the main emphasis on wages. The need for an incomes policy therefore apparently results from the fact that balanced economic growth has not been achieved by means of general financial and monetary policy and of wages policy.

Since a comprehensive incomes policy relates to all kinds on income - wages, incomes of self-employed persons, rents, interest, dividends and undistributed profits - it must embrace the whole mechanism of the economic system. The problem of how to influence other types of income besides wages in different

situations is therefore unavoidable. The question is necessarily raised of the role of profits for economic growth.

Price changes more directly affect non-wage income than wages. Prices are not determined by the agreements made between buyers and sellers as are wages by the agreements made in the labour market.

Non-wage income thus creates a more difficult problem for an incomes policy than does a wages policy.

It is important that economic development should not deviate substantially from the aims laid down by an incomes policy. Our economy is sensitive to fluctuations in the international economic situation the effects of which are difficult to eliminate by domestic economic policy measures. If price changes and wage drift, which are closely connected with the trade cycle, become considerable confidence in the incomes policy is undermined. Consequently,

one of the problems to be faced in incomes policy is how to take into consideration the fluctuations in economic activity.

In incomes policy negotiations a problem will be created by the fact that a considerable part of total income is not determined by market forces and/or agreements made, since as a result of legislation some incomes will follow changes in others. As an illustration of this it can be mentioned that agricultural prices and civil service salaries are tied to the general level of salaries and wages.

From the point of view of an incomes policy it is therefore necessary to pose the following question:

How can incomes policy measures, which are designed to affect all incomes, be applied to incomes which are legislatively tied to other incomes?

#### 4. Proposals

As far as we can see it will take time to implement an efficient incomes policy in Finland. Consequently, the following proposals are aimed at clarifying questions about an incomes policy and at gradually developing it in this country.

An urgent task to be carried out when developing an incomes policy over the next few years is to study comprehensively the income distribution and the price and wage determination in the Finnish economy. This calls for improved information on the distribution of income between different industries and population groups and on changes in relative levels of income. The effects of competition and particularly of monopolistic elements in the economy on price and wage developments should be especially analysed.

On the basis of the above we propose that Talousneuvosto should start without delay to prepare a report on the means of developing an incomes policy. This would be based on an overall study of income distribution and price and wage determination in Finland and would give guidelines for an incomes policy in the next few years.

It has been pointed out above that an incomes policy can be realized only gradually in Finland. Since policy decisions concerning incomes have, however, to be made continuously

Talousneuvosto should, at the same time as setting out a basis for a comprehensive incomes policy, make regularly evaluations of the general economic situation for use by the government and by the employer and employee organizations.

As has already been emphasized, an incomes policy cannot only comprise a search for "technical" solutions or a manipulation of the tools of economic policy available to the Govern-

ment. It also necessitates the development and acceptance of the "rules of the game" needed for negotiations between the Government and the different organizations. Therefore, when Talousneuvosto undertakes the task of developing an incomes policy,

the participation of those organizations, whose active co-operation is needed for a successful incomes policy would be highly advisable.

Endeavours have been made to find simple norms for an incomes policy, according to which changes in income should take place. One of these "rules of thumb" recommended has been the productivity norm. According to this nominal wages should follow changes in productivity, prices remaining unchanged, or prices should decrease (increase) in line with the increase (decrease) in productivity with constant nominal wages. In recent international discussions on incomes policy this norm has prevailed. In order to avoid the use of this kind of vague norm, the weaknesses of which are generally known,

when preparing studies for an incomes policy special emphasis should be placed on finding out more accurate guidelines for incomes policy.

In the Report of Talousneuvosto on Growth Policy in Finland it was suggested that a special negotiating body should be established for incomes policy. Since the developing of an incomes policy requires a great deal of work and because this fits into the activities of Talousneuvosto, which has specialized in problems of long-term economic policy, it is not in our opinion necessary to found a new negotiating body to deal with incomes policy. Instead, we would propose a consideration of

whether there would be grounds for a reorganization of Talousneuvosto so as to form two sections that would be subordinate to the three chairmen: the section of growth policy and that of incomes policy.

The section of growth policy should continue to develop and to set out guidelines for a growth policy, the work already being carried out by Talousneuvosto. The section of incomes policy should concentrate on the tasks concerned with the developing of an incomes policy outlined above. In order to preserve flexibility in the organization of Talousneuvosto it would presumably be necessary to have a joint secretariat for both sections.

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