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The Fight Against Unemployment

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Although Australia's unemployment is currently at its highest level since the 1930s, the public response to it has been inadequate, in two respects. First, there is a fundamental lack of concern about the situation. Politicians and commentators talk of a 'boom' and 'the best conjunction of economic fundamentals in many years'; and the Keating Government was able to win the 1993 federal election even though at the time it had no serious policies to deal with unemployment. Second, recent discussion has assumed that unemployment is a social rather than an economic problem, and gone on to explore ways of living with it rather than solving it. It is time to focus the debate on the *causes* of unemployment. Social policies are undeniably necessary to deal with the problems created by unemployment. Nevertheless, we should also be searching for long-term policies to banish unemployment.

The major cause of unemployment is an inappropriate level of labour costs. Any policy package that fails to address labour costs offers no fundamental solution to unemployment, which requires reform of wages policy and, in the short run, reduction of or at least restraint in labour costs.

This article surveys the evidence on the causal relationship between labour costs and unemployment. It goes on to evaluate the treatment of labour costs in the federal government's 1993 Green Paper on unemployment, and reconsiders the most recent case of wage reductions in Australia, namely, the reduction of award wages in the 1930s. It then considers some current explanations of unemployment that have provided rationalisations for ignoring the influence of wages policy and for underplaying the importance of the problem. It concludes by surveying present policies for dealing with unemployment, including those set out in the federal government's White Paper of May 1994.

Labour Costs and Unemployment

Mainstream economic theory has long recognised that wages have a substantial impact on employment. However, in Australia 'wages' must be defined so as to include such non-wage labour costs as payroll tax, workers' compensation insurance, provisions for various forms of leave, and the Superannuation Guarantee Charge. An increase in these non-wage labour costs will have the same effect on employment as an increase in wages proper.

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In the Harvester case of 1907, Mr Justice Henry Higgins introduced into Australia the illusion that wages could be set on the basis of supposed fairness, or to achieve a desired distribution of income, without any reference to economic conditions. This illusion has grown over time and is now reinforced by the vested interest of the union movement and its institutionalised role in government. Although it is contrary to mainstream economics, it has become the dominant paradigm in Australian industrial relations. In view of the popularity of this illusion in Austrália, it would be worthwhile first of all to briefly rehearse the insights that economic theory provides into the relationship between employment and labour costs. (A more detailed exposition, with references, is given in Valentine, 1994.)

Consider the impact of an increase in labour costs on the amount of labour employed by an individual business. The theory of the firm indicates that the reaction to an increase in labour costs will be, first, a reduction in the firm's demand for labour arising from (in most cases) an increase in the demand for other factors (i.e. a substitution of other factors for labour) and a reduction in output (a scale effect on employment); and second, an increase in the price of the firm's output. The strength of these effects will depend on three factors: the ease with which the firm can substitute other inputs for labour; the elasticity of the demand for the final product (an increase in the cost of labour will cause a greater fall in the demand for labour the more elastic is the demand for the firm's output); and the share of labour costs in the firm's total costs. In some cases an increase in labour costs can lead to a 'corner solution': the firm ceases business altogether. Its demand for labour then drops to zero.

Consider now the macroeconomic impact of an increase in labour costs. Two arguments have been used to suggest that labour costs do not affect employment. The first is that any change in labour costs will be reflected in a corresponding change in prices so that real labour costs and therefore employment will be unaffected. This argument was advanced in *Restoring Full Employment*, the federal government's Green Paper on unemployment (Committee for Employment Opportunities, 1993) and will be discussed in some detail below. But it may be noted here that if aggregate demand is faltering, businesses cannot increase prices to absorb increased labour costs. They trim their profit margins instead and reduce their demand for labour.

The second argument is that an increase in labour costs increases aggregate expenditure. This view is accepted uncritically by many commentators, particularly those from the union movement. But increases in labour on-costs (such as superannuation payments) will not necessarily affect expenditure at all. In addition, whether or not wage increases lead to higher aggregate wage income depends on the elasticity of the demand for labour. If the demand for labour has an elasticity above unity in magnitude, the increase in wages will be more than offset by the fall in employment, so reducing aggregate wage income.

Even if this is not the case, it is not clear that a shift from profits to wage income will increase aggregate expenditure. It appears that investment expenditure is very sensitive to profits. The recent paper by Mills, Morling and Tease (1994) identifies cash flow as an important determinant of corporate investment. An increase in labour costs will reduce business cash flow. In addition, any price increase arising from the

increase in labour costs will lead to an increase in the real exchange rate, at least to the extent that the nominal exchange rate does not adjust to offset the increase in prices.

A large number of statistical studies provide support for the theoretical conclusions we have just surveyed. For example, Gregory (1993) argues that lower increases in real wages in the US than in Australia produced lower unemployment in the former. Many other commentators have cited the greater responsiveness of the US wage fixation system to economic factors as the major explanation for the lower unemployment in the US than in most other OECD countries.

Wage Flexibility

In a country, such as Australia, that depends heavily on overseas trade and financial markets, wage flexibility is important. Australia's economic position is subject to external shocks and when an unfavourable shock occurs the domestic economy must adjust to it in some way. The obvious adjustment is for wages to fall (or for their growth to be slowed). An attempt to maintain living standards in the face of a negative external shock will force adjustments in other areas. In particular, the economy will go into recession and unemployment will increase. Average living standards will have fallen. Indeed, it is likely that this adjustment process is an inefficient one, so that the fall in living standards is greater than would otherwise have been necessary. The adjustment process is inefficient because of the costs created by unemployment and because of its impact on consumer and investor sentiment, causing further falls in aggregate expenditure.

Japanese wages are flexible partly because a significant proportion of a worker's pay is in the form of a bonus whose size is related to the performance of the economy. As well, incomes in the large family employment sector are naturally sensitive to economic conditions (Layard, Nickell & Jackman, 1991:71-2). Japan's wage flexibility has helped it absorb external pressures such as oil price shocks. Australians should note that this flexibility has not led to low living standards in Japan: if anything, it has helped them rise.

Flexibility in relative wages is desirable also in order to encourage the workforce to accumulate relevant skills. If wages are free to react to supply and demand, a shortage of skills in a particular area will lead to higher incomes for those who possess that skill. The increased margin will encourage additional workers to acquire the skills in question.

It is often argued that labour costs have already been adjusted downwards because real unit labour costs are now lower (real unit labour costs are defined as output per employee divided by real labour costs). But all this means is that as workers are laid off, output per head increases for the workers who remain in employment. This outcome is not surprising because it is the marginal workers who are laid off. The fall in the real unit labour cost does not mean, therefore, that it has become more attractive to employ additional workers.

Some Sensible Policies

These considerations suggest the policies we should adopt. First, labour costs should not be allowed to increase. This raises doubts about the Superannuation Guarantee Charge, which is set to increase in future years regardless of economic conditions. This represents an increase in labour costs and it will therefore lead to higher unemployment.

Second, the wage-fixing process should be more sensitive to economic conditions. The switch to enterprise agreements is a move in this direction, but their usefulness is limited if unions are able to control them. The 'safety net' approach also means that the wages of lower income workers are raised even though such increases are not justified by the demand for labour in this category, resulting in higher unemployment among lower-income workers. Increasing minimum wages is not the most effective approach to protecting low-income families. It would be better to allow wages to adjust to provide employment for as many of these workers as possible, and if necessary to supplement their incomes through the social-security system. Maximising the number of jobs for low-income workers provides them with the most effective training for participation in the workforce. Long periods of unemployment leave the victims unable to adjust to employment. And the best way to prevent long-term unemployment is to prevent short-term unemployment.

Third, insiders (the employed) tend to increase the cost of employing outsiders (the unemployed) to protect their own position (see Lindbeck & Snower, 1986). One way of doing this is to make it costly to lay workers off once they have been employed. Recent industrial-relations legislation does this (Sloan, 1994) and is therefore likely to slow down the absorption of the unemployed as the economy expands. This problem has been recognised in recent revisions to the legislation, but it has not been entirely removed.

The Treatment of Labour Costs in *Restoring Full Employment*

The 1993 Green Paper *Restoring Full Employment* is a typical product of the current Australian debate on unemployment. It includes very little economic analysis, but concentrates on ways of reducing the pain caused by unemployment: that is, it deals with ways to treat the symptoms of the disease rather than attempting to diagnose its basic causes.

Restoring Full Employment does pay lip service to the effects summarised in the previous section. For example, it says: 'Another lesson from the 1970s and 1980s is labour costs matter. If Australia is to progress towards full employment, sound macro-economic policies will have to be supported by restraint in nominal incomes' (p.13). Again, 'Lower real unit labour costs can also improve employment while still maintaining lower inflation' (p.13). Yet the document does not suggest reforming the process that determines labour costs. Instead, it goes on:

> The Committee believes, however, that an across-the-board cut in nominal wages to solve the unemployment problem would have to be so large that it is

> not readily achievable. This is because nominal wage cuts would be more likely to lead to price reductions and would not translate readily into real wage reductions. Moreover, those jobs created by across-the-board wage cuts would be most likely to go to people other than the long-term unemployed. (pp.13-14)

The policy rejected in this statement is an extreme one, and its rejection does not justify ignoring the effect of labour costs on employment. For example, the policies for reducing or restraining wage costs discussed in the previous section warranted some consideration. And the argument that the policy might not provide jobs for the long-term unemployed is irrelevant: as already noted, the best way to prevent an increase in long-term unemployment is to reduce short-term unemployment. This view does not rule out the adoption of additional policies to help those who have become unemployed on a long-term basis because of the failure to react more promptly to short-term unemployment.

The Wage Reductions of the 1930s

One member of the Committee on Employment Opportunities that drafted *Restoring Full Employment* is the coauthor of an important study of the 1930s experiment. Gregory, Ho and McDermott (1988) conclude that wage reductions cannot have made a substantial contribution to the recovery from the Depression. However, Valentine (1988) argues that the wage reductions of the 1930s had a positive effect on the economy. There are at least two reasons why this favourable effect should have occurred. First, prices do not react to changes in wage rates immediately or, as discussed above, in full. Second, falling prices lead to a fall in the real exchange rate if the nominal exchange rate does not change. The series on the Australian real exchange rate reported by McKenzie (1986) all show a sharp fall from 1929 on.

More important, a closer examination of the events of 1929-32 suggests that the reduction in wages was not an attempt to reduce unemployment but was actually forced by a prior fall in prices. These falling prices were a result of the workings of the Sterling Exchange Standard (see Schedvin, 1970:76-8). Under this system, a reduction in the banks' London Funds caused them to reduce their advances; the contraction of credit led to a reduction in the money supply, which caused a fall in domestic income and prices; and the fall in domestic income and prices led to a reduction in imports that in the end restored the banks' London Funds.

The major steps in this process over the period 1901/02 to 1938/39 are illustrated by Figures 1, 2 and 3, which show the relationships between the changes in M1 (cash plus cheque accounts) and the changes in (respectively) London Funds, GDP, and prices (all data were obtained from Butlin, 1977). Multiple regression analyses indicate that the correlations apparent in these figures are actually significant. Another piece of evidence supporting the view that the wage reductions were a reaction to earlier and likely price reductions is that prices actually began to fall in 1929/30 although award wages were not reduced until 1930/31.

Figure 1

Annual changes in M1 and reserves, 1901/02 to 1938/39

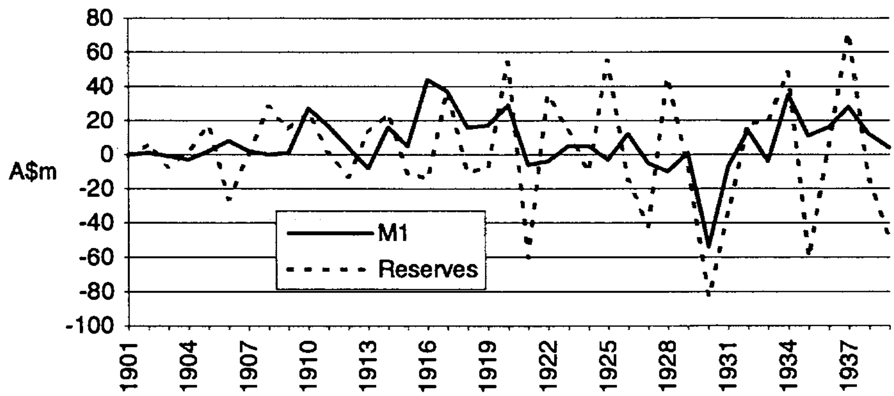


Figure 2

Annual changes in M1 and GDP, 1901/02 to 1938/39

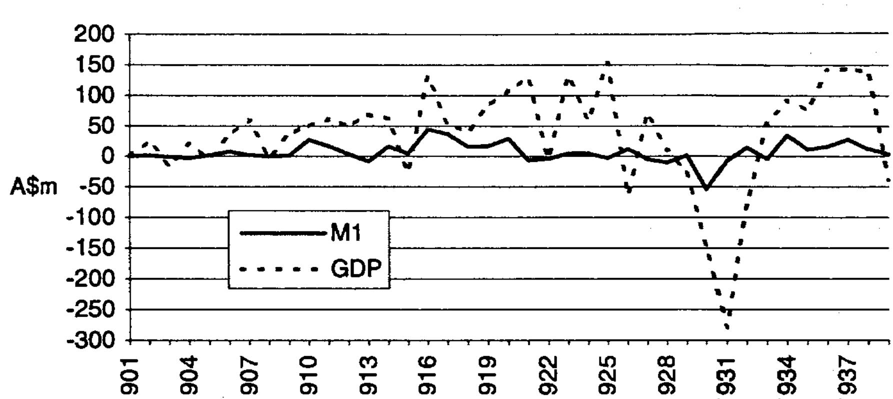
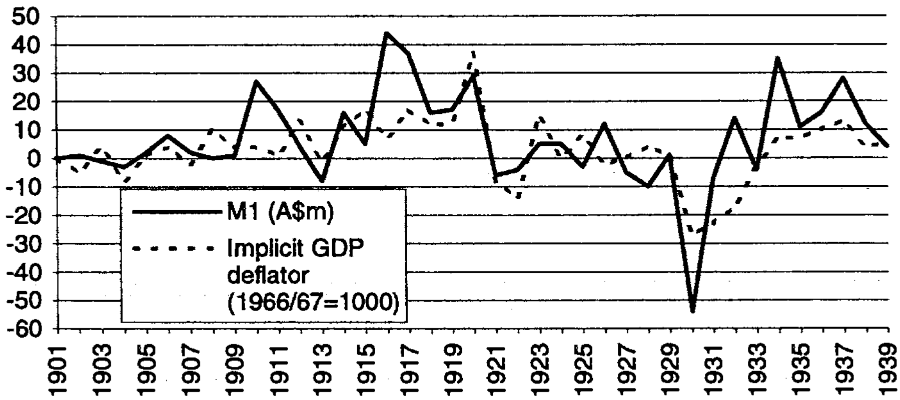


Figure 3

Annual changes in M1 and implicit GDP deflator, 1901/02 to 1938/39



Source for all Figures: Butlin (1977).

London Funds fell in 1928/29, 1929/30 and 1930/31 causing a large fall in M1 in 1929/30 and a smaller fall in 1930/31. This means that prices were bound to fall in the early 1930s. If award wages had not been reduced, there would have been a substantial increase in the real wage. The wage reduction was necessary to offset the fall in prices originating from developments in the trade sector and it was the appropriate reaction under the Sterling Exchange Standard. If it had not occurred, unemployment would have been even greater. As already noted, further wage reductions would have had a beneficial effect on the economy and the level of unemployment. Unfortunately, in the present day wages are not flexible in the downward direction and cannot react to externally generated pressures as they did in the 1930s.

Rationalisations of Unemployment

Public debate has given currency to several arguments for avoiding economic solutions to unemployment. These arguments are usually bogus.

Increased leisure, part-time employment and job-sharing. One of the most insensitive rationalisations of unemployment is the argument that it foreshadows a world of shorter working hours and increased leisure. The problem with this is that the increased leisure available in the present environment is not evenly distributed across the working population and those who 'enjoy' it do so without choice and usually without the resources to benefit from it.

Increased part-time work may be part of the long-term solution to unemployment. Nevertheless, the growth of part-time employment can be largely explained as a

reaction to the economic incentives created by Australia's industrial relations system. Requirements to provide leave, rostered days off and the high costs of terminating employment all contribute to making it more desirable for employers to offer part-time rather than full-time employment. Additional efforts to provide workers with improved conditions in these areas will lead to further increases in the proportion of jobs that are available only on a part-time basis.

Job sharing is unlikely to suit most workers. It will also be inappropriate in most areas of employment because it generally involves high switchover and disruption costs. Passing tasks to other workers is time-consuming, and interchange of information with customers or other workers is often inconvenienced by employee absence.

Economic growth. It is certainly true that higher economic growth would reduce unemployment (see Valentine, 1993). It is also true that as labour productivity rises, the wage rate that is consistent with low unemployment also rises. None of this, however, justifies ignoring the impact of wages on unemployment. Making wages more flexible would reduce the level of economic growth necessary to achieve a given rate of unemployment.

However, policies to promote higher growth are absent. In particular, the failure of private investment to contribute to the current upturn is bound to lead to a lower rate of productivity growth. And until higher economic growth and increased productivity emerge, the arguments for wage restraint remain strong.

Structural change. It is sometimes suggested that as unemployment is caused by structural change, the solution lies in some form of industry policy, involving significant government intervention, and in the retraining of workers. It seems likely that some unemployment has been caused by structural change in Australian industry, but this factor alone cannot explain the majority of job losses.

In December 1993 seasonally adjusted non-farm vacancies amounted to 38,500 as against 955,000 unemployed. Clearly, removing any mismatches (through, for example, training programs) would not substantially reduce unemployment. Again, since 1965 all substantial increases in unemployment have been associated with increases in real wages. This was the case in 1974/75, 1981/82, 1982/83, 1989/90 and 1990/91. This association suggests that at least some apparent 'structural change' resulted from high wages, which led to the substitution of capital for labour and the contraction of uncompetitive industries. In any case, the sharp increases in unemployment in the years mentioned are difficult to explain by reference to structural changes.

Earlier discussion indicates that policies that promote economic growth and wage flexibility would reduce unemployment. In particular, wage flexibility would facilitate the adjustment made necessary by structural change. Falling wages in declining professions and rising wages in expanding professions would provide appropriate incentives for workers. As well, high differentials for scarce skills would encourage workers to acquire such skills and reduce the number of mismatches. Nevertheless, these policies may not be able to reduce unemployment below a minimum level that depends in part on structural change.

Industry policy may assist in reducing it further, but this is a case in which concentration on the short term can easily lead us to adopt policies that exacerbate our long-term problems. The history of industry policy in Australia has few long-term successes to its credit.

Present Policies

Fiscal stimulus. A fiscal stimulus may be appropriate in the face of high unemployment, but its effectiveness is likely to be greatly reduced by the tendency for higher budget deficits to lead to larger current-account deficits. The high level of external debt is an important constraint on fiscal policy. If Australia's credit rating falls, debt-servicing costs will increase.

This comment raises the question of the reaction of financial markets to expansive fiscal policy. Markets do not like budget deficits, fearing that they presage higher inflation. This is a legitimate concern and markets should be free to react to it. Nevertheless, a government cannot allow its economic policy to be dictated by financial markets, which of necessity focus on very short-term outcomes. This is not to suggest that financial markets always react in a rational and well-informed way, even in the short run. Market participants focus on the deficit figure, and this leaves them open to manipulation by the government. For example, the deficit figure is reduced by asset sales, even though these sales represent as much a drain on available savings as a sale of government securities.

In addition, the deficit figure tells us nothing about the composition of government spending and taxation collections and their effect on the economy. Fiscal stimulus is currently being provided in the form of consumption, and public-capital formation is a declining proportion of GDP. Government borrowing leads to offshore borrowing, but this may be a responsible policy when the borrowings are used to expand productive capacity so that the debt can be serviced more easily. If they are used to finance consumption, the long-term effects are likely to be very unfavourable.

Training. Training has become the all-purpose solution to unemployment. It is not clear why this is so because training does not in itself create jobs. Nor is it possible to train anybody for any occupation. There will always be a need for jobs for unskilled workers.

It is the quality, rather than the quantity, of training being provided that must be questioned. Relatively little thought has been given to designing education so that its output meets the needs of employers. There is also increasing cynicism about the quality of the education system. A major obstacle to the accumulation of skills by the workforce is the inflexibility of the wage structure. Skill differentials do not adjust rapidly enough or by a sufficient magnitude to properly reflect shifts in the demands for different skills. It is only when skill differentials become sensitive to demand and supply conditions that the educational process will become sensitive to economic conditions. Similarly, educational institutions will become sensitive to the needs of their students and their potential employers only when their funding is tied to demand and adequate competition has been introduced in the educational market.

Employment programs. *Working Nation: Policies and Programs*, the government's White Paper on unemployment, was released in May 1994. It proposed a comprehensive program for dealing with the unemployed, but the emphasis is on easing the social pain rather than reducing unemployment. The major planks of the policy are as follows:

- programs in which employers are subsidised up to $230 a week for six months for each long-term unemployed person they hire;
- a scheme under which employers pay a lower 'training wage' and are required to provide formal training for workers;
- a 'jobs compact' in which the long-term jobless are paid $280 a week for up to six months to work on community projects and spend 40 per cent of their time on training;
- traineeships, including the Australian Traineeship System, under which trainees work for three days a week and spend two days at TAFE; and
- extensive case management increasing in intensity as the term of unemployment increases.

Although it is desirable to assist the unemployed, these policies suffer from a number of important weaknesses. First, they rely heavily on the training solution which, we argued above, is not the panacea the government assumes it to be.

Second, the programs involve significant bureaucratic activity to provide case management and to administer the various subsidy schemes. These schemes will require considerable supervision to prevent abuses, and this supervision could create compliance costs that make the programs less attractive to business.

Third, since many of the programs provide short-term jobs, they simply defer the problem. They involve marking time in the hope that jobs will come from somewhere — a domestic upturn or favourable developments overseas.

Fourth, it is quite possible that the wage subsidies and training wages in the programs will move unemployment around rather than reduce it. The workers employed on lower wages could displace other workers and they may in their turn be displaced when the subsidy runs out or the lower wage terminates.

Conclusion

The major cause of unemployment is to be found in the level and flexibility of labour costs. Policies that do not take account of the dependence of employment on wages, such as those announced in *Working Nation*, can provide only short-term relief. Necessary as these short-term policies may be, they do not remove the need to search for a lasting solution to the problem.

A solution is available only if we are prepared to take steps to make wages more sensitive to economic conditions and to allow greater flexibility in the wage structure. This means that we must surrender the illusion that was introduced by Mr Justice Higgins in 1907. Wages cannot be used both to redistribute income and to maintain high employment. Higher living standards cannot be mandated, but they can be facilitated by wage flexibility.

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