The myth of the short, sharp shock

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Macro-economic policy designed to inflict a short, sharp shock on the economy can have long and costly consequences. In the two recession years of 1983 and 1991, if there had been a marginal improvement in employment based on historic growth rates, long-term unemployment would have been half its actual level of 200,000. It follows that it is extremely important for Australia to avoid policy-induced recessions. Their consequences are large and persistent.

In the 1970s, the Australian policy discussion used to refer to the imposition of restrictive monetary and fiscal policy as a "short, sharp shock". The idea was that an increase in interest rates could be engineered to eliminate inflationary expectations, and thus to reduce the potential for continuing inflation. At that time there was relatively little discussion of what such "short, sharp shocks" meant for unemployment beyond the initial period. And there was neither data nor consideration of the possible implications for long-term unemployment, defined as those jobless and searching for employment for 12 months or more.

What follows challenges the notion that there can ever be such a thing as a "short, sharp shock", and does so through a focus on the implications of recession for long-term unemployment. The discussion follows closely the paper of Chapman and Kapuscinski (2000), and highlights their major findings. To help set the scene there is first consideration of the contemporary unemployment debate.

Unemployment as a policy priority

Australian unemployment at the start of the 21st century remains a critical policy issue. While the unemployment rate has fallen significantly in the past few years, it is still above 6 per cent in the middle of 2000 and remains very high relative to the experience from 1950 to the mid-1970s. The question of how best to reduce unemployment has been a significant part of the policy agenda for at least two decades.

Governments have not yet been able to solve the problem. Researchers do not yet agree as to either the causes or the solutions. There is an impasse, even if some important points of policy consensus have been forthcoming. In the interest of highlighting that there has been progress, these points of agreement should be recognised.

The first is that high economic growth is a necessary condition for an eventual reduction in unemployment. This assumption underlay the former Labor Government's Working Nation strategy, and has been a

consistent theme of the Coalition Government since its election in 1996. Further, all academic labour economists agree strongly with the proposition.

A second broad point of agreement is that unemployment duration is a fundamental issue for policy. Approaches to high unemployment duration have differed, but emphasis on the reduction in the numbers of those experiencing high unemployment duration is a continuing policy priority. The basis of this reorientation is now explored.

The importance of unemployment duration for policy

It is instructive to illustrate the extent to which high-duration unemployment has become an increasingly important facet of Australian unemployment. Relevant data are now shown in Figure 1, which depicts disaggregations of the unemployment stock by broad duration category.

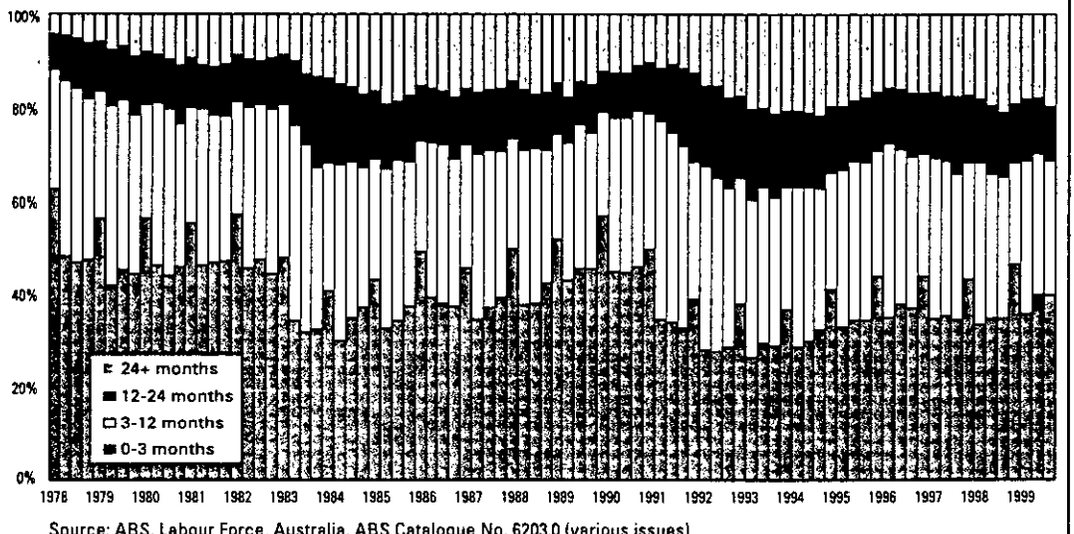
The major point from the figure is that since the late 1970s the addition of the number of people unemployed for between 12 and 24 months, and the number unemployed for 24 months or more - very long-term unemployment (VLTU) - has approximately trebled, mostly at the expense of the shortest duration category (three months or less). The change, however, has been much more pronounced in the VLTU than for those unemployed between 12 and 24 months: the percentage of the unemployed which is VLTU rose from 3.7 per cent at the beginning of 1978 to 19.2 per cent at the end of 1999. During the same period the share of the 12 to 24 months unemployed increased from 7.8 per cent to 11.7 per cent.

It is clear that the Australian labour market has undergone a distinct and important change over the past two decades. A large and increasing proportion of the unemployed have been in this state for a long time. Thankfully, governments over this period have paid increasing attention to the issue.

There are two reasons governments are concerned with high-duration unemployment. The first can be broadly labelled an issue of distribution, which can also be seen to be a matter of equity and social justice. The second concerns macroeconomic efficiency, and the implications for both forgone output and the budget.

With respect to the first, the case for

Figure 1: Distribution of unemployment durations, 1978-1999.



Source: ABS, Labour Force, Australia, ABS Catalogue No, 6203.0 (various issues).

attention being paid to the long-term unemployed is overwhelming. It is well documented that members of the group are some of the least-advantaged in the labour market, and this group is disproportionately made up of those with low formal skills and education, Aboriginals and Torres Strait Islanders, and immigrants from non-English speaking backgrounds.

Moreover, those with high unemployment duration are by definition not accumulating labour market experience, one of the most important determinants of wage income. These combinations of disadvantage make the equity case for focusing policy attention on the long-term unemployed overwhelming.

Long-term unemployment is also fundamental to policy due to its impact on macroeconomic efficiency. The basic point is that a labour supply pool with a large proportion of long-term unemployed will be characterised by structural mismatch; employers will prefer to bypass people with high unemployment duration in job hiring, for rational reasons. That is, information on the likely performance of prospective employees is likely to be critical to the hiring decision, and one indicator will be recent success in attaining employment.

The above suggests that members of the long-term unemployed group will have more difficulty in finding jobs, and many of them will be considered to be irrelevant in firms' hiring decisions. There is considerable evidence that the labour market works more efficiently when the unemployed are able to slot easily into jobs as vacancies emerge. Fahrer and Pease (1993), Chapman (1993), and Hughes (1987) all report empirical confirmation of this phenomenon.

The consequence of this structural mismatch in the labour market is that unemployment is higher than it would otherwise be, simply because a significant proportion of the pool has been unemployed for long periods, and this has implications for the budget. That is, because unemployment would be lower if the proportion of the unemployment pool that is long-term were reduced, there is a loss of tax revenue and higher government outlays for social security. The possible extent of these budgetary losses has been documented in Piggott and Chapman (1995) who estimate that long-term unemployment in the early 1990s cost Australian taxpayers in the order of $1 billion a year as a result of forgone taxes and additional unemployment benefit outlays.

In addition, there is considerable evidence that structural mismatch from long-term unemployment decreases the potential for an economy to recover quickly from recession, because the skill losses associated with long-term unemployment imply that employers will be bargaining over a relatively small pool of "relevant" labour. This, in turn, implies an increased probability of wage inflation, even in periods when measured unemployment is relatively high. A likely consequence is for governments to be more receptive to the adoption of restrictive demand management measures (such as higher interest rates) in response to concerns about potential inflation; this, in turn, means lower potential output.

The bottom line is that high-duration unemployment is very costly, in equity, macro-efficiency and budgetary terms. Moreover, high duration unemployment has grown from a meagre proportion of all unemployment to a major aspect of Australian joblessness in just over 20 years. These issues motivated the Chapman and Kapuscinski exercise, with our principal contribution being to show that the avoidance of recession is probably the single most important thing a government can do. This is demonstrated through the use of a number of counter-factual scenarios related to employment growth.

Linking economic growth and long-term unemployment

To provide a link between economic (employment) growth and its association with high duration unemployment, we can utilise techniques developed by Chapman, Junankar and Kapuscinski (1992). These techniques and the empirical relationships uncovered form the basis of the analysis reported in the following section and, consequently, require some explanation and justification.

The Chapman et al methodology estimates time-series models with respect to the proportion of the jobless stock that is long-term unemployed (LTU) on the basis of both different lags in the unemployment rate and the past history of long-term unemployment. Results reported in Chapman et al. (1992) as well as in Junankar and Kapuscinski (1998) have demonstrated the robustness of this methodology and the very good fit of the estimated models. In other words, the technique provides a sound empirical basis for forecasting LTU levels given different hypothetical scenarios of the future course of the aggregate unemployment rate.

We use the two annual outliers in the profile of employment growth, the troughs of the recessions of the early 1980s and 1990s. Employment growth was 2.17 per cent in 1983 and 2.29 per cent in 1991. Our counter-factual experiments then consist of evaluating the impact of alternative scenarios of employment growth in those two years on the profiles of LTU and VLTU.

Between 1966 and 1999, the average annual employment growth was 1.93 per cent. If you take only the years over that period in which there was below-average employment growth, the annual rate of increase was 0.38 per cent. Scenario A adds this figure for the years in which there was poor employment growth to the actual results in the two outlier years. This produces new growth figures for those years of 1.79 per cent and 1.91 per cent.

Scenario B assumes that growth in 1983 and 1991 was higher by the 1.93 per cent average growth rate over the three decades. This scenario assumes the growth rate in the two years was 0.24 per cent and 0.36 per cent.

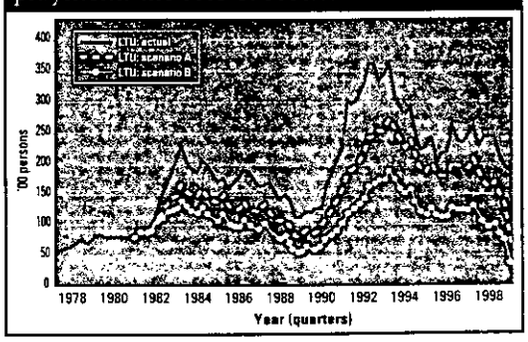
These two scenarios of employment growth in 1983 and 1991 describe what are arguably realistic, even modest, boundaries of possible outcomes if international circumstances and/or domestic demand management had been more propitious for employment in these two years. That is, even a slightly better employment growth environment should be expected to deliver at least 0.4 per cent more jobs per annum. In defence of our claim that the scenarios are conservative, it should be noted that even in the optimistic scenario, employment growth in both 1983 and 1991 is still negative, and this represents very low annual employment growth outcomes by Australian historical standards.

The results of the experiments

The results of our experiments are presented in Figure 2.

The data from Figure 2 show clearly that higher employment growth in 1983 and 1991 would have resulted in a considerably lower level of LTU. At the end of the 1990s, for example, LTU would have been not much more than 100,000 if employment growth in 1983 and 1991 had been just 0.4

Figure 2. Projections of long-term unemployment: the role of recession avoidance.



per cent per annum higher, and about 50,000 if these years had instead experienced an increase in employment growth equal to the average annual employment growth of the whole period.

What actually transpired was an LTU of well over 200,000 in the last half of the 1990s. This suggests that better employment growth in only two years could have reduced LTU by around 50 to 80 per cent. These constitute very large reductions.

The bottom line

Unemployment remains one of Australia's major economic challenges, and long-term unemployment in particular is a persistent and costly phenomenon. Most of the policy debate focuses on the important issue of solutions to the problem. We have taken a different tack through consideration of the benefits of avoiding its emergence.

Specifically, we address the issue of the consequences for high-duration unemployment under different scenarios of employment growth. It is important to note that our counter-factuals are modest. History has only been re-run for the two poorest years of employment growth over the past few decades, 1983 and 1991, and the two adjustments made to employment are, in the first case, small and, in the other, optimistic but still realistic.

The results are clear, indeed they are arguably very powerful. Even in the small adjustment scenario there are very significant decreases in the number of people who would have experienced unemployment for long periods, the pool being reduced by at least 40 per cent. The more speculative counter-factual eventually results in falls of high duration unemployment by up to 80 per cent.

The experiment does not inform the Australian contemporary unemployment debate with respect to the solution to the current high-duration unemployment malaise. But it should leave us in no doubt that just a few poor years of economic growth has very significant medium-term implications for high duration unemployment.

The analysis strongly reinforces the notion that there are significant potential dangers from restrictive macroeconomic management. The challenge lies in avoiding policies that increase the likelihood of recessions, given that they are so expensive. Prevention is better than cure.

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