Restoring Full Employment: A Problem of Policy Balance

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1. Introduction

The goal of full employment harks back to the period following World War II when Australia sought, via an expanding public sector, to develop large scale assembly-based manufacturing with the aim of preventing a recurrence of the mass unemployment of the 1930s. While the world economy has avoided a return to Depression levels of unemployment, it has been plagued by persistently high levels since the mid 1970s. Even though Australia experienced a strong growth phase in the mid to late 1980s, not enough jobs were created in relation to labour supply. Further, at the recent G7 Jobs Summit in Detroit, a rising trend in the world economy was identified—the increasing numbers of the 'new working poor'. This refers to the fact that economies are producing increasing numbers of low paid, service sector jobs as manufacturing employment opportunities decline.

A focus on the issue of full employment is thus timely and welcome. *Restoring Full Employment* (hereafter the Green Paper), released by the Committee on Employment Opportunities, brings the issue back into the policy debate after many economists in the 1980s were content to classify the higher levels of unemployment as voluntary, search or structural and not amenable to macroeconomic policy manipulation. To place our discussion of the Green Paper in context, Table 1 summarises Australian labour force aggregates for the period 1978 to 1993. While there were 1.7 million jobs created over the period, unemployment still rose by an average of 5.8 per cent per annum due to the relatively more rapid labour force growth and more than half of the jobs created were part-time. The Australian economy thus did not produce enough jobs. Related evidence suggests that the rising importance of the service sector and part-time employment has resulted in an increasing number of employed persons receiving below average wages (see Mitchell 1994b).

The Green Paper must also be seen in the context of our current recovery. Recent national accounts figures report a 4 per cent GDP growth rate. This provides scope for a modest diminution in the unemployment rate. But growth driven largely by private consumption and volatile export growth (with some help

Table 1 Labour Force Aggregates, 1978 to 1993
(thousands)

	Labour force	*Total employment*	*Full-time employment*	*Part-time employment*	*Unemployment*
1978	6424.8	6031.3	5092.8	938.5	393.5
1993	8664.4	7741.7	5928.2	1813.5	922.7
Absolute change	2239.6	1710.4	835.4	875.0	529.2
Average annual growth (per cent)	2.0	1.7	1.0	4.5	5.8

Source: ABS, *The Labour Force, Australia*, Cat. no. 6203.0.

from government spending and stock building) is not likely to be sustained. To achieve growth rates consistent with rapid reductions in unemployment and to maintain our competitiveness we need stronger growth in investment. In the 1960s our investment (private plant, equipment, buildings and other constructions) to GDP ratio was around 10 per cent. There has been a steady decline since the 1970s. Between 1990 and 1993, investment in plant and equipment has averaged around 8 per cent of GDP. Any approach to achieving full employment must address the reasons for the loss of private capital formation.

Finally, since 1983 significant structural reform which has resulted in job losses—particularly in textiles, clothing and footwear—has taken place. The losses have been exacerbated by demand-deficiency in the 1990s. This combination may have more relevance for particular regions than for the economy in general. At any rate, while microeconomic reform may deliver benefits in the longer term, it is costly in the short term in terms of jobs and incomes. It is essential to maintain a strong level of macroeconomic activity while pursuing structural reforms in order to speed up the absorption of the micro changes and minimise the adjustment costs. It is not an adequate strategy to rely on the market to react to an improved microeconomic structure while the aggregate economy delivers persistently high unemployment. The losses from macro failure swamp the losses that may arise from micro inefficiency.

While reintroducing the concept of full employment as a policy priority, the Green Paper unfortunately places an excessive emphasis on microeconomic factors and sidesteps the macro policy issues. It states that:

> In order to achieve a higher growth rate, policies would need to be directed toward increased flexibility in the labour market, income restraint, accelerated micro-economic reform and stronger productivity growth. Active labour market programs would also have a part to play in this process. [p. 43]

Not enough recognition is given to the fact that macroeconomic factors, in particular an excessively restrictive monetary and fiscal policy in the late 1980s and early 1990s, caused the current unemployment problem. In this context, expansionary macroeconomic stimulus accompanied by some micro incentives to influence the structure of investment would help reverse the damage done by the policy lapses in the recent past.

In this sense, the Green Paper lacks a vision for balanced policy. I see the Green Paper as belonging to the same rationalist pedigree which pervaded and hamstrung macro policy in the 1980s. The Green Paper prescribes no role for an activist macroeconomic policy, preferring to maintain the view of the 1980s that continued microeconomic reform is the solution to the woes that lack of investment and a shrinking public sector have brought upon us.

More significantly, the Green Paper ignores any consideration of why the economy is failing to create enough jobs even in times of high growth (as we saw in the late 1980s). A related issue is the question of sustainable growth and the concept of green jobs. The Green Paper is content to let the market via price incentives achieve conservation aims. This is controversial and would take us beyond the scope of this critique.

2. The NAIRU and Aggregate Demand Policy

The Green Paper does not really define full employment. Instead it concentrates on the related concept of the non-accelerating inflation rate of unemployment (NAIRU). Its focus is about reducing the NAIRU, presumably as a first condition for restoring unemployment to some frictional and irreducible minimum. The Green Paper rightly sees a reduction in the NAIRU as being essential for sustained growth with low inflation. The scope for growth is reduced if demand pressures impact on prices rather than output. However, much of the micro policy justification is lost if we have no estimates of the NAIRU. In the last strong employment growth phase, the unemployment rate fell to around 6 per cent without any pressure on wages emerging. Had we reached the NAIRU at that time?

Additionally, we need to be clear on what this NAIRU-constrained world means (see

Mitchell, 1987, for a discussion of terminology). While the NAIRU concept clearly introduces non-competitive, institutional and structural factors into the definition of the unemployment rate where inflation is steady, factors which are absent in the Walrasian natural rate of unemployment concept, the analytical conclusions are similar. In both models, the long-run Phillips Curve is vertical and attempts to use aggregate demand policy to permanently reduce the unemployment below the NAIRU are eventually futile. The Green Paper adopts this version of the NAIRU and hence sees microeconomic reform as the path to lower unemployment without inflation (pp. 50–1). For the unemployed, this translates into reductions in their relative wage upon employment or increased participation in training schemes to lift their market productivity. The fact that changing relative costs of one group will merely shuffle the positions of the unemployed in the queue rather than expand the number of jobs is ignored. But the important thing for the Green Paper is that the 'more marketable' the long-term unemployed can become, the less pressure will come from wages as growth occurs.

The NAIRU must be distinguished from the notion of a steady state unemployment rate which is cyclically sensitive or hysteretic. In this world, the steady state unemployment rate is not only sensitive to microeconomic changes, but also to the business cycle. There is nothing in the Green Paper to suggest it has a hysteretic vision. Had the Green Paper embraced this type of model the policy mix would have been more weighted to macro initiatives which work more quickly and involve fewer adjustment costs. Unfortunately the Green Paper sees the task as preparing the unemployed for work rather than providing the demand necessary to create the required jobs. The Green Paper should have shown that the NAIRU was a binding factor and could only be reduced through microeconomic initiatives. Instead, it relied for its modelling on the Access Economics Murphy (AEM) model which has an inbuilt neoclassical NAIRU with no scope for macro policy to drive unemployment down permanently.

3. Macroeconomic Policies Are Needed

The sharp rise in unemployment in the 1990s cannot be attributed to excessive growth of real wages. This recession was the product of demand-deficiency, deliberately induced by Federal Government policy. Policy makers must decide on two issues. First, are inadequate skills reducing the employment opportunities for those recently unemployed? Second, where state dependence and heterogeneity have reduced the re-employment probability of the long-term unemployed, what form of special treatment is necessary to improve the prospects of these individuals?

The Green Paper eschews direct job creation for newly unemployed. Yet the correct approach is to get the newly unemployed quickly back into work of some kind so that they maintain their link with the labour market and retain their current income levels. They do not lack skills and hence training would be wasteful. Palliative care is needed until the cycle improves (see Green, Mitchell and Watts 1992).

In general, the Green Paper favours a mix of training schemes and wage subsidies over direct stimulation. This is consistent with the Committee's belief that excessive wage costs and low skills prevent job expansion. At the present award rates, the unemployed are too costly to hire. A wage subsidy or a training wage is thus required to induce employers to hire.

But measures that reduce relative wage costs for one group merely shuffle the unemployment queue, with the net gains being marginal. So a wage subsidy for one demographic group may only provide work for that group at the expense of another substitutable demographic group. Thurow (1975) also showed that the relative upgrading of skills of one group of workers in the queue via education and training will merely amount to a relative downgrading of some other workers in the queue. Without rising levels of aggregate demand creating extra jobs, all the training in the world will come to nothing.

The startling focus in the Green Paper is that its authors have sourced the problem and solution of unemployment in the labour market.

One of the most striking events of the 1980s was that the scale of investment in productive capacity did not reflect the unprecedented redistribution of national income from wages to profits. Wage inflation was low, the exchange rate had delivered increased international competitiveness, yet the increased profits were largely wasted on speculative transfers.

The major problem facing the unemployed in Australia is that the entrepreneurial class is generally moribund. It exists within a speculative culture and has not emerged from its cloistered existence under the high tariff barriers of the past. High productivity, high employment and high wages are all products of robust investment. Tinkering with microeconomic reforms cannot hope to deliver the returns that a strong investment rate will provide. To increase investment we must eliminate the incentives for speculative gain. Reform to the taxation system is essential. But that takes us out of the labour market and the Green Paper becomes silent.

4. The 1970s and 1980s—A Revisionist History

The Green Paper provides a narrow interpretation of recent history. Throughout the first three chapters it tells us that excessive real wages and market impediments are largely to blame for the high unemployment in Australia. The Green Paper does recognise that after 1990 '[t]he reduction in employment . . . was much more related to a downturn in aggregate demand.' (pp. 31–2), although there is virtually no follow up to this point.

The historical summary reads as if there was never a debate in macro labour economics following the rapid rises in unemployment in the mid 1970s. It should be stated that whether the unemployment in the 1970s and early 1980s was Classical (real wage caused) or Keynesian (demand deficient) is really not the issue. The emphasis in the Green Paper on establishing that real wages caused high unemployment is, however, consistent with a continued focus on microeconomic factors constraining growth and increased employment, rather than on macroeconomic factors.

Some of the Green Paper's claims do not fit the facts. It claims that productivity growth followed the substitution of capital for labour after the real wage explosions in 1973–74 and 1981–82 (p. 29). If the macro economy was subject to diminishing returns in its usual operating range, then with such an increase in capital intensity and rising unemployment, productivity growth should have surged. In fact, since the mid to late 1970s, productivity growth has slowed. A Keynesian might point out that sluggish demand generates both high unemployment and low productivity growth.

Also, Figure 1.9 on page 33 of the Green Paper charts real wages and employment and is supported with the statement that:

> The close link between real wage costs and employment was particularly evident in 1974–5 when a large increase in labour costs led to a sizeable decrease in the proportion of the population employed.
> [p. 31]

Whatever happened to the difference between correlation and causation? While not denying that wage costs may impact adversely on employment, the figure reveals nothing causal and is an example of the Green Paper's assertive approach.

For the record, aggregate demand and output were growing by barely 0.5 per cent per annum by March 1975, following a declining trend beginning as early as March 1972. Growth did not return until the late 1970s, whereupon employment duly followed suit. Again, from December 1981 to around September 1983, real output growth was falling and was negative after about September 1982. The employment series reflected this behaviour. In the post 1983 period, three trends are evident. Demand and employment grew until late 1989, then both declined dramatically. Real unit labour costs fell almost continuously throughout the entire period. None of these movements exclusively supports a neoclassical factor substitution argument.

5. The Numbers

In Chapter 2, the Green Paper does some Okun-type accounting as the basis of its projected decrease in the unemployment rate. It is hard to agree with the projections. The projected sustained GDP growth is 3.5 per cent per annum until the year 2000. Labour productivity is predicted to grow 'at around the levels experienced over the 1980s' (p. 46), which is noted earlier (p. 29) to be 1.0 per cent per annum.

The extent to which the unemployment rate will fall, then depends on the labour force growth over the same period. DEET (1991) estimates that the labour force for those aged 15 to 64 years, under conservative net migration, will exhibit an average growth rate over the 1990s of 1.51 per cent. With these aggregates and assuming average hours worked remains constant, there would be scope to reduce the unemployment rate to the target proposed.

Yet how realistic is the productivity assumption? My own estimates (Mitchell 1994a) show an average rate of around 1.4 per cent since the 1980s. Further, with the policy effort aimed at increasing productivity then we should expect it to rise. Assume it is a very conservative 1.5 per cent per annum. Then the scope for reducing the unemployment rate is reduced and by 2000 the unemployment rate would be around 8 per cent.

The Green Paper goes off the rails when it suggests that a projected participation rate of 77 per cent is 'a reasonable working assumption' (p. 71). This would yield a 1.8 per cent per annum labour force growth rate. With 3.5 per cent GDP growth per annum and 1.5 per cent productivity growth, the unemployment rate is going to fall by a bare 0.2 percentage points per annum. The situation worsens if significant productivity growth occurs.

The GDP growth rates required to achieve a 5 per cent unemployment rate appear very high (around 4.75 per cent per annum sustained). But where does the growth come from? The Green Paper lapses into Says law. The Green Paper says that:

> The simulations underpinning such a high growth scenario suggest that this could be feasible with: an acceleration of micro-economic reform and other reforms designed to increase productivity growth, and associated improvements in the labour market leading to reductions in nominal wage inflation consistent with a 2 percentage point reduction in the NAIRU.
> [p. 51]

And:

> Further ahead, the proposed policies to accelerate the supply potential of the economy would to a large extent lead to self sustaining growth . . .
> [p. 51]

Apart from the logical problem that increases in productivity will reduce the capacity to decrease the unemployment rate, there is still the problem that shifting the aggregate supply curve does not in itself increase output. The Green Paper merely relies on the simulations from the AEM model which has built in classical long-run neutrality. Why should we accept the results of the AEM model simulations?

It is obvious that if we write out models with cyclically independent NAIRUs and then impose some microeconomic efficiency measures which reduce the NAIRU, the inflation–unemployment trade-off will improve, and price reductions will stimulate demand via real balance effects. Evidence in the literature (see, for example, Mitchell 1987; Watts and Mitchell 1990) is highly suggestive of a hysteretic NAIRU, which rejects classical long-run neutrality and, on a practical level, opens up a vastly different policy vista to that proposed in the Green Paper. Further, how long must we wait for the microeconomic reforms to stimulate investment? We have had a relatively large degree of efficiency-improving microeconomic reform over the last 10 years and yet the lack of investment remains a problem.

What is required to sustain the GDP growth rate at these high levels, balance of payments constraints notwithstanding, is sustained levels of effective demand. Effective demand focuses on both aggregate supply and aggregate demand. Policies to enhance both are required. Microeconomic policies alone will not necessarily improve effective demand.

6. The Job Compact

The Green Paper advances the notion of a Job Compact as an essential part of its long-term strategy. The idea that the Government would guarantee a job for everyone is a lofty ideal. The Job Compact falls short of this and only targets those who have been unemployed for at least 18 months. The Green Paper says the 'major principle underlying the Job Compact is that of responsibility on both sides' (p. 10). Both the government and the unemployed have obligations. The governmental obligations appear to be to improve the profit margins of the private sector through wages restraint and deregulation. For the unemployed, the Green Paper appears to have a model of recalcitrance. They must accept reasonable job offers. What evidence exists that they have not? They should be prepared to work at below award wages with peers who would be receiving award wages. They must submit themselves to a sequence of programs.

In a philosophical sense, the Green Paper provides a plethora of micro measures intended to prepare the long-term unemployed for work rather than actually give them jobs. In Kalecki's (1971) terminology, nominal wage restraint requires a large number of work-ready long-term unemployed to discipline wage demands by the employed.

However, the Green Paper says nothing of the obligations of the private sector to use the redistributed income from wage restraint to invest in productive capacity, to provide career paths to workers, to ensure that productivity growth is distributed across all demographic groups, to provide adequate levels of training to its workforces, and to ensure that discriminatory employment practices are abandoned.

Further, how does the Green Paper see the conflict between a technological sector with declining employment and the low productivity service sector with rising employment being resolved in distributional terms? With decentralised wage determination, what mechanisms would exist to ensure that workers in the low productivity sectors actually shared in the spoils? We cannot rely simply on factor substitution and changing patterns of demand to resolve this. The service sector will continue to supply low productivity, labour intensive employment where the scope for wage gains is limited. The increasingly capital intensive, high productivity sectors will provide scope for higher wages but fewer will directly benefit. Markets do not necessarily deliver equity.

Mitchell (1994b) shows that the majority of the extra jobs which will be created in the next expansion will be located in the industries which are, relative to average, low productivity, low pay sectors with a predominance of part-time employment. It is likely that most of the beneficiaries of any training and other Green Paper initiatives who actually get jobs will find themselves in these sectors. How do they share in the wealth that would come with a 4.5 per cent GDP growth? Certainly not through their pay packets!

7. Conclusion

I started reading the Green Paper with a particular view of unemployment. In a society which defines employment as gainful activity within the market sector and places a virtuosity on this type of work, unemployment is the largest social problem faced by the economy. Other social problems which stem from poverty (crime, divorce, child neglect etc.) are exacerbated by unemployment. If unemployment is persistently high, there is a danger that an underclass forms which is deprived of the material rewards of the production sector and the social esteem which comes with employment. Endemic poverty and welfare dependence are all that members of this group can expect for themselves and their children. The concept of an underclass is generally anathema to our ideals of fairness.

Persistent unemployment implies that the rate of investment in the private sector is insufficient and suggests that the government must intervene quickly to resolve the demand-deficiency. I reject the idea that demand is not a problem when unemployment exists. Waiting for the market to work via microeconomic reform is equivalent to consigning a large percentage of the unemployed to long-term gloom. The macro costs are enormous compared to the smaller micro gains that might be made.

Ross Gittens says that microeconomic reform 'has become a mantra for the nation's economists.' (*Sydney Morning Herald*, 26 February 1994, p. 36). I must say I do not see economics as a branch of mysticism. And I am still unconvinced that the gains from exclusively focusing on the microeconomic sphere will ever outweigh the losses resulting from long-term neglect of the macro sphere.

After all, how many Harberger triangles can you fit into one Okun Gap!

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