

Policy Forum: Unemployment in Australia

Comment on ‘Towards Full Employment’

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Peter Dawkins and John Freebairn (hereafter, DF) have written a very useful and stimulating paper on Australia’s most pressing economic problem, unemployment. They present a fairly mainstream analysis of the causes of unemployment, attributing it essentially to two factors, high real wages and inadequate economic growth. They propose a solution aimed at reducing the aggregate rate to around 5 per cent over the next few years, which is to allow a fall in real wages of around 10 per cent.

The most significant contribution of the paper lies in DF’s recognition of the close nexus between wage outcomes and social security arrangements. This leads them to promote a radically different role in Australia for the tax and transfer system, one designed eventually to lead to negative income taxes. Their essential argument for a negative income tax is that such an approach allows cuts in real wages without increasing the dispersion of incomes; further it is alleged that the policy can be designed to avoid the current high effective marginal tax rates which make the reduction in unemployment more difficult than it need be.

It is rare in Australian unemployment debate that such an explicit identification of the fundamental connection between wage levels and income support is made. Moreover, it is uncommon for those calling for real wage cuts to offer policy proposals taking into account both income distribution and effective marginal tax rate implications. DF have now made it very difficult for us to take seriously any future calls for real wage reductions as the solution to un-

employment unless there is included analysis of these issues.

In what follows I concentrate not on the large number of issues raised by DF which are not contentious but focus instead on some potential problems with the paper. They are threefold: the lack of attention paid to alternative explanations of the level of unemployment; the significant implications of unemployment duration for their analysis and policy proposal; and, the need to examine more closely some of the potential economic and budgetary consequences of the negative income tax proposal.

Perhaps the most significant issue for this Policy Forum relates to an explanation of Australia’s high and seeming intransient level of employment. This is because each explanation will have as an implication a solution, as does the DF train of thought. However, DF have given relatively little weight to other factors contributing to unemployment, and even a cursory look at the other papers for this Policy Forum imply strongly a lack of consensus. While wages and growth seem to be obvious—and even uncontroversial—elements in an explanation of unemployment, a significant matter relates to the determinants of growth. If this issue is not unwrapped properly we must be left in some doubt as to the merits of any policy proposals, including the myriad promoted by the other commentators in this volume.

It might be useful to consider what such an unwrapping might look like. One issue is that the role of government is not examined satisfactorily. There are potentially both cyclical and structural factors at work here.

On the cyclical side, the government's response to the large increases in nominal wages in both 1974–75 and 1981–82 likely contributed to the ensuing increases in unemployment. Moreover, while it is certainly true that real wage increases at these times were very high (of the order of 12 and 6 per cent respectively), their high correlation with very large changes in inflation (to 18 and 12 per cent respectively) make difficult confident interpretation of the large number of econometric exercises purporting to isolate the role of these different factors. It is not just that the Australian government put on the monetary brakes at these times, so did the governments of a large number of other countries; as well, it must be the case that there were changes in both investment and consumption in response to the increased uncertainties associated with higher inflation.

A similar point can be made with reference to the Accord period, which DF promote as further evidence for the proposition that real wage restraint delivers important employment creation. Certainly it is hard to argue otherwise, but it should be acknowledged that some part of the 1980s unemployment reduction is attributable to the effectiveness of the Accord as an anti-inflation instrument,¹ which both encouraged investment and facilitated a more relaxed monetary stance. On this general point, and in contradistinction, the role of monetary policy was clearly fundamental to the timing and depth of the 1990s recession.²

The 'structural' issue with respect to the role of government relates to the public sector as both an employer³ and in terms of the provision of infrastructure⁴. Have changes in the size and nature of government contributed to relatively low rates of employment growth in the last 25 years or so? Is the relatively slow growth in public sector services irrelevant to our understanding of unemployment, as DF imply? These are questions worth posing, particularly given that the potential policy ramifications are strongly at variance with those of DF.

A second concern with the paper is the relatively innocent discussion of the wage-employment elasticity, a point that can be traced in part to the elasticity literature. The authors contend that the assumption of an elastic-

ity of around 0.75 is what is required for a 10 per cent cut in real wages to deliver an unemployment rate of around 5 per cent after about four years. But this assessment does not take into account the fact that a very large number of the unemployed currently have high unemployment duration, and are very unlikely to be found attractive to employers even with a 10 per cent cut in wages.

Those who followed the introduction of *Working Nation* in 1994 would be sceptical of there being much employment response for the long-term unemployed to a wage cut as low as 10 per cent. After all, the wage subsidies from JOBSTART were as large as 60–80 per cent, but it was clear that even with this significant cut in labour costs there was little interest in employing those with the highest unemployment duration. Indeed, the take-up of JOBSTART actually *fell* with the introduction of *Working Nation*, which can plausibly be attributed in part to increased emphasis being given to the take-up of those with the highest (three years and more) unemployment duration.

The empirical significance of the above is worth stressing. Currently, there are around 250 000 people who have been unemployed for over 12 months, and several hundred thousand more in the 6–12 month category. That is, a lot more than half of the pool might be considered to be of relatively low relevance to employers, which would seem to imply that the predicted outcome from a 10 per cent cut in wages is very optimistic. Putting this differently, the elasticities reported in the literature with respect to the 'unskilled' do not typically take into account unemployment duration as contributing to low levels of skill, the implication being an important overstatement of the likely size of the response in the contemporary Australian labour market.

A policy message from the above would seem to be that wage cuts of the order suggested by DF are unlikely by themselves to deliver what is desired, at least over as short a period as four years. Recognition of the role of long-term unemployment as a contributor to structural mismatch in the labour market, and thus as an influence on the non-accelerating inflation rate of unemployment, implies a

different (perhaps complementary) policy stance. DF ignore the matter, and with this implicitly accept the alleged validity of elasticity estimates, and implicitly reject the significance of all contemporary research on hysteresis with its accompanying policy ramifications.

Finally is the matter of negative income taxes as a policy instrument. It would have been very useful if DF had offered costings for the proposal, for two reasons. One is that no government takes seriously policy proposals without an assessment of the budgetary implications—how can a cost–benefit analysis be undertaken without any indication of costs? The other point here is partly presentational, in that an alleged benefit of the proposal is that effective marginal tax rates would be reduced with the DF scheme, but we will not know how big the decrease is without an indication of how much additional revenue is needed.

There is a more important set of issues related to a negative income tax, which can be clarified as follows. It might be useful to consider binding minimum wages as a form of employment tax on the firm, but one in which the ‘tax’ (the additional cost to the firm of employment) is distributed to those with minimum wage jobs. Considered in this way, the removal of the ‘tax’, that is, the reduction in wages, switches the incidence of this form of income support from the firm to the government. In other words, to maintain a given income distribution would seem to suggest the need for a higher tax take.⁵

Some part of the higher tax revenue needed would presumably be provided by additional employment, and higher economic growth, but DF need to tell us how much. They need also to provide an assessment of the economic costs and benefits of changing the income support incidence from the firm in the public sector. Critical to this analysis would seem to be a discussion of the increases in distortions from having a larger tax base. After all, some estimates of the economic costs from the distortion from the raising of an additional dollar of tax, including by one of the authors, come in at as high as 20 cents.

These issues notwithstanding, this paper deserves serious attention by the profession, and by those in positions of policy influence. Certainly it is hoped that DF’s central focus on the critical nexus between wages and social security arrangements now becomes a permanent part of the Australian unemployment debate.

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Endnotes

1. See Chapman (1996) for a summary of the evidence.
2. See Pagan (1996).
3. See Langmore and Quiggin (1994).
4. See Kenyon, this volume.
5. It is worth noting that the increases in taxes to maintain a given distribution of income might be smaller than some suggest. After all, some of those on the lowest wages might also be in households with relatively high incomes, implying no income support increases for this group. This is a critical point for the overall issue of Australian wages and social security policy, and one in need of empirical attention.

References

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